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Taxing the Coronation Group: Comparing South Africa, UK, USA and Ireland's CFC Rules for Targeted Income and Foreign Business Establishment Exemptions

A research report submitted to the Faculty of Commerce, Law and Management to meet the criteria for the Master of Commerce degree with a specialization in Taxation.

Applicant: Sandise Njamela

Student number: 2349142

Supervisor: Jane Ndlovu

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Abstract

The taxation of controlled foreign companies (CFCs) is a critical international issue affecting multinational corporations, governments, and their revenue authorities. CFCs are pivotal in the context of base erosion and profit shifting (BEPS) and efforts to combat tax evasion. Misinterpretation of CFC rules can have profound financial implications for corporations, as illustrated by the Commissioner for the South African Revenue Service (CSARS) v Coronation Investment Management SA (Pty) Ltd (CIMSA). In this case, the CSARS imposed an additional tax of R761 million, representing 45% of CIMSA's profit before tax (R1 689 million) for the accounting period ending 30 September 2023. The dispute centred on the interpretation of section 9D of the Income Tax Act No. 58 of 1962 (Republic of South Africa, 1962), particularly the foreign business exemption.

This research report compares the legislative and judicial approaches to CFCs, focusing on targeted income and the foreign business establishment (FBE) exemption in the Republic of South Africa (RSA). It contrasts these approaches with those of the United Kingdom (UK), United States of America (USA), and Ireland to determine if South Africa's CFC rules align with international best practices or fall short owing to interpretative complexities. The findings aim to assist the National Treasury and multinational corporations to better understand and refine section 9D of the Act.

Given that the UK and Ireland use residence-based tax systems similar to South Africa, and the USA employs a citizen-based system taxing its citizens on worldwide income, this report uniquely emphasizes the USA's distinct CFC rules established in 1962. These rules serve as a benchmark in the comparative analysis. As these countries are key trading partners for South Africa, they provide relevant points of comparison.

The analysis found that while section 9D requirements are largely consistent with international norms, certain shortfalls were noted. Taxing CFCs on worldwide income was deemed unfair to multinational companies. The UK's source-based approach was found to be fairer, as it only targets CFC income derived from UK resources. South Africa's FBE exemption is complex, whereas the UK's FBE requirements are recommended for their measurability, specificity, and fairness. Additionally, South Africa's 5% exclusion threshold for CFC definition and 10% income inclusion threshold were found to be low compared to international standards.

Key Words: Controlled foreign company (CFC), foreign business establishment, foreign exemptions, Ireland, Section 9D, targeted income, United Kingdom and United States of America.

Declaration

I confirm that this research report has been independently produced by me. It is being presented as part of the criteria for the completion of the Master of Commerce programme, focusing on Taxation, at the University of the Witwatersrand. This report has not been presented for any other academic qualification or assessment at any other institution.

Dedication

Firstly, to my supervisor, Jane Ndlovu I would like to thank you for your guidance, support, and patience.

Secondly, to the Wits community and my EY colleagues, thank you very much for your support.

Lastly, to my family at large I would like to also thank you for your valuable encouragement and love.

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Chapter 1: Introduction

1.1 **Background**

The controlled foreign company (CFC) taxation rules have come under intense scrutiny in South Africa following what was for a brief period a landmark decision by the Supreme Court of Appeal of South Africa (SCA) in *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*, referred hereafter as the Coronation Case.[1] The judgment of the SCA was overturned by the Constitutional Court after sixteen months.[2]

At the crux of this legal dispute heard in the SCA was the determination of whether the Irish subsidiary, Coronation Global Fund Managers (Ireland) Limited (CGFM) within the Coronation group holding CFC status in Ireland, possessed substantive operational activities and adhered to the statutory requirements outlined in the definition of foreign business establishment (FBE) exemption, as prescribed in section 9D of the South African Income Tax Act No 58 of 1962 (section 9D).[3] As depicted in Figure 1 below, Coronation Fund Managers (Pty) Ltd (CFM), Coronation Investment Management SA (CIMSA) and Coronation Asset Management (Pty) Ltd (CAM) are South African tax residents while CFM (Isle of Man) and CGFM are Irish and Coronation International Ltd (CIL) is a UK tax resident. CFM is the parent company of CIMSA and CIMSA is the parent company of CFM (Isle of Man) and CAM. In addition, CFM (Isle of Man) is the parent of CIL and CGFM.[4]

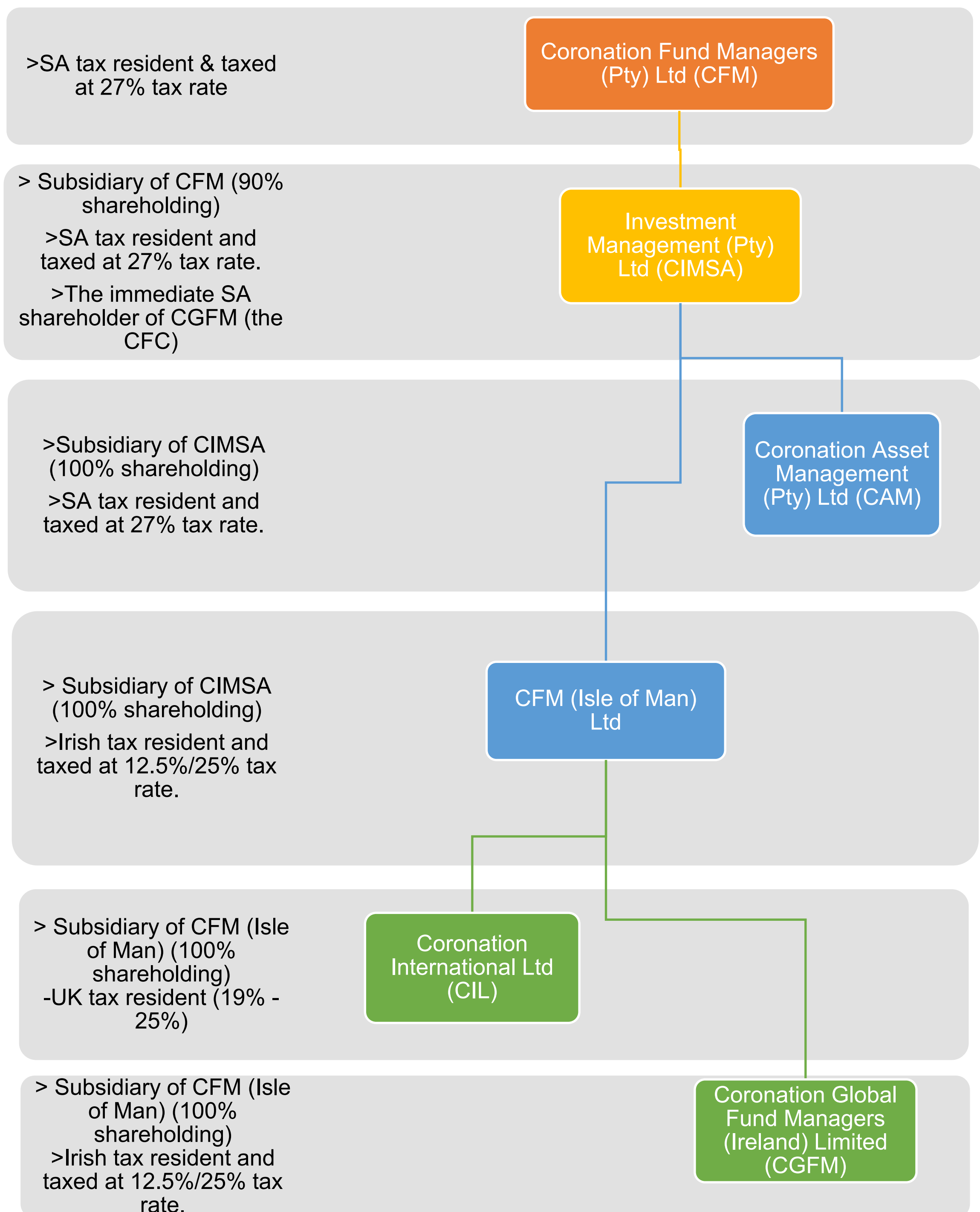
Figure 1: Coronation Group structure

[1] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.

[2] Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service, (47/23) [2024] ZACC 11, 21 June 2024.

[3] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009, page 73.

[4] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.



Source: The group structure is self-generated using data from the Coronation case.

The SCA ruled that the Irish company (CGFM) as depicted in Figure 1, integral to the CFM group, did not conduct its main trading activities in Dublin, as these functions were outsourced to the Republic of South Africa (RSA) and the United Kingdom (UK).[5] Consequently, CIMSA, as the immediate tax resident of RSA, was compelled to add the taxable profits of the Irish

[5] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023, Page 25.

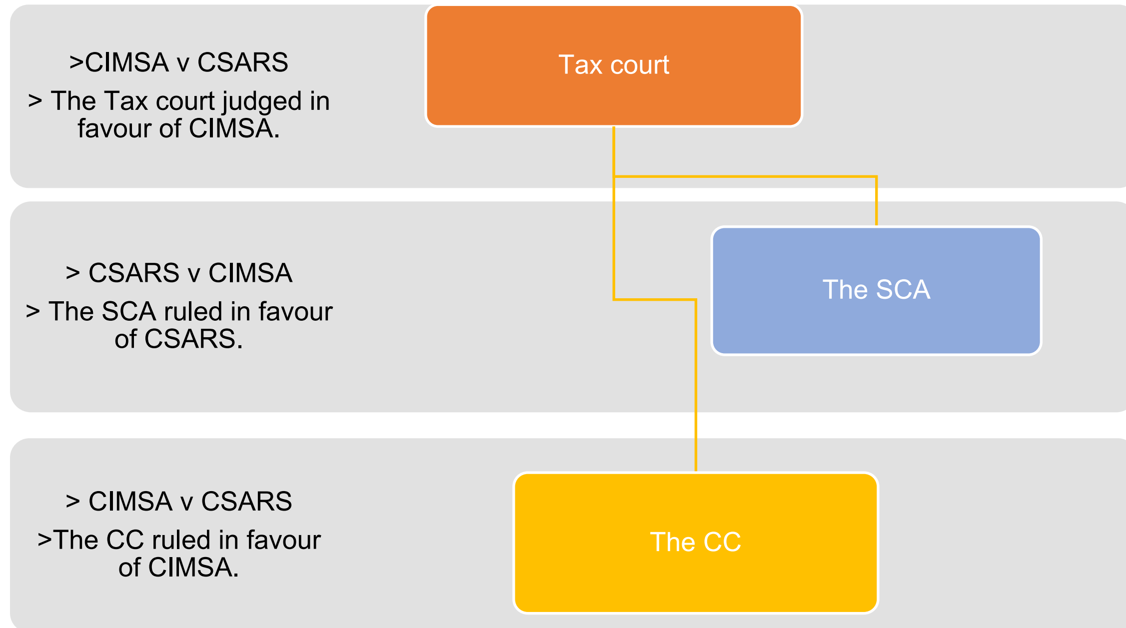
company, deemed to be a CFC, in its RSA taxable income as stipulated by the regulations of section 9D.[6] This judgment resulted in substantial additional tax liabilities for CIMSA, estimated at R761 million, constituting 45% of Coronation's profit before tax (R1 689 million) for the financial year ending 30 September 2023, significantly impacting Coronation's overall profitability.[7] The legal precedent set by this decision carried profound implications, potentially reverberating across the broader economy and affecting South African entities engaged in offshore operations.

Given the far-reaching consequences for shareholders, investors, and fellow multinational corporations, the Constitutional Court of South Africa (CC) heard the case on 13 February 2024. The CC judgment which provided clarity on how to interpret section 9D was handed down on 21 June 2024.[8] The prevailing uncertainty centred on whether the CC would rule in favour of CSARS or the Coronation Group. The case first went to the tax court where CIMSA won, then CSARS took it on appeal and the SCA upheld the appeal, thereafter the CC overturned the SCA ruling as illustrated in Figure 2 below.

The CC's decision in favour of Coronation Group is in line with the Tax Court's judgment but goes against the SCA's ruling, further emphasising the significance and complexity of this legal conundrum of interpreting section 9D. The fundamental question arises: would it have been equitable for CIMSA to bear these substantial costs, or does the interpretation of CSARS align with section 9D and does the differing interpretation of the CC align with international standards? The answer remains elusive, and this research report provides a thorough examination and clarification based on the views of tax experts.

[6] Brink, 2023, South African shareholders in businesses with offshore operations beware, CDH, 1 March 2023.
[7] Coronation Fund Managers Limited Group. 2023. Annual Financial Statements Audited.
[8] Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service, (47/23) [2024] ZACC 11, 21 June 2024.

Figure 2: Courts judgments for the Coronation case



Source: Self- generated from the Coronation case judgments.

As mentioned, the central concern underpinning the Coronation case was the accurate interpretation of section 9D by the SCA and CSARS that section 9D(2) should apply versus the interpretation by CIMSA and the Constitutional Court of South Africa that section 9D(2) should not apply. Given the inherent complexities of the provision, this prompts a critical inquiry into the targeted income defined within South African CFC rules and the precise application of the FBE exemption. An essential dimension of this investigation involves assessing the alignment of RSA CFC rules with those of the UK, the USA, as well as Ireland. Moreover, the research report seeks to clarify whether the multinational corporations based in these comparator countries, particularly the Coronation group, would, had the Constitutional Court not overturned the decision of the SCA, incur similar significant costs under analogous circumstances. As these countries are key trading partners with South Africa, the research aims to determine whether South African multinational corporations face any potential disadvantages in comparison.

1.2 The research question

1.2.1 Problem statement

The fundamental research problem addresses the need to pinpoint aspects of the CFC rules in the UK, the USA, and Ireland that could be incorporated into South Africa's section 9D. Such incorporation is envisioned to facilitate a more nuanced and effective interpretation of the South African CFC rules, thereby addressing current complexities that have raised

concerns among multinational corporations operating in the RSA. The research question is stated as:

How do section 9D rules of the Republic of South Africa, specifically targeted income and foreign business establishment exemptions, compare to those enacted in the United States of America, the United Kingdom and Ireland?

The main objective of this research report is twofold: first, to evaluate and compare both legislative and judicial approaches to CFC rules, specifically focusing on targeted income and FBE exemption in the RSA. The analysis contrasts the corresponding taxation frameworks adopted and endorsed by the UK, the USA, and Ireland. Second, to ascertain whether the South African CFC rules adhere to best practices observed in foreign jurisdictions and, conversely, to identify potential shortcomings. Any similarities between the regulatory frameworks are emphasised.

1.2.2 **Rationale for country selection**

The selected comparator countries are the UK, the USA, and Ireland, each chosen for distinct reasons. The UK's tax residence system, akin to South Africa's, and the perceived simplicity and generality of its CFC rules, make it a pertinent comparator. Furthermore, the Katz Commission,[9] a commission which had been instituted in 1994 to examine the South African tax system for the post-apartheid era, recommended the UK as a suitable comparator country for analysing tax legislature. Furthermore, the UK is a critical trading partner for South Africa.[10]

The USA adopted its CFC rules in 1962.[11] Its unique tax framework positions the USA as a crucial comparative counterpart,[12] providing a balancing perspective within this research report. Furthermore, the RSA's participation in the African Growth and Opportunity Act (AGOA),[13] a program fostering trade between the USA and eligible African countries, emphasises the economic ties and trade partnership between the two nations.[14]

Ireland, like the RSA, employs a residence-based tax system.[15] As the RSA's primary import and export partner on the African continent, Ireland holds a pivotal role as a key trading

[9] Katz Commission's 5th Report, Basing the South African Income Tax System on the Source or Residence Principle – Options and Recommendations, 1997, page 56.
[10] Department of Trade, Industry and Competition, South Africa's Trade Relationship with the United Kingdom continues unchanged as the UK leaves the European Union, 2020.
[11] Arnold & McIntyre, International Tax Primer Second Edition, 2002, Page 88.
[12] Katz Commission's 5th Report, 'Basing the South African Income Tax System on the Source or Residence Principle', 1997, page 1.
[13] BusinessTech, South Africa cracks the USA's list, 2024.
[14] Pillay, What is Agoa? This is what you need to know, 2024.
[15] Irish Tax and Customs, Tax Residence, 2023.

partner.[16] The introduction of Ireland's CFC rules in January 2019,[17] reflecting contemporary economic realities, adds a layer of relevance to this comparative analysis. Notably, the Coronation Group's involvement with a CFC in Ireland, as highlighted in the Coronation case, further justifies the inclusion of Ireland in this research report.

Considering the RSA's trading partnerships with these nations, particularly the USA and Ireland, it becomes imperative to avoid placing South African multinational corporations, exemplified by the Coronation Group, at a disadvantage. This consideration is especially crucial given the competitive landscape involving multinational corporations from these developed nations.

1.3 **The sub-research questions**

1.3.1 How does the definition of 'controlled foreign company' in the RSA compare to the definitions in the legislation of the UK, USA, and Ireland?

The research report covers the background, including definitions of the CFCs of these respective jurisdictions and assesses which CFC regime has aspects that can enable a better interpretation of section 9D. Any identified aspects are recommended to National Treasury.

1.3.2 What is the targeted income in section 9D(9A) and how does this targeted income need to be improved to align with the UK, USA and Ireland's CFC regimes?

The second sub-problem is to assess and evaluate the complexities in application of the targeted income of section 9D and compare these with targeted income of the UK, the USA and Ireland. The goal is to identify the aspects that may assist with better interpretation of the targeted income of section 9D(9A). This includes the recommendations to National Treasury with the aim of improving section 9D requirements on protecting the tax base of South Africa without disadvantaging international competitiveness for South African based multinational corporations.

1.3.3. What are the requirements of the FBE exemption in South Africa and do these requirements need to be improved to align with the UK, the USA and Ireland's CFC regimes?

The third sub-problem is to assess and evaluate the complexities in application of the FBE exemption of section 9D(9)(b), and compare these with relevant exemptions of

[16] The Department of International Relations and Cooperation, South Africa and Ireland to strengthen political and economic relations, 2023.
[17] Tax and Duty Manual, Controlled Foreign Company Rules, 2023, Page 6.

the UK, the USA and Ireland. The objective is to identify the aspects that may assist with better interpretation of the FBE exemption of section 9D(9)(b). This includes recommendations to National Treasury with the aim of improving section 9D requirements on protecting the tax base of South Africa, also without disadvantaging international competitiveness for South African based multinational corporations.

1.3.4. What recommendations can be made to the South African CFC rules using the guidance of the UK, USA and Ireland CFC rules?

The recommendations are expected to assist both multinational corporations and CSARS in interpreting the CFC rules, especially the targeted income and FBE exemption. The recommendations are expected to address the current shortfalls and complexities of section 9D.

1.4 The importance of the research report

This report is expected to assist National Treasury to improve section 9D to be in line with international standards, which will assist in improving SA's competitiveness. It will also help multinational companies in interpreting the current requirements of section 9D.

Prior to the Constitutional Court delivering its aforementioned judgment, National Treasury expressed its intention to amend the requirements of FBE definition to align to the SCA's judgment in the Coronation case.[18] National Treasury proposed that the CFC performs all the essential activities for which the CFC is remunerated.[19] It should be noted that several tax experts have expressed concerns about the proposed changes.[20] Therefore, there is still an issue with section 9D, hence the research report is considered significant for National Treasury and its upcoming amendments.

For the CSARS, the Constitutional Court, multinational corporations and investors, the research report aims to assist with interpretation of the section 9D requirements and assess how they are different to the interpretation of the UK, US and Ireland CFC rules. This will be done with the objective of assisting in clarifying the complexities around section 9D. The research report may also assist the Organization for Economic Cooperation and Development (OECD) in drafting recommendations pertaining to economic and social policies for eligible countries.

[18] Mekgoe, Controlled Foreign Companies and Business Establishment Relief, 2023, page 35.
[19] Draft Taxation Laws Amendment Bill, 2023, page 12.
[20] Mekgoe, Controlled Foreign Companies and Business Establishment Relief, 2023, page 35.

1.5 **Research method**

In this research, a qualitative methodology was employed with a specific focus on the doctrinal research approach. Unlike quantitative research, which seeks to test hypotheses, qualitative research aims to explore and understand complex phenomena without predetermined hypotheses.[21] Given the nuanced and interpretative nature of tax research, particularly in with regards to CFC rules, a qualitative approach was deemed most fitting.

Quantitative methods, often associated with experimentation and surveys, are commonly utilised in research designs.[22] However, in tax research, the primary concern revolves around the judicious selection of populations and access to relevant data.[23] Surveys and experimentation are not deemed applicable to the nature of the inquiry, thereby rendering a qualitative approach more pertinent.

The chosen research approach was the doctrinal research method, which involves a meticulous examination of legal principles and concepts derived from diverse sources.[24] These include but are not limited to case law, such as the pivotal Coronation[25] and Cadbury Schweppes cases,[26] statutory regulations,[27] textbooks,[28] and academic journals.

