

**CURBING OFFSHORE TAX AVOIDANCE:
THE CASE OF SOUTH AFRICAN COMPANIES AND TRUSTS**

by

ANNET WANYANA OGUTTU

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PROMOTER: PROFESSOR RCD FRANZSEN

CO-PROMOTER: PROFESSOR HCAW SCHULZE

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SUMMARY

This work entails a study of some of the schemes that are employed by country residents when companies and trusts are used as vehicles for investing in offshore tax-haven and low tax jurisdictions so as to avoid taxes.

The study also entails a critical analysis of the effectiveness of the some of the laws in South Africa that curb such offshore tax avoidance schemes. Similar laws in the United Kingdom and in the United States are analysed in order to come up with some

recommendations that could be considered for possible reform of the relevant South African laws where they are found wanting.

Since offshore tax avoidance is an international issue, the effectiveness of the recommendations of some international organisations in preventing the depletion of countries' tax bases are also analysed.

KEY TERMS

Beneficial ownership

Conduit companies

Controlled foreign companies

E-commerce

Harmful tax competition

Harmful tax practices

Hybrid entities

Offshore companies

Offshore jurisdictions

Offshore tax avoidance

Offshore trusts

Place of effective management

Preferential tax regimes

Residence based taxation

Tax avoidance

Tax-haven jurisdictions

Transfer pricing

Treaty shopping

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND INFORMATION

Adam Smith, in his famous work on “the wealth of nations”, states the following:

The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities that is in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint ventures of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observance or neglect of this maxim consists what is called the equality or inequality of taxation.¹

In the past three decades, the world has generally witnessed radical changes in the patterns of population growth, peoples’ expectations, and levels of personal wealth. These changes have created increasing political and economic instabilities that have led governments of both developed and developing nations to continuously levy high taxes, in order to meet the rising demands and expectations, as well as the associated costs of providing new and improved infrastructure. With the introduction of new taxes and the continuous increase in the rates of the existing taxes, taxpayers have come to realise that often, the after-tax receipts increase less substantially or less rapidly than gross receipts. This, coupled with inflation, has often resulted in earnings being largely minimal, and many taxpayers have been propelled into higher income tax brackets, although their real purchasing power has risen little, if at all.² Today, even the individual worker can see that a tax system, in which higher income brackets produce

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- 1 A Smith “An Inquiry into the Nature and Causes of the Wealth of Nations” (1776) Vol 2 at 350-351, edited by RH Campbell, AS Skinner & WB Todd. See also AS Silke *Tax Avoidance and Tax Evasion Within the Framework of the South African Income Tax Legislation with Specific Reference to the Effects on the Fiscus and to Current Anomalies and Inequalities* (1959) at 561. BJ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 56 states that the dominant purpose of any income tax system is to raise revenue to finance government expenditure.
 - 2 United Nations: Ad Hoc Group of Experts on International Co-operation in Tax Matters: *International Co-operation in Tax matters: Guidelines for International Co-operation against the Evasion and Avoidance of Taxes (With Specific Reference to Taxes on Income, Profits, Capital and Capital Gains)* (1984) at 11.

progressively higher tax rates, is stifling to individual initiative and productivity.³ In order to lessen their tax exposure, taxpayers get involved in tax avoidance schemes, with the aim of minimising their tax liabilities.

1.2 DEFINING TAX AVOIDANCE

The term “tax avoidance” is different from the term “tax evasion”. The difference between these two terms lies in the fact that tax evasion is illegal. It is generally defined as the non-compliance with the tax laws and includes activities (like the falsification of tax returns and books of account) that are deliberately undertaken by a taxpayer to illegally free himself from the tax, which the law charges upon his income. Tax authorities normally resort to criminal prosecution to prevent tax evasion.⁴ On the other hand, tax avoidance involves using perfectly legal methods of arranging one’s affairs, so as to pay less tax. This is done by utilising loopholes in tax laws and exploiting them within legal parameters.⁵ Although tax avoidance may be against the purpose of the law, no legal measures can be taken to prevent it, unless the legislature amends the law and prohibits the practice in question. In this regard, the courts hold the view that no legal obligation rests upon a taxpayer to pay higher taxes than he is legally bound to under the taxing Act and that a taxpayer is not prevented from entering into a genuine, or *bona fide*, transaction which, when carried out, has the effect of avoiding or reducing liability to tax. This view is brought out by the following dicta expressed in various court decisions. In *Levene v IRC*,⁶ Viscount Summer held that

3 A Starchild *Tax Havens for International Businesses* (1994) at 4; A Ginsberg *International Tax Havens* 2 ed (1997) at 10.

4 D Meyerowitz *Meyerowitz on Income Tax* (2006-2007) in par 29.1; K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 350; s 75 of the South African Income Tax Act 58 of 1962 provides for a fine or imprisonment of up to 60 months; see also OECD *Issues in International Taxation No 1 International Tax Avoidance and Evasion (Four Related Studies)* (1987) at 1 where tax evasion is defined. V Krishna *Tax Avoidance: The General Anti-Avoidance Rule* (1990) at 9, also distinguishes between tax evasion and avoidance.

5 Meyerowitz in par 29.1; Huxham & Haupt at 350-351. On the meaning of “tax avoidance” see also L Olivier “Tax Avoidance Options Available to the Commissioner for Inland Revenue” (1997) 4 *South African Law Journal* at 1-3. A Rapakko *Base Company Taxation* (1989) at 39 states that it is the courts that are ultimately faced with the difficult task of having to draw a line in certain practical cases between tax avoidance and evasion.

6 [1928] AC 21.

[i]t is trite law that His Majesty's subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the taxing Act. They incur no legal penalties, and they, strictly speaking, no moral censure if having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them.

Lord President Clyde held in *Ayrshire Pullman Motors Services and D M Ritchie v IRC*,⁷ that

[n]o man in this country is under the smallest obligation, moral or otherwise, to arrange his legal relations to his business or to his property so as to enable the In-land Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take advantage, which is open to it under the taxing Statutes for the purpose of depleting the taxpayer's pocket. The taxpayer is in the like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.

Lord Tomlin also held in the celebrated case of *Duke v Westminster*,⁸ that

[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however inappropriate to the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he can not be compelled to pay an increased tax.

From the above, it can be deduced that the courts hold the view that it is open to any taxpayer to arrange his affairs, so as to avoid or reduce tax by preferring the kind of transaction that is not taxed, or that is taxed at a lower rate. But if the taxpayer has organised his affairs in such a way as to attract tax liability in terms of the clear letter of the law, he is liable to pay the tax, no matter what the resulting hardship.⁹

Impermissible tax avoidance

⁷ *Ayrshire Pullman Motors Services and DM Ritchie v IRC* 14 TC 754.

⁸ *ICR v Duke of Westminster* 51 TIR 467. South African courts have also expressed the view contained in this dictum on numerous occasions, for instance in *Hicklin v SIR* 1980 (1) SA 481 (A) at 483F; *CIR v Estate Kohler and others* 1953 (2) SA 584 (A) at 591F-592H; see also *CIR v Sunnyside Centre (Pty) Ltd* 1997 (1) SA 68 (A) at 77F in which Schutz JA commented that, "Companies are often used in a variety of ways to avoid taxes. When a scheme works, no tears are shed for the commissioner. That is because the taxpayer is entitled to order his affairs so as to pay the minimum of the tax. When he arranges them so as to attract more than the minimum he has to grin and bear it."

⁹ In *CIR v Delfos* [1933] AD 242 at 253, it was held that: "If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, can not bring the subject within the letter of the law, the subject is free, however apparently within the law the case

Although tax avoidance is not illegal, in 2005, SARS released a discussion paper on tax avoidance.¹⁰ It contains a discussion of what is referred to as “impermissible tax avoidance”. In attempting to describe “impermissible tax avoidance”, the discussion paper refers to certain “tax avoidance” practices that extend beyond what is legally acceptable. Reference is made to the Australian Report on Business Taxation,¹¹ which refers to a form of “tax avoidance” which is essentially a misuse or abuse of the law that is driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by Parliament. It also includes the manipulation of the law and a focus on form and legal effect rather than substance. Lord Templeman explained this state of affairs as follows in the United Kingdom case *CIR v Challenge Corporation Ltd*:¹²

Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.

The economists Brooks and Head¹³ comment as follows on this type of tax avoidance:

[i]n legal discussions of tax avoidance, the primary focus is clearly on contrived and artificial schemes, which do not change the substantive character of an activity or transaction but may serve nevertheless to bring the activity within some tax-exempt or more tax-favourable legal category.

Drawing upon these definitions, the Discussion Paper uses the term “impermissible tax avoidance”, to refer to artificial arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed to manipulate tax laws in order to achieve results that conflict with or defeat the intention of Parliament.¹⁴

The discussion paper however, distinguished the term “impermissible tax avoidance” from the term “tax planning”. Noting that “tax planning” is concerned with the

10 might otherwise appear to be.” See also, *Cape Brandy Syndicate v IRC* [1921] 1 KB at 64.
 Law Administration SARS *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* (2005).

11 Australian Government *Final Report of the Review of Business Taxation: A System Redesigned* (1999) at 6.2(c).

12 [1987] AC 155.

13 M Brooks & J Head “Tax Avoidance: In Economics, Law and Public Choice” in *GS Cooper Tax Avoidance and the Rule of Law* (1997) at 71 as quoted by SARS “Discussion Paper on Tax Avoidance at 4.

organisation of a taxpayer's affairs so that they give rise to the minimum tax liability within the law, without resorting to "impermissible tax avoidance" that is described above.¹⁵ It is reasoned that the term "tax planning" is similar to the term "tax mitigation", which was described as follows in *CIR v Challenge Corporation Ltd*:¹⁶

Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability.

In the United Kingdom case *CIR v Willoughby*,¹⁷ the court held that the hallmark of tax mitigation is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.

According to SARS, the notion of "tax planning" or "tax mitigation" is in effect what Lord Tomlin referred to in his famous dictum: "every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be".¹⁸ SARS is of the view that this type of legitimate tax planning has to be distinguished from "impermissible tax avoidance".¹⁹ SARS points out that the world has changed enormously since Lord Tomlin made the above statement in the *Duke of Westminster* case, 70 years ago.²⁰ Although a government may still be viewed by some as nothing more than a revenue-maximising "leviathan",²¹ the role of taxation as a means that government uses to fund its expenditures cannot be underestimated. Thus, the right of taxpayers to minimise their tax liabilities within the bounds of the law must be balanced against other rights and obligations.²² In this regard, Woodhouse, J noted that:

Nevertheless, since the House of Lords was obliged to consider the highly beneficial arrangements which were able to be made in 1930 on behalf of the Duke of Westminster, there has been a growing awareness by the legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not

14 SARS Discussion Paper on Tax Avoidance at 4.

15 SARS Discussion Paper on Tax Avoidance at 4.

16 [1987] AC 155.

