

NATIONAL TREASURY'S DETAILED EXPLANATION TO SECTION 9D OF THE INCOME TAX ACT

(June 2002)

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PREFACE

As part of its overall effort to reduce South African tax rates by widening the tax base, the Minister of Finance introduced the Revenue Laws Amendment Act 59 of 2000. The amendments contained in the Act widened South Africa's tax base by shifting the tax system from a "source plus" system to a "residence-minus" tax system. Under the former "source plus" system, South Africa taxed items arising only from South African sources plus a limited category of foreign source items. Under the current "residence-minus" system, South Africa imposes taxes on a worldwide basis less a limited category of foreign source items.

One key element of the current "residence-minus" system is section 9D which provides for South African taxation of certain foreign sourced income generated by South African controlled foreign companies. South African tax applies where failure to tax foreign controlled company income will likely lead to an artificial flow of funds offshore, not where taxation will likely damage South African international competitiveness.

As will be described herein, taxation under section 9D requires a complex balancing approach. National Treasury has issued the attached explanation in order to facilitate taxpayer understanding of section 9D in both technical and policy terms. The attached explanation describes the initial revision to section 9D (i.e., the Revenue Laws Amendment Act 59 of 2000) as well as subsequent amendments to section 9D introduced in 2001 (the Taxation Laws Amendment Act, 2001, the Revenue Laws Amendment Act, 2001, and the Second Revenue Laws Amendment Act, 2001).

I. OVERVIEW

A. Rationale

Under the residence (i.e., worldwide) taxing system, South African residents are subject to tax on their income earned domestically and abroad. One important facet of this system is how to address income earned by South African owned foreign companies and other South African owned foreign entities of a similar nature. If this latter form of income goes untaxed, South African residents can avoid tax simply by shifting their income to foreign entities, and the income earned by foreign entities will be taxed only once repatriated as a dividend (current section 9E). This failure to impose immediate tax is known as “deferral.” This failure to impose immediate tax is of great significance because taxpayers often delay repatriation for years or never repatriate funds at all.

Example: Facts. On 1 January 2001, South African Individual transfers cash to a newly formed foreign company in exchange for all the foreign company's shares. The foreign company then uses the cash to purchase foreign bonds. The foreign bonds generate interest equal to R100 in 2001.

Result. If income from South African owned foreign companies falls completely outside of the tax net, no South African tax will apply to the bond interest as earned in 2001. This result is problematic because South African Individual continues to fully own these bonds indirectly through the foreign company. South African tax will only apply when the foreign company distributes the bond interest as a dividend to South African Individual.

Section 9D is designed to prevent deferral through South African owned foreign entities. However, international law only allows South Africa to tax foreign residents on their South African source income. International law does not allow South Africa to directly tax foreign entities on their foreign source income, even if those foreign entities are completely owned by South African residents.

However, in order to remedy the problem of deferral while complying with international law, section 9D (like other internationally used regimes of this kind) taxes South African owners on the foreign income earned by their foreign entities as if those foreign entities immediately repatriated their foreign income when earned. For instance, returning to the example above, section 9D does not tax the foreign subsidiary on its R100 of earnings. Section 9D instead taxes South African Individual as if South African Individual received R100 of a revenue nature in 2001 (i.e., the same year the interest is earned by the foreign subsidiary). No additional South African tax applies when the R100 of earnings are actually repatriated.

B. Balance Between Anti-Deferral and International Competitiveness

A pure anti-deferral regime would immediately deem back all the South African owned foreign company income so that none of this foreign income receives any advantage over domestic income. Yet, section 9D (like other internationally used regimes of its kind) falls short of this purity in order to cater for international competitiveness. International competitiveness dictates that foreign company income should be ignored so that South African multinationals can fully compete on an equal basis with their foreign local rivals.

Example: Facts. South African Company owns all the shares of Foreign Subsidiary. Foreign Subsidiary generates R100 of income in Country X. Country X imposes a 10 per cent tax on all income earned within its territory.

Result. Under a pure anti-deferral regime, South Africa would fully tax the 20 per cent differential (a 30 per cent tax less a 10 per cent tax credit rebate). However, full taxation would mean that the income of Foreign Subsidiary would be subject to a cumulative 30 per cent income tax rate while foreign local competitors would be subject to a rate of only 10 per cent. This higher rate would leave the Foreign Subsidiary with comparably less after-tax profits for re-investment, thereby making operations non-competitive.

The principles of anti-deferral and international competitiveness are diametrically opposed. Anti-deferral warrants complete taxation, whereas international competitiveness warrants complete exemption. In the end, section 9D follows international norms favouring a balanced approach. Section 9D achieves this balance by favouring international competitiveness (i.e., exemption) where the income stems from active operations. Anti-deferral (i.e., immediate taxation) applies where the income stems from passive investments or from transactions that meet objective criteria with a high tax avoidance risk.

C. The Interaction Between Section 9D and Double Taxation Agreements

The CFE legislation taxes the resident shareholders of the CFE, and not the CFE itself. As the same resident is not being taxed twice on the same amount, no double taxation arises. It therefore cannot be said that the CFE legislation overrides any double taxation agreements.

Where the resident shareholder is taxed on foreign amounts that are calculated according to proportional holdings in the CFE, this would amount to economic double taxation in the absence of the granting of appropriate foreign tax credits and not juridical double taxation.

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

D. Structure and Short Summary of Section 9D

Section 9D falls into three analytical parts:

1. Determining which foreign entities fall within section 9D;
2. Determining which South African residents must include a portion of foreign entity income under Section 9D; and
3. Determining which forms of foreign entity income potentially create an inclusion under section 9D.

Before going into detail, section 9D can be summarised as follows. Section 9D mainly applies to foreign companies that are mostly owned by South African residents. South African residents owning 10 per cent or more of the shares in these foreign companies must include a proportional ownership percentage of the net income earned by that foreign company. Lastly, only limited forms of net income of a foreign company create an inclusion for South African residents. These limited forms of foreign company income mainly involve objective forms of

income that represent a potential threat to the South African tax base while presenting few international competition concerns.

II. FOREIGN ENTITIES SUBJECT TO SECTION 9D

A. Controlled Foreign Entities: Section 9D(1)(Definitions of “controlled foreign entity” and “foreign entity”)

1. Basic Rules

Determining the applicability of section 9D involves a two-part test. First, income must be generated by a “foreign entity”, and second, that entity must be “controlled” by South African shareholders. A “foreign entity” means any entity that does not qualify as a South African resident under the South African Income Tax Act or as a result of the application of a South African Income Tax Treaty. Foreign entities contemplated in section 9D mainly include foreign companies or foreign business organisations of a similar tax nature under foreign law. These foreign entities do not include foreign partnerships or similar flow-through regimes because income is deemed to have been immediately received by the South African owners of these entities in any event. Foreign entities under section 9D also do not include foreign trusts because foreign trust income is typically subject to immediate tax by its South African donors or beneficiaries under the principles of section 7 and/or the beneficiaries in terms of section 25B(2A).

As stated above, section 9D applies only to a foreign entity that qualifies as a “controlled foreign entity” (a “CFE”). In order for a foreign entity to qualify as “controlled,” South African residents must hold, directly or indirectly, more than 50 per cent of the entity’s participation rights (e.g., rights to profits and capital) or are entitled to exercise more than 50 per cent of the voting rights, or control. South African residents typically have this control if they own (whether acting individually or jointly) more than 50 per cent of the voting shares or shares that represent more than 50 per cent of the undistributed profits or capital. Participation rights include shares representing equity share capital as well as other forms of shares, such as non-participating preference shares. Consistent with the anti-avoidance nature of the CFE rules, the term “participation rights” is defined broadly in order to ensure that South African taxpayers cannot enter into convoluted share arrangements as a means of controlling foreign entities while avoiding tax under section 9D. However, convertible debentures, options, and similar interests do not qualify as participation rights because these instruments do not represent a participation interest until converted into shares.