The doctrinal research method, often defined as library-based research, involves a comprehensive investigation into legal questions using a variety of resources, encompassing law books, statutes, legislation, commentaries, and other pertinent legal documents.[29] This method aligns seamlessly with the objectives of this research report, emphasizing the need for a thorough analysis to derive valid conclusions.[30]

The research report employed the doctrinal research method through an extensive library-based exploration aimed at addressing the main problem and sub-problems identified. Key sources for analysis include the RSA tax regulations, with a specific focus on the requirements of section 9D of the Income Tax Act No 58 of 1962, in comparison with CFC rules from the

[21] McKerchar, Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: applying the Principles of Research Design and Conduct to Taxation, 2008.
[22] ibid.
[23] ibid.
[24] Dahiya, All about Doctrinal and Non-Doctrinal Research, 2021.
[25] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023) and Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service, (47/23) [2024] ZACC 11, 21 June 2024.
[26] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.
[27] Specifically, the CFC rules as outlined in the Income Tax Act No 58 of 1962, Finance Act 14 of 2012, Internal Revenue Code of1986 and Taxes Consolidation Act of 1997.
[28] Including authoritative works such as the International Tax Primer Second Edition, Silke on International Tax, and Silke on South African Income Tax.
[29] Dahiya, All about Doctrinal and Non-Doctrinal Research, 2021.
[30] ibid.

United Kingdom, the United States of America, and Ireland. Insights from tax experts, as documented in published journals and textbooks, will further contribute to the doctrinal analysis, ensuring a comprehensive and nuanced understanding of the research questions at hand.

1.6 **Delimitations of the research report**

The report does not cover the following aspects:

1.6.1 South African exemptions other than FBE exemption

Owing to the Coronation case, the focus is on the targeted income and the FBE exemption. Therefore, other exemptions are not discussed in detail in this research report. The other exemptions are key to multinational corporations; however, since these other exemptions are not the key contention in the Coronation case, these are excluded in this research report.

1.6.2 Transfer pricing regulations and international tax treaties (regulations)

These regulations interact with section 9D requirements as these are used in combating deferral of profit from South African tax base. However, the requirements of section 31 of the South African Income Tax Act No. 58 of 1962 is not thoroughly examined in this report as it requires its own research report owing to its complexities in application and interpretation, especially in determining the market-related prices for international transactions involving connected parties.

1.6.3 Administration aspects of the CFC rules

Administrative aspects including submissions to SARS, interest and penalties are not discussed in detail in the research report as these also require a separate research report due to the complexities and administrative nature of the requirements. To understand the penalties, one needs to assess the relevant requirements of the Tax Administration Act and relevant case laws to assess if there is a bona fide inadvertent error. This is not considered necessary for this research report as the SCA offset the penalties in the coronation case.

1.7 **Chapter overview**

The first chapter functions as an introductory section, encompassing the relevant background, the importance of the research, the main problem and sub-problems identified, as well as the research methodology employed. The delimitations are also highlighted.

Chapter two sets out the main objectives and general rules of the CFC rules as detailed in section 9D. This chapter also assesses the CFC rules of the UK, the USA and Ireland to assess how these jurisdictions deal with difficulties of interpreting CFC rules like those faced by South Africa. A comparability assessment is performed.

Chapter three examines and compares the CFC rules, specifically the targeted income of section 9D(9A) and compares this with the requirements of the CFC rules of the UK, the USA and Ireland. This chapter assesses the difficulties in interpreting the targeted income and identifies aspects that can be recommended to National Treasury to improve section 9D(9A).

Chapter four involves a comparison of the CFC rules, focusing on the FBE exemption under section 9D(9)(b), and a comparison with the CFC rules of the UK, the USA, and Ireland. This chapter also assesses the difficulties in interpreting the FBE exemption and identifies aspects that can be recommended to National Treasury to improve section 9D(9)(b) .

Chapter five applies the CFC rules and interpretation guidance of the respective countries to the Coronation case and assesses the different outcomes per country. The objective is to assess if the SCA judgment was fair when compared to other countries' CFC rules and interpretations. This chapter also focuses on highlighting recommendations on the differences in targeted income and FBE exemptions amongst South Africa, the UK, the USA and Ireland.

Chapter six concludes on the findings and connects them to the objectives of this report. This chapter also summarises the recommendations for National Treasury to improve section 9D.

Chapter seven offers final thoughts on the conclusions drawn from the research report and proposes potential avenues for further study.

Chapter 2: An evaluation of RSA's CFC rules and the rules of the selected countries

2.1 Introduction

The definitions of CFCs and the income subject to taxation under CFC rules vary significantly across different jurisdictions.[31] In this chapter, a comparative analysis is presented regarding the history, definitions, and basic requirements of CFCs in the RSA, the UK, the USA, and Ireland. The objective is to determine which country has a fairer CFC definition and basic requirements, highlighting the provisions that may be advantageous to the South Africa National Treasury.

2.2 South African's CFC rules

The RSA functions within a residence-based tax system, as recommended by the Katz Commission in 1997.[32] The commission was established to evaluate the tax system's ability to address the effects of globalization.[33] Consequently, CFC rules were introduced in 2001.[34] This system grants South Africa the legal authority to enforce tax laws beyond its territorial boundaries, allowing the taxation of CFCs through South African shareholders as if they were tax residents of South Africa.[35] The taxable profit of a CFC may be attributed to the South African shareholders, regardless of whether any income is actually repatriated to them.[36] The criteria outlined in section 9D of the Income Tax Act No. 58 of 1962 (ITA) govern the taxation of CFCs.

A CFC refers to any 'foreign company' that is owned, either directly or indirectly, by one or more residents of the RSA.[37] Section 1 of the ITA provides a definition of a company that does not qualify as a South African resident for tax reasons.[38] This definition implies that a company is classified as foreign if it is not registered, founded, or organised in the RSA, or if its place of effective management is situated outside the Republic.[39] The ITA does not provide an explicit definition for the term 'place of effective management.' Consequently, Interpretation Note No. 6 (Issue 2) section 1(1) Resident – Place of effective management (companies) issued by SARS is utilised to understand its meaning.[40]

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[31] Arnold & McIntyre, 2002, Page 88.
[32] Katz Commission's 5th Report, Basing the South African Income Tax System on the Source or Residence Principle – options And Recommendations, 1997, pages 56.
[33] ibid.
[34] Grimm & Kraamwinkel, 2018, CFCs: have we gone too far?, Page 28 - 29.
[35] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.43.
[36] Section 9D(9A) of the Income Tax Act, No. 58 of 1962.
[37] Section 9D(1) of the Income Tax Act, No. 58 of 1962.
[38] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[39] ibid.
[40] Interpretation Note no. 6, 2015, Resident – Place of Effective Management (companies), Page 3.

According to the interpretation note, a company's 'place of effective management' is determined by the location where strategic and operational decisions essential for the company's operations are actually taken.[41] This place is typically where the senior management team and the executive leadership team regularly convene to discuss and finalise important strategic and commercial decisions for the company.[42] For instance, in the case of an Irish CFC (CGFM), the location where key strategic and commercial decisions related to fund management and compliance monitoring are made would be in Ireland.[43] As a result, an Irish CFC would not meet the criteria to be classified as a resident of the RSA.

Once a non-resident company has been identified as such, it is also crucial to assess the control over this company as part of the CFC definition.[44] Section 9D(1) of the ITA outlines the conditions under which a foreign company is classified as a CFC. A non-resident company is considered a CFC if over half of its total ownership or voting rights are owned or can be exercised by the South African shareholder(s), excluding those that are headquarter companies.[45] It should be noted that voting rights in a foreign company that are traded on stock markets, or rights exercised indirectly through a listed company, are not considered.[46] The participation rights referenced in section 9D(1) of the ITA must entitle the shareholder of South Africa to the profits and capital of the company abroad.[47] These rights typically include shares representing the equity of the company abroad.[48] Control is established if these rights grant the South African shareholder a claim to more than half of the undistributed retained income or capital.[49]

A non-resident company is also deemed a CFC if its voting rights can be directly or indirectly exercised by another CFC, in which 50% or more of the rights are controlled directly or indirectly by the South African shareholder.[50] For instance, in the case of the Coronation Group, the Irish CFC A (CGFM) is indirectly controlled by a shareholder in South Africa (CIMSA), which holds 100% of the shares in Irish CFC B (CFM (Isle of Man) Ltd). As CFC B holds 100% of the shares in Irish CFC A, the effective indirect shareholding is 100% for CIMSA as depicted in Figure 3 below.

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[41] Interpretation Note no. 6, 2015, Resident – Place of Effective Management (companies).

[42] ibid.

[43] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023, Page 9.

[44] Section 9D(1) of the Income Tax Act, No. 58 of 1962.

[45] ibid.

[46] ibid.

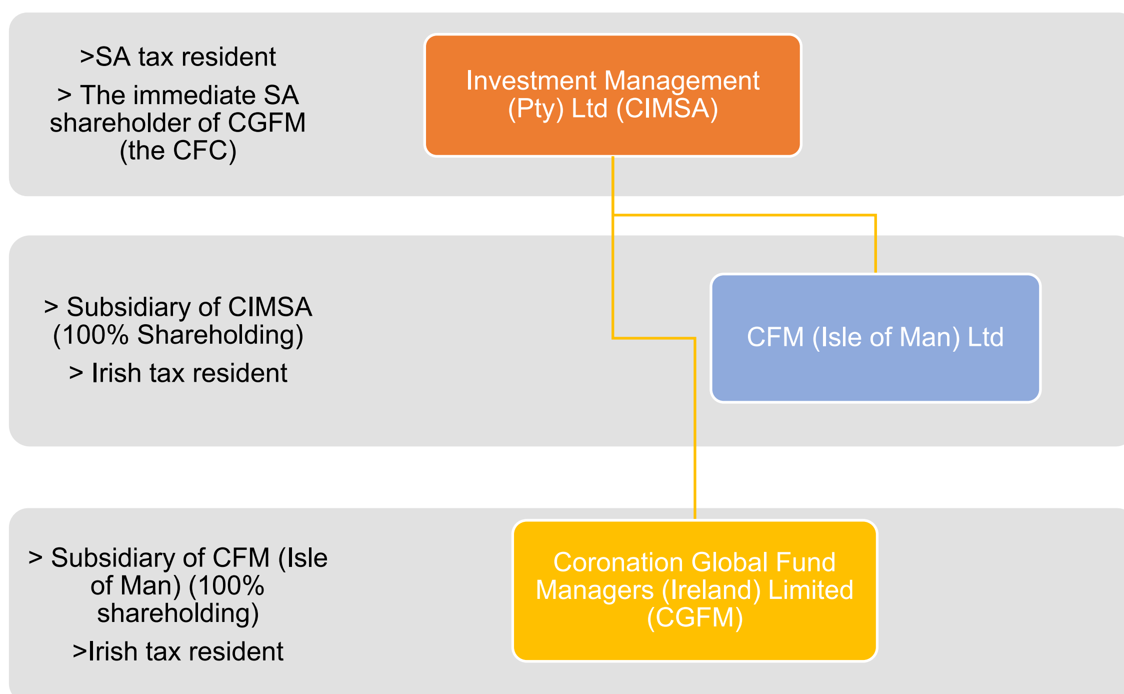
[47] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 3.

[48] ibid.

[49] ibid.

[50] Section 9D(1) of the Income Tax Act, No. 58 of 1962.

Figure 3: Coronation Group – Indirect shareholding



Source: The Group Structure is self-generated using data from the Coronation case

Section 9D(1) of the ITA provides an exclusion for South African shareholders holding not more than 5% of the participation or voting rights in a company abroad, including shares held through a listed company or collective investment schemes. These shareholders are considered foreign persons, and consequently, the company abroad does not meet the CFC definition.[51] This exclusion aims to mitigate the administrative burden associated with tracking small shareholdings in large foreign companies.[52]

The 5% exclusion, however, does not apply if all shareholders holding 5% or less of participation or voting rights are connected persons and their combined shareholding exceeds 50%.[53] In such cases, the company abroad will be classified as a CFC to prevent groups of economically connected parties from exploiting the 5% exemption.[54]

Section 9D(1) of the ITA also recognizes a non-resident company as a CFC if it is controlled by a South African shareholder according to the control requirements of IFRS 10 and is thus

[51] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 5.
[52] ibid.
[53] Section 9D(1) of the Income Tax Act No. 58 of 1962.
[54] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 5.

consolidated as a subsidiary in the shareholder of South Africa's financial statements. This provision excludes headquarter companies.[55]

The consolidated financial statements display the financial position and performance of both the parent company and its subsidiaries as one cohesive economic unit.[56] Control under IFRS 10 is typically achieved through holding rights that confer the power to direct business activities significantly affecting the subsidiary's earnings.[57] Therefore, the parent company oversees the decisions pertaining to the assets and risks that result in profit generation.

The above definition grants residents the right to engage in the share capital, share premium, current year profits, retained income, or other reserves of the CFC, either directly or indirectly.[58] This right encompasses participation in the income of the CFC.[59] It is suggested that if residents do not hold more than 50% of the shareholding but have the right to appoint the company's directors, the company may still be a CFC, depending on the interpretation of the term 'participate ... indirectly'.[60] Voting rights, as described by Olivier and Honiball (2011), refer to shareholders' authority over the allocation of income or capital.[61] Consequently, participation rights enable the resident to benefit from the dividends declared by the CFC.

If a company is identified to be a CFC then the South African shareholder needs to incorporate a share of the CFC's net profits into their taxable income.[62] According to section 9D(2) of the ITA, the attribution rules for net income to the shareholder of South Africa commence from the date the non-resident company first meets the definition of a CFC and end on the day the company ceases to qualify as a CFC. The net profits attributable to the shareholder of South Africa is determined based on the CFC's year of assessment and is apportioned either based on the number of days the company was a CFC or on the actual net income earned during the period the company qualified as a CFC.[63] The income added to the taxable income of the South African shareholder corresponds to the CFC income earned during the resident's year of assessment.[64] The net profit is apportioned based on the South African shareholding.

Section 9D(2) of the ITA requires that the South African shareholder who holds over 50% of the shares or voting rights in a CFC must incorporate a proportional share of the CFC's profit

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[55] Section 9D(1) of the Income Tax Act No. 58 of 1962.
[56] Explanatory Memorandum of the Taxation Laws Amendment Bill, 2017, Page 76.
[57] ibid.
[58] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[59] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[60] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[61] Olivier & Honiball, 2011, International Tax: A South African Perspective, 5th ed, Page 568.
[62] Section 9D(2) of the Income Tax Act No. 58 of 1962.
[63] ibid.
[64] ibid.

into their taxable income. There are certain exemptions, with the key exemption being the FBE exemption.[65] This key exemption is explored later in chapter 4. Apart from the FBE exemption, section 9D(2A) of the ITA stipulates that the apportionment of net profit to a resident shareholder does not apply if the resident, together with a related party, holds below 10% of the equity interests. Consequently, the resident shareholder is not liable for any additional tax related to the CFC's net profit.

The 10% rule is assessed on the final day of the CFC's tax period, or on the final day the non-resident company was a CFC if it ceased to be one during the year.[66] Therefore, a resident who individually own less than 10% of the voting rights or participation rights, but collectively holds more than 10% with connected persons, would still need to add an amount in its taxable income in respect of its participation rights.[67]

2.3 The UK's CFC rules.

CFC rules were introduced in the UK in 1984.[68] In 2012, the UK government introduced significant updates to these rules.[69] To understand the motivations behind these changes, it is essential to examine the previous regime, outlined below.

The old CFC rules were encapsulated in the Income and Corporation Taxes Act 1988 (ICTA). According to section 747 of the ICTA, a CFC was described as a non-resident company controlled by the UK shareholders and was subjected to reduced tax rates in its jurisdiction during the financial year. The primary aim of the old CFC rules was to combat tax avoidance by preventing UK resident companies from transferring taxable profits to their CFCs situated in jurisdictions with lower tax levels.[70]

An essential aspect of the previous CFC regime was section 749 within the ICTA. Section 749 of the ICTA specified that a non-UK company was one with its domicile, residence, or 'place of effective management' outside the UK. The 'place of effective management' was defined as the location where the company's directors and management discussed and finalised the operational and control decisions.[71] Thus, a company was considered non-resident if its

[65] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.43.
[66] ibid.
[67] ibid.
[68] Duenas, 2019, CFC Rules Around the World, page 25.
[69] ibid.
[70] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 2 May 2006, paragraph 2.
[71] Viviers, 2014, An Analysis of the South African Controlled Foreign Company Regime in Light of Amendments in the United Kingdom, Page 14.

controlling board of directors operated outside the UK.[72] The analysis aligned with section 749(2) of the ICTA, where the 'place of effective management' was considered synonymous with the company's residency.

Upon determining that the CFC was a non-resident company, it became crucial to pinpoint the specific business establishment within the CFC's jurisdiction responsible for generating income from the CFC's core functions.[73] Paragraph 7(1) of Schedule 25 of the ICTA defined a business establishment as premises that were occupied and used, or intended to be utilised, with some degree of permanence from which the operations of the CFC were wholly or substantially conducted. The location of these premises had to be within the jurisdiction where the CFC was considered a tax resident.[74] Premises could include an 'office, shop, factory, or other buildings or parts of buildings', as well as a 'mine, oil or gas well, quarry, or any other place of extraction of natural resources'.[75] Additionally, 'a building site or the site of a construction or installation project' was considered a business establishment, provided the project duration was at least 12 months.[76]

The old CFC rules required that the non-resident company be controlled by UK shareholders. The UK shareholder was defined as a resident of the UK, meaning a shareholder domiciled, resident, or having its 'place of effective management' in the UK, according to section 749 of the ICTA. Control was typically assessed based on the ownership of shares, voting powers, and the ability to influence key financial and operational decisions.[77] Control could be manifested through various rights:[78]

- Ownership or entitlement to acquire the shares or voting powers of the company abroad.
- The right or entitlement to receive dividends from the company abroad.
- The entitlement to obtain (either directly or indirectly) the earnings or possessions of the company abroad, encompassing both present and future earnings and possessions.
- Control of the company abroad, either alone or in conjunction with other shareholders.

[72] This is consistent with Lord Loreburn's speech in De Beers Consolidated Mines Ltd v Howe, 5TC213, which ruled that De Beers was the UK resident as the board of directors exercised their powers in the UK. Source: HMRC, 2016, Company residence: the case law rule - central management and control, INTM120060.
[73] OECD (2015), Designing effective controlled foreign company rules, Action 3 – 2015 Final Report, page 48.
[74] Paragraph 7(1) of schedule 25 of the ICTA.
[75] ibid.
[76] ibid.
[77] Section 749(5) of ICTA.
[78] ibid.

This control mechanism was designed to ensure that companies genuinely managed from the UK, but utilizing foreign tax benefits, would still be subject to UK taxation on their diverted profits. Section 416 of the ICTA specified that a UK shareholder was deemed to control a non-resident company if they could exercise or have the right to exercise control over the affairs of that company. This control was typically demonstrated by holding or being entitled to:

- The greater part of the shares or voting power in the non-UK company.
- A greater part of the distributable profit of the non-UK company.
- A greater part of the distributable assets of the non-UK company upon liquidation.

While section 416 of the ICTA did not define 'greater part' in precise percentage terms, it is generally assumed to be more than 50%.[79]

A critical component of the old CFC definition was that the non-resident company had to be taxed at rates significantly lower than those in the UK.[80] The objective of this aspect was to deter tax avoidance tactics that involved transferring profits to jurisdictions with lower tax rates, thus weakening the tax revenue of the UK. Section 450 of the ICTA stated that a non-UK company was identified to be deemed to face a reduced tax burden if it paid taxes on its profits at a rate less than 50% of the equivalent UK tax on those profits.

A non-UK company was considered a CFC once the above three discussed requirements were met, namely non-resident company, control by UK shareholders, lower tax rates. The UK shareholder was then required to include the net taxable profit of the CFC into their own taxable income. Section 747 of the ICTA exempted the UK shareholder from including the CFC's attributable profit if they held less than 10% rights in the non-UK company.

Section 748 of the ICTA provided exemptions for foreign companies involved in certain operational activities. Part 11 of Schedule 25 of ICTA exempted the income of a CFC if the following conditions were met throughout the relevant accounting period:

- The CFC was resident in a jurisdiction where it was subject to a lower tax level.
- The business operations of the CFC were effectively managed in that country for the entire accounting year.
- The CFC operated a business entity in the overseas jurisdiction where it was domiciled.
- The trading operations were managed in the foreign country for the entire accounting period.

[79] Viviers, 2014, An Analysis of the South African Controlled Foreign Company Regime in Light of Amendments in the United Kingdom, Page 14.
[80] Section 450 of ICTA.

- The primary operations of the CFC did not involve investment business or dealing with goods for delivery to or from the UK, or to or from UK related parties.
- If the CFC's primary business was wholesale, distribution, or financial services, less than half of its net profit was derived from related parties either directly or indirectly.
- The parent company earned at least 90% of its net profits from its subsidiaries, which were all residents of the same foreign country and involved in exempt activities.
- The parent company earned at least 90% of its net profits from its subsidiaries, which might not all be residents of the same foreign country but were involved in exempt activities.

The above CFC rules indicate that a non-resident company was targeted if it paid lower tax levels abroad without assessing the business rationale for its establishment in that foreign country. This definition risked taxing a CFC with a legitimate economic presence abroad.

The exemption for CFCs engaged in trading activities aimed to mitigate this risk by excluding active trading income from taxation. Nevertheless, these exemptions did not sufficiently address the risks of taxing active income justified by substantial economic reasons. The two major difficulties associated with the old UK CFC regime are discussed below.