17 [1997] 4 All ER 65 at 73.

18 *IRC v Duke of Westminster* [1936] 19 TC 490 at 520.

19 SARS Discussion Paper on Tax Avoidance at 5.

20 *IRC v Duke of Westminster* [1936] 19 TC 490.

21 Brooks & Head at 82-91; G Brennan & JM Buchanan "Towards a Tax Constitution for Leviathan" (1977) 8 *Journal of Public Economic* 255.

22 SARS Discussion Paper on Tax Avoidance at 14.

merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that they have social consequences which are contrary to the general public interest.²³

The House of Lords itself has recognised the limits of the *Duke of Westminster* case. For example, Lord Diplock made the following statement in *IRC v Burmah Oil Co Ltd*²⁴

Lord Tomlin's oft quoted dictum . . . tells us little or nothing as to what methods of ordering one's affairs will be recognised by the courts as effective to lessen the tax that would otherwise attach to them if business transactions were conducted in a straight-forward way.

Lord Steyn made the point even more bluntly in *CIR v McGuckian*.²⁵

While Lord Tomlin's observations in the *Duke of Westminster's* case still point to a material consideration, namely the general liberty of the citizen to arrange his financial affairs as he thinks fit, they have ceased to be canonical as to the consequences of a tax avoidance scheme.

Lord Denning also made a characteristically terse admonition that "the avoidance of tax may be lawful, but it is not yet a virtue".²⁶

Impermissible tax avoidance has continued to become a problem in the past decade.²⁷ It often involves increasingly complex and sophisticated tax schemes that are being marketed by banks, multinational accounting firms and law firms particularly with respect to schemes involving tax havens.²⁸ The United States Department of the Treasury has noted that "[s]ome commentators explain the growth in corporate tax shelters as a reflection of more accepting attitudes of tax advisers and corporate executives towards aggressive tax planning".²⁹ At the same time, the lucrative market for tax avoidance schemes and "tax optimisation" plans has led to an increase in the resources and talent being devoted to those areas by professional firms in many countries.³⁰

Disadvantages of "impermissible tax avoidance"

23 *Elmiger v CIR* [1966] NZLR 683 (SC) at 686.

24 [1982] STC 30 (HL) at 32.

25 [1997] 3 All ER 817 (HL).

26 *Re Weston's Settlements* [1968] All ER 338 at 342.

27 SARS Discussion Paper on Tax Avoidance at 8.

28 SARS Discussion Paper on Tax Avoidance at 5; OECD *Harmful Tax Competition: An Emerging Global Issue* (1998).

29 United States Treasury Department *The Problem of Corporate Tax Shelters – Discussion Analysis and Legislative Proposals* (1999) at 19. Available at ><http://www.quotloos.com/whiteppr.pdf><, last accessed 4 April 2007.

30 SARS Discussion Paper on Tax Avoidance at 8.

The manipulation of tax laws through artificial schemes that have little economic substance undermines the ability of national governments to set and implement economic and social policies for the country.³¹ The loss of tax revenue caused by impermissible tax avoidance has the effect of limiting the government's ability to pursue its economic and social objectives. This forces governments to divert scarce resources from their intended targets³² and to shift the burden of taxation to less mobile factors such as labour and consumption.³³

The other negative effect of impermissible tax avoidance is that it encourages the disrespect for the tax system.³⁴ In view of this, the New York State Bar Association - hardly a "pro-tax" organisation – has stated that:

The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions.³⁵

It is a fundamental principle of taxation that the burden of tax should be spread as fairly and as equitably as possible among all the taxpayers.³⁶ However, if certain taxpayers are free to arrange their affairs to reduce their tax obligation, they secure an unfair advantage over other taxpayers who are not in a position to take advantage of the loopholes in the law. The proliferation of arbitrary tax avoidance schemes leads to a perception that the tax system is unfair.³⁷ Tax avoidance can be viewed as "a form of subsidy from those paying their fair share of tax according to the intention of the law, to

31 Brooks & Head at 53-91.

32 SARS Discussion Paper on Tax Avoidance at 14.

33 RS Avi-Yonah "Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113 *Harvard Law Review* at 1578; See also SARS Discussion Paper on Tax Avoidance at 14.

34 D Kruger & W Broomberg *Broomberg on Tax Strategy* (2003) 4 ed at 1; United States Treasury Department Report on the Problem of Corporate Tax Shelters at 19.

35 Statement of H R Handler, on behalf of the Tax Section, New York State Bar Association, before the Committee on Finance (27 April 1999) at 2. Quoted in the United States Treasury Department Report on the Problem of Corporate Tax Shelters at 3.

36 This principle originates from the four maxims articulated by Adam Smith – equality, certainty, convenience and freedom from economic burden. See Smith at 350 -351.

37 OECD Report on Harmful Tax Competition at 4.

those shirking their similar obligations”.³⁸ Taxpayers engaging in impermissible tax avoidance are thus seen as tax “free riders”.³⁹ The loss of revenue by the government as a result of wide-spread tax avoidance may also result in an increase in the rate of tax payable.⁴⁰ This state of affairs discourages compliance, even by taxpayers that had not previously engaged in tax avoidance.⁴¹ The tax avoider, like the illegal tax evader, shifts his burden on to the shoulders of others who often are poorer tax payers. The prevalence of tax avoidance may lead to increased tax evasion, because, if one taxpayer is aware that his neighbour is not paying tax in terms of legal means which he cannot benefit from, he may be tempted to adopt illegal means to obtain the same or similar benefits of reduced taxation accruing to his neighbour.

The negative effectives of tax avoidance have also been criticised by the courts. In *Cot v Ferera*,⁴² it was stated that:

I endorse the opinion expressed that the avoidance of tax is an evil. Not only does it mean that a taxpayer escapes the obligation of making his proper contribution to the fiscus, but the effect it has is to cast an addition burden on taxpayers who imbued with a greater sense of civic responsibility, make no attempt to escape or, lacking the financial means to obtain the advice to set up the machinery, fail to do so. Moreover the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that ‘good citizens’ will always fare badly.

And in *Latilla v IRC*,⁴³ it was stated that:

Judicial dicta may be cited which points out that, however elaborate and artificial...avoidance methods may be, and that those who adopt them are ‘entitled’ to do so. There is of course no doubt that they are within their legal right, but that is no reason why their efforts or those of the professional gentlemen who assist them in the matter should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship.

Impermissible tax avoidance has led to a proliferation of specific anti-avoidance laws that are enacted in response to particular schemes. However, the increasing complexity of tax laws may be self-defeating, as invariably, taxpayers devise more complex

38 See the Australian Government’s Final Report of the Review of Business Taxation at par 6.2(c); SARS Discussion Paper on Tax Avoidance at 13.

39 J Waincymer “The Australian Tax Avoidance Experience and Responses: A Critical Review” in *GS Cooper Tax Avoidance and the Rule of Law* (1997) at 256.

40 L Olivier “Tax Avoidance and Common Law Principles” (1996) 2 *Tydskrif vir Die Suid-Afrikaanse Reg* at 378.

41 OECD Report on Harmful Tax Completion in par 30; SARS Discussion Paper on Tax Avoidance at 10.

42 *Cot v Ferera* (1976) 2 SA 653 at 656F-G.

43 *Latilla v IRC* [1943] 1All ER 265.

schemes and the cycle goes on. This has the effect of increasing costs for the economy, such as costs for continuous amendments of the legislation, administrative costs and increasingly comprehensive and detailed reporting requirements. Invariably, this also increases the compliance burdens upon all taxpayers.⁴⁴ Additional costs are also reflected in the diversion of resources from productive investment to the development, marketing, implementation and subsequent defence of impermissible tax avoidance schemes.⁴⁵ At a deeper level, impermissible tax avoidance creates significant losses for the economy by distorting trade and investment flows.⁴⁶ This is because resources are reallocated or misallocated from productive investments to activities that may be marginally profitable to the economy.⁴⁷ These distortions reduce economic efficiency and impede growth.

In response to the SARS discussion paper on tax avoidance sections, 80A-80L (general anti-avoidance provisions) were inserted in to the South Africans Income Tax Act to deter taxpayers from engaging in impermissible tax avoidance schemes.⁴⁸ This thesis will not however cover a detailed analysis of the general anti-avoidance provisions.⁴⁹

One of the means that taxpayers use to avoid taxes in their countries of residence is to move their investments offshore (i.e. out of the taxpayer's country of residence) into a jurisdiction where the investments will be subject to zero or minimal taxation.⁵⁰

44 OECD Report on Tax Competition in par 30; See also United States Treasury Department Report on the Problem of Corporate Tax Shelters at 20.

45 J Slemrod & S Yitzhaki "The Costs of Taxation and the Marginal Efficiency Cost of Funds (1996) 43 *IMF Staff Papers* at 172; SARS Discussion Paper on Tax Avoidance at 11.

46 P Groenewegen "Distributional and Allocation Effects of Tax Avoidance" in D Collins *Tax Avoidance and the Economy* (1984) at 23.

47 Groenewegen at 23; SARS Discussion Paper on Tax Avoidance at 12.

48 For an explanation of the working of the general anti-avoidance provisions under s 80A-80L see Meyerowitz at 401-406; K Jordaan, A Koekemoer, M Stiglingh, L van Schalkwyk, M Wassermann & J Wilcocks *Silke: South African Income Tax* (2007) par 25.2-25.4.

49 As is explained below, this work covers some of the specific provisions that are used to curb impermissible tax avoidance when investments are made in offshore companies and offshore trusts.

50 HCAW Schulze "Legal Aspects of Offshore Transactions" (1994) xxvii *CILSA* 26; A Study by the Rotterdam Institute for Fiscal Studies (Vol A) *International Tax Avoidance* (1979) at 29.

1.3 FACTORS THAT HAVE ENCOURAGED OFFSHORE TAX AVOIDANCE

Historically, tax policies were developed to deal mainly with domestic economic and social concerns. However, the domestic tax systems of most countries also had an international dimension, in that they had to deal with the foreign source income of domestic residents, but the interaction of domestic tax systems was relatively minimal, since there was limited mobility of capital.⁵¹ This has changed in the past few decades, as a result of the major geopolitical changes that the world has seen. Notable among these changes have been the acceleration in the process of globalisation of trade and investment, and the removal of exchange controls and other barriers to the free movement of capital. These factors have fundamentally changed the relationships among domestic tax systems, resulting in an increase in international trade and the regional integration of national economies. This has in turn had a great impact on the way in which the domestic policies of various nations impact on one another. Globalisation has increased the mobility of capital and has also promoted the development of capital and financial markets, thereby encouraging countries to reduce tax barriers to capital flows, and to modernise their tax systems to reflect these developments.⁵²

This has in turn led to increased competition among businesses in the global marketplace. Faced with high tax rates in their countries of residence, individuals and multinational enterprises are increasingly developing global strategies, in order to maximise profits, and their links with any single country with a favourable tax climate are becoming more tenuous. It is a well known fact that, in all business transactions, tax is an expense like any other, and if businesses are to remain competitive, taxes should not be too high. Thus, “the possibility of reducing tax costs by basing a business in a favourable tax jurisdiction, is an inherent aspect of international tax planning”.⁵³ International businesses often consider foreign taxes to be part of their investment appraisals.