Example (1): Facts. Foreign Company X has issued 100 ordinary shares which are owned by 100 different South African residents. None of these South African residents are connected to one another nor do any of these shareholders have any formal or informal arrangement to vote as one or more blocks.

Result. Foreign Company X qualifies as a CFE. Foreign Company X is more than 50 per cent owned by South African residents. It makes no difference whether the shareholders act individually or jointly.

Example (2): Facts. South African Individual owns all the shares of Foreign Company X which in turn owns all the shares of Foreign Company Y.

Result. Both Foreign Company X and Foreign Company Y qualify as CFEs. Foreign Company X is more than 50 per cent directly owned by South African Individual and Foreign Company Y is more than 50 per cent indirectly owned by South African Individual.

Example (3): Facts. South African Individual owns 60 per cent of the shares of Foreign Company X which owns 60 per cent of the shares of Foreign Company Y. Both Foreign Companies X and Y each have only one class of ordinary shares outstanding.

Result. Both Foreign Company X and Foreign Company Y qualify as CFEs. Foreign Company X is more than 50 per cent directly owned by South African Individual. Even though South African Individual has only an indirect 36 per cent stake in the participation rights of Foreign Company Y (60 per cent x 60 per cent), South African Individual indirectly has more than 50 per cent of the votes. South African Individual has the majority voting stake in Foreign Company X which in turn has the majority voting stake in X.

Example (4): Facts. Foreign Company X has issued 100 ordinary shares, of which South African Individual owns 50 and Foreign Individual owns 50. South African Individual and Foreign Individual have a voting agreement in terms of which South African Individual decides all tie-votes.

Result. Foreign Company X qualifies as a CFE. The power to decide all tie-votes provides South African Individual with control over Foreign Company X.

Example (5): Facts. Foreign Company X has issued 100 ordinary shares. South African Company owns 50 shares and Foreign Individual owns the other 50 shares. All the shares of South African Company are owned by South African Individual.

Result. Foreign Company X does not qualify as a CFE because South Africans do not own more than 50 per cent of Foreign Company X. South African Individual's indirect ownership through South African Company is ignored because the same 50 shares cannot be counted twice.

Example (6): Facts. Foreign Company X, a company with R5 million capital in 2001, has issued 3000 ordinary shares and 1 000 000 4% cumulative preference shares of R2 each. South African Company owns all the preference shares, and foreign individuals own all the ordinary shares. The preference shares have no voting rights, but provide the holder with a right to R2 million in the capital if Foreign Company X liquidates. The ordinary shares possess all the voting rights as well as the rights to any remaining profits and liquidation proceeds. In 2002, Foreign Company X generates R400 000 and declares R80 000 as a dividend to South African company as the sole preference shareholder.

Result. Foreign Company X does not qualify as a CFE. South African Company has no voting power in Foreign Company X. South African Company also lacks more than 50 per cent of the participation rights to the underlying undistributed profits and capital of Foreign Company X (having a right of only R2 000 000 in the capital of R5 320 000).

2. Exclusion for De Minimis Owners of Widely Held Foreign Entities

The Second Revenue Laws Amendment Act in 2001 added an exception to the general rule for listed foreign companies and foreign unit trusts, both of which are widely held. In terms of the exception, holders of less than 5 per cent of the participation rights in these entities are deemed to be foreign persons. The purpose of this rule is to avoid ownership tracking problems associated with *de minimis* shareholders in large-scale foreign entities. In many jurisdictions, possible disclosure of shareholders in widely held entities is typically limited to shareholders with a minimum 5 per cent stake.

Example: Facts. South African Company owns 40 per cent of the participation rights in Foreign Company X, the latter of which is listed on a recognised foreign exchange. Other than the participation rights held by South African Company, all the shares in Foreign Company X are widely held with no shareholder owning more than 3 per cent.

Result. Foreign Company X is not a CFE because all the other shareholders are deemed to be foreign persons. This rule applies even if some of the less than 5-per cent shareholders are in fact South African residents.

The just described 5 per cent *de minimis* test does not apply if connected persons own more than 50 per cent of the foreign entity. This anti-connected person limitation prevents a group of economically linked parties from utilising the *de minimis* test as an artificial means for undermining the “more than 50 per cent” control threshold.

B. Proportional Inclusion after applying the 10 Per Cent Threshold: Subsection 9D(2)

South African residents that have participation rights (e.g., shares) in a CFE are potentially subject to tax on the “net income” of that CFE as if that net income were immediately repatriated when earned by the CFE. South African residents are deemed to receive CFE net income only to the extent of their proportional ownership in the CFE. However, this deemed income rule does not apply to South African residents who own less than 10 per cent (after taking into account connected persons) of both the participation rights and voting rights in the CFE. This 10 per cent threshold prevents this defined income rule from applying to minority owners who have no practical say over the CFE’s affairs.

Example (1): Facts. Foreign Company X has issued 100 shares. South African Company owns 45 shares, South African Individual owns 6 shares, and various foreign individuals own the remaining 49 shares. None of the parties are connected persons. Foreign Company X has R500 000 of net income.

Result. Foreign Company X qualifies as a CFE because South African Company and South African Individual collectively own more than 50 per cent of the participation rights (i.e., 51 of the total 100 shares). South African Company must include its 45 per cent proportional share of Foreign Company X’s net income or R225 000 (45% of R500 000). South African Individual need not include any CFE net income because South African Individual holds less than 10 per cent of the participation rights (i.e., 6 of the total 100 shares).

Example (2): Facts. Foreign Company X has issued 100 shares, each of which is held by a separate South African resident, none of whom are connected to one another.

Result. Even though Foreign Company X qualifies as a CFE and is controlled by South African residents, none of the South African shareholders have an inclusion under section 9D because none of these shareholders satisfy the 10 per cent threshold.

Timing rules exist for the inclusion of CFE income. A South African shareholder must include CFE income during that shareholder's year of assessment in which the CFE's foreign tax year ends.

Example (3): Facts. South African Company owns all the shares of CFE. South African Company has a year of assessment which begins on 1 March and ends at the end of February. CFE has a foreign tax year which begins on 1 January and ends on 31 December. CFE generates R1 000 000 of net income during the 2002 calendar year.

Result. The R1 000 000 of CFE income must be included in South African Company's year of assessment running from 1 March 2002 and ending on 28 February 2003 (because the R1 000 000 of CFE net income arose in CFE's tax year which ends on 31 December 2002).

C. General Calculation of Net Income or Loss: Subsection 9D(2A)(but not (c))

As previously stated, South African residents are generally subject to tax on their proportional share of CFE "net income" (unless they hold less than 10 per cent of the CFE). A CFE determines its net income as if that CFE were a South African resident. This determination requires the CFE to maintain two sets of tax books – one for the home country and one for South Africa. This administrative price is essential if CFE income is to be kept on par with domestic income.

The general rules do not apply if a CFE has net losses. While a proportional amount of net income of a CFE is included in the income of a South African resident, South African residents cannot deduct net losses of a CFE. This anti-loss rule ensures that the worldwide system of taxation does not undermine the domestic tax base. This anti-loss rule is consistent with the anti-loss rule for foreign branch losses which similarly cannot be used as an offset against South African source income. The net loss of one CFE also cannot be used as an offset against the net income of another CFE. This second anti-loss rule exists because South Africa does not have group tax rules for losses. However, it should be noted that excess CFE losses are not simply eliminated. A CFE with net losses carries forward any of these excess losses which can be used to reduce future net income of that CFE.