2.3.1 Shifting of the tax base by multinational companies

Multinational companies shifted their tax headquarters from the UK to other countries as a result of the stringent CFC rules.[81] For instance, Ferguson plc (formerly Wolseley plc), the world's largest supplier of plumbing and heating products, announced in 2010 its plans to move its tax base to Switzerland, citing unfavourable CFC rules in the UK as the primary reason.[82] Despite 81% of Wolseley's revenue coming from outside the UK, the UK CFC rules taxed the company, prompting its relocation.[83]

Wolseley joined other UK multinational companies that had already left the UK tax base. British business media group Informa moved its tax base to Switzerland earlier in 2010, while insurance company Beazley plc, advertising group WPP plc, pharmaceutical company Shire plc, and media group UBM plc relocated their tax bases to Ireland as well.[84] The exodus of these companies highlighted how ineffective the old CFC rules were in protecting the tax base of the UK, emphasizing the need for reform.

[81] The Irish Times, 2010, Wolseley plans Swiss Tax Status.
[82] ibid.
[83] ibid.
[84] ibid.

The judgment in the Cadbury Schweppes case further accentuated the inadequacies of the old UK CFC regulations.

2.3.2 The Cadbury Schweppes case findings against the old UK CFC rules

The 2012 revision of the CFC rules was also influenced by the judgment in the Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 12 September 2006 (hereafter referred to as the Cadbury Schweppes case). This judgment was based on the 'principles of freedom of establishment' (FOE). The European Union (EU) FOE treaty ensures that economic entities can pursue activities in any member state without impediments,[85] and it opposes the creation of wholly artificial arrangements lacking economic reality aimed at tax avoidance.[86] The FOE principles protect UK CFCs engaging in genuine economic activities in another EU state, even if these activities result in lower taxes for the CFC outside the UK.[87] Consequently, all EU member states, including the UK, must design their CFC rules in compliance with these principles.[88]

In the Cadbury Schweppes case, the central issue was whether the UK motive test, an anti-diversion rule within the UK CFC regulations, could be enforced on a UK holding company with a CFC operating in a low-tax jurisdiction.[89] The motive test examined whether transactions resulting in the annual profits for the CFC reduced the UK's tax liability compared to what it would have been without the CFC transaction.[90] The UK resident company had to demonstrate that the primary objective of these transactions was not to lower UK tax liabilities by shifting profits generated in the UK.[91]

Cadbury Schweppes plc (CS), a company based in the United Kingdom, served as the parent company of the Cadbury Schweppes Group, which encompassed subsidiaries in the UK, as well as in other EU member states like Ireland, and in third countries.[92] The group consisted of two subsidiaries located in Ireland, namely Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI).[93] These subsidiaries were indirectly

[85] Duenas, 2019, CFC Rules Around the World, page 14.
[86] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.
[87] ibid.
[88] Duenas, 2019, CFC Rules Around the World, page 14.
[89] ibid.
[90] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.
[91] ibid.
[92] ibid.
[93] ibid.

owned by CS through a series of subsidiaries led by Cadbury Schweppes Overseas Ltd (CSO).[94]

The two Irish subsidiaries engaged in treasury activities, raising finance and providing it to other companies in the group as part of their active business operations.[95] These activities were taxed at a 10% rate in Ireland, significantly lower than the UK tax levels.[96] The UK Special Commissioners determined that the act of setting up companies in different member states with the sole purpose of taking advantage of a more favourable tax system was deemed a misuse of the principles outlined in the FOE treaty.[97]

The European Court of Justice (ECJ) ruled that the FOE must be construed in such a way as to prevent the resident shareholder (the UK) from including in the tax base the net profits generated by a CFC abroad (Ireland) if these net profits were taxed at a lower rate than in the UK.[98] This exclusion applied unless such profits arose solely from purely artificial arrangements designed to evade national tax normally payable in the UK.[99] Therefore, the CFC rules could not be enforced if it could be proven, through verifiable and concrete evidence, that even though tax considerations were present, the CFC was established in Ireland and conducted legitimate business operations in the country.[100]

From the above, it is evident that both the FOE principles and the ECJ opposed the UK's CFC rules. Consequently, the revised CFC rules, known as the CFC gateway, were introduced, effective from 1 January 2013.[101]

The 2012 reforms to the UK's CFC rules were driven by the need to address deficiencies and loopholes in the previous regime. The old CFC rules, while effective in certain respects, required modernization to cope with evolving international tax planning strategies. By examining the old regime, it becomes clear that the key elements—non-residency, control by UK shareholders, and lower foreign tax rates—were foundational in the UK's efforts to curb tax avoidance. These principles continue to inform the contemporary CFC framework, albeit with refined mechanisms to ensure greater efficacy and fairness in the global tax framework.

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[94] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.
[95] ibid.
[96] ibid.
[97] Duenas, 2019, CFC Rules Around the World, page 14.
[98] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.
[99] ibid.
[100] ibid.
[101] HMRM, 2016, Controlled Foreign Companies.

2.4. UK's new CFC rules

According to the latest UK CFC regulations, a CFC is a non-UK resident entity subject to control by a UK resident individual or individuals.[102] According to section 749 of the ICTA, a non-resident entity is defined as a company whose domicile, residence, or 'place of effective management' lies outside the UK. The assessment of the 'place of effective management' is contingent upon where the directors discuss and finalise operational and control decisions.[103] Consequently, if the controlling board operates outside the UK, the company is classified as a non-UK resident, while the UK resident individual is one whose domicile, residence, or 'place of effective management' is within the UK.

Control, as defined in the CFC definition, is ascertained through various criteria encompassing legal control (ownership of shares or voting power), economic control (right to a majority of the profits or right to dispose of more than 50% of the shares), or accounting control (parenting the company for financial purposes according to UK accounting standards, typically indicating a 50% shareholding).[104]

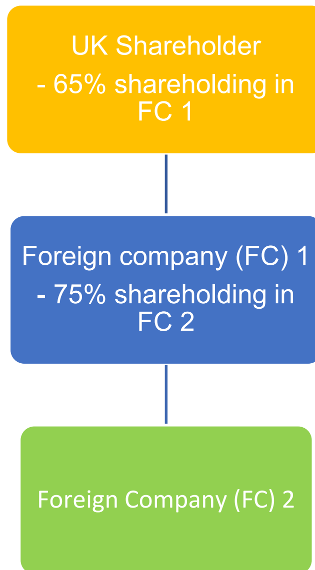
The aforementioned types of control, elucidated in Chapter 18 of Schedule 20 of the Finance Act, 2012 (FA), are delineated in section 371RB as follows:

- The UK shareholder exercises control over a non-resident company if the shareholder owns more than half of the ordinary shares or voting powers of the non-UK company, either directly or indirectly. This shareholding must grant the UK shareholder entitlement to the assets, equity (inclusive of undistributed income), and distributions of the non-UK company.
- The UK shareholder controls a non-UK company through powers conferred by the Memorandum of Incorporation (MOI).

The indirect shareholding as indicated above in the first instance is illustrated in Figure 4 below.

Figure 4: Diagram of indirect shareholding

[102] Finance Act 2012, Schedule 20, Controlled foreign companies and foreign permanent establishments, section 371AA(3).
[103] Viviers, J.A., 2014, An Analysis of the South African Controlled Foreign Company Regime in Light of Amendments in the United Kingdom, Page 14.
[104] Duenas, S., 2019, CFC Rules Around the World, page 25.



Source: Adopted from HMRC International Manual (2016).

In Figure 4 it can be seen that the UK shareholder's direct shareholding of 65% in FC 1, coupled with FC 1's 75% direct shareholding in FC 2, emphasises the UK shareholder's indirect control over FC 2.[105] This assertion stems from the fact that the UK shareholder directly controls FC 1 through a majority shareholding of 65%, thereby indirectly exerting control over FC 2 via its direct control of FC 1.[106] The rationale behind this indirect control lies in the eventual benefits the UK shareholder stands to gain from the profits of FC 2, which are anticipated to be distributed to FC 1 in the future.[107]

These scenarios grant the UK shareholder the authority to dictate the conduct of the non-resident company's business affairs according to its preferences, thereby designating the non-resident company as a CFC.

Economic control, as outlined in section 371RB(2) of the FA, posits that the UK shareholder holds economic control over a non-UK company if it is reasonable to expect that the UK shareholder will secure the majority share of one or more of the following elements, either directly or indirectly:

- Revenue generated from the sale of shares owned by the non-UK corporation.
- Benefit from the allocation of the non-UK company's earnings.
- Assets of the non-resident company upon liquidation, derived from assets available for distribution.

[105] HMRC, 2016, Controlled Foreign Companies, Legal and Economic Control, INTM236225.
[106] ibid.
[107] Delaney & Murray, 2012, Tolley's Tax Digest: The New Controlled Foreign Companies Regime, Page 3.

The principles governing indirect control under this section align with those elucidated in section 371RB of the FA, the legal control segment. The 40% rule in section 371RC of the FA recognizes situations where joint shareholders control the non-resident company, with one joint controller being the UK shareholder and the others non-UK shareholders, typically in joint venture arrangements. The UK shareholder attains control over the non-resident company if the following criteria are met:

- The joint controllers, comprising the UK shareholder and non-UK shareholders, collectively control the non-resident company.
- The UK shareholder, as a joint controller, controls a minimum of 40% of the shares or rights in the non-resident company.
- The joint non-UK shareholder controls a minimum of 40%, but not exceeding 55% of the shares or rights in the non-resident corporation.

The aforementioned criteria endow the UK shareholder with the authority to ensure that the non-resident company's business operations align with the shareholder's intentions. The 40% threshold indicates the extent of legal (shareholding/rights/powers) or economic control.[108]

The supplementary provision in section 371RD of the FA states that the UK shareholder is vested with various rights and powers (legal and economic) and assumes control over the non-resident company. These rights and powers include:

- Rights that the UK shareholder may acquire in the future or will be eligible to acquire.
- Rights held by or through nominees and similar entities (obtained on behalf of, under the direction of, or for the benefit of the shareholder in the UK).
- Rights and powers held by connected persons of the UK shareholder, provided that these connected persons are also UK residents. Section 1122 of the Corporation Tax Act[109] establishes that a UK shareholder is connected with another UK resident if the UK shareholder exercises control over the UK resident.

Section 371RE of the FA states that control must be determined by reference to accounting standards. According to section 371RE of the FA, the UK shareholder controls the non-resident company if the UK shareholder serves as the parent company and has the authority to consolidate the non-resident company (subsidiary) in accordance with Financial Reporting Standards (FRS). FRS 102 specifies that control involves the authority to oversee the financial and operational strategies of the organization in order to gain advantages from its commercial

[108] HMRC, 2016, Controlled Foreign Companies, Legal and Economic Control, INTM236275.
[109] United Kingdom, 1988. Income and Corporation Taxes Act 1988.

operations.[110] Control is established when the UK shareholder has the right to receive a minimum of 50% of the taxable profits generated by the non-UK company, allowing them to enjoy the advantages of its assets and earnings.

Under the UK rules, the UK shareholder is deemed related to the CFC if they hold at least a 25% shareholding in the CFC, entitling them to a minimum of 25% of the CFC's taxable profits.[111] A 25% shareholding classifies the UK shareholder as a related party of the CFC, granting entitlement to the CFC's chargeable profits.[112] Thus, no allocation of CFC profit occurs if the UK shareholder holds less than a 25% shareholding.

In summary, the CFC definitions necessitate at least a 50% shareholding or rights held by the UK shareholder(s), enabling them to benefit from the profits and additional value generated by the CFC. These benefits are subject to inclusion in the taxable income of the UK shareholder if they own a minimum of 25% interest in the CFC. Notably, the main distinction between this new CFC regime and the old regime lies in the fact that the former targets only the chargeable profits of the CFC if profits are thought to have been purposely moved out of the UK tax jurisdiction, rather than all profits.[113]

2.5 The USA's CFC rules

The USA adopted its first CFC rules in 1962.[114] The primary objective of these rules, known as Subpart F, was to tax most types of passive income and certain types of active business profit that could be easily diverted to tax havens.[115] A 2000 U.S. policy study reiterated this goal, emphasizing the importance of enhancing economic efficiency through measures aimed at preventing U.S. companies from diverting profit to foreign tax havens.[116]

Arnold & McIntyre (2002) argued that the CFC rules are highly controversial, a sentiment echoed by USA-based multinationals who claim that these rules do not promote a competitive advantage.[117] Conversely, the USA Treasury contends that the CFC rules enhance international competitiveness, as evidenced by the 2000 US study.[118]

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[110] The Financial Reporting Standard, 2022, FRS 102, section 9.4.
[111] Finance Act 2012, Schedule 20, Controlled foreign Companies and Foreign Permanent Establishments, section 371VF.
[112] ibid.
[113] Beebeejaun, 2023, An Analysis of Controlled Foreign Company (CFC) Rules of Mauritius; a Comparative Study with the UK and US, Page 594.
[114] Arnold & McIntyre, 2002, International Tax Primer, Page 88.
[115] ibid.
[116] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000, Page 53.
[117] Arnold & McIntyre, 2002, International Tax Primer.
[118] ibid.

Section 957(a) of the Internal Revenue Code of 1986 (IRC) outlines that a CFC is characterized by US shareholders owning over 50% of the total voting power of all stock classes eligible to vote, or over 50% of the total value of the corporation's stock on any given day within the taxable year. Stock, as defined in section 958(a)(3) of the IRC, encompasses any certificate conferring voting rights to the holder in the non-resident company. According to section 7701(a)(30) of the IRC, a US shareholder is classified as a US person, encompassing US citizens or residents, as well as domestic companies. A domestic company is a business entity established or incorporated in the USA or under the jurisdiction of US laws, as specified in section 7701(a) of the IRC.

According to section 951(b) of the IRC, a US shareholder is required to possess a minimum of 10% of the combined voting power of all voting classes of stock in the foreign corporation, or a minimum of 10% of the overall value of shares of all classes of stock in the foreign corporation. This implies that a US shareholder is considered a US shareholder under the definition of a CFC if they own a minimum of 10% of the stock of the foreign corporation.

2.6 Ireland's CFC rules

Ireland employs a residence-based tax system.[119] The Irish CFC regulations were implemented starting on 1 January 2019 with the aim of stopping the deliberate shifting of profits from Irish investors to foreign companies located in jurisdictions with low or no tax rates.[120]

The CFC rules operate by assigning the untaxed profits of CFCs, which result from artificial arrangements set up mainly to evade taxes, to the controlling company domiciled in Ireland or to a related company in Ireland.[121] The attribution takes place when the parent company or an affiliated company engages in significant Irish operations, including making active decisions related to the assets and risks of the CFC, within Ireland.[122]

Arrangements involving relevant Irish activities conducted at arm's length or falling under the transfer pricing regime are exempt from the CFC rules.[123] These regulations, deemed intricate, were implemented on January 1st, 2019.[124]

Section 835I of the Taxes Consolidation Act,1997 (TCA) outlines that a CFC is a non-Irish company under the control of Irish resident company or companies. Section 835M(1) of the

[119] Irish tax and Customs, Tax residence, 2023.
[120] Tax and Duty Manual, Controlled Foreign Company Rules, 2023, Page 6.
[121] ibid.
[122] ibid.
[123] ibid.
[124] Smith, Finn, & Douglas, 2019, The importance of significant people functions in the context of CFCs and profit attribution.

TCA states that a CFC is a non-resident if it is liable to pay taxes in a foreign jurisdiction based on factors such as domicile, residency, or 'place of management'. The 'place of management' refers to the 'place of effective management' of the CFC, as specified in section 835M(2) of the TCA.

An Irish tax resident company is deemed to have control over a CFC if it possesses direct or indirect control, the ability to exercise control, or the right to exercise control over the company's affairs, in accordance with section 835J(1) of the TCA. Based on these criteria, a corporation that is a tax resident in Ireland is considered to have control over the CFC if it possesses, or has the right to obtain greater part of:

- The shares of the CFC, or the voting power in the CFC.
- Such part of the shares of the CFC that entitles the company to the significant part of the distributable profits of the CFC.
- Rights that, upon the winding up of the CFC, would allow the company to claim the majority of the CFC's distributable assets.
- Through ownership of shares in the CFC, one has the power to determine the members of the CFC's board of directors.

The aforementioned requirements stipulate that control of a CFC necessitates the acquisition of a 'greater part' of its shares or voting rights. Specifically, 'greater part' implies an acquisition exceeding 50%.[125]

Accordingly, an Irish corporation is considered to exercise authority over a CFC if it holds over 50% of the CFC's issued share capital, voting rights, or distribution amounts, either directly or indirectly.[126] Furthermore, control also encompasses the capacity to impact the makeup of the CFC's board of directors.[127]

2.7 Conclusion

Table 1 summarises the similarities and differences in the definitions of the CFC in the RSA, the UK, the USA and Ireland.

Table 1: Comparison of definitions of CFCs in selected countries

[125] Notes for Guidance - Taxes Consolidation Act 1997 - Finance Act 2023 Edition - Part 35B, December 2023, page 6.
[126] Tax and Duty Manual, Controlled Foreign Company Rules, 2023, Page 6.
[127] Smith, Finn, & Douglas, 2019, The importance of significant people functions in the context of CFCs and profit attribution.

Title	RSA	The UK (revised CFC rules)	The USA	Ireland
CFC definition	• Non-resident company • Control: > 50% total participation rights (share capital) or voting rights • Control: entitlement to more than 50% undistributed profits or capital • Control: accounting (IFRS 10) definition of a control • 5% shareholding exclusion	• Non-resident company • Legal control: > 50% holding of shares or voting powers. • Economic control: > 50% entitlement to assets or profits • Joint control: >40% shareholding • Control: accounting (FRS 102) definition of a control • 25% shareholding exclusion	• Foreign corporation • Control: >50% of voting powers or stock • 10% shareholding exclusion	• Non-resident company • Controlled by (a) company(s) • Control affairs of the non-resident company. • Control: >50% of share capital/profits or distributable assets. • Control: control the composition of the board

Source: The table is self-generated using data from the CFC legislations of SA, the UK, the USA and Ireland.

Based on the characteristics of CFC definitions across various countries, it is evident that key attributes are fairly similar. These similarities are outlined as follows:

First, the definition of a CFC is traditionally satisfied when the resident shareholder of a particular country controls the non-resident company or corporation by holding over 50% of the shares or voting power. Section 9D of the ITA also adheres to these principles, indicating a consistency in defining control across jurisdictions.

Secondly, the criteria for non-resident companies are consistent among all the countries surveyed. Section 9D of the ITA aligns with the core requirements through the assessment of tax residency, incorporation, establishment, or formation of the company, as well as its place of effective management beyond the borders of the RSA.

When it comes to control, the UK provides more options and detailed guidance, followed by Ireland. Nevertheless, the essence of control criteria is fairly similar across all countries, emphasizing the resident shareholder's capacity to oversee the operations of the foreign company that produces profit. Section 9D's control criteria are fair and consistent with international standards, linking control to shareholders who can influence the non-resident company's returns.

South Africa's threshold for excluding shareholders in the CFC definition, however, appears extremely low at 5% shareholding, compared to 10% in the US and 25% in the UK, with Ireland not having a similar requirement. This conservative threshold in section 9D of the ITA creates an additional administrative burden and is not aligned with international norms. It is advisable

for the National Treasury to reassess this requirement, considering raising it to at least 10% after evaluating the costs and benefits for taxpayers.

In summary, the fundamentals of CFC definitions are fairly similar across countries, except for the shareholder exclusion threshold in section 9D of the ITA, which is more conservative. Addressing this discrepancy could streamline administrative processes and align South Africa's regulations with international norms.

The next chapter will examine whether section 9D of the ITA aligns with international standards concerning the targeted income and assess any potential risks of section 9D targeting income from genuine trading activities.

Chapter 3: An evaluation of section 9D(9A)'s targeted income and the CFC rules of comparable countries.

3.1 Introduction

After establishing that a non-resident company is under the control of a tax resident shareholder, as outlined in the preceding chapter, the subsequent task is to evaluate the various forms of income being targeted. This chapter evaluates the targeted income across selected countries to identify gaps or similarities, specifically whether the targeted income under section 9D of the Income Tax Act, No. 58 of 1962 (ITA) arises from genuine trading activities. Attribution rules for targeted income will also be covered.

3.2 Targeted income in South Africa

Section 9D(9A)(a)(i) of the ITA focuses on the earnings of a CFC from its FBE in cases where the earnings result from the direct or indirect sale of inventories to a related customer who is a tax resident of the RSA. This income is targeted if the CFC does not primarily trade with independent (unconnected) suppliers and customers. Similarly, section 9D(9A)(a)(iA) of the ITA targets profit generated by a CFC from the sale of inventories to an unconnected South African customer if the inventory sold was initially purchased from a connected South African supplier, no significant value was added to the inventory by the CFC before sale, and the CFC primarily trades with connected suppliers and customers.

Section 9D(9A)(a)(ii) of the ITA targets income derived by the CFC from services rendered directly or indirectly for the advantage of a related party from the RSA if the service is performed in the RSA. These provisions are collectively known as diversionary income clauses.

The following sections address passive income clauses:

- Section 9D(9A)(a)(iii) of the ITA: targets profit arising from financial instruments, unless the CFC is primarily trading in financial instruments as a banker, financial service provider, or insurer, excluding the operations of a treasury department or a captive insurance company.
- Section 9D(9A)(a)(iv) of the ITA: targets profit earned from rental of movable property unless it arises from operating leases or leases that constitute a financial instrument.
- Section 9D(9A)(a)(v) of the ITA: pertains to income generated from the utilization or licensing of intellectual property that originates from the RSA sources or owners, unless it was developed by the CFC. This rule is also relevant for profits made from selling intellectual property as outlined in section 9D(9A)(a)(vi) of the ITA.