51 OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) at 13-14.

52 OECD 1998 Report at 13-14.

53 M Grundy *The World of International Tax Planning* (1984) at 1-2; Ginsberg at 5. Arnold at 62 also states that taxation is a factor in foreign investment decisions.

1.4 STATEMENT OF THE PROBLEM

It is a known fact that taxes have always varied, not only from individual to business, but also from country to country and there has always been an incentive to live or work in, or from, a lower-tax jurisdiction. As the wealth of both business entities and individuals has increased over the years, this incentive has become the foundation for business in its own right. It is therefore not surprising that more and more taxpayers are exploiting variations across international borders and international tax systems. These variations include differences between countries' tax rates, legal concepts, standards of administration, reporting and enforcement, and governments' attitudes towards the liberty and privacy of taxpayers and the confidentiality of financial and business transactions.

Taxpayers will ensure that foreign assets and income are concealed and kept outside their domestic tax jurisdiction. In many cases, this very concealment can take them over the dividing line between tax evasion and tax avoidance. They avail themselves of banking secrecy rules in other countries and other means, by which the ownership of assets, or income, or the transactions of their business, can be kept from the knowledge of the tax authorities.⁵⁴ These objectives are easily achieved when investments are made in the so-called "tax-haven" countries, which develop tax policies aimed primarily at diverting finances and other geographically mobile capital from high tax to low tax countries.⁵⁵

The prospect of investing in foreign markets, where in most cases annual returns are guaranteed without being reduced by high taxation, is an appealing one. Statistics show that, over the past 30 years, the number of financial transactions that have taken place in or through offshore jurisdictions, have increased at a rapid rate which is showing no

54 United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters at 18.
55 OECD 1998 Report at 13.

sign of abating.⁵⁶ Furthermore, many of the world's leading financial institutions have offshore activities.⁵⁷ It is estimated that 60% of the world's money is offshore, where it is likely to receive favourable tax treatment and be subject to fewer restrictions,⁵⁸ and that a large proportion of the world's private wealth is owned through offshore structures.⁵⁹ In South Africa, where uncertainty is the order of the day, offshore transactions have assumed an additional psychological attraction. The ability of South Africans to invest offshore has been enhanced by the relaxation of Exchange Control Regulations that began on 1 July 1997.⁶⁰ Currently the Exchange Control Regulations permit South African resident individuals to invest up to R2 million in direct offshore investments.⁶¹

One does not need a "crystal ball" to be able to predict that in the absence of contrary measures, investing offshore will continue to be employed as a means of tax minimisation. If the ensuing tax benefits are allowed to continue unchecked, the result will be that the public will lose confidence in the tax system and the tax administration, and this will tempt many taxpayers not to comply with tax laws and to continually seek artificial ways around them, to the detriment of the national economy.

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- 56 P Roper *Offshore Options* (1999) at 1; P Roper & J Ware *Offshore Pitfalls* (2000) at vii. V Tanzi International Monetary Fund Working Paper *Globalization, Tax Competition and the Future of Tax Systems* (1996) at 11 notes that in recent years there has been an increase in the number of countries and territories which impose low or even zero taxes, thereby encouraging individuals and enterprises to use them to establish a tax address to which income earned in other countries can be channelled; Ginsberg at 3 gives examples of jurisdictions such as Cyprus, Malaysia, Madeira, Malta, Mauritius, Nevis, Western Samoa and Gibraltar that have emerged as new tax shelters.
- 57 J Ware & P Roper *Offshore Insight* (2001) at 3 provide examples of financial institutions such as CNN, Chase Manhattan, Citi Bank, Goldman Sachs Schwab, the Bank of America, Barclays Bank, Rothschilds, the Royal Bank of Canada and Deutsche Morgan Grenfell that have offshore operations; see also Ginsberg at 56.
- 58 PEW Roper "Investing in the Offshore Market Place" (June 2000) *Insurance and Tax Journal* at 7; Ware & Roper at 3-4; P Gumbel "The Storms Over Tax Havens: Corporate Scandals Have Boosted the Pressure on Offshore Havens to Open their books. Some Have Done So - But the Global Crackdown Has a Long Way to Go" February 16 2004 *Time Magazine* at 2, where it is noted that the International Monetary Fund estimates that as much as \$7 trillion in financial assets of various kinds are now held offshore.
- 59 B Spitz & G Clarke *Offshore Service* (March 2002) 7 at INT/2; see also MWE Glautier & FW Bassinger *A Reference Guide to International Taxation: Profiting from your International Operations* (1987) at 265. DD Beazer "The Mystique of Going Offshore" (1996) 9 *The Utah Bar Journal* at 19 notes that approximately half of the world's funds pass through tax havens each year and this is a sum which is over \$5 trillion.
- 60 Roper (2000) at 5; DM Davis *Estate Planning* (2004) in par 17.1; Ginsberg at 29 and at 581; J Ware & P Roper "The Impact of Residence-Based Tax on Offshore Trusts" (2001) 16 *Insurance and Tax Journal* at 21; Davis in par 17.1.
- 61 South African Reserve Bank "Exchange Control Manual" in par 6.1.1. Available at

It is thus necessary to study some of the schemes that taxpayers employ in offshore tax avoidance, and to evaluate the effectiveness of the legislation that South Africa has in place to curb such schemes. If no such legislation is in place, or if current legislation is ineffective, the methods that other countries have used to deal with this problem were studied, so as to come up with recommendations for the reform of our laws.

The focus of this work is on the establishment of companies and trusts in offshore jurisdictions. The reason for choosing companies and trusts was that these are the two main vehicles used for investing in offshore jurisdictions.

1.5 HYPOTHESIS

In this work, it will be argued that there are two main factors (set out below) that encourage investment in offshore trusts and offshore companies. These factors have to be addressed, in order to curb the ensuing tax avoidance.

1.5.1 THE EXISTENCE OF LOW-TAX AND "TAX-HAVEN" JURISDICTIONS

Offshore tax avoidance through investment in offshore trusts and companies is encouraged by the very existence of low-tax and "tax-haven" jurisdictions.⁶² These are sovereign jurisdictions that have a right to determine their own tax policy (including making their country a tax haven). Other countries cannot enact legislation to remove the very existence of tax-haven countries. This issue can only be addressed at an international level, if at all.⁶³ This study will therefore consider the effectiveness of the

><http://www.reservebank.co.za/> <, last accessed on 16 May 2007.

62 A tax haven is described as a jurisdiction actively making itself available for the avoidance of tax that would have been paid in high tax countries. OECD Issues in International Taxation No 1 20; see also Ginsberg at 5-6; Roper & Ware at 5.

63 RL Doernberg, L Hinnekens, W Herrerstein & L Jinyan *Electronic Commerce and Multi-jurisdictional Taxation* (2001) at 92-93.

recommendations offered by some international organisations that could be applied, so as to prevent tax havens from being used to deplete other countries' tax bases.

1.5.2 STRUCTURAL FEATURES OF TRUSTS AND COMPANIES THAT MAKE THEM IDEAL VEHICLES FOR OFFSHORE TAX AVOIDANCE

Offshore tax avoidance is also encouraged by the structural features of companies and trusts that make them ideal vehicles for offshore tax avoidance. These structural features are used to take advantage of loopholes in the legislation. Countries often enact anti-avoidance legislation to close such loopholes and thus curb the ensuing tax avoidance. This work will discuss the effectiveness of some of the anti-avoidance legislation that South Africa has in place to curb the tax avoidance that results when taxpayers invest in offshore companies and offshore trusts.

When South Africa was excluded from international affairs because of apartheid, its tax laws that relate to international transactions did not develop at the same pace as that of its trading partners. Since 1994, when apartheid was abolished and South Africa rejoined the global economy, South African residents have actively participated in international trade. This has exposed them to tax avoidance schemes that have been employed by other countries' residents. At this stage, our legislation may not have sufficient devices in place that can counteract these tax avoidance schemes. This can result in a tremendous loss of revenue for the nation. It is thus necessary to make a comparative study of the offshore anti-avoidance legislation of other countries as a basis for recommendations for the reform of our legislation where necessary. To this end, comparable legislation in the United States and in the United Kingdom will be studied. These two nations were chosen because they have had legislation that targets offshore tax avoidance in place for decades. Their experience in this regard is a valuable resource that South Africa can draw on.

A study of offshore tax avoidance in the world today would be incomplete without taking cognisance of current developments in telecommunications that make it possible to trade electronically. Electronic commerce has opened up a new route for the exchange

of goods and services, and the accessing of offshore facilities. E-commerce is an area that has not yet been fully examined or regulated.⁶⁴ It is feared that e-commerce will lead to the erosion of the tax base, because of the ease with which the jurisdictional requirements can be manipulated. This work does not cover a detailed study of e-commerce, but some of the challenges that e-commerce poses to the legislation dealt with in this work will be briefly pointed out.

1.6 SCOPE OF THE STUDY

It is recognised that offshore tax avoidance does not necessarily only take place in tax-haven jurisdictions, but also in low-tax jurisdictions that are not necessarily tax-haven jurisdictions. The role of tax-haven jurisdictions will however, be emphasised, as the term “offshore” has historically been used in relation to islands in Europe and the Caribbean that are located off the mainland continents.⁶⁵ This work will deal with the characteristics of these jurisdictions that make them ideal for offshore tax avoidance, but it will not include a review of any particular tax-haven jurisdiction.⁶⁶

International transactions offer many opportunities for avoiding taxes. The following are some examples:

- the establishment of controlled foreign companies in tax havens to which a taxpayer can divert his domestic source income;⁶⁷
- the establishment of offshore trusts in tax havens;
- the use of “transfer pricing” techniques whereby related companies engaged in cross-border transactions can manipulate transfer prices and shift profits from high to low tax jurisdictions;⁶⁸

64 C Sher “Taxation of E-commerce” (2000) 39 *Income Tax Reporter* at 172.

65 G Clarke *Offshore Tax Planning* 11ed (2004) at 6.

66 A review of particular offshore jurisdictions can be found in Spitz & Clarke.

67 “Controlled foreign company” legislation that is discussed in detail in the preceding chapters has the effect of preventing the deferral of the undistributed income of a controlled foreign company, but it is taxed to its domestic shareholders on a current basis. See B Arnold *The Taxation of Foreign Controlled Corporations: An International Comparison* (1986) at 131.