Example: Facts. South African Company owns all the shares of CFE X and CFE Y. South African Company earns R500 000 of South African source income. CFE X generates R100 000 of income and R140 000 of associated expenses that are part of the CFE X net income calculation. CFE Y generates R200 000 of income and R90 000 of associated expenses that are part of the CFE net income calculation.

Result. CFE X has a net loss of R40 000, and CFE Y has net income of R110 000. CFE X cannot use the net loss of R40 000 against the R500 000 of South African source income. South African Company similarly cannot use the net loss of R40 000 from CFE X to offset the R110 000 of net income earned by CFE Y. The R40 000 of net loss of CFE X can only be carried forward to offset future CFE X net income.

With the enactment of the Taxation Laws Amendment Act, 2001, capital gains and capital losses have additionally become part of the CFE net income calculation. South African corporate shareholders with CFE capital gains include those gains at the 50 per cent inclusion rate. South African individuals, special trusts, and individual policyholder fund shareholders must include CFE capital gains at the 25 per cent inclusion rate. Both sets of rules are consistent with domestic capital gains.

D. Base Cost Adjustments: Paragraph 20(1)(h)(iii) of the Eighth Schedule

South African residents with an interest in a CFE must adjust their base cost of that interest for net income inclusions as well as certain dividends from that CFE. As a general matter, South African residents receive an upward base cost adjustment in their CFE shares to the extent of any net income inclusions. They also receive a full upward base cost adjustment for their net capital gains (even though those gains are only partial includible as income). However, South African residents must reduce the base cost in their CFE shares to the extent they receive a tax-free dividend distribution that represents previously taxed section 9D income.

Example: Facts. South African Company owns all the shares of CFE with a R500 base cost. In 2001, CFE generates R100 of active income, R30 of passive interest income, and R40 of passive capital gains. The latter two items are included in South African Company's income by virtue of section 9D. In 2002, CFE distributes all R170 of the previously described profits.

Result. South African Company receives an upward base cost adjustment of R70 (to R570) in 2001 as a result of the R50 inclusion ($30 + (40 \times 50\%)$) under section 9D. The tax-free distribution of R70 then creates a downward R70 adjustment (back to R500) in 2002. The R100 of active income has no effect on base cost.

III. EXEMPTIONS

A. Types of Exemptions Available

The amount of income and loss included within the net income of a CFE is subject to the following exemptions:

- (1) The Designated Country Exception;
- (2) The Business Establishment Exception;
- (3) The Concurrently Taxed Exception;
- (4) The Related and Intra-Group Exceptions; and
- (5) The Share Participation Exception.

Of these exemptions, the Business Establishment Exception is the most significant. The Business Establishment Exception allows CFE business income to escape the ambit of section 9D unless that income is diversionary or passive.

B. The Designated Country Exception: Section 9D(9)(a)

[Reserved]

C. The Business Establishment Exception: Section 9D(9)(b) and (11)

1. Background

CFE income may alternatively be exempt from tax if that income is attributable to any “business establishment.” As a policy matter, this exemption promotes international competitiveness. This rule applies only if the income poses no threat to the South African tax base. The legislation accounts for these concerns by exempting all CFE business establishment income unless that income qualifies as:

- (1) Mobile Foreign Business Income;
- (2) Diversionary Foreign Business Income; or
- (3) Mobile Foreign Passive Income.

Mobile Foreign Business Income involves income from paper shell businesses without economic substance that attract taxable income. Shell businesses involve operations whose sole economic activity is maintaining a post office address or a website. The fungible nature of these business activities means that no real non-tax business reason exists for maintaining income offshore versus generating that income within South Africa.

Diversionary Foreign Business Income involves income that a CFE generates from certain sales and services transactions conducted with related South African residents. This test acts as a proxy for the transfer pricing regime under section 31. Diversionary Foreign Business Income arises when a CFE engages in transactions with a related South African resident in a manner that will most likely lead to transfer pricing tax avoidance.

Mobile Foreign Passive Income involves income from passive assets, such as dividends and interest from portfolio shares and bonds. These items do not involve any direct international competitiveness concerns because no business is directly involved. Moreover, the mobile nature of the income potentially means that South African residents could otherwise avoid the ambit of worldwide taxation merely by shifting these mobile passive assets to a controlled foreign company.

Restated in technical terms, the Business Establishment Exemption applies only if:

- (1) The income is attributable to a “business establishment” (i.e., is not Mobile Foreign Business Income);
- (2) The income does not involve sales and services with a related South African resident (i.e., is not Diversionary Foreign Business Income); and
- (3) The income is not of a passive nature (i.e., is not Mobile Foreign Passive Income).

* * * *

With the enactment of capital gains tax, the exemption also applies to the disposal of capital gain items attributable to a business establishment. Stated differently, if CFE factory income is exempt, so is any capital gain stemming from that CFE’s sale of the factory. *Section 9D(9)(b)(iii)*.

2. Business Establishment Income (Non-Mobile Foreign Business Income)
Sections 9D(1)(definition of “business establishment”) and 9D(9)(b)

In order for CFE 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 at home. These three tests effectively exclude paper businesses (i.e., Mobile Foreign Business Income) that would otherwise be located in South Africa but for tax savings (i.e., like passive assets). Paper-like businesses do not receive the exemption because their paper-like nature suggests that no real business activity exists for international competitiveness to act as a consideration.

i. Locational Permanence

An exempt business establishment must first operate through a fixed location that suggests some permanence (i.e., that the business is somewhat immobile). The fixed location requirement ensures that the business involved is not mere a mailing address, website, or momentary single business project. The fixed location test can be satisfied as long as the CFE possesses a business falling into one of the three following categories:

- (1) The CFE must use or continue to use an office, shop, factory, warehouse, farm, or other structure for a period of not less than 1 year in order for that location to qualify as a business establishment. The 1 year “use” requirement can be satisfied by direct ownership or by lease. However, “use” implies some level of activity with regard to the structure. Mere possession of ownership or leasing rights is insufficient.
- (2) CFE’s with mines, oil or gas wells, a quarry or any other place of extraction of natural resources satisfy the fixed location test per se without regard to time. Operation of these places demonstrates a clear level of permanence to the foreign location involved because the geographically unique nature of the holding makes that holding immobile as a practical matter.
- (3) Construction or installation sites for buildings, infrastructure, heavy machinery, and other projects of comparable magnitude satisfy the location test as long as that site lasts for a period of not less than 6 months. CFE operations of this kind again demonstrate a clear level of permanence. A direct geographic link to the underlying business activity exists, rendering the activity immobile as a practical matter. The 6-month requirement is designed simply to ensure that the CFE is providing an activity that amounts to more than a momentary service.

ii. Economic Substance and Business Purpose

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 (e.g., core daily) operations of that business. This substance element ensures that the business is more than just a paper transaction or a disguised form of passive income.

In business purpose terms, the business must have a bona fide non-tax business reason for operating abroad rather than in South Africa. Similar to the tax avoidance rule of section 103, a bona fide business reason exists only when that reason bears some significance other than the tax advantage of operating abroad.

Example (1): Facts. South African Company owns all the shares of CFE #1, a Country X company. CFE #1 leases a building in Country X for a 5-year period. CFE #1 makes pills purchased from ingredients produced by CFE #2, a Country Y corporation that is also wholly owned by South African Company. CFE #1 owns all of its machinery and employs 35 on-site full-time and part-time employees to produce the pills. CFE #1 relies on outside independent contractors for security, cleaning, garbage disposal, and other incidental functions. CFE #1 also employs 2 full-time managers to oversee the production process and local record keeping. Foreign Subsidiary sells its pills to various connected CFEs indirectly owned by South African Company.