By examining these provisions, we can assess whether section 9D of the ITA is consistent with international norms in targeting income that may not arise from genuine trading activities. The subsequent sections will delve into the targeted income for each country, evaluating if Section 9D of the ITA appropriately addresses the risks of targeting trading income from genuine activities.

The provisions set forth in section 9D(9A) of the ITA illustrate that this provision targets income arising from 'passive investment-type income' and 'diversionary income,' referring to business structures vulnerable to transfer pricing breaches.[128] Passive income consists of 'interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, and similar income, as well as associated capital gains'.[129] Olivier and Honiball (2011) have confirmed that passive income is typically generated from structures designed to avoid tax, thus justifying its inclusion in targeted income categories.[130] The specifics of 'diversionary income and passive income' targeted by section 9D(9A) of the ITA are discussed in further detail below.

Although net profit belonging to an FBE is generally exempt under section 9D(9)(b) of the ITA, not all profits attributable to an FBE are excluded, as indicated in section 9D(9A) of the ITA. Certain profits are deemed 'non-genuine' transactions and are known as 'diversionary transactions.'[131] These transactions pertain to passive-type income and dealings with South African residents.[132] Diversionary transactions of a CFC result in tainted profit, which is allocated to the taxable income of the RSA resident, although it can be attributed to an FBE.[133] The types of diversionary income are as follows:

- Sales to Connected Customers: section 9D(9A)(a)(i) of the ITA targets profit from the direct or indirect sale of inventories by the CFC to a related customer who is a resident of the RSA. This applies if the CFC does not primarily trade with independent suppliers and customers.
- Sales Involving South African Suppliers: section 9D(9A)(a)(iA) of the ITA targets profit from sales of goods to an unconnected South African customer when the inventory sold was bought from a connected South African supplier, with no significant value add from the CFC before sale, and the CFC primarily trades with connected suppliers and customers.

[128] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.43.
[129] ibid.
[130] Olivier & Honiball, 2011, International Tax: A South African Perspective, 5th ed, Page 581.
[131] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.47.
[132] Tickle, 2022, Controlled Foreign Corporations and the Future of the Business Establishment Exemption, Page 42.
[133] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.47.

- Services Rendered for Connected Persons: section 9D(9A)(a)(ii) of the ITA targets profit derived by the CFC from services rendered, either directly or indirectly, for the benefit of a related party if these services are performed in the RSA.

Diversionary income is added in the net profit of the CFC as per section 9D(9A)(a)(i) of the ITA if that profit is generated from the trade of inventories by the CFC, either directly or indirectly to any related party who is a resident of the RSA. However, the FBE exemption applies under certain conditions outlined in section 9D(9A)(a)(i) of the ITA.

Sections 9D(9A)(a)(i)(aa) and 9D(9A)(a)(i)(dd) of the ITA state that the FBE exemption is applicable if the CFC purchased inventories or similar items for delivery in its jurisdiction from an unrelated party. This means the CFC bought inventories that are situated in the country of its residence.[134] The specific location of the purchased inventories indicates an economic nexus to the resident jurisdiction, which likely has sufficient infrastructure to manufacture these inventories.[135] Jurisdictions that have advanced infrastructure usually refrain from implementing artificially low tax rates on domestic sales.[136] These indications point towards the CFC engaging in the purchase and resale of inventories at a strategic location for valid business purposes, rather than artificially increasing resale prices for a related South African resident.[137]

Section 9D(9A)(a)(i)(bb) of the ITA allows the FBE exemption when the 'creation, extraction, production, assembly, repair, or improvement of goods undertaken by the CFC involves more than minor assembly or adjustment, packaging, repackaging, and labelling'. Large-scale manufacturing activities usually occur in countries with well-developed infrastructure, where local production is less likely to be taxed at artificially low rates.[138] This indicates that the CFC's location was chosen primarily for non-tax reasons.

Section 9D(9A)(a)(i)(cc) of the ITA provides for the FBE exemption in cases where a CFC sells inventories to a related party of the RSA that are of a comparable nature and price to goods sold to unrelated parties. Factors taken into consideration in this comparison include wholesale and retail sales, volume discounts, and geographical variations like location-specific

[134] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 13.
[135] ibid.
[136] ibid.
[137] ibid.
[138] ibid.

delivery expenses.[139] The CFC's sales to unrelated parties indicate that it maintains a sustainable business presence beyond the borders of the RSA.[140]

Pursuant to section 9D(9A)(a)(iA) of the ITA, any diversionary profit generated from the trade of inventories by the CFC to a non-related party of the RSA is targeted. This provision is applicable if the CFC initially acquired those inventories, or any tangible intermediary inputs, directly or indirectly from one or more related residents.[141] However, the FBE exemption applies under the following conditions outlined in section 9D(9A)(a)(iA) of the ITA.

Section 9D(9A)(a)(iA)(aa) of the ITA grants the FBE exemption if the CFC acquires a minimal amount of materials, parts, or ingredients from affiliated South African residents. CFCs that source most of their sub-components from unrelated parties, rather than from connected party of the RSA, likely possess autonomous additional worth and are organized overseas mainly for business purposes unrelated to taxation.[142]

In accordance with ITA's section 9D(9A)(a)(iA)(bb), the FBE exemption is triggered when the CFC undertakes significant manufacturing activities that extend beyond minor assembly, adjustment, packaging, repackaging, and labelling. The CFC location was primarily chosen for reasons other than tax advantages, as demonstrated by the notable significant manufacturing activities taking place there.[143]

The FBE exemption is activated under sections 9D(9A)(a)(iA)(cc) and 9D(9A)(a)(iA)(dd) of the ITA when the CFC conducts the distribution of its inventories or similar inventories within the CFC's country of origin. This suggests that the CFC's country of residence has an economic link to the relevant consumer market.[144] To qualify for this exemption, two tests must be passed: [145]

- The CFC's sales need to be predominantly to unconnected persons.
- The inventories sold must be physically delivered in the country where the CFC is located; constructive delivery holds no significance.

Section 9D(9A)(a)(ii) of the ITA encompasses diversionary profit as part of the CFC's net profit if the profit is generated from any service provided by the CFC, either directly or indirectly, for

[139] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 13.
[140] ibid.
[141] Section 9D(9A)(a)(iA) of the ITA.
[142] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 14.
[143] ibid.
[144] ibid.
[145] Bennett & Roelofse, 2023, Silke on International Tax, Chapter 3.6.

the advantage of a related resident party. The FBE exemption, however, applies under the following specific circumstances outlined in section 9D(9A)(a)(ii) of the ITA.

Section 9D(9A)(a)(ii)(aa) of the ITA applies the FBE exemption when the CFC's production-related services are conducted abroad and directly relate to the 'creation, extraction, production, assembly, repair, or improvement of goods' utilized abroad. Services related to goods delivered within South Africa are considered diversionary income because there is minimal business rationale for shipping inventories overseas for maintenance and subsequently bringing them back to the RSA.[146]

Sections 9D(9A)(a)(ii)(bb) and 9D(9A)(a)(ii)(cc) of the ITA provide for the FBE exemption if the CFC's selling-related services are carried out outside of the RSA and are specifically connected to the sale or promotion of inventories of a related resident. The merchandise should be sold to individuals not associated with the company for in-person delivery within the CFC's nation of domicile. The exemption is warranted due to the economic connection between the CFC's country of domicile and the pertinent consumer market.[147] In order for the exemption to be valid, the recipients of the CFC's services should be the clients within the CFC's jurisdiction, rather than a South African vendor utilizing the CFC as a representative for marketing or sales purposes.[148]

Section 9D(9A)(a)(ii)(dd) of the ITA applies the FBE exemption when the CFC's services are performed outside South Africa and no deduction is available to the related party of the RSA for the amount paid to the CFC for those services.

The aforementioned clauses suggest that diversionary revenue stems from dealings between a CFC and an affiliated South African resident, with the possibility of price manipulation.[149] The South African tax objective here is to focus on important types of active income, including sales and services, specifically when these CFCs do not have a strong economic connection to the CFC's nation of domicile.[150]

Unless specific exemptions are met, passive income obtained by a CFC is taxable under section 9D(9A) of the ITA. Even if passive income is derived from FBE activities, it does not

[146] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 16.
[147] ibid.
[148] Bennett & Roelofse, 2023, Silke on International Tax, Chapter 3.6.
[149] Olivier & Honiball, 2011, International Tax: A South African Perspective, 5th ed, Page 585.
[150] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.

qualify for the FBE exemption.[151] The reason for this is that passive income does not require active involvement in business activities and does not pose direct competition issues.[152]

The CFC rules are designed to tackle non-authentic transactions that are established to evade tax by focusing on passive income, thereby guaranteeing that this income is taxed in the RSA. This aligns with international norms, as passive income is generally seen as susceptible to tax avoidance strategies, justifying its inclusion in targeted income categories.

Overall, the clauses under section 9D(9A) of the ITA reflect South Africa's efforts to align its CFC rules with international standards while addressing specific national tax avoidance concerns. The targeted passive income including certain exclusions are discussed below.

Section 9D(9A)(a)(iii) of the ITA encompasses profit from financial instruments, including foreign exchange differences, earned by a CFC. Such income is included in the net income, even if its attributable to an FBE, unless the financial instruments are linked to primary trading activities, such as banking, financial services provision, or insurance (this exclude treasury operations or captive insurance).[153] Passive CFC income is exempt under the working capital exemption, which typically applies if tainted financial instrument profit is below 5% of total gross CFC profit attributable to an FBE.[154]

According to section 9D(9A)(a)(iv) of the ITA, any profit generated by a CFC from the rental of movable assets is required to be fully taxed, unless the lease is classified as an operating lease or a financial instrument. The exception for operating leases pertains to legitimate transactions where the CFC (lessor), assumes a considerable amount of the economic risk related to the leased assets.[155] This interpretation is supported by De Koker & Williams (2023).[156]

Royalties and income from intellectual property earned by a CFC are subject to taxation in terms of sections 9D(9A)(a)(v) and (vi) of the ITA unless the CFC actively develops the underlying intellectual property (IP). The exemption is not applicable if the IP is tainted, primarily involving IP that was previously subject to South African taxation.[157] This aligns with the findings of Tickle (2022).[158]

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[151] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.47.
[152] Olivier & Honiball, 2011, International tax: A South African perspective, 5th ed, Page 591.
[153] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.47.
[154] National Treasury's Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013, section 5.4.
[155] National Treasury's Explanatory Memorandum on the Revenue Laws Amendment Bill, 2011, pages 108-109.
[156] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.47.
[157] National Treasury's Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011, Page 108.
[158] Tickle, 2022, Controlled Foreign Corporations and the Future of the Business Establishment Exemption, Page 42.

Insurance premiums received by a CFC are typically subject to taxation under section 9D(9A)(a)(vii) of the ITA. However, the CFC (insurer) is entitled to an exemption if the income is generated from the principal trading activities, except in cases where the insurer acts as a captive insurer.[159]

The requirements outlined in section 9D of the ITA aim to target all forms of tainted income, including passive income and diversionary income, generated by CFCs. This method is consistent with the assertions of Olivier & Honiball (2011), who argue that section 9D of the ITA adopts an entity-based approach, attributing all CFC profits to a South African shareholder.[160] This approach contrasts with a transactional approach, which would attribute only specific tainted income to a South African shareholder.[161]

According to the regulations outlined in section 9D of the ITA, the tainted net profit of a CFC is determined and subsequently incorporated into the taxable income of the shareholders in the RSA.[162] This tainted net income primarily comprises passive income and diversionary income, instances where the CFC lacks substantial real activity.[163]

The ITA's section 9D(2A) offers the guiding framework for calculating a CFC's net profit. This section stipulates that the CFC’s net profit for the year is calculated in accordance with the stipulations outlined in the South African Income Tax Act. This computation treats the CFC as the RSA taxpayer and applies relevant provisions concerning gross income, deductions, and allowances.

Furthermore, section 9D(2A)(b) of the ITA ring-fences assessed losses. Any losses are carried over to the subsequent tax year of the CFC. These assessed losses can be used to offset the profit of the CFC in the following year, as stated in section 20 of the ITA.

In the case of a CFC with a foreign tax year ending in the resident's assessment year, a proportional share of the foreign tax paid by the CFC on its profit is accounted for.[164]

Concerning the computation of net profit, the CFC's net profit is treated as if it were a resident of the RSA.[165] Consequently, the South African shareholder factors in the worldwide profit of the CFC.[166] However, the CFC is entitled to a foreign tax credit under section 6quat of the ITA

[159] National Treasury’s Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011, Pages 107 - 108.
[160] Olivier & Honiball, 2011, International Tax: A South African Perspective, 5th ed, Page 613.
[161] ibid.
[162] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.43.
[163] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[164] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.43.
[165] Olivier, L. & Honiball, M., 2011, International tax: A South African perspective, 5th ed.
[166] ibid.

for taxes already incurred abroad.[167] Once the worldwide taxable income of the CFC is determined, it is added to the taxable income of the South African shareholder who controls the CFC.

3.3 Targeted income in the UK

In the UK, the targeted income under the CFC regulations includes profits that are not exempted and pass through one or more of the charge gateways, primarily governed by Chapter 3 of Schedule 20 of the Finance Act, 2012 (FA).[168]

Chapter 4 of the FA comes into effect when none of the CFC exemptions apply. This chapter specifically targets CFC profits derived from relevant UK activities that facilitated the generation of those profits.[169] Relevant UK activities encompass activities conducted within the UK by the CFC or by connected companies under arrangements suspected of not being at arm's length.[170]

The charge under Chapter 4 of the FA is triggered when the CFC possesses assets or assumes risks under an agreement aimed at reducing or eliminating tax liabilities. Moreover, if the arrangement results in an expectation of increased profitability for the CFC, the CFC charge applies to this case. This provision aims to prevent profit diversion from the UK to tax havens by ensuring that profits generated from UK-related activities are appropriately taxed in the UK.

Under the UK's CFC rules, trading profits are exempt if the CFC can demonstrate its ability to maintain commercial viability without relying on relevant UK activities.[171] This entails conducting transactions with unconnected parties at arm's length while remaining profitable.[172] This exemption provision safeguards legitimate business activities from UK taxation. It applies when the arrangement involving the CFC holding assets or bearing risks is primarily driven by genuine commercial objectives, rather than tax considerations.[173] Moreover, if the active decision-making regarding the asset or risk occurs outside the UK, the trading profit is exempt.[174]

[167] Olivier, L. & Honiball, M., 2011, International Tax: A South African Perspective, 5th ed.
[168] Duenas, 2019, CFC Rules Around the World, page 25.
[169] HMRC, 2016, Controlled Foreign Companies, Chapter 4, INTM200100.
[170] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371CA.
[171] ibid.
[172] ibid.
[173] HMRC, 2016, Controlled Foreign Companies, Chapter 3, INTM197310.
[174] ibid.

Section 371DC of the FA describes UK activities minority exclusion. Assets or risks are excluded if the majority of the CFC's profit is generated by activities mainly performed outside the UK.[175]

The exemption under section 371DD of the FA is applicable when the CFC generates significant economic value, other than UK tax benefits, through holding assets or assuming risks. The economic benefits should be primarily driven by commercial reasons rather than UK tax advantages.

Profits obtained by CFC from agreements that would have been made by unrelated companies are not considered under section 371DE of the FA. Transactions between connected parties that are done at arm's length are excluded.

Section 371DF of the FA states that trading profits are wholly excluded from the Chapter 4 targeted profits if specific criteria are satisfied, which are elaborated upon in Chapter 4 of this research report. In summary, the UK CFC rules target trading income derived from relevant UK activities suspected to lack arm's length transaction status or genuine commercial motivations. However, trading income from legitimate business activities is exempt from taxation.

Under Chapters 5 and 9 of the UK's CFC legislation, non-trading finance profits are subject to taxation. These gains are triggered when CFCs engage in lending activities to other entities within the multinational group or to third parties.[176] Specifically, if the funding for such loans originates from UK capital investment or if key management functions associated with the loans are conducted by UK residents, the profits fall within the scope of the UK CFC rules.[177]

Non-trading finance gains encompass any income other than trading profits, including interest and gains or losses on loans.[178] This chapter aims to target profits derived from the CFC's assets and assumed risks, particularly when significant people functions (SPFs) related to risk assumption or asset ownership occur in the UK.[179] SPFs are delineated as functions requiring active decision-making for the CFC within the context of its business activities.[180]

[175] Section 371DC of the Finance Act.
[176] HMRC, 2016, Controlled Foreign Companies, Chapter 5, INTM203000.
[177] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371EB & 371EC.
[178] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371VG.
[179] HMRC, 2016, Controlled Foreign Companies, Chapter 5, INTM203310.
[180] ibid.

There are three targeted CFC profits which are:[181]

- UK capital investment which encompasses non-trading finance gains resulting from investments of UK funds or assets, constituting returns from UK-related investments.
- Special Arrangements in Lieu of Dividends are arrangements that involve loans from the CFC to the UK to repatriate monies, typically to avoid dividend withholding tax. The focus is on loans lacking commercial rationale.
- This targets CFC profits arising from finance leases granted to UK resident-connected companies or UK permanent establishments of the companies abroad related to the CFC. There must be a valid commercial purpose for opting for a finance lease over other acquisition methods.

In essence, these provisions aim to prevent profit shifting through financial arrangements involving UK assets, management functions, or entities.

Exempt CFC profits pertain to non-trading finance profits incidental to the CFC's trading business activities. This encompasses profits constituting up to a maximum of 5% of trading or property CFC profit, or 5% of the income received from exempt distributions, providing a safe harbour.[182]

The chapter targets income earned by CFCs, such as interest and dividends, derived from relevant UK assets, including investments and active decision-making activities. Additionally, it addresses related-party arrangements, such as CFCs providing loans to UK shareholders instead of dividends lacking commercial purpose. However, incidental income arising from legitimate CFC business activities is exempted.

Chapter 6 of the UK's CFC legislation scrutinizes CFCs with trading finance profits, such as financial trading entities like banks or insurance companies, to assess overcapitalization resulting from contributions from connected UK companies.[183] If overcapitalization leads to trading finance profits, then the profits will be subject to taxation as outlined in Chapter 6, subjecting the UK shareholder to taxation.[184]

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[181] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371EB, 371EC and 371ED.
[182] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371CD.
[183] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371FA.
[184] HMRC, 2016, Controlled Foreign Companies, Chapter 6, INTM207100.

For a CFC's trading finance profits to fall within Chapter 6, two conditions must be met.[185] Firstly, the CFC must hold free capital or assets greater than expected if it were not under the control of other corporations. Secondly, UK-related capital injections must be present. The overcapitalization test discerns whether the CFC retains free capital and/or assets due to external control rather than commercial motives.[186]

A capital contribution linked to the UK, in relation to a CFC, refers to any financial investment made (either directly or indirectly) to the CFC by a UK resident company associated with it, irrespective of whether it includes the issuance of shares or not.[187]

Free capital encompasses share capital (including share premium) and retained profits, and may also encompass interest-free debt, provided it doesn't give rise to loan relationship debits.[188] Free assets, on the other hand, are the surplus amounts of an insurance which are assets over its borrowed capital, representing the equity of the CFC.[189]

This chapter 6 of the UK's CFC legislation addresses the accumulation of excessive equity in CFCs attributable to UK connected capital contributions. However, if such accumulation is justified for commercial (non-tax) purposes, it remains exempt.

According to Chapter 7 of the UK's CFC legislation, a captive insurance company is established to underwrite risks within its group but may also insure risks of the group's customers.[190] The targeted profit arises from activities such as insuring risks that come from a linked UK group company or from UK residents who have acquired inventories or services from a UK company associated with the captive.[191]

The CFC rules target captive insurance activities lacking commercial justification, formulated to attain tax benefits.[192] These include tax deductions for UK insured companies on premiums paid to the CFC and the likelihood of minimal or low taxation on premium income and investment returns in the CFC's jurisdiction.[193]

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[185] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371FA.
[186] HMRC, 2016, Controlled Foreign Companies, Chapter 6, INTM207200.
[187] HMRC, 2016, Controlled Foreign Companies, Part 9A, INTM248100.
[188] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371FA.
[189] ibid.
[190] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371GA.
[191] HMRC, 2016, Controlled Foreign Companies, Chapter 7, INTM210100.
[192] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371GA.
[193] HMRC, 2016, Controlled Foreign Companies, Chapter 7, INTM210100.

This chapter 7 focuses on profits from insuring UK-originating risks suspected to lack commercial justification. However, profits from genuine commercial activities are exempt if the contract of insurance arrangement lacks significant UK non-tax reasons.

Solo consolidation, as contained in Chapter 8, permits a UK bank to treat an unregulated CFC as an integral part of the bank, subject to meeting the criteria outlined in the Financial Services Authority Handbook.[194] This provision offers a significant incentive for a UK bank to invest capital in a CFC situated in a jurisdiction with low tax rates, provided it secures approval for solo consolidation. Under this arrangement, the CFC conducts banking operations without incurring borrowing costs, leading to disproportionately large profits.[195] Conversely, the UK bank assumes all borrowing costs for both its UK and non-UK (CFC) banking operations. Consequently, solo consolidation of a CFC could substantially diminish the profitability of the UK bank without impacting the profitability of the combined entity.[196]

Chapter 8 aims to address the excessive profits generated by a CFC through solo consolidation by comparing the profits generated within the solo consolidation framework with the profits that would have been generated if the CFC operated as a standalone bank (i.e., by paying for its borrowing costs). If the primary motive behind the solo consolidation arrangement is to secure a tax advantage, the excess profit derived will be taxed within the UK.