68 Transfer pricing legislation is used to prevent the manipulation of prices in order to reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country. See SARS

- the use of unusual proportions of loan to equity capital (“thin capitalisation”) in order to achieve tax advantages;⁶⁹
- investment in offshore hybrid entities(e.g partnership/corporate structures);⁷⁰
- the use of “treaty shopping” techniques whereby a taxpayer avoids taxes by making use of advantageous tax treaties.⁷¹

This work discusses the operation of some of these tax avoidance strategies and the effectiveness of the anti-avoidance legislation designed to curb the ensuing tax avoidance. The work does not entail a discussion of “thin capitalisation”. Though a detailed study of “transfer pricing” is not covered, some aspects of this topic are discussed.

Although the study of exchange controls is not the main focus of this work, a discussion on “offshore tax avoidance” cannot be complete without reference to the role of exchange controls in limiting the flow of capital to offshore jurisdictions.

1.7 METHODOLOGY

The study will entail a review of South African and international textbooks, journal articles and case law on the topic studied as well as on related issues.

1.8 CONCLUSION

To abolish tax-haven jurisdictions may not be easy, as they have been in existence for

Practice Note No 7, 6 August 1999 “Section 31 of the Income Tax Act 1962 (the Act): Determination of Taxable Income of certain persons from International Taxation: Transfer Pricing” at paragraph 2.1.

69 Thin capitalisation rules are rules used to prevent the use of unusual proportions of loan to equity capital in order to gain tax advantages. See M Van Blerck “Transfer Pricing and Capitalisation” (1995) 8 *SA Tax Review* at 44; The Second Interim Report of the Commission of Inquiry into Certain Tax Structures of South Africa *Thin Capitalisation Rules* (1995) par 1.3b.

70 BJ Arnold & MJ McLntyre *International Tax Premier* (2002) at 114.

71 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) at 1; T Viitala *Taxation of Investment Funds in the European Union* (2005) at 95; RL Reinhold “What is Tax Treaty abuse? (Is Treaty Shopping an out dated concept?)” (2000) 53 *The Taxpayer* at 673; SJ Haug “The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis” (1996) 29 *Vanderbilt Journal of Transnational Law* at 220.

decades, and they have the right as sovereign nations to determine their own tax policies. Curbing offshore tax avoidance is going to take a concerted effort, at both the national and the international levels. Nationally, countries will have to enact and/or reform the relevant anti-avoidance legislation where it is found wanting. Campaigns against tax havens by international organisations, such as the OECD, will also go a long way towards curbing offshore tax avoidance, more especially if countries commit themselves to heeding the recommendations of these organisations.

CHAPTER 2

LOW-TAX AND TAX-HAVEN JURISDICTIONS: CATALYSTS FOR OFFSHORE TAX AVOIDANCE

It is scarcely possible to deal with the topic of offshore tax avoidance without discussing the role of low-tax jurisdictions and/or tax-haven jurisdictions. It is partly because of the presence of these jurisdictions that taxpayers in high-tax countries are encouraged to make investments in these jurisdictions where they will be subject to zero or minimum tax rates.

2.1 WHAT IS A TAX-HAVEN JURISDICTION?

According to the Organisation for Economic Cooperation and Development (OECD),¹ a tax haven is described as a jurisdiction actively making itself available for the avoidance of tax that would have been paid in high-tax countries.² It has been noted, however, that the expression “tax havens” does not have a precise technical meaning and that the term is commonly used in a very broad sense.³ The difficulty in giving “tax havens” a precise meaning lies in the

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- 1 The OECD is an international organisation that was established in 1961 to contribute to economic development and growth in its member countries. The organisation seeks to promote economic development by issuing publications and statistics on various topics, such as competition, corporate governance, electronic commerce, trade and taxation. Through its publications, the OECD chooses the tools of dialogue, consensus, peer review and pressure in order to encourage economic development and change in the market economy. Though the primary focus of the OECD is on member countries, its additional goals of contributing to the expansion of world trade and the development of the world economy affect non-members as well. See OECD “History of the OECD”. Available at http://www.oecd.org/document/63/0,2340, and_2649_201185_1876671_1_1_1_1,00.html, last accessed on 20 November 2006; JG Salinas “The OECD Tax Competition Initiative: A Critique of its Merits on the Global Market Place” (2003) 25 *Houston Journal of International Law* 538.
 - 2 OECD Issues in International Taxation No 1 *International Tax Avoidance and Evasion* (1987) at 20; see also A Ginsberg *International Tax Havens* 2 ed (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000) at 5.
 - 3 M Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) at 9 notes that there is no internationally accepted definition of exactly what a tax haven is. However, he describes tax havens as jurisdictions that have no or at least low direct and indirect taxes compared with the other jurisdictions. See also United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters *International Cooperation in Tax Matters: Guidelines for International Cooperation Against the Evasion and Avoidance of Taxes (with Specific Reference to Taxes on Income, Profits, Capital and Capital Gains)* (1984) at 30-31; RL Doernberg, L Hinnekens, W Herrenstein & L Jinyan *Electronic Commerce and Multi-jurisdictional Taxation* (2001) at 91.

fact that the definition can be given either a broad meaning or a precise one.⁴ In a broad sense, any given country can be said to serve as a tax haven in some respects. Almost every country in the world has a lower tax rate on some activity than another country's rate on the same activity. This is because countries often use their tax laws to influence the use of capital. In fact income tax rates on any given activity are likely to vary throughout the world. If the definition of a tax haven is based solely on the comparison of the tax rates applicable in various jurisdictions, the resultant definition is unlikely to be meaningful in practice.⁵

Similarly, if a tax haven is defined precisely as a jurisdiction which applies a low or zero rate of tax on all income items, on certain income items or on capital gains, this would encompass many countries. There are instances where relatively high-tax countries provide opportunities or devise policies to attract investment by charging low taxes in order to provide incentives and encourage certain economic activities.⁶ In practice, therefore, the term "tax haven" cannot be precisely defined.⁷

Generally tax havens are divided into three main categories: the zero-tax havens which offer no direct taxes (like income tax and capital gains tax), the low-tax havens, and the typical tax havens which impose tax at normal rates but grant exemptions or other preferential treatment to certain categories of income.⁸

4 Hampton at 10.

5 Hampton at 10, where it is pointed out that the complications of giving tax havens a precise definition lies in the fact that some high-tax countries may offer similar tax advantages to tax havens when, for example, tax exemptions are granted for certain types of businesses.

6 MWE Glautier & FW Bassinger *A Reference Guide to International Taxation: Profiting from Your International Operations* (1987) at 228; A Ogle Tolley's *Tax Havens: A Practical Guide to the Leading Tax Havens of the World* 1 ed (1990) at 4 notes that such countries cannot be considered tax havens in a strict sense since they levy direct taxes at normal rates while relieving from tax certain types of income.

7 United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters at 30-31, where it is noted that attempts to provide a single definition of a tax haven are bound to be unsuccessful. It is widely recognised that there is no single, clear objective test which permits the identification of a country as a tax haven.

8 Ogle at 3; see also Institute for International Research *Guide to Tax Havens* (1977) at 3; Ginsberg at 5; Glautier & Bassinger at 228; see also MJ Langer "Tax Havens of the World" (1970) 24 *Bulletin for International Fiscal Documentation* at 424-425; B Spitz *Tax Havens Encyclopaedia* (1977) at 1; Rotterdam Institute for Fiscal Studies, *International Tax Avoidance Vol A* (1979) at 70; IFA (1981) at 32, where it is noted that the first two categories are predominantly made up of small economies whose revenue needs are met by direct taxes or by a combination of indirect taxes and low direct taxes. These territories

The OECD has divided jurisdictions that charge nil or minimum taxation into two main categories: tax-haven jurisdictions and harmful preferential tax regimes.⁹ An OECD report published in 1998¹⁰ states that both tax-haven jurisdictions and harmful preferential tax regimes have harmful tax practices in place that may lead to the depletion of other countries' tax bases.¹¹ The report distinguishes between these two categories of jurisdiction by pointing out the characteristics that can be used to identify the relevant jurisdictions.

2.2 THE CHARACTERISTICS OF TAX-HAVEN JURISDICTIONS

Tax-haven jurisdictions are characterised by high levels of secrecy in the banking and commercial sectors. People who transact business in or through tax-haven jurisdictions are therefore assured of confidentiality.¹² This makes it difficult for foreign tax authorities to ascertain the identity of the relevant investors for the purposes of collecting taxes.¹³ It is common knowledge that many jurisdictions follow the common law precedent which provides for the privilege of information that a banker receives from his customer.¹⁴ This has evolved into a standard basis for protecting banking affairs and financial transactions from divulgence to foreign tax authorities. These secrecy provisions are, however, often abused in

use the absence of direct taxation or low direct tax rates in order to promote investment in their financial sectors.

9 OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) in par 75; see also B Spitz & G Clarke *Offshore Service* (2002) at OECD/3.

10 OECD 1998 Report; see also WH Diamond & DB Diamond *Tax Havens of the World* (2002) Publication 722 Release 108 at INTRO 13.

11 OECD 1998 Report in par 75; see also Spitz & Clarke at OECD/3.

12 Spitz & Clarke at INT/7; Oglely at 7 notes that users of tax haven will be concerned to ensure that their affairs remain confidential. In order to reassure users or potential users, a number of tax havens have introduced confidentiality laws imposing criminal sanctions on bankers or other professionals who betray their client's confidence. The most notable examples are Switzerland and Liechtenstein; see also Hampton at 12 and 14; Glautier & Bassinger at 234. Some countries have tax conventions with tax havens for the exchange of information, but this does not entail a breach of bank secrecy. Access to information of a public nature may not be denied but permission has to be granted. See also RA Westin *International Taxation of Electronic Commerce* (2000) at 384.