Result. Setting aside the issue of whether a bona fide non-tax reason exists for operating in Country X as opposed to South Africa, CFE #1's pill production satisfies the business establishment standard. The building is under a 5-year lease with the on-site machinery, managers and employees overseeing and conducting the primary operations of the business. The work performed by the independent contractors is only incidental.

Example (2): Facts. South African Company owns all the shares of CFE, a company located in a Tax Haven. CFE owns a 100-unit apartment building located in Country X. CFE hires an independent contractor to run all the daily operations of the apartment building, paying the independent contractor a flat annual fee. CFE has two office employees located in a Country X office. The Country X office has been leased for many years; the two office employees occasionally visit the apartment building; and all the apartment accounting functions are handled at the Country X office.

Result. CFE does not have a business establishment. CFE lacks economic substance in running the primary daily operations of the business, all of which are conducted by an independent contractor.

Example (3): Facts. South African Company owns all the shares of multiple foreign subsidiaries, including CFE. CFE is a resident of Tax Haven, a Mediterranean Country which imposes income tax at a 10 per cent statutory tax rate. CFE leases a large warehouse within Tax Haven. CFE operates as a central delivery point for products shipped to customers located in Southern Europe and the Middle East. CFE employs 2 managers and 5 employees that handle all storage and shipment contracts. CFE 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.

Example (4): Facts. South African Company owns all the shares of a CFE, a company located in a Tax Haven. Within the Tax Haven, CFE engages in an electronic sales distribution business and has an office under a 2-year lease. The office has 1 local

manager and 3 local employees. The sales distribution business purchases products from various unrelated South African businesses for resale in Europe. CFE never takes physical delivery of the goods. CFE instead places the order with the South African suppliers, the latter of which are responsible for delivery. The employees receive a total of R200, 000. Had the employees been employed in South Africa, the employees may have cost R240, 000. Had the electronic sales business been located within South Africa, CFE would have had to pay R5 million in additional tax.

Result. The place of business of CFE does not constitute a business establishment. The place of location does not have a *bona fide* non-tax business purpose. The employee cost savings of R40, 000 is insignificant when compared to the additional R5 million of South African tax that would have otherwise applied.

3. Connected CFE Sales and Services Income (Diversionsary Foreign Business Income): Section 9D(9)(b)(i) and (ii)

a. *General Background*

CFEs with income attributable to a business establishment receive the benefit of the business establishment exemption only so long as that income does not stem from diversionsary sales and services. Diversionsary sales and services potentially exist if the sales or services are conducted with a connected South African person. The purpose of this rule is to ensure that CFE activities are not being employed to shift taxable income offshore through artificial transfer pricing. Although transfer pricing rules exist under section 31, transfer pricing requires intensive case-by-case enforcement. This anti-diversionsary rule essentially acts as a backstop.

The anti-diversionsary rule attacks the problem of transfer pricing between CFEs and related South African residents in two ways. First, the anti-diversionsary rule increases the penalty for artificial transfer pricing. Second, the anti-diversionsary rule creates a higher business activity standard.

b. *Increased Penalty: Section 9D(9)(b)(i).*

Under the first anti-diversionsary rule, if a CFE engages in a sales or services transaction with a connected South African resident, transfer pricing inconsistent with arms length pricing in accordance with section 31 creates deemed income under section 9D. This deemed income under section 9D exists for all the net income of the CFE derived from the transactions with connected South African persons, not just the disparity in price.

Section 9D applies in addition to section 31 which provides the Commissioner with the power to reallocate the price back to an arm's length standard (*see section 31(2) and paragraph 4.4 of Practice Note 7*). In practice, the Commissioner may first adjust the price for both the South African resident and the CFE under section 31, followed by the section 9D inclusion. In the case of aggressive tax avoidance where profits of a CFE are inflated as a result of transactions entered into with a South African resident, the Commissioner may apply the provisions of section 31 solely in respect of the South African resident and not in respect of the CFE and fully include the profits of the CFE from these transactions in the income of the resident in terms of section 9D.

Example: Facts. South African Company owns all the shares of a CFE, a company located in Country X which imposes income tax at a rate of 20 per cent. South African

Company assembles televisions for R600 each and sells those televisions to CFE for R700 each. CFE has a business establishment that modifies these televisions for thousands of customers within Country X at a cost of R80 each, and then CFE resells the televisions for R1 000 each. Under market principles, the arm's length price between South African Company and CFE under section 31 amounts to R900 rather than R600.

Result. The Commissioner has the power to readjust the sales price between South African Company and CFE to R900. In exercising this power, the Commissioner may first readjust the price for both parties so that R300 of gain (R900 deemed sales price – R600 cost) is solely attributed to South African Company, thereby treating the full R300 as South African source gain (i.e., not subject to section 6quat rebates). The Commissioner may then reduce the gain for CFE to R20 (R1 000 customer price – the R900 deemed purchase price – the R80 customising cost), all of which will be taxed as foreign source income under section 9D.

c. Higher Business Activity Standard: Section 9D(9)(b)(ii)

Under the second anti-diversionary rule, if a CFE engages in certain sales or service activities with a connected South African resident, these sales or services create deemed income under section 9D without regard to section 31. This second rule targets structures that most likely contain artificial pricing without undertaking the transfer pricing exercise. This second rule achieves this goal by subjecting all CFE sale and service transactions with a connected South African resident to section 9D unless the CFE's conduct falls within a higher business activity standard than the standard prescribed by the business establishment rule. This higher business activity standard serves as a proxy method for preventing artificial pricing because identifying net income attributable to specific categories of transactions is easier than calculating an arm's length price for those transactions, the latter of which often requires a time-consuming economic analysis. This higher business activity standard is typically found in CFE legislation used throughout the world.

The higher business activity standard is additionally aimed at another concern. Certain sales and service transactions with connected South African residents are so closely linked with South Africa that these transactions call into question the reason why these operations are being conducted offshore. While the business establishment test already takes into account this concern, the business establishment threshold is fairly light. The higher business activity threshold ensures that offshore businesses are of substantial substance. Tax reasons should not induce South African businesses to shift offshore to the competitive disadvantage of companies operating from South Africa.

The higher business activity standard is divided into three sets: (i) CFE inbound sales, (ii) CFE outbound sales, and (iii) CFE South African connected services. CFE inbound sales exist when a CFE sells goods to a connected South African resident. CFE outbound sales exist when a South African resident sells goods to a connected CFE. CFE South African connected services exist when a CFE provides services for a related South African resident. Under the higher business activity standard, all these sale or service transactions fall outside the business establishment exemption (i.e., are subject to section 9D) unless the transaction contains objective criteria demonstrating that: (i) the transaction has a non-tax economic nexus with its country of residence, or (ii) the transaction most likely does not contain indicia of transfer pricing.

Situation A: CFE Inbound Sales of Goods: Section 9D(9)(b)(ii)(aa). The CFE sale of goods to a connected South African resident fails to qualify for the higher business activity standard unless the sale falls into one of three categories.

Local Purchases: Section 9D(9)(b)(ii)(aa)(A). The first category applies when a CFE purchases goods that are physically located within the same country in which the CFE is a resident (i.e., where the CFE is incorporated, established, formed or has its place of effective management). This physical location of the goods purchased establishes that the CFE has an economic nexus to the country of residence, and the country of residence most likely has a sufficiently high infrastructure to produce the goods. Countries with a high infrastructure typically do not tax their local sales at artificially low tax haven rates. These factors indicate that the CFE is most likely purchasing and reselling the goods at a convenient location for non-tax business reasons, and that the CFE is not over-inflating the price on resale to a related South African resident.