The determination of the CFC's net profit hinges on the profits that traverse through the CFC gateway. The procedure includes implementing various charge gateways on various profit types, especially those that are not exempted under UK CFC rules (exemptions specified in chapters 10 - 14).[197] These gateways serve as filters to ascertain which profits are liable to taxation.[198] Chapters 4 – 9 elucidate how these gateways can restrict or nullify the use of CFC rules, as discussed above within the confines of targeted income.

A corporation considered a resident of the UK and possessing a significant stake in the CFC meets the criteria to be classified as a chargeable corporation.[199] In case a UK resident holds

[194] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371HA.
[195] HMRC, 2016, Controlled Foreign Companies, Chapter 8, INTM213100.
[196] ibid.
[197] Duenas, 2019, CFC Rules Around the World, page 25.
[198] ibid.
[199] ibid.

a minimum of 25% of shares, rights, and powers in the CFC, they will be liable to pay taxes on the CFC profits that pass the gateways test.[200]

3.4 Targeted income in the USA

Section 952(a) of the Internal Revenue Code, 1986 (IRC) delineates various categories of tainted income subject to scrutiny. The types of income encompass insurance income, foreign base company income, income related to international boycotts, income from illegal payments like bribes or kickbacks, and income from countries with denied foreign tax credits.[201] Additionally, section 956 of the IRC encompasses profits from property investments of the USA. This segment, known as Subpart F income, warrants detailed examination.

Section 952(b) of the IRC exempts income sourced within the USA, provided it is essentially associated with the conduct of a trade or business within the USA, unless it falls under a tax exemption or reduced tax rate as per obligations outlined in a treaty with the USA.

Section 953 of the IRC pertains to insurance income involving related persons. This encompasses income from insurance or reinsurance policies where the insured party is either a US shareholder in the CFC or a connected party to such a shareholder, with the USA shareholder holding a minimum of 20% of the CFC shares, as stipulated by section 953(c)(3) of the IRC.

The provisions for foreign base company income are contained in section 954 of the IRC. Subpart F's foreign base company income rules aim to address tax haven arrangements devised to evade the USA or foreign country taxes by exploiting various foreign tax systems.[202] This income comprises three categories: 'foreign personal holding company income (FPHCI), foreign base company sales income (FBCSI), and foreign base company services income (FBCS).'[203]

The provisions for FPHCI are contained in section 954 of the IRC. FPHCI includes interest, dividends, rents, royalties, profits from property sales that generate passive income or are held for investment, profits from commodities and foreign currency transactions, and other similar sources of income.[204] Owing to its passive nature, FPHCI is highly mobile and susceptible to redirection.[205] However, certain types of investment income are not considered FPHCI, including rents and royalties received from unrelated parties involved in active trade

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[200] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371BD (1).
[201] Section 952(a) of Internal Revenue Code (IRC).
[202] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000.
[203] ibid.
[204] ibid.
[205] ibid.

or business, as well as dividends, interest, and specific gains from banking or insurance operations.[206]

Section 954(c)(3) of the IRC specifies certain exclusions from FPHCI when income is received from related persons. Dividends and interest received by the CFC from a related party will not be considered if the related party is a tax resident in the same jurisdiction as the CFC and a substantial amount of its assets are utilized for business purposes in that jurisdiction.[207] Moreover, any income derived from rents and royalties paid by a related entity for the utilization of assets within the CFC's jurisdiction is not subject to taxation.[208]

Profits obtained from rents and royalties in the operational activities of a business involving related parties are also exempted according to section 954(c)(2)(A) of the IRC.

Section 954(d)(1) of the IRC defines FBCSI as profits generated from various transactions involving the purchase and sale of personal property between the CFC and related or unrelated parties. This income arises from sales transactions where the manufacturing and selling functions occur in different tax jurisdictions, particularly aimed at limiting the usage of tax havens to minimise tax liabilities on related company sales profits.[209]

The provisions aim to address situations where the USA parent or related USA or foreign corporations manufacture products that tax haven subsidiaries (CFC) sell, potentially resulting in lower tax rates.[210] Transactions with related parties and the separation of manufacturing and selling activities across jurisdictions are under close scrutiny. The rules emphasize that income earned by the CFC with minimal functions, such as minor assembly or packaging, will be restricted.[211] However, the income is exempt if the CFC is the manufacturer of the property it sells.[212]

These provisions target FBCSI arising from related party transactions with divided manufacturing and selling functions across tax jurisdictions, unless the property sold was produced by the CFC itself.

Foreign base company services income (FBCS), as defined in section 954(e) of the IRC, encompasses income derived by the CFC from providing various services for or on behalf of a connected party outside the CFC's jurisdiction. The objective is to deter deferral tactics involving the utilization of a tax haven CFC to transfer some of the parent or affiliated

[206] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000.
[207] Section 954(c)(3) of the IRC.
[208] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000.
[209] ibid.
[210] ibid.
[211] ibid.
[212] ibid.

corporation's active business earnings to a jurisdiction with low tax rates, especially through the segregation of services from manufacturing operations.[213]

Section 954(e)(2) of the IRC exempts income earned by the CFC from services that are directly linked to the sale of inventories manufactured, produced, grown, or extracted by the CFC. This provision targets FBCS generated from services offered to related parties outside the CFC's jurisdiction unless the services are associated with inventories produced by the CFC within its jurisdiction of operation. Notably, the exemption extends to servicing specialized machines produced by the CFC and sold to related entities abroad, provided the service is directly linked to the legitimate business activity of that CFC.

The regulations under Subpart F, specifically section 956 of the IRC, dictate that US shareholders must account for the CFC's growth in earnings from investments in US property as part of their taxable income. Section 956(c) of the IRC outlines that US property encompasses tangible assets situated within the USA, shares of a domestic company, debts owed by a US individual, and entitlements to utilize patents, copyrights, and other intellectual property in the USA. This provision targets income earned by US property for the CFC.

Subpart F income encompasses various categories, including income attributable to participation in an 'international boycott, income from bribes, kickbacks, or other payments, and income from countries with denied foreign tax credits.'[214] These provisions primarily address broader foreign policy concerns other than tax considerations and are not extensively covered in this research report.[215]

In accordance with section 964(a) of the IRC, the CFC's annual earnings or losses should be calculated in a manner that closely resembles the methods used for domestic corporations, as outlined by regulations set forth by the Secretary of the US treasury. This entails computing the taxable income as if the CFC was a US resident.

According to section 951(a)(1) of the IRC, upon completion of the taxable income calculation for the CFC, the US shareholder must report the CFC's taxable income as part of their taxable income. The US shareholder will add their proportionate share of the CFC's taxable income that is not exempt, with US tax rates applying accordingly.

The US shareholders are obliged to add certain undistributed earnings of the CFC in their taxable income, termed as deemed dividends.[216] Subpart F primarily targets passive income

[213] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000.
[214] ibid.
[215] ibid.
[216] ibid.

and diversionary income when the production and the servicing/sales are split across different tax jurisdictions.

3.5 Targeted income in Ireland

Section 835R of the Taxes Consolidation Act, 1997 (TCA) defines non-genuine arrangement for tax avoidance. Irish CFC rules focus on income arising from non-genuine arrangements established primarily for obtaining a tax advantage.[217] These rules encompass the following key criteria.

Situations that may lead to non-genuine arrangements include cases where the CFC is not in possession of the assets or does not assume the risks associated with generating its profits, as well as instances where Irish activities are pivotal in generating such profit.[218]

The key focus of the essential purpose test is to assess if the main reason for the arrangement is to gain a tax advantage, emphasizing the need for commercial motivations to prevail instead.[219]

Significant people functions (SPF) and key entrepreneurial risk-taking functions (KERT) refer to value-contributing functions within an organization, such as ownership of assets from a legal and beneficial standpoint, as well as the assumption and handling of risks, requiring active decision-making.[220] The SPFs and KERTs are the Irish activities.

These encompass relevant functions performed in Ireland, such as SPFs or KERTs, executed by a chargeable party for the CFC or CFC group.[221] Absence of significant Irish activities related to the ownership of assets and assumption of risks of the CFC results in no CFC charge to the Irish taxpayer.

The inclusion requirements of income are contained in sections 835I, 835Q, 835R, and 835S of the TCA. The imposition of a CFC charge is contingent upon undistributed income credited to relevant Irish activities executed by either the holding company or a connected party, where non-genuine arrangements exist for securing a tax advantage.[222] Notably, the charge applies to a chargeable company, defined as a holding company or related entity, engaged in relevant

[217] Tax and Duty Manual, Controlled Foreign Company Rules, 2023, Page 38.
[218] ibid.
[219] Section 835R of the TCA.
[220] Smith, Finn, & Douglas, 2019, The Importance of Significant People Functions in the Context of CFCs and Profit Attribution.
[221] Tax and Duty Manual, Controlled Foreign Company Rules, 2023.
[222] ibid.

Irish activities on behalf of a CFC group.[223] This entails an Irish nexus with the income, ensuring that the charge is levied appropriately.

Sections 835Q and 835R of the TCA contain the regulations for the determination of the CFC's profit, called undistributed income. The undistributed income for the financial period is computed as the CFC's distributable profits, deducting any relevant distributions made during the period. This income comprises the pre-tax profit for the period, excluding capital gains or losses and dividends exempt from Irish tax if the CFC is Irish tax resident.[224] The Irish shareholder's tax liability is determined by applying the tax rate of 12.5% or 25% to the undistributed income, based on the nature of the income generated by the entity engaged in Irish activities.[225]

3.6 Conclusion

The targeted income under section 9D of the ITA of the RSA exhibits similarities with the targeted income of the USA and the UK to some extent. Section 9D of the South African ITA focuses on diversionary income arising from genuine business activities of FBEs when engaged in related party transactions. It deems these transactions as non-genuine if the CFC lacks an external customer and supplier base and is not primarily earning revenue by trading with unrelated parties at arm's length. Additionally, services provided for related parties are targeted unless they relate to products produced by the CFC, aiming to exempt income if significant value is added, and services are performed outside South Africa.

Similarly, US CFC rules target diversionary income to limit exploitation of tax havens for lower tax rates. They focus on arrangements concerning related parties where production and selling activities span different tax jurisdictions, exempting income if the CFC manufactures inventory it sells or for services it provides. Hence, both South African and US rules aim to exclude transactions lacking commercial substance.

Nuances exist, however, with South Africa's rules, specifically addressing related party transactions lacking commercial value, while US regulations focus on transactions exploiting tax havens.

The USA targets CFCs based on the rise in profits linked to investments in US property and the income derived from US assets. Conversely, section 9D of South Africa does not focus on

[223] Tax and Duty Manual, Controlled Foreign Company Rules, 2023.
[224] Smith, Finn, & Douglas, 2019, The Importance of Significant People Functions in the Context of CFCs and Profit Attribution.
[225] ibid.

the source of assets generating CFC income, leaving potential for National Treasury to explore whether such targeting would be beneficial for the country.

Another point of differentiation lies in the approaches adopted by the UK and Ireland in identifying income for targeting. The UK primarily targets income influenced by the source of CFC capital and external control from the UK, where more than 50% of active decision-making occurs. Income from non-UK sourced capital or decision-making conducted outside the UK at arm's length is exempt. Similarly, Ireland's CFC rules target income from significant people functions (SPFs) predominantly performed within Ireland.

Section 9D of South Africa also targets passive income not directly linked to active business activities, exempting such income if it constitutes less than 5% of total income. Similarly, the US regulations target passive income due to its mobility, exempting income earned from unrelated customers or in the active conduct of trade. However, passive income from related parties is targeted unless the transactions occur locally within the CFC's country.

Moreover, the UK targets passive income related to UK investments, or SPFs conducted in the UK, or from related party transactions lacking commercial substance. Passive income is exempt if it is incidental to the primary business, not exceeding 5% of total CFC income. Ireland's CFC rules mirror the UK's approach, targeting income originating from relevant Irish activities associated with CFC assets and risks, unless the arrangement is at arm's length and commercially substantive.

The UK rules regarding targeted income allocation present a balance between multinational companies' interests and safeguarding the UK tax base. By focusing on income linked to SPFs conducted in the UK, these rules offer a fair approach. National Treasury could consider adopting similar principles to assess their potential benefits for South Africa.

In contrast, section 9D of South African rules cast a wider net, particularly targeting income from related party transactions. These regulations encompass such transactions, even if they stem from genuine business activities, as long as they involve related parties without an evident external customer and supplier base. Unlike the UK and Ireland, which target income associated with national resources, section 9D of South Africa captures a broader spectrum of income streams.

Regarding inclusion and computation requirements of net income, section 9D of South Africa mandates that net income added to shareholders of South Africa's hands be computed on a global scale, treating the CFC as a resident taxpayer. This computation includes foreign tax credits, and the South African tax rate is then applied. Assessed losses of the CFC are ring-fenced for future offsetting against taxable income.

These section 9D rules align with the US requirements, where taxable income is similarly computed as if the CFC were a US tax resident. The US shareholders who own a minimum of 10% of the shares are subject to taxation on the proportionate income, known as deemed dividends.

In contrast, the UK taxes income that passes through the CFC gateway, originating from UK resources (assets and active decision-making), provided the UK shareholder owns a minimum 25% of the CFC's shares. This 25% threshold, comparatively higher than the 10% of section 9D and the US, alleviates administrative burdens for both the fiscal authorities and multinational corporations. National Treasury is encouraged to evaluate the viability of adopting the UK's 25% exemption, potentially revising the current 10% threshold.

Similarly, the Irish CFC rules impose tax, in the hands of Irish shareholders, if an amount equivalent to the undistributed income generated by relevant Irish activities, under the condition that non-genuine arrangements are in place to secure a tax advantage. Both the UK and Irish regulations primarily focus on income earned through resources within their respective jurisdictions, contrasting with section 9D of South Africa, which targets global income.

Considering this assessment, the UK's inclusion rules seem more favourable, particularly with the exemption of shareholding up to 25% and the focus solely on income generated by UK resources. Consequently, the UK approach is recommended for further evaluation by National Treasury. This approach may aid section 9D of South Africa in avoiding taxation of genuine transactions between related parties. Notably, certain arrangements are exempt from taxation, with one key exemption being the FBE exemption, discussed subsequently.

Identification of differences and similarities in a tabular format:

Table 2: Analyses of the SA's targeted income against the UK, the US and Ireland targeted income.

Title	RSA	UK (revised CFC rules)	USA	Ireland

Targeted income	The diversionary income of the FBE:
	• Sale of goods to SA connected resident.
	• Sell goods to external SA customers that originate from a connected SA resident.
	• CFC Services for connected SA residents.
	
	Passive income
	
	FBE exclusion:
	• Excluded if passive income is not greater than 5% of the total FBE income
		• Chapter 4 targets trading profits linked to UK activities.
		• Chapter 5 targets passive income that is linked to UK activities. Exempt if the passive income is less than 5% of total trading profit.
		• Chapter 6 deals with trading finance income derived from UK connected capital contributions.
		• Chapter 7 deals with the CFC income arising from insurance contracts with UK persons, and there are suspected significant tax benefits emanating from the arrangement.
		• Chapter 8 targets banks that are aiming to shift profits to CFCs that are in low tax jurisdictions through investment in those CFCs.
			• The CFC targets the tainted income.
			• Targeted profit includes:
			  • Insurance income
			  • Foreign-based company income
			• increase in earnings linked to investments in US property.
			
			Note: other targeted income linked to boycott actions and bribes are not comparable to section 9D.
				• Targets profits arising from non-genuine arrangements that lack commercial substance.
				• Relevant Irish activities that wholly or mainly generate the income of the CFC.
				• Exemption is provided for genuine arrangements that attract trading income, arrangements concluded at arm's length, or CFC income arising from relevant Irish activities that is negligible.

Inclusion requirements of the income	• Covers the inclusion of the profit of the CFC in the resident's tax amounts. Thereafter, exemptions are disregarded. • The SA shareholder owns a minimum of 10% of shares or rights.	• Chapter 2 includes net profit of the CFC to a UK resident if that profit is not exempt . • The UK shareholder owns at least 25% of the shares.	• Exemptions and threshold requirements such as exempting trading profit. • Thereafter, the CFC profit is computed for inclusion. • US shareholder (citizen or resident of USA) has to own at least 10% of voting power.	• A CFC charge will arise from profits linked to relevant Irish activities provided no exemption applies. • There are non-genuine arrangements in place that lack commercial substance.
Computation requirements of the net income	• Computation of net income are computed on a world-wide basis	• Chapters 4 to 8 of HMRC targets CFC income that is attributable to UK activities such as the UK investments and decision making.	• The taxable income is computed as if the CFC is a US corporation.	• Determining the amount of undistributed, targeting profits that are linked to relevant Irish activities.

Source: The table is self-generated using data from the CFC legislations of SA, the UK, the USA and Ireland.

Chapter 4: Evaluation of South Africa's section 9D(9)(b) FBE exemption and comparable CFC Rules

4.1 Introduction

The FBE exemption under section 9D(9)(b) of the RSA's tax legislation aims to strike a delicate balance between taxation and fostering the expansion of international business activities.[226] This equilibrium is achieved by exempting CFC income derived from bona fide business operations, a notion reinforced by Tickle's assertion (2022) that income arising from genuine active business endeavours is exempted.[227] The underlying rationale behind this exemption is to incentivize and facilitate companies to venture into foreign markets, thereby stimulating economic growth and enhancing international trade.[228] However, the implementation of the FBE exemption is not devoid of complexity and controversy, as illustrated by the Coronation case discussed in the following chapter.[229]

4.2 FBE exemption requirements in South Africa

The FBE exemption is intricately linked to the notion that CFC regulations are not aimed at taxing profit originating from substantive trading functions conducted abroad.[230] While there exist exceptions to this rule, fundamentally, the inquiry revolves around whether the CFC possesses adequate substance abroad.[231] The existence of an FBE constitutes merely the initial criterion a CFC must satisfy to invoke the FBE exemption. The primary purpose of this initial requirement is to confirm if real trading activities, and hence value addition, are happening within the CFC's jurisdiction.[232] Subsequently, the second requirement mandates a precise amount to be attributed to the FBE in the CFC.[233] The overarching policy goal of the FBE exemption is to foster meaningful local activity within the CFC.[234] If all of the CFC's net profit is linked to the FBE, then the net profit will be completely exempt.[235]

The FBE exemption stands out as the most frequently utilized exemption.[236] Olivier & Honiball (2011) posit that this exemption constitutes one of the most convoluted clauses within the legislation.[237] This assertion finds support in Grimm & Kraamwinkel's (2018) observation that

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[226] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 34.
[227] Tickle, 2022, Controlled Foreign Corporations and the Future of the Business Establishment Exemption, Page 42.
[228] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 34.
[229] ibid.
[230] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[231] ibid.
[232] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[233] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[234] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[235] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[236] Bennett & Roelofse, 2023, Silke on International Tax, Chapter 3.6.
[237] Olivier, L. & Honiball, M., 2011, International tax: A South African perspective, 5th ed, Page 581.

the mechanical substance test for the FBE exemption, introduced in 2001, has progressively become less flexible and more onerous.[238] Furthermore, Grimm & Kraamwinkel (2018) note that the RSA CFC regulations are robust, intricate, and, to some extent, ambiguous.[239] The Davis Tax Committee (2016) concurs, indicating that the South African CFC regulations are sophisticated, complex, and lacking in clarity.[240]

The ITA section 9D(9)(b) exempts CFC net profit that is attributed to the FBE, subject to detailed determinants and conditions. Essentially, for a business to be considered a foreign establishment, it must possess commercial substance and operate in a specific location with some degree of permanence.[241] The FBE must also align with the policy objective of fostering meaningful local activity within its country of residence.[242] This commercial substance doctrine ensures that profit is not exempt if a foreign facility exists solely on paper without objective economic reality.[243] According to Olivier and Honiball (2011), the FBE exemption is applicable to profits obtained from valid commercial activities.[244]

The definition of 'FBE' under section 9D(1) of the ITA encompasses various criteria to determine the eligibility of a CFC. Firstly, the CFC must have a fixed establishment, which entails the presence of a physical structure indicating permanence, staffed with managerial and operational employees making strategic decisions, equipped adequately for primary operations, and possessing facilities to support these operations.[245] Additionally, the business activities conducted abroad should primarily serve commercial purposes rather than tax benefits.[246] Moreover, if the CFC shares structures with connected companies, it can still be considered an FBE if specific criteria are fulfilled, including tax residence in the same country as the primary operations and physical presence and operations aligned with the CFC's fixed establishment.[247] Furthermore, specific activities such as mining, long-term construction projects, agricultural activities, utilization of transportation vessels or aircraft, engagement in international shipping, and utilization of ships for international operations are also considered under the FBE criteria.[248]

[238] Grimm & Kraamwinkel, 2018, CFCs: Have We Gone Too Far?.
[239] ibid.
[240] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[241] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[242] Davis Tax Committee, Base Erosion and Profit Shifting (BEPS) Final Report.
[243] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[244] Olivier, L. & Honiball, M., 2011, International Tax: A South African Perspective, 5th ed, Page 581.
[245] Section 9D(1) of the Income Tax Act of South Africa (ITA).
[246] ibid.
[247] ibid.
[248] ibid.