13 Spitz & Clarke at INT/7; Oglely at 7.

14 Diamond & Diamond at INTRO-35 note that common law secrecy is based upon an implied contract between a banker and his customer requiring the banker to treat all the customer's affairs as confidential. Secrecy may also be based upon statutes, which provide penalties, fines or imprisonment for violation of the provisions; see also DJ Workman "The Use of Offshore Tax Havens for Purposes of Criminally Evading Income Taxes" (1982) 73 *The Journal of Criminal Law and Criminology* (1982) at 679.

tax havens so as to facilitate the avoidance of taxes.¹⁵ These secrecy provisions serve as an incentive for offshore banking, mainly because tax havens usually distinguish between resident and non-resident banking activities. Non-resident banking activities do not have bank reserve requirements and they are taxed more lightly (if at all).¹⁶ This favourable treatment is based on the fact that tax havens thrive largely because of the presence of foreign banks since such financial activities generate revenue for the host country.¹⁷ In one Cayman Islands case,¹⁸ a bank from the United States of America which had a subsidiary in the Cayman Islands was issued with a summons by the United States of America's Internal Revenue Service for the purpose of identifying (for tax liability) persons who had transferred or received large sums of money during a specific period. The Cayman Islands court held that the safeguarding of confidentiality was a cornerstone of the banking business and the preservation of this principle was the basis on which the economy of the Cayman Islands so substantially relied. It thus outweighed the interests of America's Internal Revenue Service in enforcing its summons.

The other characteristic of tax-haven jurisdictions is a lack of transparency and effective exchange of information with other governments concerning the benefits taxpayers receive from the tax haven.¹⁹ Information exchange provisions help in curbing tax avoidance as the jurisdictions concerned can share the data that are necessary for the effective enforcement of their tax laws.²⁰

Tax havens are also characterised by a general lack of foreign exchange controls, which in itself is one of the major incentives for investing in tax havens, as it enables taxpayers to transfer money subject to minor restrictions.²¹ In contrast, high-tax countries have strict exchange controls that make it hard for

15 Hampton at 12; Ginsberg at 13 also notes that "the common advantages of tax havens include freedom from liability for tax, strict laws of secrecy for banking and commercial transactions and no exchange controls". See also United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters at 36.

16 Spitz & Clarke at INT/7; Ogley at 7; B Arnold & MJ McIntyre *International Tax Primer* 2 ed (2002) at 139 also give details of the characteristics of tax havens.

17 Spitz & Clarke at INT/7; Ogley at 7.

18 *In the matter of Bank of America Trust and Banking Corp (Cayman) Ltd*, and *In the matter of Bank of America National Trust and Savings Association* 1992 93 CILR 574, read from G Clarke & B Spitz *Offshore Service Cases Vol 1* (1999) at 158.

19 1998 OECD Report in par 79; see also Workman at 678.

20 Salinas at 534-535.

domestic residents to move their money at any time. The lack of exchange controls also prevents the loss of income that would result from the differences in the value of the currencies of different countries.²² Tax havens usually have a dual currency control system, which distinguishes between residents and non-residents and between local currency and foreign currency, by allowing non-residents' businesses to operate effectively outside their exchange controls while protecting the domestic economy from such freedom.²³

Taxpayers are generally attracted by the reduced statutory formalities that tax-haven jurisdictions offer, which make it easy to conduct business transactions in or through them. However, it is the resulting tax advantages that have traditionally been the driving force for offshore involvement.²⁴

Regarding harmful preferential tax regimes, the 1998 OECD Report points out that a harmful preferential tax regime can occur in both tax-haven and high-tax jurisdictions. Harmful tax regimes are characterised by having no or low effective tax rates on income; the regimes are ring-fenced²⁵ and there is a general lack of transparency and effective exchange of information with other countries.²⁶

Despite the fact that preferential tax regimes also play a role in offshore tax avoidance, it is the tax-haven jurisdictions that are mainly notorious in this regard. Writers on this topic have noted that the concept of "tax havens" is central to the idea of offshore tax planning.²⁷ This assertion is based on the fact

21 Glautier & Bassinger at 238.

22 Rotterdam Institute for Fiscal Studies at 76.

23 Hampton at 13-14; see also Workman at 680.

24 J Ware & P Roper *Offshore Insight* (2001) at 3; see also Glautier & Bassinger at 244-245.

25 The term "ring-fencing" refers to the artificial demarcation or limitation of profits or losses for tax purposes, ignoring the corporate form of the taxable or restricting the application of particular provisions to transactions inside the ring fence. See L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 488; see also Salinas at 540, where it is noted that ring-fencing protects a country from the financial burden of its own incentive regime, while adversely affecting only the foreign tax base. HCAW Schulze "The Free-trade Programmes of Namibia and Mauritius and the Latest Developments in Europe: Lessons for South Africa" (1999) 32 *CILSA* 185 at 202.

26 Salinas at 541 notes that a lack of transparency involves the unclear application of a tax regime to a taxpayer, with the application being unavailable to the tax authorities of other affected countries. Ineffective exchange of information means that secrecy laws or administrative policies may hinder the application of tax treaties and national legislation by preventing home-state tax authorities from obtaining information on taxpayers benefiting from a preferential tax regime; see also Olivier & Honiball at 463.

27 Arnold & McIntyre at 8.

that international tax schemes used to minimise taxes often involve the use of tax havens and tax havens play an important part in the international operations of many entities.²⁸

It is worth pointing out that the term “tax haven” is sometimes used interchangeably with the term “offshore financial centre”. It is argued that the latter term better reflects the wide range of commercial and financial activities carried on in the jurisdictions concerned.²⁹ Although both of these terms are used to refer to the withdrawal of capital from domestic jurisdictions, tax havens are based upon taking advantage of the taxation differences between states and they are usually jurisdictions that have low direct taxes or no direct taxes at all. Conversely, an offshore financial centre may be taken to mean a jurisdiction where a number of financial activities and services take place and where there are branches or subsidiaries of major international banks.³⁰ Tax havens may or may not host a range of financial services. Although an offshore financial centre may be a tax haven, not all tax havens are offshore financial centres.³¹ For the purposes of this work, the term “tax haven” is used.

2.3 HISTORICAL DEVELOPMENT OF TAX-HAVEN JURISDICTIONS

The history of the evolution of tax-haven jurisdictions shows that places offering foreigners little or no taxation on the investments made in these jurisdictions are not a new development. In the 12th Century, for example, the City of London exempted merchants of the Hanseatic League from all taxes.³² The cities of the

28 Diamond & Diamond at INTRO 1; G Clarke *Offshore Tax Planning* 11 ed (2004) at 250 points out that the term “offshore jurisdiction” tends to be used interchangeably with the term “tax haven”.

29 Clarke at 250.

30 Hampton at 15; Spitz & Clarke at INT/5; Roper & Ware at 5; Ware & Roper at 3.

31 Ginsberg at 3 and Olivier & Honiball at 463 note that the term “tax havens” has become increasingly unpopular with both tax advisers and the authorities in the relevant jurisdictions as it has come to imply the circumvention of another country’s tax laws. Increasingly reference is being made to “low-tax jurisdictions” or “offshore financial centres” in order to create a more positive image.

32 The Hanseatic League was a confederation of northern European trading cities which flourished from the 12th century to 1669. It was organised by German and Scandinavian seafaring merchants. Since there were no navies to protect their cargoes, no international bodies to regulate tariffs and trade, and few ports had regulatory authorities to manage their use, the merchants banded together to establish tariff agreements, provide for common defence and to make sure ports were safely maintained. The basis of the

Hanseatic League³³ owed much of their prosperity to the favourable tax treatment given to commerce.³⁴ In the 15th century, Flanders (now a part of Belgium) lifted the duties on much of its trade and imposed very few exchange restrictions. As a result, it became a flourishing international commercial centre where many English merchants sold their wool rather than in England, where they were taxed heavily.³⁵ Similarly, in the 16th, 17th and 18th centuries, the Netherlands imposed very low duties and few restrictions and was consequently able to attract thriving trade to its ports.³⁶ Switzerland has historically also been known as a tax haven for capital flight, a practice that dates back to Roman times.³⁷ By the 1930s, the Bahamas were already being used by wealthy Canadian and United States citizens as a location for private offshore trusts and holding companies in order to protect their assets from excessive taxation.³⁸ Despite their early existence, tax havens were not frequently used for tax avoidance purposes and for most people they still represented the proverbial “pot of gold at the end of the rainbow” - a fantasy beyond reach.³⁹ The original concept of tax havens as a means of avoiding taxes was first introduced in

League’s power was its monopoly of the Baltic trade and its relations with Flanders and England. The league became so profitable and so powerful that it survived for more than three centuries. The decline of the Hanseatic League after the 15th century was caused by the closing and moving of trade routes and the development of nation states. See Wikipedia: The Free Encyclopedia “Hanseatic League”. Available at >http://en.wikipedia.org/wiki/Hanseatic_League<, last accessed on 18 May 2007; see also J Mills “The Hanseatic League in The Eastern Baltic” (May 1998). Available at ><http://depts.washington.edu/baltic/papers/hansa.html>>, last accessed on 28 May 2007. See also C Doggart “Tax Havens and Their Uses” (1990) Special Report No. 1191 *The Economist Publication* at 1.

- 33 At the height of its power in the late 14th century the Hanseatic League included over 160 cities and towns, among them Lübeck, Hamburg, Cologne, Breslau, Kraków, Visby, Bruges, Bergen and Novgorod. See Wikipedia: The Free Encyclopedia “Lists of Former Hansa Cities”. Available at http://en.wikipedia.org/wiki/Hanseatic_League#Lists_of_former_Hansa_cities<, last accessed on 18 May 2007; see also ><http://depts.washington.edu/baltic/papers/hansa.html><, last accessed on 18 May 2007. See also HCAW Schulze *International Tax-free Trade Zones and Free Ports: A Comparative Study of their Principles and Practices* (1997) at 34, where mention is made of some of the cities in the Hanseatic League.
- 34 Doggart at 1; see also J Mills “The Hanseatic League in The Eastern Baltic” (May 1998). Available at ><http://depts.washington.edu/baltic/papers/hansa.html>>, last accessed on 28 May 2007.
- 35 Doggart at 1.
- 36 Doggart at 1.
- 37 Hampton at 17.
- 38 United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters at 30; Hampton at 17.
- 39 E Chambost *Using Tax Havens Successfully* (1978) at 13; Ogley at 3 notes that originally tax havens enjoyed a certain mystique and were regarded as a vehicle used only by the

international business after World War 1 and since then tax havens have proliferated on every continent around the world.⁴⁰ By the 1960s to 1970s, many United States banks had set up branches in Caribbean tax havens to serve as Euro-currency booking offices.⁴¹ For many years, the core offshore jurisdictions have been islands in Europe and the Caribbean that are located off the shores of the mainland continents. That is why the term "offshore" is used in respect of these jurisdictions although the term also applies to land-locked jurisdictions.⁴² But from the 1960s onwards, the scale on which individuals⁴³ have shifted their operating bases from place to place in search of tax relief has increased tremendously. This has generally been encouraged by developments in telecommunication and the worldwide removal of obstacles to the free movement of persons and property.⁴⁴ The increased tax rate differences among countries that have emerged in recent decades have also encouraged the diversion of funds and business transactions from jurisdictions with high taxes to low-tax jurisdictions which offer a more favourable environment for depositing funds and transacting business. In fact the use of a suitable tax-haven jurisdiction appears to have become a necessary component of international tax planning and many of the world's business transactions take place in tax-haven jurisdictions.⁴⁵ Furthermore, the offshore industry has grown substantially in the past decade. Today's leading mutual funds, stock broking firms and banks are based offshore and tax havens completely dominate such international activities as shipping, aircraft financing and captive insurance.⁴⁶

very wealthy.