Local Production: Section 9D(9)(b)(ii)(aa)(B). The second category applies when a CFE engages in foreign production activities that involve more than minor assembly or adjustment, packaging, repackaging, and labeling. Significant production activities of this kind typically occur within countries that have a developed infrastructure which presumably do not tax local production at artificially low tax haven rates. Significant foreign production activities further indicate that the foreign location was chosen mainly for non-tax reasons. Whether foreign production activities are significant is a facts and circumstances test. This test takes into account many factors, such as how the CFE's production costs (e.g., labour, physical overhead, leasing, and machinery repair) compare to the total cost of goods sold or whether special skills are employed in order to provide added value.

Comparable sales: Section 9D(9)(b)(ii)(aa)(C). The third category applies when a CFE sells goods to a connected South African resident that are of the same, or of a similar nature, to goods sold to unconnected persons at comparable prices (after taking into account whether the sales are wholesale or retail, volume discounts and other geographical differences such as location costs of delivery). Little transfer pricing is likely to occur in these circumstances because independent outside pricing is fully available. In addition, sales to unconnected persons by the CFE demonstrate that the CFE has a viable business operating outside of South Africa.

Example (1): Facts. South African Company owns all the shares of CFE, a Country X resident. CFE purchases all of computers and telecommunications equipment from an unconnected company that has its entire physical location in Country X. CFE resells all the computers to South African Company at a profit.

Result. The CFE sales to South African Company satisfy the higher business activity standard. All of the resales stem from local Country X purchases.

Example (2): Facts. South African Company owns all the shares of CFE, a Country X resident. CFE does not engage in any production activities

but maintains a purchasing office and a warehouse within Country X that qualifies as a business establishment. CFE purchases desks from an unrelated Distributor, a company with its full physical location in Country Y. CFE resells 30 000 of these desks to various retailers located within Country Z at R 4500 each and resells 20 000 desks to South African Company at R 5 000 each (the difference in price reflects a difference in geographic proximity).

Result. The CFE sales to South African Company satisfy the higher business activity standard. Admittedly, CFE does not engage in any local purchases (since none of the goods purchased were ever located within Country X) nor any production activities. However, CFE is selling the desks to a significant number of unconnected persons at comparable prices after taking into account differences in geography.

Example (3): Facts. South African Company owns all the shares of CFE, a Country X resident. CFE assembles machinery in a 100-person factory located within Country X which CFE then resells to South African Company. CFE purchases the machinery parts from various distributors located outside Country X at a cost of R730 per unit. Each machine has 250 parts to assemble. The physical factory overhead, equipment, and labour costs to produce the machinery amount to R200 per machine. The management, accounting, and administrative fees amount to R70 per machine. CFE sells each machine to South African Company for R1 600.

Result. The machinery sold satisfies the higher business activity standard. The factory conducts more than minor assembly or adjustment. The 250-part assembly is significant and so are the physical production costs that amount to 20 per cent of the total (R200/R1 000).

Situation B: CFE Outbound Sales of Goods: Section 9D(9)(b)(ii)(bb). If a CFE sells goods to foreign residents or unconnected South African residents, and those goods were initially purchased from connected South African residents (or goods representing resultant products from materials, parts, or ingredients purchased from connected South African residents), the CFE sale does not satisfy the higher business activity standard unless that sale falls into one of three categories.

Insignificant South African Purchases: Section 9D(9)(b)(ii)(bb)(A). The first category applies when a CFE purchases only an insignificant amount of materials, parts, or ingredients from connected South African residents. Transfer pricing manipulation usually occurs when the nature of an item sold by a South African resident is roughly the same as the item resold by the CFE (i.e., has no intermediary value added). A CFE that purchases most of its sub-components elsewhere (i.e., only a small amount of sub-components from related South African residents) contains independent added value, thereby probably being structured offshore for mostly non-tax business reasons.

Local Production: Section 9D(9)(b)(ii)(bb)(B). The second category applies when a CFE engages in foreign production activities that amount to more than minor assembly or adjustment, packaging, repackaging, and labeling. This second

category has the same rationale and application as the local production rule for CFE sales to connected South African persons.

Local Sales: Section 9D(9)(b)(ii)(bb)(C). The third category applies when a CFE delivers its goods within the CFE's country of residence. In this instance, the CFE's country of residence (i.e., the country where the CFE is incorporated, established, formed or has its place of effective management) has an economic nexus to the consumer market at issue. Customers for purchased goods are also typically located in countries with a significant infrastructure (and attendant high taxes). Stated differently, tax haven sale subsidiaries typically sell their products to consumers located outside their country of residence.

Example (1): Facts. South African Company owns all the shares of CFE 1 and CFE 2. CFE 1 is a Country X company, and CFE 2 is a Country Y company. CFE 1 assembles radios from its 20-person workshop located in Country X which CFE 1 sells and delivers to CFE 2 in Country Y at a R250 per unit price. CFE 1 purchases the internal mechanics from South African Company for R120 per unit and the coverings from unrelated parties at a cost of R30 per unit. In the hands of CFE 1, each radio requires a 6-part assembly process for completion that requires little skill. The factory overhead, equipment, and labour cost incurred by CFE 1 to produce each radio costs R10 per machine.

Result. CFE 1 sales fail to satisfy the higher business activity standard. CFE 1 is purchasing a significant amount of the parts from a connected South African resident (R120 out of R150), and no delivery occurs within the Country X market. CFE 1 is engaging in minor assembly that requires little skill and amounts to only 6.67 per cent of the total materials cost (R10/R150). (Note: CFE #2 falls wholly outside of the section 9D(9)(b) business establishment exclusion because CFE #2 is not engaging in any transaction with a connected South African resident.)

Example (2): Facts. The facts are the same as *Example (1)*, except that CFE 1 sells and delivers the radios to unconnected Foreign Company in Country X. Foreign Company solely sells to Country X customers at the retail level.

Result. CFE 1 satisfies the higher business activity standard despite the low level of value-added production. CFE 1 is selling to a person (other than a connected South African resident) for delivery within its country of residence (Country X).

Situation C: CFE Services for Connected South African Residents: Section 9D(9)(b)(ii)(cc). Services performed by a CFE for a connected South African resident generally fail to satisfy the higher business activity standard, except if those services directly relate to certain goods utilised outside South Africa or certain sales/marketing services with respect to those goods utilised outside South Africa (as described below). CFE services of a more general nature, such as management fees, internal accounting fees, and fees to guarantee loans never satisfy the higher business activity standard. These more general fees typically bear the mark of transfer pricing (due to their mobile nature), and little non-tax

business reason exists for CFEs to be servicing their South African connected persons in this manner.

Example: Facts. South African Company owns all the shares of Country X CFE in addition to other CFEs. Country X CFE acts as a finance subsidiary for the group. In its capacity as a finance subsidiary, Country X CFE guarantees certain loans made by South African Company in order for South African Company to expand factory operations. Country X CFE charges South African Company R1 million for this guarantee.

Result. The R1 million guarantee fee charged by Country X CFE does not satisfy the higher business activity threshold. The guarantee fee does not directly relate to goods utilised outside South Africa or sales/marketing services with respect to goods sold outside South Africa.

Special Rules for Production Related Services: Section 9D(9)(b)(ii)(cc)(A). CFE production related services performed outside South Africa satisfy the higher business activity standard if: (i) they directly relate to the creation, extraction, production, assembly, repair, or improvement of goods, and (ii) the goods at issue are utilised outside South Africa. These services do not represent a significant means for transfer pricing because these services have no relation to South Africa. Services relating to goods delivered within South African fall outside this category because little business reasons exists for shipping products offshore for foreign servicing, followed by a repatriation of those products back to South Africa.