The parameters outlined in sections 9D(1)(a)(i) to (v) establish the foundational criteria for qualifying as an FBE. While the numerical benchmarks for these tests may seem stringent, it is conceivable for more assertive taxpayers to meet the criteria with minimal resources, including just one manager, one operational employee, a small-shared office, and basic office equipment.[249] The Davis Tax Committee (2016) proposed a reassessment of the substance requirement for the FBE exemption, including an evaluation of outsourcing models.[250]

An FBE necessitates a permanent business location abroad, utilized or intended for use in conducting business for a minimum of one year.[251] This denotes a permanence not solely confined to temporal considerations, distinguishing it from sporadic transactions.[252] The real infrastructure abroad should be responsible for the income generation.[253]

The mandate for an FBE to be properly staffed with on-site operational and managerial employees, engaged in primary business operations necessitates employees dependent on the CFC and obligated to conduct its business within the territorial jurisdiction of the fixed location.[254] Although the term 'operational staff' lacks a precise definition, it presumably encompasses employees tasked with core functions pertinent to the CFC's business.[255] National Treasury stipulates that these employees must oversee the primary daily operations of the CFC, excluding independent agents.[256]

While outsourcing is common for ancillary operations, essential primary tasks of a CFC should not be outsourced to qualify for the FBE exemption.[257] Bennett & Roelofse (2023) concur, asserting that outsourcing critical functions jeopardizes FBE eligibility.[258] Companies often engage in partnerships with suppliers and contractors to enhance operational efficiency.[259] However, for the FBE exemption to apply, CFC managers overseeing primary operations must possess requisite expertise and authority over outsourcing contracts.[260] National Treasury

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[249] Davis Tax Committee, Base Erosion and Profit Shifting (BEPS) Final Report.
[250] ibid.
[251] Section 9D(1) of the Income Tax Act of South Africa (ITA).
[252] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[253] Marais, A., 2023, The coronation judgment and its impact on controlled foreign companies, page 30.
[254] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[255] ibid.
[256] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 9.
[257] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[258] Bennett & Roelofse, 2023, Silke on International Tax, Chapter 3.6.
[259] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[260] ibid.

emphasizes that outsourcing primary daily operations undermines the economic substance of the FBE, although incidental functions may be outsourced.[261]

Olivier & Honiball (2011) contend that managerial and operational employees making day-to-day decisions must be physically present at the FBE.[262] They express scepticism regarding the qualification of independent agents or consultants, typically not classified as employees.[263]

While the FBE exemption acknowledges outsourcing as a prevalent practice in the modern economy, its complete elimination may not necessarily signal artificiality.[264] Outsourcing to affiliates might raise suspicions, but genuine businesses engage in such practices for various non-tax reasons, including risk management, cost considerations between employees and contractors, and operational flexibility.[265] The Davis Tax Committee (2016) proposed an investigation into the tax base risks associated with different outsourcing models.[266]

A CFC's formation should be driven primarily by demonstrable commercial reasons rather than solely seeking tax advantages.[267] This highlights the necessity for a credible argument that decisions leading to the establishment of a CFC primarily serve legitimate business objectives, even if incidental tax savings are realized. [268]

Paragraphs (b) to (g) of the FBE definition typically obviate the need for an economic substance test due to the set structure of the tasks being carried out, making it challenging to fabricate business activities for tax planning purposes.[269]

It is evident that the primary operations of a CFC should be conducted in its country of residence, either by the CFC directly or by a related party. It is not allowed to outsource core operations outside of the CFC's jurisdiction. Legitimate business activities should occur abroad, supported by transparent commercial justifications unrelated to tax considerations.

4.3 FBE exemption requirements in the UK

Under section 371DF of Schedule 20 of the Finance Act, 2012 (FA), the trading profits of the CFC will be excluded from the provisional Chapter 4 profits, provided that certain conditions

[261] National Treasury's Detailed Explanation to section 9D of the Income Tax Act, June 2002, page 10. This was covered in example 1 & 2 where National Treasury was illustrating that the core functions of the FBE cannot be outsourced.
[262] Olivier, L. & Honiball, M., 2011, International Tax: A South African Perspective, 5th ed, Page 582.
[263] ibid.
[264] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[265] ibid.
[266] ibid.
[267] Section 9D(1) of the Income Tax Act.
[268] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[269] Olivier, L. & Honiball, M., 2011, International Tax: A South African Perspective, 5th ed, Pages 583 - 584.

are satisfied, effectively exempting trading profits wholly from the Chapter 4 charge when all criteria are satisfied.

Section 371DG of the FA states that the business premises condition necessitates that the CFC maintains facilities throughout the tax period in its country of tax residence, fulfilling the following criteria:

- Existence of physical premises: the premises must be occupied or intended for use for a reasonable period, demonstrating permanence.
- Commercial activities: the premises must serve as the primary location from which the CFC conducts its activities abroad.

The term ‘premises’ encompasses various physical locations, such as offices, workshops, factories, mines, and construction sites, provided the construction or project lasts at least 12 months.[270] This condition ensures the CFC's tangible presence in its jurisdiction of residence.

The income condition, as stated in section 371DH of the FA, restricts the proportion of income derived from the UK to ensure that the exemption applies only to CFCs with a relatively minor percentage of UK profit, indicating a limited operational presence in the UK. It is met if the CFC’s profit originating from the UK constitutes:

- 20% or less of the total relevant trading income for normal CFC business.
- 10% or less of the total relevant trading income for banking CFC business.

‘Relevant trading income’ refers to the trading earnings of the CFC, excluding UK-related profit from the trading of inventories produced in its jurisdiction of residence.[271]

A high proportion of UK income suggests significant operations in the UK, making the significant people functions (SPF) approach more suitable.[272]

The management expenditure condition is set out in section 371DI of the FA and the condition is fulfilled when the UK-related management expenses are 20% or less of the total related management expenses. It assesses the level of control over the CFC's business activities in the UK, verifying that the exemption is limited to CFCs with a small amount of UK management expenses.

[270] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371DG.
[271] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371DH.
[272] HMRC, 2016, Controlled Foreign Companies, Chapter 4, INTM200830.

Section 371DJ of the FA contains the intellectual property (IP) condition. This condition applies if UK-related IPs transferred to the CFC within the last six years, or profits derived from UK IPs, represent less than 10% of the aggregate value of the CFC's IPs or profits directly linked to the IP.[273] It aims to identify intra-group sales of IP and contractual arrangements enabling the retention of IP profits by the CFC, ensuring that IP-related income does not disproportionately originate from the UK.[274]

Compliance with section 371DK of the FA is achieved when the CFC's trading profit derived from exportation of inventories by the UK does not exceed 20%. However, income generated from exportation of inventories by the UK into the CFC's jurisdiction is disregarded.[275] The justification for this requirement is that a considerable amount of the CFC's profit generated from UK stock exports implies that profits are sustained by UK activities (SPF).[276] Chapter 4 exempts trading income resulting from legitimate business activities if the arrangements adhere to arm's length principles and a significant portion of the CFC's profit does not stem from UK-related activities.

4.4 FBE exemption requirements in the USA

The exemption requirements for the USA's FBEs can be found in the US Code of Federal Regulations (C.F.R.), 26 CFR 1.355-3. Subpart F generally exempts current taxation of active business income unless the income can be easily redirected to a tax haven, such as shipping income or income from certain transactions between related parties.[277]

One underlying premise of subpart F is that a US-owned CFC engaged in active business will have valid business reasons for its presence in a specific country, such as proximity to markets, compliance with local content requirements, or access to a skilled workforce.[278]

CFC income is exempt if the CFC is actively conducting a trade or business.[279] A CFC is deemed to be actively involved in carrying out a trade or business if it directly engages in such activities, or if the majority of its assets are comprised of stocks or securities of subsidiary corporations that are actively conducting business operations.[280]

[273] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371DJ.
[274] HMRC, 2016, Controlled Foreign Companies, Chapter 4, INTM200840.
[275] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371DK.
[276] HMRC, 2016, Controlled Foreign Companies, Chapter 4, INTM200850.
[277] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000.
[278] ibid.
[279] US Code of Federal Regulations (C.F.R.),2023, 26 CFR 1.355-3(a).
[280] ibid.

To be classified as engaged in active business, a CFC must fulfil the outlined requirements:[281]

- Trade or business: the CFC must engage in activities for the purpose of earning income or profit, including income collection and expense payment.
- Active conduct: the determination of active conduct considers all facts and circumstances. The CFC is required to carry out significant management and operational tasks internally, without relying on external entities for such activities.

Engaging in the operation of a trade or business precludes:

- Holding property for investment purposes.
- Ownership and operation of property unless significant services are provided in its management.

The trade or business used to satisfy the active conduct requirement must have been actively carried out for the entire five-year period leading up to the distribution date.[282] This implies that the US company should have operated the business transferred to the CFC as an investment over the last five years. The distribution pertains to the shares of the CFC being distributed to the US shareholders.

According to the Internal Revenue Code and Treasury regulations, the term 'trade or business' lacks a comprehensive definition. However, for purposes of section 162, the Supreme Court has interpreted it as an activity involving continuity and regularity and pursued primarily for income or profit.[283] Implicitly, activities falling below a certain threshold of continuity and regularity may not qualify as a trade or business. This interpretation highlights the requirement for ongoing and customary activity.

4.5 FBE exemption requirements in Ireland

According to section 835R of the Taxes Consolidation Act, 1988 (TCA) the CFC charge is exempt under the following circumstances:

- When the CFC never held assets or bore risks under an arrangement deemed to be entered into solely to secure a tax advantage.
- When the CFC has no non-genuine arrangements in place.

[281] US Code of Federal Regulations (C.F.R.),2023, 26 CFR 1.355-3(a).
[282] ibid.
[283] Dinh, 2018, Can a Trade or Business include Activities conducted in a Different Entity?, paragraph 1. This relates to judgment in case: Groetzinger, 480 U.S. 23 (1987).

This exemption is based on an objective test rather than a subjective one, presenting a theoretical scenario regarding what a rational individual would deem appropriate given the circumstances.[284]

The CFC charge is not triggered by undistributed income linked to the Irish SPFs, provided that the profit stems from an arrangement that can be deemed as one that parties would engage in at arm's length.[285] This test is also objective in nature.

Undistributed income associated with Irish SPFs is not subject to the CFC charge if it is deemed reasonable that the main objective of the arrangements is not to obtain a tax advantage.[286]

Likewise, the CFC levy does not apply to unallocated earnings linked to Irish SPFs in cases where the earnings stem from agreements governed by the transfer pricing regulations.[287] From the foregoing, it appears that CFC income is exempt if the arrangements are at arm's length with clear commercial reasons, even if the income is attributable to Irish SPFs.

4.6 Conclusion

Table 3 shows the similarities and differences in the FBE exemption requirements.

Table 3: Analysis of the SA's FBE exemption requirements against the UK, the US and Irish FBE exemption requirements.

Title	RSA	UK (Revised CFC rules)	USA	Ireland
FBE exemption requirements	• FBE exemption of active income that relates to a business of a CFC. • The active income should link to the risks and functions factually performed by the CFC. • There are commercial reasons for conducting the business abroad.	• FBE exemption. • The CFC has premises in which are planned to be used with a reasonable degree of permanence wholly or mainly for trading purposes.	• Profit earned from active trading activities. • The CFC has routine activities of collecting income and paying operating expenses.	• Exempt CFC trading income that is arising from genuine arrangements. • There is a genuine commercial reason for the CFC to be outside Ireland.

Source: The table is self-generated using data from the CFC legislations of SA, the UK, the USA and Ireland.

[284] Tax and Duty Manual, Controlled Foreign Company Rules, 2023.
[285] ibid.
[286] ibid.
[287] ibid.

The FBE exemption clauses across different countries share a common objective: to exempt trading income resulting from substance-based business activities of CFCs, as long as transactions are carried out at arm's length and commercial intent is the main driver.

In South Africa, section 9D grants exemption to CFC income when there exists sufficient commercial substance abroad responsible for generating income. This entails actual operations and the generation of value taking place within the CFC's jurisdiction, with decision-making vested in local management and primary activities utilizing local resources. Additionally, meaningful local activity is required, with on-site managerial and operational employees performing core daily functions related to the CFC's business. Outsourcing of primary activities abroad is disallowed, emphasizing the necessity for activities to be performed by the CFC itself, and the business must demonstrate permanence by operating abroad for at least 12 months.

Similarly, the USA exemption requirements mirror those of section 9D of South Africa, focusing on active business income. In order to be eligible for exemption, the CFC must engage in a group of activities aimed at earning income or profit, which includes regular cash collection and cost payments. Active conduct of business is mandated, necessitating the CFC to perform substantial management and operational functions internally. Outsourcing of primary activities is prohibited, aligning with the principle that activities must be conducted by the CFC itself, without reliance on external contractors. These requirements exhibit consistency with the principles outlined in section 9D of the South African regulations.

In assessing the trading activities, the duration of the preceding period varies among jurisdictions. For instance, the USA requires a 5-year period of active conduct before the distribution, unlike South Africa's section 9D, which mandates only one year. The US regulations closely resemble section 9D, encompassing similar provisions on outsourcing but deviating with the five-year rule.

In the UK, all trading profits are exempted if a relatively small proportion originates from UK sources. The criteria include:

- Business premises conditions: mandating a physical structure abroad for a minimum of 12 months, where primary activities are conducted. This mirrors section 9D's emphasis on the permanence of CFC activities abroad.
- Income condition: requiring the majority of income to be derived from external, independent sources, with UK income limited to 20% for normal businesses and 10% for banking businesses. This evidences the CFC's independence from UK sources.

- Management expenditure condition: granting exemption if UK-related management expense remains below 20% of the total, emphasizing limited UK management of CFC assets and risks.
- Intellectual property (IP) condition: restricting income from UK-related IPs to less than 10%.
- Export of goods condition: exempting trading income if less than 20% is earned from goods exported from the UK.

These provisions reflect stringent criteria aimed at ensuring that CFC income exempted from taxation is predominantly derived from activities conducted outside the UK.

The UK regulations offer exemptions for income generated from non-UK sources if there is substantial evidence indicating the insignificance of income linked to UK sources. This contrasts with South Africa's section 9D, which evaluates the overall substance of the CFC rather than solely focusing on income generated from South African resources. The UK rules exhibit specificity and seem advantageous to multinational enterprises, which would include Coronation, as expounded upon in the following chapter.

Similarly, Ireland's regulations grant exemptions when the CFC demonstrates genuine arrangements and commercial business purposes. This entails adherence to arm's length arrangements, with significant income not derived from Irish SPFs. Although less detailed than the UK regulations, Ireland's rules share a source-focused approach.

In light of these considerations, the UK requirements emerge as specific and quantifiable, with delineated percentage thresholds for key business activities. Consequently, the UK regulations appear favourable, offering multinational enterprises a fair opportunity to compete in their respective industries.

The FBE exemptions have been assessed and it has been noted that the UK rules are more favourable. National Treasury is advised to assess if the source-based specific approach can be applied in South Africa. Below, the application of these FBE requirements to the Coronation case will be applied with the objective of assessing if Coronation would have been taxed if it was a tax resident in other countries.

Chapter 5: Evaluation of the Coronation case against section 9D and comparable CFC Rules

5.1 Introduction

The evolution of global business and technological advancements has reshaped the international economic landscape, altering traditional productivity paradigms and transforming business operations.[288] Consequently, the substance of FBE exemptions has not kept pace with these changes.[289] Olivier & Honiball (2011) emphasized the risk of overly rigid CFC rules, which may render residents unable to compete effectively within their markets, potentially prompting them to seek jurisdictions with more favourable regulatory environments.[290] The Davis Tax Committee (2016) further cautioned against overly stringent regulations that could impede legitimate business activities, highlighting the need for refinement, particularly concerning anti-diversionary rules surrounding service income.[291]

The complexities inherent in interpreting FBE exemptions are exemplified by the Coronation case, where different interpretations of section 9D in South African Courts were highlighted. This case will be scrutinized in detail in this chapter.

The Davis Tax Committee (2016) also emphasised the importance of considering the globally competitive implications of any government crackdown on active income taxation, cautioning against actions that may appear to be anti-competitive unless they are implemented by a substantial number of nations.[292] The FBE exemptions rules of the UK, the USA and Ireland are also applied below to the Coronation case to assess if section 9D conforms to the international norms.

5.2 Detailed background of the Coronation case

Coronation Investment Management SA (Pty) Ltd (CIMSA) serves as the holding company for the Coronation Group, with its registration and tax residency situated in South Africa. In 2012, CIMSA functioned as a 90% subsidiary of Coronation Fund Managers Limited (CFM) and held full ownership of Coronation Asset Management (Pty) Ltd (CAM), both registered for tax in South Africa. Additionally, CIMSA wholly owned CFM (Isle of Man) Ltd, which was tax resident in the Isle of Man. CFM (Isle of Man) Ltd, in turn, held full ownership of Coronation Global

[288] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.

[289] ibid.

[290] Olivier, L. & Honiball, M., 2011, International Tax: A South African Perspective, 5th ed, Page 559.

[291] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.

[292] ibid.

Fund Managers (Ireland) Limited (CGFM) and Coronation International Ltd (CIL), registered and tax resident in Ireland and the United Kingdom respectively.[293]

The South African Revenue Service (SARS) initiated an audit on CIMSA covering the assessment years from 2011 to 2013, following which it issued additional assessments to incorporate the net income of CGFM into CIMSA's taxable income.[294] The matter proceeded to the Tax Court, where the ruling favoured CIMSA.[295] Subsequently, CSARS lodged an appeal with the Supreme Court of Appeal (SCA), resulting in a verdict in favour of CSARS on 7 February 2023.[296]

The central issue in this appeal pertains to whether the net profit of CGFM should be included in the taxable income of CIMSA, or if CGFM's profit was eligible for an FBE exemption under section 9D.[297] This determination hinged on the primary functions performed by CGFM in Dublin, Ireland. Notably, CGFM had adopted an outsourcing business model, prompting scrutiny into its tax status. The court deliberated on whether CGFM's primary operations, particularly if outsourced, warranted an exemption under section 9D. The court's interpretation of section 9D, specifically the FBE exemption, was pivotal in assessing CIMSA's tax liability.

5.2.1 The taxation of Coronation in the RSA

The conclusion reached by the SCA, and its underlying rationale are analysed here, alongside an evaluation of arguments against the ruling presented by tax experts. The judgment of the Constitutional Court of South Africa (CC) is also assessed.

To arrive at its decision, the SCA meticulously examined various factors, including the level of substance in CGFM's business operations, its purpose, and the degree of control exerted by CIMSA.[298] CIMSA contended that the determination of primary operations should be grounded in the actual activities conducted by CGFM on a day-to-day basis, reflecting normal commercial practices as outlined in its business plan.[299] However, the SCA rejected the notion that a CFC's chosen business model alters the fundamental nature of its operations. Instead,

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[293] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023, Page 4.
[294] Mollagee & Sarembock, 2023, Primary Operations of a Business: Am I who I decide to be, or am I simply what I'm authorised to be? The Case of SARS v Coronation, Page 3.
[295] ibid.
[296] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[297] ibid.
[298] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 35.
[299] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.

the SCA asserted that a CFC's operations are delineated by the activities for which it has been licenced, irrespective of whether these functions are outsourced.[300]

Several factors were considered in determining CGFM's primary operations. Firstly, the memorandum of association and authorized licence of CGFM sets out fund management including investment management as its primary function.[301] Additionally, the source of revenue – derived primarily from fees associated with managing assets under management – further corroborated CGFM's role in investment management.[302] This delineation aligns with the understanding that CGFM primarily focuses on investment management.

Having identified investment management as CGFM's primary operations based on source documents and source of revenue, the SCA observed that outsourcing these key functions beyond Ireland implies that the fixed establishment of CGFM in Ireland does not have the required personnel and infrastructure to carry out these activities. This scenario contravenes the objective of CFC rules aimed at preventing exemptions in low-tax jurisdictions where primary operations do not occur. The SCA emphasized that CGFM cannot outsource its primary business operations unless they are subcontracted to a tax-resident company in Ireland.

Consequently, the judges concluded that CGFM's primary operations entail fund management, including investment activities. Given that these operations are outsourced outside Ireland, the FBE exemption requirements were not satisfied, mandating CIMSA to include CGFM's taxable income in its own.[303] This ruling holds significant financial implications for CIMSA and has engendered uncertainties for other multinational entities, particularly in the light of proposed amendments by the National Treasury post-judgment.

5.2.2 National Treasury's proposed amendments

In response to the SCA's ruling in the Coronation case, the National Treasury aims to amend the FBE exemption requirements.[304] The proposed changes are intended to bring about clarity by stating that all critical duties for which a CFC is remunerated must be executed by either the CFC itself or by another CFC within the identical corporate group, provided that it is domiciled and liable to taxation in the same nation as the CFC's fixed place of business.[305] Although these amendments have been postponed at the time of writing as they were pending

[300] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[301] ibid.
[302] ibid.
[303] ibid.
[304] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 35.
[305] ibid.

the CC judgment in the Coronation case which was finalised on the 21 June 2024, it is noteworthy that numerous tax commentators have expressed apprehensions regarding the proposed changes.[306] Such amendments are poised to significantly impact outsourcing models that distribute key functions across various tax jurisdictions to enhance cost-effectiveness and operational efficiency.