40 Diamond & Diamond at INTRO 2-3.

41 Hampton at 17.

42 Clarke at 6.

43 V Tanzi *International Monetary Fund Working Paper: Globalization, Tax Competition and the Future of Tax Systems* (1996) at 9 notes that in recent years there has been an increase in the incomes that individuals derive from investments made in other countries. This is because information technology encourages the investment of personal savings abroad. As a result, the total and global incomes of individuals now contain a large and growing component of foreign-earned income.

44 Tanzi at 4; Salinas at 533. See also Ogley at 3 who states that the growth in international trade and the developments in telecommunication have led to a substantial growth in the number of tax havens. However, the increased telecommunication has led to a reduction in unit costs and this has resulted in tax havens being used by a larger sector of society.

45 Ginsberg at 5-6; Glautier & Bassinger at 228 note that the use of tax havens has been favoured by those most affected by high rates of direct taxation, namely business corporations, wealthy individuals with high levels of personal income and trusts established to protect accumulated wealth against death and succession duties.

46 J Christensen "Tackling Dirty Money: Illicit Capital flight and Tax Evasion" (World Social

The significance of tax havens lies in the fact that large amounts of money are sheltered there. The tax bases of other countries could well become depleted as a result. It is therefore necessary to explore ways of curtailing the use of tax havens for offshore tax avoidance.

As will be pointed out in subsequent chapters, domestic legislation can be enacted to close the loopholes in the law that encourage tax avoidance when investments are transferred to offshore companies and offshore trusts, but domestic anti-avoidance measures cannot remove the very existence of low-tax or tax-haven countries. Since each country has the right to determine its own tax policy (including establishing a tax haven), this issue can only be addressed at an international level, if at all.⁴⁷

2.4 A SURVEY OF SOME INTERNATIONAL INITIATIVES TAKEN TO STIFLE THE DEVELOPMENT OF TAX HAVENS

As the growth of tax havens continues to be a major cause of the depletion of countries' tax bases, the international community has taken some measures to stifle their development. A brief survey of the past and present steps taken by some of these bodies will now be offered and the effectiveness of the measures introduced considered.

European Union (EU) initiatives against tax havens

In 1992, the EU issued a report containing recommendations on company taxation in Europe that would prevent residents of member countries from transferring investments to other member countries that levied lower taxes. One

Forum - Bamako, Mali. 19-23 January 2006) at 9. Available at >http://www.taxjustice.net/cms/upload/pdf/World_Social_Forum_at_Bamako_-_JEC_-_Jan_2006.pdf<, last accessed 3 July 2007. Isle of Man Treasury "Island 'Committed to Global Business Growth'" (February 2007) *Isle of Man Financial Review* at 1; J Alm, JM Vazquez & M Rider "The Challenges of Tax Reform in a Global Economy"(2006) at 208. Available at ><http://books.google.co.za/books?id=0X4ZNFtChHcC&pg=PA207&ots=TbmB9R90XI&dq=tax+haven+investments+in+last+5+years&sig=KLQXSFA0umEI3C3jiYIloxz3hm7A#PPA208,M1><, last accessed 28 May 2007.

of the recommendations was to establish a minimum and a maximum corporate income tax rate for member countries of 30% and 40% respectively. However, this recommendation was not followed. Ten years later, in 2002, corporate income tax rates still varied greatly, the lowest being 16% in Ireland and the highest 40% in Greece. In addition, in some jurisdictions like Gibraltar (which is regarded as part of the United Kingdom in terms of EU law), some offshore companies still enjoyed tax-free status.⁴⁸ The EU drafted a directive on a common withholding tax which was designed to prevent the flow of funds to low-tax jurisdictions. It required member states to charge a minimum withholding tax of 20% on non-resident income from savings accounts. For example, if a resident of the United Kingdom had a savings account in Luxembourg, Luxembourg was required either to withhold 20% of that person's income or to forward the details of the investment to the United Kingdom's Inland Revenue Department. This directive was also to be followed by the Channel Islands dependent territories, namely; Guernsey and Jersey, and the Caribbean dependent territories, such as the Cayman Islands, Bermuda, the Turks and Caicos and British Virgin Island. However, the directive was met with objections from countries such as the United Kingdom, which were concerned that measures relating to withholding taxes and the sharing of information could reverse the flow of funds and have a negative impact on promoting the "Eurodollar" as a currency that could successfully compete against the American dollar as a world currency.⁴⁹

In 1997, the EU Council of Economic and Financial Ministers (ECOFIN) agreed on a package of measures to tackle harmful tax competition in order to help reduce distortions in the single market and to prevent excessive loss of tax revenue.⁵⁰ The measures included: a "Code of Conduct" on business taxation,⁵¹ a commitment to a draft a directive to deal with taxation of savings, including withholding taxes on bank interest payments and share dividends, and a

47 Doernberg *et al* at 92-93.

48 J Kesti *KPMG European Tax Handbook* (IBFD 2003) at 14; Olivier & Honiball at 475.

49 Diamond & Diamond at INTRO 24.

50 T Bennet *International Initiatives Affecting Financial Havens* (2001) at 115.

51 The "Code of Conduct" is a political commitment, not a legally enforceable rule. See W Bratton & J McCahery "Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation" (2001) 28 *Common Market Law Review* 677.

commitment to a draft directive on interest and royalty payments between companies.⁵²

In terms of the Code of Conduct, EU member countries were called upon to stop any measures that constituted harmful tax competition and to desist from introducing any new measures.⁵³ It was agreed that all harmful tax measures were expected to be withdrawn by 1 January 2003.⁵⁴ “Harmful tax measures” were defined as measures (including administrative practices) which affected in a significant way, the location of business activity in the Community, and which provided for a significantly lower effective level of taxation than the general level of taxation in the member States concerned. A group of representatives of the EU member States called the “Primarolo” group was set up to gather information and to assess any national tax measures that might fall foul of the Code.⁵⁵ In 1998 the Primarolo group came up with a report that blacklisted harmful national tax measures.⁵⁶

As a result of the Primarolo report, in 1998, the EU came up with a Communication on Unacceptable State Aid in regard to Direct Business Taxation.⁵⁷ In 2000, the State Aid in the form of tax incentives was prohibited in the European Community as it distorts competition.⁵⁸ As a follow-up measure, several investigations were conducted in 2001 to determine whether the member countries had complied with the Communication. For example, in 2001, an investigation was conducted into the Gibraltar qualifying offshore company’s rules and the Gibraltar exempt offshore company’s rules. The outcomes of the investigation were favourable to Gibraltar.⁵⁹

52 Bennet at 115.

53 BJM Terra & PJ Wattel *European Tax Law* 4 ed (2005) at 242; MF Ambrosanio & MS Caroppo “The Responses of Tax Havens Against Harmful Tax Competition: Formal Statements and Concrete Policies” (October 2004) *Quaderni Dell’Istituto Di Economia E Finanza* 6. Available at <http://www.unicatt.it/Istituti/EconomiaFinanza/Quaderni/571004.pdf> last accessed 25 June 2007.

54 B Spitz *Offshore Strategies* (2001) at 251; P Laidlow *Tolley’s International Tax Planning* (2000) at 19-20; Bennet at 115.

55 Terra & Wattel at 284; Bratton & McCahery at 701.

56 Ambrosanio & Caroppo at 6; see also Terra & Wattel at 284.

57 Terra & Wattel at 288.

58 Terra & Wattel at 288.

The EU also addressed the harmful tax competition that came about when certain member countries, like Luxembourg and Switzerland attracted the savings income of non-resident individuals. This they did by upholding bank secrecy and exempting from withholding tax, interest paid to non-residents. This facilitated non-declaration of income, thus draining other States tax revenues, notably.⁶⁰ Consequently, in 2003, the EU issued a Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different member States (Interest and Royalty Directive).⁶¹

In 2003, the EU also issued a Directive on the effective taxation of savings income as part of the policy package for preventing harmful tax competition (The Savings Income Directive).⁶² The application date of this Directive was set on 1 January 2005 on condition that an agreement was reached with certain countries on equivalent effective taxation measures on their part. In 2004, agreements were signed with Switzerland, Liechtenstein, Monaco and San Marino,⁶³ in terms of which, a system of exchange of information on harmful tax competition was to be effected on 1 July 2005.⁶⁴ Commenting on the EU initiatives against harmful tax competition, it has been noted that,

The EU has a better chance to curbing tax competition among its own members, both through its directives and through the European Court of Justice, which is steadily, enforcing tax harmony in the name of the single European market. But any success the EU achieves internally may simply make it more vulnerable to tax competition from non-EU countries.⁶⁵

The 1998 G7 initiatives

In 1998, the G7 countries⁶⁶ put forward a number of initiatives, in terms of which

59 Kesti at 14; Olivier & Honiball at 475.

60 Terra & Wattel at 243.

61 Directive 2003/49/EC as read from Terra & Wattel at 627. See also Bennet at 115.

62 Directive 2003/48/EC as read from Terra & Wattel at 643.

63 Terra & Wattel at 643.

64 Terra & Wattel at 243; Christensen at 9.

65 Bennet at 35.

66 The term "G7 Countries" refers to the Group of Seven Industrialised Countries. Before 1997, this group comprised: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America. In 1997 Russia formally joined the group and now it is referred to as the G8. However, Russia is not included in the group's economic meetings for financial officials since its economy is comparatively small as measured by gross

they put in place a comprehensive Code of Conduct on Business Taxation. The initiative committed the G7 nations to take international action on tax-related issues by allowing the exchange of information among member states.⁶⁷ The G7 noted that with the globalisation of business and use of the Internet, the threat of the depletion of countries' tax bases as a result of investment in tax havens has been exacerbated, and made it clear that they would be less tolerant of the use of tax haven bank secrecy and tax avoidance by the residents of high-tax countries.⁶⁸ The G7 agreed to reinforce the initiatives of EU and the OECD in tackling harmful tax competition and obtaining information about transactions in tax havens and preferential tax regimes.⁶⁹

In 1999,⁷⁰ the G7 held a summit in which member countries reaffirmed their support of the OECD initiatives against harmful tax. In the 2000 summit,⁷¹ the G7 welcomed the OECD 2000 Report on Progress on Identifying and Eliminating Harmful Tax Practices (that is discussed below)⁷² and urged all jurisdictions to make commitments to eliminate harmful tax practices. In line with the OECD recommendations, the G7 also called on all countries to work towards a position where they can permit access to, and exchange of, bank information for tax purposes.⁷³ In 2001 the G7 commended the OECD member countries for their commitment to eliminate harmful tax practices and urged the OECD to continue to monitor the effective implementation of those commitments. The G7 also commended the OECD for its continual dialogue with non-OECD member

domestic product. The term G7 now refers specifically to the seven countries excluding Russia, in the context of meetings for finance ministers and governors of central banks from those countries. See Wikipedia: The Free Encyclopedia "G8". Available at ><http://en.wikipedia.org/wiki/G8#History><, last accessed 16 May 2007.