Selling Related Services: Section 9D(9)(b)(ii)(cc)(B). CFE selling services performed outside South Africa satisfy the higher business activity standard if: (i) these services relate to the sale and marketing of goods produced by a connected South African resident, and (ii) the goods are sold to unconnected persons for delivery within the CFE's country of residence. This rule is the service analogue to local sales rule for CFE sales to unconnected persons. Selling services of this kind are exempt because the CFE's country of residence (i.e., where the CFE is incorporated, established, formed or has its place of effective management) has an economic nexus to the consumer market at issue. Related selling services of a Tax Haven CFE typically lack local consumer markets.

Example: Facts. South African Company owns all the shares of CFE, a Country X company. South African Company sells refrigerators to various customers located in Country X. CFE provides services for the refrigerator installation as well as a 90-day warranty. CFE also markets and sells the refrigerators within Country X on South African Company's behalf. South African pays R1 million to CFE for the installation and repairs, as well as R5 million for sales commissions and marketing fees.

Result. CFE satisfies the higher business activity standard for:

- (i) the R1 million of installation and repair fees because all these fees relate to refrigerators utilised outside South Africa; and

- (ii) R5 million of sales commissions and marketing fees because these fees relate to refrigerators sold by South African company to unconnected customers within Country X, CFE's country of residence.

d. Ministerial Discretions: Section 9D(10)

Section 9D contains two Ministerial discretions that alleviate CFEs from the higher business activity standard. Under the first discretion, the Minister may treat multiple countries as a single country for purposes of determining whether the higher business activity standard is satisfied. Under the second discretion, the Minister may wholly waive the higher business standard for economic reasons.

Treatment of Multiple Countries as a Single Country: Section 9D(10)(a). Because non-tax business reasons may exist for a CFE to operate within multiple countries, the Minister has discretion to treat multiple foreign countries as one country for purposes of sections 9D(9)(b)(ii)(aa)(A), (bb)(C), and (cc)(B). This unified treatment may apply when foreign countries reflect a single economic market and unified treatment will not lead to unacceptable erosion of the South African tax base. For instance, the Minister may treat the countries within the European Union as one country to the extent these countries impose a rate of income tax that is comparable to one another. Such treatment would mean, among others, that a CFE residing in the European Union could satisfy the higher business activity threshold when acting as a sales distributor on behalf of connected South African goods for customers located within multiple European Union countries.

Economic Waiver: Section 9D(10)(b). The Minister (in consultation with the Commissioner) may grant a general waiver from the higher business activity standard for economic reasons. In specific terms, this waiver may be provided only when taxation "will unreasonably prejudice national economic policies or South African international trade and such exemption will not lead to an unacceptable erosion of the tax base." Section 9D contains this special exemption from the higher business activity standard in recognition of the fact that some unanticipated hardship situations may arise in which a CFE may inadvertently fall subject to section 9D where no potential tax avoidance is involved.

4. CFE Income of a Passive Nature (Mobile Foreign Passive Income): Section 9D(9)(b)(iii)

a. General Background

Besides satisfying the diversionary rules, CFE receipts and accruals attributable to a business establishment will not qualify for exemption if those receipts and accruals are of a passive nature. Passive receipts and accruals consist of dividends, interests, royalties, rents, annuities, insurance premiums, and similar income of a passive nature. Passive receipts and accruals also consist of capital gains derived from the disposal of assets that generate the categories of passive income just described (e.g., the sale of shares). Lastly, passive receipts and accruals include all forms of currency gains (i.e., section 24I income, and currency gains in respect of foreign equity instruments).

Passive income and gains are fully subject to tax because no direct competitiveness concerns are at stake if no active business is involved. Assets generating passive income or gain, such as portfolio stocks and bonds, are also readily mobile. As such, these assets can easily be

shifted abroad without economic consequence (e.g., to wholly owned CFEs). Immediate taxation of CFE passive income is consistent with international practice.

No working capital exception exists for passive items. As a result, a CFE cannot claim that passive income or gains are eligible for the business establishment exemption merely on the grounds that the income or gain acts as working capital or will be used for future CFE business activity. Section 9D does not contain this form of exception because a CFE could always contend that passive income could ultimately be used for a business undertaking. However, certain exceptions exist for passive income, such as the *de minimis* exception and the exception for banking, insurance, financial service, and rental businesses.

b. The De Minimis Exception: Section 9D(9)(b)(iii)(aa).

Passive income is subject to a *de minimis* rule for administrative convenience. This rule prevents section 9D from applying when a CFE earns trivial amounts of income from passive investments. This *de minimis* rule applies as long as CFE passive income does not exceed 5 per cent of the CFE's total (i.e., gross) receipts and accruals. This rule is an "all-or-nothing" rule. Passive income either falls within or outside of the 5 per cent threshold. If passive income exceeds the 5 per cent level, all passive income (not just the amounts exceeding 5 per cent) are subject to section 9D.

Example (1): Facts. South African Company owns all the shares of CFE. CFE has R20 million receipts and accruals and incurs R13 million expenses with respect to its business establishment. The R20 million amount includes dividends of R800 000 from various foreign portfolio share investments held as working capital.

Result. Although CFE dividends are normally subject to section 9D despite their connection to a business establishment, section 9D does not apply because the dividends are *de minimis*. These dividends of R800 000 amount to less than 5 per cent of the total receipts and accruals (R800 000/R20 million).

Example (2): Facts. The facts are the same as *Example (1)*, except that CFE instead earns only R15 million total receipts and accruals.

Result. None of the dividends qualify for the *de minimis* exception because the R800 000 amount exceeds 5 per cent of the total (R800 000/R15 million).

Passive 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.

Example (3). Facts. South African Company owns all the shares of CFE. CFE earns R4 million of income from the sale of its trading stock. In addition, CFE sells Foreign Company X Shares with a R600 000 base cost for R1 million cash, and CFE sells Foreign Company Y Shares with a R1 300 000 base cost for R500 000 cash.

Result. The R400 000 of gains on the Foreign Company X Shares do not qualify for the *de minimis* exception. These gains amount to 9 per cent of the total (R400 000/R4 400 000). The losses on the Foreign Company Y shares are disregarded for purposes of the *de minimis* calculation.

c. *The Banking, Financial Services, Insurance, Rental Business Exception: Section 9D(9)(b)(iii)(bb).*

Passive income may alternatively be exempt from section 9D if that passive income arises from the principal trading activities of a bank, financial services, insurance, or rental business.

The purpose of the principal trading activity requirement is to ensure that a CFE is not merely a finance or a treasury operation with a better label designed to avoid section 9D. CFEs also cannot shelter portfolio passive investments under this rule to the extent the passive income stems from portfolio investments unrelated to the principal trading activity of the business. While passive income is normally incidental to a business, passive income of this kind represents core business activities, thereby re-raising the spectre of international competitiveness. However, no exemption of this kind exists for royalties or other income from the use of intangibles due to anti-avoidance concerns. The distinction between an active royalty business and series of passive streams is simply too amorphous.

Example (1): Facts. South African Company owns all the shares of CFE, a Country X corporation. CFE is licensed to perform banking activities in Country X. CFE earns R3 million of interest from making commercial and private loans, R2 million in interest from credit card charges and services, and R500 000 from issuing letters of credit and providing guarantees.

Result. Assuming the bank qualifies as a business establishment, all the income is exempt under the principal trading activity exception of section 9D(9)(b)(iii)(bb) because the income arises from principal trading activities of the bank.

Example (2): Facts. South African Company owns all the shares of CFE, a Country X corporation. CFE earns R2.6 million of rental income from an apartment complex and R400 000 in interest from deposits in a local bank.