5.2.3 Arguments against the SCA judgment

The SCA ruling ushered in heightened uncertainties within the tax community, prompting multinational corporations to reassess their CFC structures, particularly those employing outsourcing models. In disagreement with the SCA judgment, CIMSA and several tax experts have raised objections, in agreement with the initial tax court ruling. Although the tax court decision is not binding, it provides valuable context and diverse interpretations of section 9D of the ITA. The Constitutional Court of South Africa (CC) also disagreed with this SCA judgment.

Initially, when the tax issue was heard by the Tax Court,[307] the judge interpreted the FBE exemption by assessing the primary operations based on the actual activities conducted by the CFC (CGFM). This assessment was bolstered by the myriad of activities undertaken by the CFC in Ireland to maintain the requisite licences and facilitate CIMSA's provision of offshore investment opportunities to South African investors.[308] Consequently, the primary operations were deemed to encompass fund management, predicated on the CFC's tangible activities. The ruling of the Tax Court was in favour of the CFC, determining that it operated from an FBE and thus qualified for the FBE exemption. Crucially, the judgment delineated the CFC's primary business as fund management, implying that the outsourced activity of investment management did not constitute its primary operations.[309] Therefore, the Tax Court concluded that the CFC's operations possessed economic substance and satisfied the FBE exemption requirements. This judgment contrasts with the SCA ruling due to differing interpretations of the FBE exemption rules, accentuating the complexities inherent in their application.

Some tax experts have expressed disagreement with the SCA judgment, contending that relying solely on source documents rather than the actual daily activities of the CFC is theoretical and impractical. The arguments put forth by these experts are discussed below.

[306] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 35.
[307] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023, Pages 12 - 14.
[308] Mollagee & Sarembock, 2023, Primary Operations of a Business: Am I who I decide to be, or am I simply what I'm authorised to be? The Case of SARS v Coronation.
[309] ibid.

Horak & McKinnell (2023) assert that the SCA's interpretation of the FBE exemption requirements is erroneous, leading to significant uncertainty for multinational corporations.[310] According to this perspective, the judgment restricts the CFC from determining the scope of its primary business activities independently.[311] This restriction stems from the requirement to ascertain primary operations based on objective factors, such as the Memorandum of Incorporation (MOI) and the terms and conditions of the specific licence obtained by the CFC to conduct its business.[312]

The argument posits that while source documents like the MOI and licence may outline broad objectives, they may not accurately reflect the actual business activities undertaken by the CFC.[313] Mollagee & Sarembock (2023) support this viewpoint, suggesting that legal documents of CFCs are often drafted broadly to accommodate potential changes in business activities without necessitating formal legal amendments to the MOI.[314]

Similarly, Clegg (2023) concurs with this stance, arguing that functions specified in the licence represent a comprehensive list of authorized activities, but the licence does not mandate the CFC to execute all functions therein.[315] Thus, the contention is that relying solely on source documents fails to capture the nuanced operational reality of the CFC, potentially leading to misinterpretations and adverse consequences.

The business plan outlined an outsourcing model where daily activities were designated to occur in Ireland, excluding investment management functions.[316] Moreover, it is contended that the licence provided does not encompass the conduct of investment management functions in Ireland,[317] suggesting a requirement for a new licence, a stance supported by Clegg (2023).[318] This interpretation aligns with CIMSA's and the tax court's judgments, which CSARS subsequently appealed.

It is proposed that the CFC should delineate its primary operations in its business plan and be assessed against this plan.[319] Additionally, transactions should undergo scrutiny by SARS to

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[310] Horak & Mckinnell, 2023, Outsourcing and the Foreign Business Establishment Rule for CFC Purposes: Why the SCA got it wrong in CSARS v Coronation Investment Management SA (Pty) Ltd.
[311] ibid.
[312] ibid.
[313] ibid.
[314] Mollagee & Sarembock, 2023, Primary Operations of a business: Am I who I decide to be, or am I simply what I'm authorised to be? The Case of SARS v Coronation, Page 6.
[315] Clegg, D., 2023, How Foreign is your Business Establishment?, Page 3.
[316] Horak & Mckinnell, 2023, Outsourcing and the Foreign Business Establishment Rule for CFC Purposes: Why the SCA got it wrong in CSARS v Coronation Investment Management SA (Pty) Ltd, page 22.
[317] ibid.
[318] Clegg, D., 2023, How Foreign is your Business Establishment?, Page 3.
[319] Horak & Mckinnell, 2023, Outsourcing and the Foreign Business Establishment Rule for CFC Purposes: Why the SCA got it wrong in CSARS v Coronation Investment Management SA (Pty) Ltd.

ensure compliance with arm's length principles under the transfer pricing regulations outlined in section 31 of the Income Tax Act.[320] Mollagee & Sarembock (2023) advocate for this approach, emphasizing the importance of utilizing transfer pricing mechanisms to safeguard South Africa's taxing rights.[321]

Furthermore, it is argued that if CAM (the subsidiary performing investment management functions in the RSA) were compensated on an arm's length basis, the profit would be fully taxable in the RSA through CAM, while the profit in the CFC from CIL (the UK entity performing investment functions) would be attributable to the FBE, thus warranting FBE exemption application.[322]

The analysis stresses the complexity and varying interpretations of the FBE exemption rules, leading to heightened uncertainties for multinational companies. Due to these varying interpretations and the significance of this matter, the Constitutional Court (CC) was approached to intervene.

5.2.4 The Constitutional Court judgment

The CC considered multiple factors when making its decision, including the objectives of section 9D, the FBE requirements, the nature of CGFM's business operations, its purpose, and prevailing industry trends such as outsourcing business models.[323] The CC confirmed that CGFM met all the criteria of an FBE as detailed in section 9D.[324] As a result, CIMSA is exempt from including the net profit of CGFM in its taxable income. The factors influencing this judgment are analysed below.

The CC emphasized that the objectives of the ITA's section 9D are twofold: to protect the tax base of the RSA and to encourage international competitiveness.[325] The promotion of international competitiveness is achieved through the exemption of profit generated from active operations conducted overseas.[326] This underscores that if CIMSA were incorrectly taxed on the active income of CGFM, it would be disadvantaged, contravening the objectives of section 9D.

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[320] Horak & Mckinnell, 2023, Outsourcing and the Foreign Business Establishment Rule for CFC Purposes: Why the SCA got it wrong in CSARS v Coronation Investment Management SA (Pty) Ltd.
[321] Mollagee & Sarembock, 2023, Primary operations of a business: Am I who I decide to be, or am I simply what I'm authorised to be? The Case of SARS v Coronation, Page 6.
[322] ibid.
[323] Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service, (47/23) [2024] ZACC 11, 21 June 2024.
[324] ibid.
[325] ibid.
[326] ibid.

The interpretation of how to determine the primary operations of CGFM was scrutinized. The CC concurred with CIMSA and the Tax Court that the determination of primary functions must be based on the actual activities conducted by CGFM on a daily basis in Ireland.[327] This interpretation contrasts with that of the SCA, which based its determination on source documents such as the MOI and authorized licences.[328] The CC's interpretation of section 9D affirms that primary functions are determined based on the actual activities of the CFC, an interpretation that aligns with international norms.

The actual activities of CGFM were determined by assessing whether CGFM performed all the core activities required of a fund manager.[329] These core practical functions were identified based on approved documents such as the business licence, business plan, and prevailing industry practices. The licence was evaluated to ensure that CGFM was performing the functions it was authorized to perform. The Constitutional Court confirmed that CGFM could not engage in investment activities beyond those authorized by its licence.[330] Once the core practical functions were established, CGFM's actual daily activities were compared to these functions, and it was concluded that CGFM performed all the core functions of a fund manager. Importantly, these core functions were also recognized and considered operational by the Central Bank of Ireland.[331]

The Constitutional Court considered additional factors in determining CGFM's primary operations. It was noted that CGFM's revenue was generated from fund management activities,[332] contrary to the SCA's judgment, which found that the revenue source was outsourced investment activities.[333]

The interpretation of what constitutes having commercial substance abroad was critically examined, including the use of outsourcing business models. The Constitutional Court interpreted section 9D of the ITA to permit outsourcing business models if there are justifiable commercial reasons, legal grounds, and alignment with prevailing general commercial practices.[334] Economic substance is achieved by demonstrating that the CFC (CGFM) has substantial economic presence abroad and is not merely a nominal or paper entity, regardless

[327] Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service, (47/23) [2024] ZACC 11, 21 June 2024.
[328] ibid.
[329] ibid.
[330] ibid.
[331] ibid.
[332] ibid.
[333] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[334] ibid.

of the business model employed.[335] In contrast, the SCA interpreted section 9D of the ITA as only accepting the outsourcing of primary functions within Ireland and not abroad, without considering the practices of local competitors or industry standards.[336]

Based on the evidence, the Constitutional Court concluded that CGFM's primary operations encompass fund management, including the oversight of outsourced investment activities.[337] This landmark judgment provides significant cost savings for CIMSA and offers clarity on the interpretation of the regulations, particularly regarding the FBE exemption. None the less, the question remains whether section 9D aligns with international norms, which is addressed in the subsequent analysis.

The judgments of the CC, the SCA, and the Tax Court underscore the complexities inherent in section 9D. These complexities highlight the necessity of comparing FBE exemptions with those of other key trading partners of South Africa to determine whether they are more favourable for both tax authorities and multinational corporations.

5.2.5 Application of UK's CFC rules to the Coronation case

In the UK, the applicable exemption for the CFC would be under section 371DF of Schedule 20 of the Finance Act, 2012 (FA), which exempts trading profits given CGFM's active trading. This exemption is contingent upon the fulfilment of specific conditions.

The requirements set out in section 371DG of the FA are satisfactorily fulfilled by CGFM, as it maintains a facility in Ireland with all requisite characteristics throughout the tax period:

- Existence of physical premises: CGFM operates from a commercial office in Ireland, which has been occupied and utilized for a period exceeding 12 months. This duration substantiates its real presence and establishment in Ireland.[338]
- Commercial activities: the physical premises serve as the operational hub for CGFM's daily fund management activities, including investment management oversight. Most of CGFM's fundamental functions related to fund management occur in Ireland on a routine basis.[339]

[335] Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service, (47/23) [2024] ZACC 11, 21 June 2024, page 32.
[336] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[337] ibid.
[338] ibid.
[339] ibid.

Based on the aforementioned criteria, it is evident that CGFM satisfies the business premises condition.

In accordance with section 371DH of the FA, CGFM will satisfy the income condition if the income from UK sources is below 20% of the total relevant trading profit. The income generated by CGFM through business outsourced to the UK-based company, CIL, might be perceived as UK-sourced income.

To ascertain compliance, the income from CIL should be aggregated with any other UK-sourced income, which pertains to the key decision-making processes regarding CGFM's assets and risks. While precise data on this matter is unavailable, it is reasonable to presume that only the revenue from CIL (as a minimum) would fall under the purview of UK regulations, rather than CGFM's total revenue.

Consequently, CGFM's taxable gross income under UK rules would likely be lower than under the SCA judgment, which prescribed taxation on CGFM's entire trading income.

Assessment of CGFM's UK-related management expenditure is imperative to ensure it does not exceed 20% of the total related management expenditure.[340] Given that investment management activities are overseen by CGFM, with operations conducted both in the RSA and the UK, it is projected that the majority, if not all, of the management expenditure would occur in Ireland, meeting the stipulated condition. Furthermore, there are no significant indications of intellectual property (IP) or substantial exports of goods from the UK based on available data.

Consequently, under the UK requirements, CGFM may be deemed to earn trading income from legitimate business activities, as a substantial portion of the CFC's profit does not stem from UK-related activities. If CIMSA and CGFM demonstrate that a significant portion of CGFM's income arises from Irish-related activities (pertaining to key decision-making on assets and risks), an exemption would likely be granted. The worst-case scenario would entail the taxation of revenue attributable to CIL if it is deemed to arise from UK-related activities. Thus, it suggests that CIMSA could potentially benefit from more favourable tax treatment under UK rules compared to the current SCA judgment.

5.2.6 Application of US CFC rules to the Coronation case

CIMSA is considered the US shareholder, with CAM being its subsidiary and a tax resident of the USA solely for this section. CIL remains a UK tax resident, while CGFM (CFC) remains a tax resident of Ireland. The subpart F rules exempt trading income if the CFC (CGFM) is

[340] Section 371DI of the Finance Act, 2012.

engaged in active business for valid commercial reasons in a specific country. This exemption applies to CFCs actively conducting a trade or business.

CGFM is regarded as being active in a trade or business, evidenced by its daily activities as fund managers outlined in its licence, which classifies CGFM as a management company.[341] These activities, which include cash collection and payment of costs including employee costs, are performed in Ireland with the purpose of earning a profit.[342] CGFM's activities are carried out with continuity and regularity, with the primary objective being profit generation.[343] This purpose is underlined by CGFM's incorporation in Ireland in 1997 to facilitate client investment in the RSA and Irish domiciled 'collective investment funds' (CIS).[344] CGFM manages assets on behalf of customers, charging fees, and making profits.[345]

CGFM conducts its fund management functions daily in Ireland, including active and substantial management and operational functions.[346] CGFM has offices located in Ireland, staffed by four individuals, comprising a managing director, two accounting officers, and a compliance officer, all residents of Ireland.[347] Additionally, investment management activities conducted in the USA and the UK are supervised by CGFM.[348] Considering these factors and assumptions, it is reasonable to conclude that CGFM's activities constitute active conduct performed by its employees on a regular basis, rather than being outsourced.

CGFM was incorporated in 1997, satisfying the five-year period preceding the tax period in question, which is 2012.[349] The assessment indicates that CGFM operates with regularity and continuity to generate profit, based in Ireland for valid business reasons such as proximity to markets and fulfilling local content requirements of its licence from the Central Bank of Ireland.[350] Consequently, it appears that the subpart F rules may exempt CGFM's trading income.

5.2.7 Application of Irish CFC rules to the Coronation case

According to Irish rules, the trading income is exempt if arrangements are conducted at arm's length with clear commercial reasons.[351] CIMSA is the Irish shareholder, with CAM being its

[341] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[342] ibid.
[343] ibid.
[344] ibid.
[345] ibid.
[346] ibid.
[347] ibid.
[348] ibid.
[349] ibid.
[350] ibid.
[351] Section 835R of the Taxes Consolidation Act, 1988.

subsidiary and a tax resident of Ireland only for this section. CIL remains a UK tax resident, while CGFM (CFC) is a tax resident of the RSA.

CGFM is deemed to have genuine arrangements in place, supported by its licence and the customer market in the RSA.[352] The practice of outsourcing investment functions, integral to CGFM's arrangement, is common among fund managers in Ireland, Europe, and the RSA, acknowledged as legitimate by the Central Bank of Ireland (CBI).[353] Therefore, it is reasonable to infer that CGFM's arrangements align with industry norms, potentially warranting exemption. Additionally, CGFM's management is actively involved in executive decisions concerning assets and risks, as evidenced by its daily fund management activities, including proactive supervision of service providers and compliance with regulations, as outlined in its business plan.[354] Hence, it is logical to conclude that CGFM's management decisions are made in the RSA for commercial purposes rather than to secure tax advantages.

There is no indication that transactions with related parties are not conducted at arm's length, and given CGFM's profitability, it can be assumed that CGFM charges its services at market-related prices. Consequently, transactions can be deemed to be market-related, thus qualifying for exemption under Irish rules.

If these arrangements with related parties are considered to not be at arm's length, only the income generated from CAM, an Irish tax resident, may be at risk of taxation, particularly if transactions are not at arm's length, or if CAM income arises from Irish significant people functions (SPFs). In such a scenario, the tax impact on CIMSA would be mitigated as only CAM income would be vulnerable to taxation in CIMSA's hands.

Considering the analysis presented above, it is probable that CGFM's trading income will be exempt, viewed as emanating from genuine commercial activities in line with industry standards. At worst, only CAM income may face potential taxation risks if arrangements are determined not to be conducted at arm's length and if income arises from Irish activities. Nevertheless, this exposure is lower compared to the current ruling by the SCA.

5.3 Conclusion

The verdict handed down by the SCA has introduced uncertainties within the tax community and may be perceived as targeting genuine trading income. The Constitutional Court overturned this ruling as it deemed the SCA interpretation of section 9D of the South African ITA incorrect. However, the complexities and uncertainties still remain. Through a comparative

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[352] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[353] ibid.
[354] ibid.

analysis with UK, the USA, and Irish regulations, it becomes evident that CIMSA could have received more favourable tax treatment had it been a tax resident in these jurisdictions. The UK's exemption rules, in particular, offer measurable thresholds that enable the tax community to assess exposure to CFC regulations more effectively. Conversely, South Africa’s section 9D appears aggressive, encompassing worldwide trading income that does not align with industry norms. It is advisable for the National Treasury to re-evaluate the FBE exemption against the UK's gateway rules. The summarized findings and their implications are further elaborated in the next chapter.

Chapter 6: Analysis and comparison

6.1 Introduction

As noted in the preceding chapter, the requirements of section 9D appear to be aggressive compared to the selected country norms, particularly in terms of the targeted income and FBE exemption requirements. The aggressiveness may negatively affect the profit margins of the multinational companies as evidenced by the Coronation Group. The significantly reduced profit margins may then negatively affect the competitiveness of these international companies in the global arena, especially if the tax regime appears to be targeting genuine trading income that is not targeted by other jurisdictions such as the UK, the USA and Ireland.

The aggressiveness of section 9D of the ITA requirements warrants a revision by National Treasury before South Africa reduces its tax base due to multinational companies such as Coronation Group moving their tax bases to other tax jurisdictions, as happened in the UK during the operation of the old CFC rules. This chapter summarises the findings noted while comparing section 9D of the ITA requirements with the CFC regulations of the UK, the USA and Ireland. The gaps in the section 9D of the ITA are highlighted and recommended for consideration by National Treasury.

6.2 Comparison of CFC rules and recommendations to National Treasury

The characteristics of CFC definitions across South Africa, the UK, the USA, and Ireland are largely similar. The key characteristics are that the resident shareholder is required to have adequate control over the decisions of the company abroad that generates its profits. The adequate control involves holding over 50% of the shares or voting rights of the company abroad, either directly or indirectly. The control enables the resident shareholder to influence how the assets of the CFC are utilised to generate its profits.

The criterion for determining a non-resident company is also consistent across all the surveyed jurisdictions and its primarily driven by the assessment of the tax residence, incorporation, establishment as well as the 'place of effective management' of that non-resident company. The section 9D CFC definition does conform to the international norms as it also has these key characteristics and criteria.

There is, however, one criterion that is different. The criterion that is different in the CFC definition is the threshold used to exclude the resident shareholder from the CFC definition. The South African shareholder exclusion threshold is currently set at 5% shareholding, and this is considered low compared to the 10% shareholding that is utilised in the USA and the UK's 25% shareholding. The Ireland CFC regime that is fairly new does not appear to impose such a requirement. The conservative threshold applied by section 9D of the ITA may create additional administrative burden that may be costly. As this threshold is not aligned with the

international norms, it is recommended that National Treasury reassess this requirement with a view to potentially aligning it with international standards, preferably at least 10% after evaluating the costs and benefits for taxpayers and the tax base of South Africa. This recommended change may then streamline the administration process and align section 9D of the ITA with international norms that are adopted by South Africa's trading partners.

The targeted income of section 9D of the ITA has similarities with the targeted income of the USA and the UK to some extent. The diversionary rules within South Africa's section 9D target related party transactions from genuine business activities of foreign business establishments (FBEs) that are seen or appear to be lacking commercial substance. These diversionary rules focus on transactions such as purchases, sales, or services where manufacturing and selling functions are divided across different tax jurisdictions, often exploiting tax havens to avoid taxation. The CFC related party transactions are considered non-genuine and targeted if the CFC cannot demonstrate that it primarily generates profits from significant transactions it enters with external customers and suppliers. The transactions with an independent customer and supplier base illustrate that the CFC is transacting at arm's length, has a genuine market base and does not depend on the group to generate profits.

Similarly, the US regulations also target diversionary income that has a risk of being shifted to tax havens, thus reducing the tax base of the USA. The USA also targets the related party sales, purchases and services as does section 9D in South Africa. The USA specifically targets related party transactions where manufacturing and selling functions span across different tax jurisdictions unless the CFC is the producer or significant modifier of the inventory that is being sold or installed in another jurisdiction. The US and SA regulations both target related party transactions that lack commercial substance.

The USA also targets the CFCs' increase in earnings invested in US property, focusing on income arising from US assets. This section targets the main resource that generates this profit. This section is similar to the UK and Ireland regulations; however, section 9D does not have this rule as it targets worldwide income of the CFC and not necessarily the income that originates from South African resources. As section 9D in South Africa does not have this clause, it is recommended that National Treasury should also assess if this option can be beneficial to the tax base of the RSA as well as multinational companies such as Coronation Group.

Another key difference in section 9D lies in the approaches that are adopted by the UK and Ireland in identifying what income to target. Both the UK and Ireland's CFC rules target income linked to the resources of their respective countries, provided transactions are not at arm's length. The UK focuses on profit primarily influenced by the source of the CFC's capital and

external control from the UK, exempting income earned from non-UK sourced capital or active decision-making taking place outside the UK. Ireland's rules similarly target income from activities predominantly performed within its borders. This source-based approach adopted by the UK and Ireland is fairly new compared to the South Africa section 9D and the US rules, as Ireland adopted it in 2019 and the UK in 2012. Therefore, one can assume that the fairly new Irish and UK rules accommodate modern trade that includes outsourcing models that are adopted by multinational companies such as the Coronation Group. Aligning South Africa's section 9D more closely with the type of source-based approach could enhance its effectiveness and align it with international norms.