67 G8 Information Centre: The Birmingham Summit "G7 Initiative on Harmful Tax Competition" (15-17 May 1988). Available at ><http://www.g7.utoronto.ca/summit/1998/birmingham/harmfultax.html><, last accessed 3 July 2007. See also Diamond & Diamond at INTRO 23;

68 Diamond & Diamond at INTRO 23.

69 See G8 Information Centre: The Birmingham Summit.

70 G8 Information Centre "Cologne Summit" (1999). Available at >http://www.g8.fr/evian/English/navigation/g8_documents/acrchives_from_previous_su...<, last accessed 3 July 2007.

71 G8 Information Centre: Kyushu-Okinawa Summit "Actions against Abuse of the Global Financial System" (21 July 2000) in par C. Available at ><http://www.g7.utoronto.ca/summit/2000okinawa/abuse.htm><, last accessed 3 July 2007.

72 OECD Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs "Towards Global Tax Co-operation Progress in Identifying and Eliminating Harmful Tax Practices". See the discussion on this report in fn 101 below.

countries to eliminate harmful tax practices and it encouraged other countries to associate themselves with the OECD initiatives.⁷⁴

The Edwards Report

In 1998, the United Kingdom's Home Secretary presented the Edwards Report to Parliament. This report, officially entitled "Review of Financial Regulations in the Crown Dependencies", described a study of the financial regulations in the United Kingdom Crown Dependencies of Jersey, Sark, Guernsey and the Isle of Man.⁷⁵ The matters investigated included cooperation by Jersey with foreign tax authorities regarding tax evasion and avoidance on Jersey; the operation of secretly-owned unsupervised companies on the Isle of Man; and the use of fictitious nominee directors in Guernsey and Sark.⁷⁶ The report accused Sark of using nominee directors for offshore companies without the knowledge of the true owners, thus allowing the offshore companies to enjoy secrecy and tax-free status.⁷⁷

The Edwards Report recommended certain measures with which these jurisdictions were required to comply.⁷⁸ In general, the findings of the report were favourable to these jurisdictions. The report commended the relevant jurisdictions for the way in which they have developed their offshore finance

73 See G8 Information Centre: Kyushu-Okinawa Summit.

74 G8 Information Centre: G8 Finance Minister's Meeting Rome, Italy "Fighting the Abuse of the Global Financial System" (7 July 2001) in par D. Available at ><http://tspace.library.utoronto.ca/bitstream/1807/262/2/fm010707-b.htm><, last accessed 3 July 2007.

75 Bennet at 37.

76 Diamond & Diamond at INTRO 25.

77 Diamond & Diamond at INTRO 26.

78 The Report recommended that

- offshore companies in these jurisdictions be forced to make public account filings;
- ownership of offshore companies should be disclosed to the Islands' regulators;
- there should be a crackdown on professional offshore advisers and rigid new regulations should be implemented to control persons assisting with company formation;
- there should be stricter supervision of attorneys and accountants in both British dependencies and persons onshore who are involved in offshore structuring and servicing;
- stringent action be taken against offshore trust companies by enforcing greater transparency and documentation of trustees and beneficiaries;
- investigations be made into the increase in the use of offshore trusts with the intention of making them the principle target of future changes. See Diamond &

centres and the manner in which those centres are regulated.⁷⁹ The Report's recommendations were duly considered both within the respective jurisdictions and in the United Kingdom. Some of the jurisdictions took steps to comply with the recommendations of the Report.⁸⁰ However some of the recommendations were not easily complied with as they required a substantial number of legislative changes, in some instances, whole revision of certain laws.⁸¹

The KPMG Report

In 1999, the British government released its plan for the Dependent Territories in a White Paper,⁸² in which it outlined the terms and conditions expected of the British Overseas Territories of Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Montserrat and the Turks and Caicos Islands. In response to the White Paper, in 2000, the government of the United Kingdom engaged the global advisory and accounting firm KPMG to investigate the financial regulations in the above British Overseas Territories. The findings of the KPMG report were, however, favourable to the territories. The criticism levelled against the investigation was that it was partially funded by these territories themselves and was therefore not very critical of them.⁸³

The OECD onslaught against tax havens

Of all the different international initiatives against tax havens, the OECD has probably played the leading role as it continues its onslaught against tax havens up to the present day. It is thus necessary to investigate the effectiveness of this campaign.

Diamond at INTRO 26; Bennet at 38-39.

79 Volaw Trust & Corporate Services Ltd, Channel Islands "The Edwards Report – 27 November 1998". Available at <http://www.volaw.com/pg428.htm>, last accessed 27 June 2007.

80 Ware & Roper 24 at 32; see also Olivier & Honiball at 475.

81 Volaw Trust & Corporate Services Ltd, Channel Islands. Available at <http://www.volaw.com/pg428.htm>, last accessed 27 June 2007.

82 Foreign and Commonwealth Office "Partnership for Progress and Prosperity - British and Overseas Territories" (17/3/99). Available at <http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1018028164839>, last accessed 18 May 2007.

83 Diamond & Diamond at INTRO 28; Ware & Poper at 33; Olivier & Honiball at 475.

In its 1998 report, the OECD pointed out that tax-haven jurisdictions and harmful preferential tax regimes distort financial and investment flows among countries.⁸⁴ The harmful tax practices of these havens undermine the integrity and fairness of tax structures; they discourage compliance by all taxpayers; they cause undesirable shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption; and they increase the administrative costs and compliance burdens on tax authorities and taxpayers respectively.⁸⁵ In order to counter those harmful tax practices, the OECD came up with certain recommendations that countries may adopt in order to enhance the effectiveness of their domestic legislation in curbing offshore tax avoidance.⁸⁶

The OECD recommended that countries should have rules concerning the reporting of international transactions and foreign operations of resident taxpayers and should exchange any information obtained under such rules. It was also recommended that countries consider undertaking coordinated enforcement programmes (such as simultaneous examinations, specific exchange of information projects, joint audits, and joint training activities) in relation to income or taxpayers benefiting from practices constituting harmful tax competition. Another suggestion was that countries review those rules that apply to the enforcement of the tax claims of other countries in order to assist in recovering such tax claims.

A further recommendation was that countries should adopt effective legislation to curb offshore tax avoidance. Such legislation includes “controlled foreign company” (CFC) legislation,⁸⁷ “transfer pricing” legislation (as that recommended

84 1998 OECD Report in par 75; see also Spitz & Clarke at OECD/3.

85 Ware & Roper at 27 state that according to member states, tax havens have increased their flow of funds, thereby undermining the onshore jurisdictions.

86 1998 OECD Report at 67-71.

87 Controlled foreign company legislation ensures that the undistributed income of a controlled foreign company is not deferred, but is taxed in the hands of its domestic shareholders on a current basis. Olivier & Honiball at 463; B Arnold *The Taxation of Foreign Controlled Corporations: An International Comparison* (1986) at 131; R Jooste “The Imputation of Income of Controlled Foreign Entities” 118 (2001) *The South African Law Journal* at 473-474; see also A de Koker *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa* (2004 service 29) vol 1 in par 5.43.

in the 1995 OECD Guidelines on Transfer Pricing⁸⁸), and also “thin capitalisation” legislation.⁸⁹

The OECD also recommended that in order to counter harmful tax competition, countries should review their laws, regulations and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities.⁹⁰ The OECD went on to recommend that countries should intensify international cooperation in response to tax competition. Furthermore, member countries were required to refrain from adopting new measures or strengthening existing measures (legislation and administrative practices) that constitute harmful tax practices. They were also required to review their existing measures and identify those that constitute harmful tax practices. OECD member countries were called upon to produce a list of tax-haven jurisdictions. Countries that have particular political, economic or other links with tax havens were asked to ensure that those links do not contribute to harmful tax competition and in particular countries that have dependencies that are tax havens were requested to ensure that their links with these tax havens are not used in a way that increases or promotes harmful tax competition. Further, countries should consider the termination of their existing tax treaties with tax-haven jurisdictions that are used to encourage harmful tax competition and they should not sign treaties with such tax havens in future. It was also recommended that non-member countries like South Africa be associated with these recommendations.

The 1998 OECD report gave rise to an uproar from the tax-haven jurisdictions

88 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (1995). Transfer pricing is also described as the systematic manipulation of prices in order to reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country. See South African Revenue Service (SARS) *Practice Note: No. 7 Section 31 of the Income Tax Act 1962 (the Act): Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (1999) in par 2.1.

89 Thin capitalisation is described as the use of unusual proportions of loan to equity capital in order to gain tax advantages. See United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matter at 18; The Second Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structures of South Africa *Thin Capitalisation Rules* (1995) in par 1.1 where “thin capitalisation” is referred to as a means of investment through debt as opposed to through equity. See also M Van Blerck “Transfer Pricing and Thin Capitalisation” (1995) 8 *SA Tax Review* at 44.

90 Spitz & Clarke at OECD/12.

whose livelihood it appeared to threaten.⁹¹ The report was criticised for focusing only on the interests of the OECD member countries and ignoring the interests and concerns of the tax-haven jurisdictions as it did not engage in effective consultations with these jurisdictions during the drafting stage.⁹² This approach, it is argued, undermines the notion of a nation's fiscal sovereignty.⁹³ The 1998 OECD report was also accused of discriminating against tax-haven jurisdictions.⁹⁴ Some OECD member countries such as Switzerland and Luxemburg which are financially oriented tax havens and were most affected by OECD recommendations, chose not to veto the 1998 Report.⁹⁵ Since the OECD had failed to obtain the cooperation of some of its own members it had no right to require non-OECD member countries to cooperate.⁹⁶

The report caused divisions among OECD member countries.⁹⁷ It was accused of setting out to impose a uniform tax system on all nations. The legislators of the United States spoke out against the OECD, calling its initiative destructive to tax havens' competitive status within the global economy.⁹⁸ Paul O'Neil, the then United States Secretary of State, made the following statement on 10 May 2001:

91 M Grundy *Essays in International Taxation* (2001) at 1.

92 Ware & Roper at 31; see also Spitz & Clarke at OECD/14-20.

93 Salinas at 555.

94 Ware & Roper at 30 note that in 1999 the Bahamas government told the OECD that the 1998 Harmful Tax Competition Report was not balanced and that it discriminated against countries whose tax regimes were considered unilaterally by the OECD to be harmful; P Gumbel "The Storm Over Tax Havens: Corporate Scandals Have Boosted the Pressure on Offshore Havens to Open Their Books. Some Have Done So - But Global Crackdown Has A Long Way to Go" (2004) 16 *Time Magazine* at 42-43. Gumbel notes that Ian Kelly, the Isle of Man's Income Tax Assessor, says, "the problem for us is that we see larger jurisdictions doing the very things we are attacked for, and nobody brings them to account". Kelly argues that "if you don't crack down on everyone, there is almost no point in cracking down on anyone". The author of the article also notes that tax havens still find themselves on blacklists even though they have taken action to become more open. It is hugely discriminatory and arbitrary says Deborah Drummond, a Cayman Islands Official; see also Diamond & Diamond at INTRO 15.