Result. Assuming CFE qualifies as a business establishment, CFE qualifies as a rental business for purposes of the exception. However, only the R2.6 million of rental income is exempt; the remaining R400 000 is not derived from the principal trading activities of the rental business.

Example (3): Facts. South African Company 1 owns all the shares of CFE, a Country X corporation. South African Company 2 enters into a sale and leaseback arrangement with CFE, whereby South African Company 2 sells an intangible to CFE with CFE licensing the intangible back to South African Company 1 for a license fee of R500 000 per annum.

Result. The licensing income earned by CFE is subject to tax under section 9D(9)(b)(iii) even if that income arises from the CFE's principal trading activities. The principal trading activity exception simply does not apply to royalties or other intangible licensing income.

The principal trading activity exception is subject to anti-avoidance rules. Under the first set of anti-avoidance rules, CFE income derived from these businesses does not receive the benefit of the exception to the extent the income is derived from: (i) a connected South African resident,

(ii) any resident who holds at least 5 per cent of the CFE's participation rights, or (iii) from any other South African resident if part of a scheme to avoid any South African tax. This set of anti-avoidance rules prevents financial institutions from engaging in round-tripping transactions utilised before the enactment of section 9E.

An important condition which can result in no CFE income being eligible for the principal trading activity exception (not even unconnected party income) is that the CFE's receipts and accruals cannot be derived mainly from connected persons (regardless of whether those persons are South African or foreign residents). The purpose of this anti-avoidance rule is to prevent taxpayers from disguising financing or treasury subsidiary operations as a bank or financial services business. No reason exists to exempt passive portfolio holdings merely because a multinational group holds this passive portfolio in a single corporate shell with a special (finance and treasury) label attached.

Example (1): Facts: South African Parent Company is an insurance company. South African Parent Company owns all the shares of CFE, a reinsurance company located in Tax Haven. South African Parent Company enters into a reinsurance contract with CFE, whereby South African Parent Company pays R1 million in premiums to CFE in exchange for CFE's assumption of certain risks relating to South African Parent Company's insurance policies.

Result. The reinsurance premiums received by CFE are not eligible for the principal trading activity exception, even though the premiums were part of CFE's core reinsurance business. The exception does not apply because CFE is earning these amounts from a South African connected person.

Example (2): Facts. South African Parent Company owns all the shares of CFE, a banking company located in Tax Haven. As part of its banking business, CFE lends R10 million to X Company, an unconnected South African Company, at a 12 per cent rate. X Company uses the R10 million to purchase preference shares in CFE amounting to 7,5 per cent of the participation rights in CFE.

Result. The 12 per cent interest received by CFE is not eligible for the principal trading activity exception, even though the loan was part of CFE's commercial banking business. The exception does not apply because X Company, a South African resident, owns 5 per cent or more of the CFE's participation rights.

Example (3): Facts. South African Parent owns all the shares of various CFEs, including Finance CFE located in Tax Haven. Finance CFE conducts all the borrowing for the CFE group in order to reduce group borrowing costs. CFE borrows R100 million in total and re-lends R85 million to the CFEs owned by South African Parent and R5 million to South African Parent. The other R10 million is used to purchase portfolio shares and debentures. Finance CFE generates R1 million in receipts and accruals from its portfolio investments and R12 million in interest from the other group CFEs.

Result. The principal trading activity exception does not apply to any of the income received by Finance CFE because CFE's finance income stems mainly from connected persons. (Note: The interest income from the connected CFEs, however, will be exempt under the CFE intra-group exception of section 9D(9)(fA)).

D. The “Already Included” Income Exception: Section 9D(9)(e)

A third exemption from section 9D applies to CFE net income that is already included as taxable income. This category of net income mainly entails South African sourced income subject to direct South African tax in the hands of a CFE. No reason exists to tax this income under section 9D because this income is already accounted for by the South African tax system.

Example: Facts. South African Company owns all the shares of CFE, a Country X corporation. CFE generates R5 million of South African source royalty income within South Africa from unconnected persons. CFE is fully subject to South African tax on the R5 million of royalty income by virtue of that income’s South African source.

Result. Section 9D does not apply to the business income because the CFE business income is already included as income under the Income Tax Act.

E. The Related and Intra-Group Exemptions: Sections 9D(9)(f), (fA), and (fB)

Section 9D contains provisions that allow related CFEs to shift income among one another without triggering tax. These rules recognise that multinational structures frequently contain multiple foreign subsidiaries that act as a single economic unit. The multilevel nature of these structures (often involving holding companies) have legitimate non-tax reasons, such as isolating risk to particular countries in which economic activities arise. Moreover, even though tax reasons may exist for multilevel structures, taxpayer efforts at tax reduction in this regard are aimed solely at reducing foreign tax as opposed to South African tax. Structures of this kind allow South African multinationals to compete in an environment where their foreign multinational competitors utilise similar foreign tax reducing structures.

Section 9D provides three exemptions from tax in recognition of these concerns. Section 9D contains: (i) an exemption for related CFE dividends, (ii) an exemption for intragroup CFE debts, licenses, and leases, and (iii) an exemption for the disposal of leased CFE intra-group assets.

1. Exemption for Related CFE Dividends: Section 9D(9)(f)

Under this exemption, a CFE can receive dividends from another related CFE without being subject to section 9D, even though dividends are passive in nature. In order for the payor and payee CFEs to be related for this purpose, both CFEs must qualify as a CFE in relation to the same South African resident (i.e., be more than 50 per cent directly or indirectly owned by the same South African resident). Dividends are exempt under this provision because the underlying earnings of the CFE payor generating the dividends are either earnings from a CFE business establishment or were already taxed directly. This rule effectively allows South African Multinationals to utilise holding company structures without triggering South African tax merely upon the receipt of dividends from lower-tier subsidiaries.

Example: Facts. South African Company owns all the shares of CFE 1, a Country X company. CFE 1 is a shell holding company that owns all the shares of CFE 2, a Country Y company. CFE 2 generates R2 million of receipts and accruals from a business establishment. CFE 2 distributes a dividend of R2 million to CFE 1 from these receipts and accruals.

Result. The R2 million dividend is exempt from tax under section 9D by virtue of the Related CFE Dividend Exemption. Both CFE 1 and CFE 2 qualify as CFEs in relation to South African Company (i.e., both are more than 50 per cent directly or indirectly owned by South African Company).

2. Exemption for Intra-Group CFE Debts, Licenses and Leases: Section 9D(9)(fA)

Section 9D contains an exception for intra-group debts, licenses, and leases. Under this exception, a CFE avoids the ambit of section 9D when receiving interest, royalties or rental income from another CFE as long as both the payor and payee CFEs are part of the same group of companies. This rule also applies to income of a similar nature and to section 24I currency gains on intra-group exchange items. The group concept involved has the same meaning as the group concept found in section 41 for company restructurings (i.e., 75 per cent or more equity share ownership). This rule effectively allows South African Multinationals to utilise finance or treasury foreign subsidiaries as a tax-free means for channelling collective group loans, licenses, and leases. Structures of this kind typically allow a group to borrow within a single administrative structure, thereby creating opportunities for reduced group rates.

Conversely, any CFE paying interest, royalties, and rents will not receive any deduction against “net income” for purposes of the section 9D calculation if the corresponding income items are exempt in the hands of the recipient CFE under the just described intra-group exception (See also 9D(2A)(c)). These deductions are denied as a matter of symmetry in order to prevent artificial mismatches of deductible payments and non-included receipts within the same economic group.