South Africa, the USA, the UK, and Ireland all target passive income unless it stems from the primary activities of the CFC and is primarily derived from unrelated customers.

Section 9D stipulates that the net profit to be added to the hands of South African shareholders is calculated on a worldwide basis, treating the CFC as a resident taxpayer, provided the South African shareholder holds at least 10% of the shares. This provision aligns with the US requirements, where taxable income is similarly computed as if the CFC were a US tax resident, with the proportionate income taxed in the hands of the US shareholder. Such profit allocated to the US shareholder is termed a deemed dividend, contingent upon the shareholder owning at least 10% of the shares.

In contrast, the UK taxes income passing through the CFC gateway, originating from UK resources (assets and active decision-making), if the UK shareholder owns a minimum of 25% of the shares. This 25% exemption threshold is notably higher than that of section 9D of the South African ITA, and the USA, reducing the administrative burden for both the fiscus and multinational companies. The UK's inclusion rules, particularly the exemption threshold of up to 25% shareholding and the targeting of income generated by UK resources, appear more favourable compared to section 9D and the US approach.

The clauses pertaining to the FBE exemption are substantively similar across all countries, aiming to exempt trading income arising from substance-based business activities of the CFC if transactions are at arm's length, and commercial purpose is the primary reason for the CFC.

The FBE exemption, as outlined in section 9D(9)(b), seeks to strike a balance between taxation and fostering the growth of international business.[355] This equilibrium is achieved by exempting CFC income derived from legitimate business activities, thereby encouraging

[355] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 34.

companies to venture into foreign markets, thereby fostering economic growth and international trade.[356]

In South Africa, section 9D exempts CFC income when there is sufficient commercial substance abroad responsible for the generated income. Real activity and value creation should occur in the CFC's jurisdiction. Conversely, the USA requires that active business be conducted by the CFC, with the company itself performing active and substantial management and operational functions conducted throughout the preceding five-year period.

The UK provisions provide an exemption for all trading profits in cases where the proportion of trading income derived from UK sources is relatively small. A facility abroad (physical structure) must be maintained by the CFC for at least 12 months, with primary activities conducted therein. This provision requires CFC income to be predominantly generated from external independent sources, with UK source income being relatively insignificant. The UK requirements exempt income generated from non-UK sources if there is evidence of its significance compared to UK-linked income.

Ireland's regulations exempt trading income when the CFC has a genuine arrangement in place with a commercial business purpose. This necessitates arm's length arrangements, ensuring that significant income is not generated by significant people functions (SPFs) of Ireland. These rules share a source-based approach with the UK, albeit not as detailed.

The specificity and quantifiability of the UK requirements, with percentage thresholds provided for key business activities, stand out. Upon assessing FBE exemptions, it becomes apparent that the UK rules are more favourable. National Treasury is advised to consider adopting a similar source-based specific approach in South Africa, incorporating measurable percentage thresholds.

The central question pertains to the equity of burdening CIMSA with substantial costs, and whether the SCA judgment aligns with section 9D requisites. The objective is to evaluate the fairness of the SCA judgment in comparison to CFC rules and interpretations in other jurisdictions.

Critics argue that the SCA judgment, based on broad source documents like licences and Memorandum of Incorporation (MOI), lacks practicality and fairness for CIMSA and other multinational corporations. This was also confirmed by the Constitutional Court judgment. In contrast, the UK requirements might have viewed CGFM's trading income as legitimate, particularly if a significant portion did not stem from UK-related activities. This demonstrates

[356] Mekgoe, 2023, Controlled Foreign Companies and Business Establishment Relief, page 34.

that CGFM's income mainly arises from Irish activities could have resulted in exemption. Thus, CIMSA might have received a more favourable tax treatment under UK rules than under the SCA judgment.

The subpart F rules, exempting trading income if CGFM conducts active business for valid reasons, support the notion that CGFM's operations aim to generate profit and are based in Ireland for legitimate business reasons. This suggests that the subpart F rules might have exempted CGFM's trading income.

In Ireland, trading income enjoys exemption if arrangements are at arm's length, with clear commercial reasons. CGFM, the CFC, would be deemed to have genuine arrangements in place, supported by its licence and the South African customer market. The outsourcing of investment functions, integral to CGFM's arrangement, aligns with common practices among fund managers in Ireland, Europe, and South Africa. Recognized as legitimate by the Central Bank of Ireland (CBI), this outsourcing practice suggests genuine arrangements consistent with industry norms, potentially exempting CGFM. Therefore, it is plausible that CGFM's trading income will be exempt, arising from genuine commercial activities in line with industry standards. At worst, only CAM income might be exposed to taxation if arrangements are deemed non-arm's length, emanating from Irish activities. This exposure is lower than under the current SCA judgment.

The SCA judgment in the Coronation case appears more aggressive compared to rules in the UK, USA, and Ireland, which might have exempted or taxed the trading income at a lower rate. This suggests that CIMSA might not face the substantial costs it did until the SCA judgment was overturned by the CC if it were based in the UK, US, or Ireland. Fortunately for CIMSA, the Constitutional court did overrule the judgment of the SCA. However, the complexities in interpreting section 9D of South Africa remain, hence changes are recommended below.

6.3 Recommendations for National Treasury

The clauses that National Treasury is recommended to assess are noted below and include the conservative 5% shareholder exclusion threshold that is used in the CFC definition. The CFC definition under section 9D(1) of the ITA provides an exclusion for South African shareholders holding not more than 5% of the participation or voting rights in a company abroad. The section 9D clauses that target world-wide income of the CFC should be revised, and consideration should be given to the source-based approach adopted by the UK and Ireland recently. Section 9D(2A) of the ITA stipulates that the apportionment of the CFC’s net profit to a resident shareholder does not apply if the resident, together with a related party, holds below 10% of the equity interests of the CFC. This conservative 10% shareholding clause for the net income inclusion clauses of section 9D(2A) of the ITA should also be

assessed with the aim of aligning these with international norms to alleviate the administrative burden.

The re-assessment of the FBE exemption clauses is also recommended to eliminate the risk of unfairly taxing valid trading income. The UK requirements are more detailed, specific, and quantifiable; therefore, they may assist in eliminating the FBE exemption complexities and uncertainties. The evaluation and updating of these highlighted clauses are expected to still protect the tax base of the RSA, provide more certainty to the tax community, and reduce the tax costs on the shoulders of the multinational companies.

The South Africa's exclusion threshold of 5% shareholding is considered low compared to the 10% shareholding in the US and 25% in the UK. It is recommended that National Treasury re-assess this clause in order to reduce administrative burden and align with international standards.

Currently section 9D targets the worldwide income of the CFC, and this approach is considered aggressive even though it aligns with the USA requirements to some extent. The source-based approach that is adopted by the UK and Ireland recently is seen as a more favourable approach that will enable multinational companies such as Coronation Group to still be competitive on the global stage. The source-based approach targets income that arises from local resources, such the local capital injection, strategic decision making that enables the CFC's assets and risks to generate profits; as well as income arising from local assets such as properties, including intellectual properties. This approach could align section 9D requirements with international norms, hence National Treasury is recommended to assess its effectiveness in the South African market.

Section 9D of the ITA indicates that net income is added to the hands of local shareholders using the worldwide approach provided that the local shareholder holds at least 10% of the shares of the CFC. The 10% threshold is considered aggressive, even though it is consistent with the US clauses. In contrast, the UK has a 25% exemption threshold that was adopted in 2012. The higher exemption of 25% is seen as assisting with reducing the administrative burden for both the fiscus and multinational companies. It appears to be more favourable compared to the section 9D clause, hence re-assessment is advised.

The FBE exemption requirements of section 9D are considered complex and may be seen as targeting tax valid trading income. The proposed solution to this is to re-assess the FBE exemption clauses and consider if the UK requirements will be beneficially to the tax base of the RSA while still enhancing competitiveness for multinational companies. The UK requirements are recommended as they are specific, detailed, and quantifiable. Therefore, the UK approach is seen by this report as a solution that may reduce the complexities and provide

more certainty to the tax community at large. However, the costs and benefits of this re-assessment should also be considered.

The re-assessment of the above clauses is considered essential for South Africa as the current section 9D requirements appear to disadvantage multinational companies such as Coronation Group when compared to their competitors in other tax jurisdictions. The disadvantage was noted when the SCA judgment was assessed against the FBE exemption requirements of the UK, the USA and Ireland. It was concluded that the Coronation Group may have received the exemption as their income would have been seen as valid trading income under the rules of the latter countries. At worst, the Coronation group would have been still taxed at a lower gross income which evidences that section 9D is aggressive compared to international norms.

National Treasury is already planning to amend section 9D to align with the SCA judgment. Even though the SCA judgment has been overturned by the Constitutional Court, the amendments are still recommended. Before implementing these amendments for the judgments, it is prudent for the National Treasury to consider the complexities and highlighted shortfalls, which could negatively impact multinational companies like CIMSA. These shortfalls should be assessed to ensure that they still protect South Africa's tax base before implementation.

6.4 Conclusion

The section 9D requirements have been compared to UK, the USA and Irish CFC rules, and the criteria for the CFC definition and passive income were consistent across the selected countries. There were, however, certain clauses in section 9D that appear aggressive by comparison. National Treasury is urged to re-assess these clauses that are not consistent with international norms. The identified shortfalls appear to be risks to the tax base of the RSA. The key risk is the shifting of the tax base by multinational companies to other tax jurisdictions. To eliminate this risk, it is recommended that National Treasury assess the identified shortfalls, including a cost-benefit analysis.

Chapter 7: Conclusion

7.1 Summarising remarks

This research report has provided a comprehensive analysis of the provisions of section 9D and compared them with the corresponding provisions in the UK, the USA, and Ireland. The specific focus was on targeted income and FBE requirements. The primary objective was to explore alternative approaches that could mitigate the complexities associated with implementing section 9D in South Africa. The report also examined how other tax jurisdictions, such as the UK, the USA, and Ireland, would have treated the current Coronation tax matter,[357] thereby assisting in evaluating whether section 9D aligns with international norms.

The criteria used to assess the definition of a CFC across these tax jurisdictions were evaluated to identify which jurisdiction has the most favourable CFC definition requirements that could potentially improve section 9D in South Africa. It was observed that the characteristics of CFC definitions across various countries are fairly similar, and section 9D's CFC requirements were generally found to be fair and consistent with international norms.

However, one aspect of the CFC definition that was deemed aggressive and not in line with international norms is the 5% shareholding threshold used to exclude the resident shareholder from the CFC definition.[358] While the USA has a similar exemption set at 10%,[359] the UK has it at 25%,[360] and Ireland has no such requirement. The lower threshold of 5% was viewed as overly stringent and burdensome, creating an additional administrative burden. Consequently, it is advised that the National Treasury should deliberate on increasing the threshold to at least 10%, after evaluating the associated costs and benefits for the RSA. This assessment of the CFC definition criteria led to a subsequent evaluation of targeted income criteria.

The targeted income provisions within section 9D were compared with those of the UK, the USA, and Ireland, with the aim of identifying areas for improvement in section 9D. The targeted income rules in South Africa for diversionary income were found to be similar to the requirements in the USA. Both jurisdictions focus on transactions involving related parties where the manufacturing (value addition) and selling/servicing functions occur across different tax jurisdictions.[361] Such related party transactions are deemed non-genuine if the CFC lacks an external customer and supplier base, indicating it cannot transact with independent parties

[357] Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, (1269/2021) [2023] ZASCA 10, 07 February 2023.
[358] Section 9D(1) of the Income Tax Act No. 58, 1962.
[359] Section 951(b) of the Internal Revenue Code, 1986.
[360] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371VF(3).
[361] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000, Page 130.

at arm's length.[362] Therefore, both the RSA and the USA aim to address related party transactions that lack commercial substance.

In contrast, the UK and Ireland adopt a source-based approach to identify targeted income, differing from the worldwide approach employed by South Africa. The UK primarily targets income influenced by UK resources, such as capital contributions and active decision-making occurring within the UK for the CFC.[363] Income derived from non-UK resources is not targeted if it arises from arm's length transactions and if the CFC's activities have commercial substance.[364] The UK's approach is similar to that of Ireland, which targets income arising solely from Irish resources.[365]

All the jurisdictions examined target passive income due to its mobile nature. However, exemptions are provided when the profit is generated from the active trading activities of the CFC or is incidental to its primary business activities.[366]

The targeted income provisions under section 9D of South Africa were also compared with those of the UK, the USA, and Ireland, with the aim of identifying areas for improvement. The targeted income rules in South Africa for diversionary income were found to be similar to the requirements in the USA, focusing on related party transactions where manufacturing and selling/servicing functions occur across different tax jurisdictions.[367] These transactions are considered non-genuine if the CFC lacks an external customer and supplier base, indicating it cannot transact with independent parties at arm's length.[368] Thus, both South Africa and the USA target related party transactions that lack commercial substance.

The UK rules regarding targeted income appear to strike a fair balance between the priorities of multinational companies and the safeguarding of the UK tax base. This balance is achieved by focusing on income linked to UK resources, as such income is perceived to be generated by those resources. Given the perceived fairness of this approach, the National Treasury is encouraged to explore the possibility of implementing a similar tactic, as it could effectively safeguard the tax base of the RSA.

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[362] Section 9D(9A) of the Income Tax Act No. 58, 1962.
[363] HMRC, 2016, HMRC internal Manual, Controlled Foreign Companies, Chapter 4, INTM200100.
[364] Section 371DC of the Finance Act.
[365] Tax and Duty Manual, Controlled Foreign Company Rules, 2023, Page 38.
[366] Olivier & Honiball, 2011, International Tax: A South African Perspective, 5th ed, Page 581.
[367] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000, Page 130.
[368] Section 9D(9A) of the Income Tax Act No. 58, 1962.

In the UK system, specific profit targeted for taxation must be incorporated into the taxable income of the UK shareholder.[369] Both section 9D and the US rules exempt local shareholders holding below 10% of the CFC shares from this inclusion requirement.[370] In contrast, the UK rules, which use a source-based approach to tax income passing through CFC gateway filters, set a higher exemption threshold of 25%.[371] This threshold is significantly higher than those under section 9D and the US rules, thereby reducing administrative burdens for both fiscal authorities and multinational companies. The National Treasury is encouraged to contemplate raising the 10% threshold attributable to the net income inclusion to 25%, following further studies to quantify the benefits and costs for the RSA. Notably, the Irish rules do not include this threshold.

While CFC rules in each country target specific income streams, they also include clauses that exempt certain income, particularly income arising from valid commercial activities.[372] The FBE exemption clauses across different jurisdictions share a common goal: to exempt trading income that arises from genuine business activities of CFCs.[373] This exemption is applicable when the transactions occur on a local basis, are done at fair market value, and are driven by a commercial purpose.[374]

Section 9D of South Africa grants the FBE exemption to CFC income when there is sufficient commercial substance abroad that drives the generation of such income.[375] This requires day-to-day commercial activities in the CFC's jurisdiction for a fixed period of at least 12 months to demonstrate permanence.[376] The day-to-day commercial activities must create significant value for the CFC, with decision-making vested in local management regarding key strategic and operational decisions driving profit generation.[377] The outsourcing of primary functions outside the CFC's jurisdiction is disallowed, emphasizing the importance of local commercial activities performed with local resources.[378]

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[369] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371BD (1).
[370] Section 951(b) of the Internal Revenue Code, 1986 & section 9D(2A) of the Income Tax Act, No. 58, 1962.
[371] Finance Act 2012, Schedule 20, Controlled Foreign Companies and Foreign Permanent Establishments, section 371BD (1).
[372] Tickle, 2022, Controlled Foreign Corporations and the Future of the Business Establishment Exemption, Page 42.
[373] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.
[374] ibid.
[375] Davis Tax Committee, 2016, Base Erosion and Profit Shifting (BEPS) Final Report.
[376] Section 9D(1) of the Income Tax Act No. 58, 1962.
[377] ibid.
[378] De Koker & Williams, 2023, Silke on South African Income Tax, Chapter 5.44.

The USA's FBE is quite similar to the requirements of section 9D, as it also aims to exempt active income arising from genuine commercial trading activities.[379] This exemption is founded on the assumption that the CFC is involved in a range of profit-generating operations, such as the consistent receipt of earnings and settlement of costs.[380] The active conduct of trade emphasizes locality, requiring daily management and operational functions to be performed within the CFC's tax jurisdiction rather than being outsourced.[381] These requirements align closely with those of section 9D in South Africa, although their application may vary, as illustrated by the Coronation case.

The US rules require a duration of five years to demonstrate permanence by the Group company that controls the CFC, which is more stringent compared to the 12-month requirement under section 9D for normal businesses.

The UK requirements exempt total trading profits if they are primarily generated from non-UK resources.[382] The criteria include the existence of the CFC for at least 12 months to demonstrate permanence and specific percentage thresholds for how much income can be generated using UK resources before it becomes targeted.[383] For normal businesses, the UK-related income is limited to 20% of the total CFC income, and for banking businesses, this threshold is 10%.[384] Additionally, total management expenditure is capped at 20%.[385] Profit earned from UK-related intellectual property is limited to 10%, and there is a 20% limit for income earned from exportation of inventories by the UK.[386] These UK exemption provisions establish quantifiable criteria aimed at exempting CFC income derived from commercial activities primarily performed using non-UK resources.

The Irish rules grant exemptions when a CFC demonstrates genuine arrangements and a commercial business purpose.[387] This includes entering into arm's length transactions and earning income primarily from non-Irish resources.[388] The fundamentals of these rules align closely with the UK rules.

In light of these considerations, the UK requirements emerge as specific, quantifiable, and simpler. This is aided by the application of percentage thresholds for key business activities,

[379] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study,2000, Page xii.
[380] US Code of Federal Regulations (C.F.R.),2023, 26 CFR 1.355-3(b).
[381] ibid.
[382] Section 371DF of Schedule 20 of the Finance Act, 2012.
[383] ibid.
[384] ibid.
[385] ibid.
[386] Sections 371DJ & 371DK of the Finance Act, 2012.
[387] Section 835R of the Taxes Consolidation Act, 1988.
[388] Tax and Duty Manual, Controlled Foreign Company Rules, 2023, Pages 51.

providing greater certainty to the tax community. These requirements appear to balance favouring multinational companies while still protecting the local tax base. As these rules address the current complexities and uncertainties of section 9D while promoting international competitiveness, it is suggested that the National Treasury assess the feasibility of adopting similar rules under a source-based approach for South Africa.

The CFC rules, particularly the FBE exemption, were then applied to the Coronation case to assess the fairness of the current SCA ruling. Judgments from the Constitutional Court and the Tax Court, as well as opinions of tax experts, indicate that the SCA's ruling was not fair. Through comparative analysis with the UK, USA, and Ireland, it is evident that CIMSA could have received more favourable tax treatment had it been a tax resident in these jurisdictions. This finding underscores that to protect the local tax base, the National Treasury should update the section 9D requirements to prevent multinational companies from relocating due to more favourable tax positions in other jurisdictions.

7.2 Areas for further research

Research into the taxation of CFCs under section 9D presents several compelling areas for further investigation. Firstly, assessing the potential economic and operational impacts of revising section 9D, particularly focusing on amendments to the FBE exemption and thresholds for CFC definitions, could provide critical insights. Such a study would involve modelling the effects on multinational corporations operating in South Africa, evaluating their tax liabilities, and forecasting broader economic consequences. Additionally, expanding comparative analyses beyond traditional economies like the UK, USA, and Ireland to include emerging markets with similar tax challenges would enrich understanding. Comparing how these countries balance tax revenue generation with attracting foreign investment could offer strategic insights into policy adjustments beneficial for South Africa's economic competitiveness.

Secondly, exploring the long-term implications of section 9D on foreign direct investment flows into South Africa would be crucial. This research could delve into investor perceptions and decisions influenced by potential changes in CFC rules, examining direct tax impacts alongside broader economic factors. Sector-specific studies focusing on industries heavily influenced by multinational corporations would also be insightful. These studies could highlight sector-specific challenges and opportunities related to CFC rules, shedding light on how different industries adapt their operations and investment strategies in response to regulatory changes in South Africa.

To address concerns raised in this research report regarding the complexities and varying interpretations of section 9D rules, as well as the risks associated with unfairly taxing legitimate trading income, consideration should be given to establishing a tax commission enquiry. The purpose would be to assess whether South Africa should transition from its current worldwide approach to a source-based approach, similar to that implemented in the UK, including revisiting its FBE exemption clauses. This initiative could draw upon insights from this report and recommendations from the Davis Tax Committee's 2016 enquiry, which also called for a revision of section 9D, particularly its treatment of FBE and outsourcing business models.[389]

Historically, tax commissions have proven valuable in facilitating significant changes, such as the transition seen with the Katz Commission in 1997, which was established in 1994 to assess the tax system of the RSA for the post-apartheid era and led to the adoption of the residence-based approach currently in use.[390]

Conducting such an enquiry would involve engaging stakeholders including the National Treasury, the SARS, and the broader tax community to gather their perspectives before any decision to adopt a source-based approach is made. The findings of the commission, along with judicial rulings such as those in the Constitutional Court's Coronation case, could inform future research and policy decisions in this area.

[389] Davis Tax Committee, Base Erosion and Profit Shifting (BEPS) Final Report.

[390] Katz Commission's 5th Report, Basing the South African Income Tax System on the Source or Residence Principle – Options and Recommendations, 1997, page 56.

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