Example: Facts. South African Company owns all the shares of CFE 1 and CFE 2, each of which has a different country of residence. CFE 1 receives R50 000 of interest from CFE 2 as a loan between the two entities. CFE 2 generates its receipts and accruals from a business establishment, and none of these items are of a diversionary or of a passive nature. The total receipts and accruals of CFE 2 amount to R180 000. The associated expenses of CFE 2 amount to R70 000, including R50 000 of interest paid to CFE 1.

Result. CFE 1 does not include the R50 000 of interest received from CFE 2 under the CFE intra-group exception for debts because both CFE 1 and CFE 2 are part of the same group of companies. CFE 2 has no net income because all of its activities stem from a business establishment, and none of the income is of a diversionary or of a passive nature. CFE 2 effectively also ignores its expenses because all these expenses relate to exempted business establishment income for purposes of section 9D.

3. Exemption for the Disposal of Leased CFE Intra-Group Assets: Section 9D(9)(fB)

As stated previously, a CFE’s business establishment income is exempt as well as the sale of assets generating business establishment income. The general rule, however, applies only for situations where the CFE owns business establishment assets. Under the exemption for the disposal of leased CFE intragroup assets, section 9D additionally exempts the sale of tangible CFE assets (other than financial instruments) if those assets are used in a business establishment conducted by another CFE within the same group. This exemption essentially allows attribution of group assets to CFE business establishments as long as both the CFE owning the asset and the CFE utilising the asset are within the same group of companies (same

economic unit). The group concept follows the company restructuring definition contained in section 41.

This exemption typically arises when one CFE leases an asset to another CFE in order for the latter to conduct its business. These cases frequently involve sale and leaseback activities. In essence, sales proceeds on leased intra-group CFE assets are exempt to the same extent as the net income attributable to a specific CFE.

Example: Facts. South African Company owns all the shares of CFE 1 which in turn owns all the shares of CFE 2. CFE 1 and CFE 2 are incorporated in different countries. CFE 1 conducts a textile manufacturing business, and CFE 2 is a pure holding company. CFE 1 owns a textile factory that CFE 1 uses in its manufacturing activities. CFE 1 then sells the factory to CFE 2 with CFE 2 leasing the factory back to CFE 1 for use by CFE 1 in its textile business. After a number of years, CFE 2 sells the factory to an unconnected party.

Result. Section 9D does not apply to the leasing income received by CFE 1 pursuant to the exception contained in section 9D(9)(fA). In addition, the initial sale of the factory by CFE 1 is not subject to tax by virtue of section 9D(9)(b) because the factory is attributable to CFE 1's business establishment, and CFE 2's subsequent sale of the factory is not subject to tax by virtue of section 9D(9)(fB) because the factory is attributable to the business establishment of CFE 1 (both of which are within the same group of companies).

F. The Participation Exemption: Section 9D(9)(h)

Under the participation exemption, a CFE disregards the disposal of certain shares of a foreign company as well as receive tax-free foreign dividends with respect to those foreign shares. In order to qualify for the exemption, the CFE must own more than 25 per cent of the equity share capital (i.e., the ordinary shares and/or participating preference shares) in the foreign company. In addition, for purposes of the disposal exemption (but not the foreign dividend exemption), the CFE must have held this more than 25 per cent stake for at least 18 months before the relevant disposal. For purposes of this 18-month rule, the disposing of CFE is deemed to have owned any foreign shares disposed of during any period in which the foreign shares were previously held by another CFE within the same group of companies.

Example (1): Facts. South African Company owns all the shares of CFE 1. CFE 1 owns all the shares of CFE 2 which consist of 100 issued ordinary shares. On 15 January 2003, CFE 1 sells 90 shares of CFE 2 (retaining the remaining 10 shares as collateral for bank debt).

Result. The participation exemption exempts CFE 1 from the application of section 9D upon the disposal of the CFE 2 shares because CFE 1 has the requisite level of ownership at the time of disposal. This exemption applies even though CFE 1 did not dispose of all its CFE 2 shares in the transaction. This exemption applies regardless of whether gain or loss results from the disposal.

Example (2): Facts. The facts are the same as *Example (1)*, except that South African Company subsequently sells all the shares of CFE 1 on 10 May 2003.

Result. The participation exemption does not apply to the sale by South African Company. The participation exemption applies only to sales by CFEs.

Example (3): Facts. South African Company owns all the shares of CFE 1, CFE 1 owns all the shares of CFE 2, and CFE 2 owns all the shares of CFE 3. CFE 3 operates a furniture factory within Country X. On 1 January 2002, CFE 2 distributes all the shares of CFE 3 to CFE 1 as a dividend after having owned CFE 3 for three years. CFE 1 then sells CFE 3 to an unconnected party on 15 March 2002.

Result. The participation exemption exempts CFE 2 from the application of section 9D for CFE 2's disposal of CFE 3 by way of the distribution *in specie* to CFE 1 as well as the receipt of that dividend by CFE 1 (CFE 1 is also exempt from tax on the receipt of the dividend by virtue of the Related CFE dividend exception of section 9D(9)(f)). The participation exemption additionally applies to the subsequent sale of CFE 3 by CFE 1 because CFE 1 is deemed to own CFE 3 for the period in which the shares of CFE 3 were owned by CFE 2.

Example (4): Facts. The facts are the same as *Example (3)*, except that CFE 2 held the shares of CFE 3 only since 1 September 2000.

Result. CFE 2 does not receive the benefit of the participation exemption with respect to the gain on the disposal by virtue of the distribution because CFE 2 held the shares for only 16 months prior to that distribution. CFE 1 remains exempt from any tax upon receipt of the dividend because the participation exemption applies to the receipt of a dividend regardless of the time in which the shares were held (CFE 1 is also exempt from tax on the receipt of the dividend by virtue of the related CFE dividend exception of section 9D(9)(f)). CFE 1 receives the benefit of the participation exemption upon subsequent sale because CFE 1 and CFE 2 (both of which are part of the same group of companies) held the shares of CFE 3 for a combined period of at least 18 months.

Consistent with the domestic company restructuring rules, the participation exemption contains an exclusion against trafficking in shares of a foreign company mainly containing financial instruments. A financial instrument company of this kind exists if more than 50 per cent of the company's gross assets consist of financial instruments (as defined in the Eighth Schedule). The more than 50 per cent test is satisfied if this threshold is met either in fair market value terms or in actual cost terms (i.e., historic book without reduction for depreciation).

The financial instrument company regime similarly contains a look-through rule for company groups. Under this look-through rule, the shares of all companies, in which a 75 per cent or greater interest is held, are ignored (see definition of "group of companies" in section 41) with underlying assets being accounted for instead. This rule effectively treats the company sold and its qualifying subsidiaries as a single economic unit.

Example (5): Facts. South African Company owns all the shares of CFE. CFE owns 30 per cent of the equity share capital of Foreign Company X. Based on fair market value and historical cost, Foreign Company X owns R3 million of portfolio corporate bonds as well as all the shares in Foreign Company Y worth R4 million. Foreign Company Y operates a factory with (i) a R3 million market value, as well as (ii) historical cost of R4 million and a depreciated book value of R2 million). Foreign Company Y also owns a portfolio of shares with an historical cost and market value of R1 million. CFE sells all of its equity share capital in Foreign Company X.

Result. The participation exemption does not apply to exempt the sale from section 9D. Foreign Companies X and Y are viewed as a single economic unit with the Foreign Company Y shares ignored. Within this group, R4 million of financial instruments assets exist in book and value terms. The factory has only a R3 million fair market value and a R4 million actual cost (i.e., historic book). Thus, Foreign Company X does not qualify as a financial instrument holding company because the more than 50 per cent financial instrument threshold based on market value is not satisfied (i.e., R4 million out of R7 million of assets are financial instruments if the foreign company shares are disregarded).