95 RS Avi-Yonah "Globalisation, Tax Competition, and The Fiscal Crisis of the Welfare State" (2000) 113 *Harvard Law Review* at 1662

96 Avi-Yonah at 1664.

97 Spitz at Clarke at OECD/14-20, where it is noted that: the OECD serves only the interests of its members and not the wider global community; the OECD lacks transparency in that the public is not allowed to participate; the harmful tax competition initiative is in effect the OECD making tax policy without the knowledge and participation of democratically elected bodies; the OECD has blurred the distinction between tax avoidance and tax evasion; and the OECD's project is an attack on taxpayers' constitutional rights, civil liberties and human rights.

98 C Scott & R Goulder "U.S. Congressman Owens Calls for US Government to Rescind Support of OECD Tax Competition Initiative" (2001) 22 *Tax Notes INT'L* at 1202, as

Although the OECD has accomplished many great things over the years, I share many of the serious concerns that have been expressed recently about the direction of the OECD initiative. I am troubled by the underlying premise that low tax rates are somehow suspect and by the notion that any country, group of countries, should interfere in any other country's decision about how to structure its own tax system. I also am concerned about the potentially unfair treatment of some non-OECD countries. The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonise world tax systems. The United States simply has no interest in stifling the competition that forces governments – like businesses – to create efficiencies ...⁹⁹

In general, the United States is of the view that although there is a need for countries to be able to obtain specific information from other countries in order to prevent tax avoidance, care must be taken not to interfere with the internal tax policy decisions of sovereign states. Furthermore, the focus of the OECD initiative should not be to limit tax competition; instead it should emphasise the need for countries to be able to obtain specific information from other countries in order to prevent non-compliance with tax laws.¹⁰⁰

Despite these criticisms, the majority of OECD member countries still supported its initiative. As a follow-up to the 1998 report, the OECD released another report in June 2000.¹⁰¹ In defence of its objectives, the OECD stated the following:

It is important to note at the outset that the project is not primarily about collecting taxes and is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the project is about ensuring that the burden of taxation is fairly shared and that tax should not be the dominant factor in making capital allocation decisions. The project is focused on the concerns of OECD and non-OECD countries, which are exposed to significant revenue losses as a result of harmful tax competition. Tax base erosion as a result of harmful tax practices can be a particularly serious threat to the economies of developing countries. The project will, by promoting a co-operative framework, support the effective sovereignty of countries over the design of their tax systems.¹⁰²

From its title,¹⁰³ it is clear that the 2000 OECD Report reflects a shift in emphasis

99 quoted by Salinas at 550; see also Ware & Roper at 31-32.
P O'Neil "What is the US Position on Offshore Tax Havens: Hearing before the Permanent Subcommittee on Governmental Affairs 107th Congress" (2001) as quoted by Salinas at 550; Grundy at 4.

100 Salinas at 550; see also Diamond & Diamond at INTRO 16; Grundy at 4.

101 OECD "Towards Global Tax Co-operation: Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices" (2000). Available at ><http://www.oecd.org/dataoecd/9/61/2090192.pdf><, last accessed 17 July 2006.

102 OECD Report (2000) at 5.

103 OECD "Towards Global Tax Co-operation: Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and

from “harmful tax competition”, as the 1998 report puts it, to the less tendentious “harmful tax practices”. This change in the terms used attracted a certain amount of criticism as the OECD did not distinguish between the meanings of these terms. It appears that the OECD defines the term “harmful tax competition” as an umbrella term that apparently includes “harmful tax practices” and “tax preference schemes”. Admittedly the OECD acknowledged in the 1998 report that low or no income taxes could never constitute harmful tax competition and that other factors were necessary, such as refusing to exchange information, separating foreign from domestic investors and insubstantial activities.¹⁰⁴ It nevertheless failed to set out those factors that definitively tip the scale, or to state what relative weight should be placed on these varying factors. The closest the OECD came to defining these terms was by stating that harmful tax practices affect the location of financial and other services, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. The report further stated that tax preference schemes create potential distortions in the patterns of trade and investment and reduce global welfare. These schemes may shift part of the tax burden from mobile to relatively immobile factors and from income to consumption and may hamper the application of progressive tax rates and the achievement of redistributive goals.¹⁰⁵ The problem with the above is that there is hardly an income tax system that does not satisfy one of these descriptions, the qualifications notwithstanding.

The OECD has also been criticised for lack of transparency because the 2000 report denies that its project is about collecting taxes.¹⁰⁶ One may well ask why the need to collect all the information if the project is not about collecting taxes. Similar criticisms have been raised about the denial that the project is about dictating levels of taxes or the design of tax systems.¹⁰⁷

The 2000 OECD Report identified and listed 47 jurisdictions with harmful

Eliminating Harmful Tax Practices” (2000).

104 OECD Report (1998) at 8 and 14.

105 OECD Report (1998) at 8 and 14.

106 OECD Report (2000) at 5.

107 Grundy at 3.

preferential tax regimes according to the criteria contained in the 1998 Report.¹⁰⁸

A list of tax haven countries was also compiled. Among the jurisdictions that were considered to be tax-haven jurisdictions are: Andorra, Anguilla, Antigua and Barbuda, Aruba, Barbados, the Bahamas, Bahrain, Belize, the British Virgin Islands, the Cook Islands, the Commonwealth of Dominica, Gibraltar, Grenada, Guernsey, the Isle of Man, Jersey, Liberia, the Principality of Liechtenstein, the Republic of the Maldives, the Republic of the Marshall Islands, the Principality of Monaco, Montserrat, the Republic of Nauru, the Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Tonga, Turk and Caicos, the United States Virgin Islands, and the Republic of Vanuatu.¹⁰⁹ The OECD was criticised, however, for doing insufficient research before listing these jurisdictions. For example, Grundy¹¹⁰ points out that Panama was included in the list, when Costa Rica - whose tax system is indistinguishable for these purposes - was not. He also suggested that Hong Kong (which also has a similar tax system) was not included in the list because, although Panama is small enough to be bullied, China is not.¹¹¹ The OECD also came in for criticism for adopting a high-handed and dictatorial approach to these jurisdictions, most of which are dependent territories or former dependent territories of major developed nations and are not in charge of their foreign affairs. This gave rise to hostility and resentment, in response to which the OECD is now trying to mend fences.

The 2000 report called on the listed jurisdictions to commit themselves to principles of transparency and effective exchange of information or they would be regarded as uncooperative tax havens that present a threat not only to the tax systems of developed and developing countries but also to the integrity of international financial systems.¹¹² Of these jurisdictions, thirty-one pledged

108 OECD Report (2000) in par 8. The list appears in par 11.

109 OECD Report (2000) in par 17. See also L B Samuels & D C Kold "OECD Initiative: Harmful Tax Practices and Tax Havens" *Taxes* (2000) at 240. See also Ware & Roper at 29; Diamond & Diamond at INTRO 13; see also Olivier and Honiball at 463.

110 Grundy at 5.

111 Grundy at 5.

112 Arnold & McIntyre at 122-123 state that the tax authorities of a country often experience difficulty in obtaining information concerning the foreign activities of residents, let alone verifying the information. For example, many countries – and all tax-haven countries – have strict bank secrecy laws but tax havens rarely have tax treaties with developed

themselves to work with the OECD to counter harmful tax practices.¹¹³ However, by 18 April 2002,¹¹⁴ seven of these jurisdictions on the OECD list, namely Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands, Nauru and Vanuatu, decided that it was not in their interests to join the OECD countries and other members of the international community in ending harmful tax practices.¹¹⁵ One of the reasons why these jurisdictions failed to cooperate was that the OECD had not established a “level playing field” where all affected countries made identical, specifically enumerated commitments. The lack of a level playing field for all affected jurisdictions has resulted in the OECD being perceived as intending to use a regulatory thrust as camouflage for its attempt to implement non-tariff barriers to trade, thereby undermining the competitive position of tax-haven jurisdictions.¹¹⁶ It was felt that until the OECD had obtained effective commitments from its own member countries, it could not reasonably seek commitments from non-OECD members to participation in the process of setting regulatory standards.¹¹⁷ The OECD nevertheless encouraged these jurisdictions to reconsider their decision. On 24 November 2000, the OECD published a document entitled, “Framework for a Collective Memorandum of Understanding

countries that provide for exchange of information concerning tax matters. Hence the need to enter into agreements with tax havens to ensure that they comply with principles of transparency and exchange of information. Samuel & Kold at 236 also point out that the OECD’s major concern appears to be that the absence of information exchange is a key condition that enables taxpayers to hide activities from domestic tax authorities. Any country that does not provide adequate information exchange is regarded as potentially facilitating the avoidance of taxes in that country. The lack of transparency is a problem because it inhibits the ability of other countries to take defensive action against harmful tax regimes. It may be indicative of favourable administrative rulings that confer lower effective tax rates on particular types of taxpayers, without any justification other than the fact that these rates are an attempt to attract certain types of activities or to favour specific types of taxpayers.

- 113 G Makhlouf, Chair of the OECD’s Committee on Fiscal Affairs “The OECD list of Un-cooperative Tax Havens” (2002). Available at >http://www.oecd.org/document/28/0,2340,en_2649_33745_2082460_1_1_1_1,00.html, last accessed on 18 May 2007.
- 114 Seiichi Kondo, Deputy Secretary General of the OECD “OECD Ending Tax Haven Abuse” (18 April 2002). Available at >http://www.oecd.org/document/28/0,2340,en_2649_33745_2082460_1_1_1_1,00.html, last accessed on 18 May 2007.
- 115 Makhlouf “The OECD list of Un-cooperative Tax Havens” (2002). Available at >http://www.oecd.org/document/28/0,2340,en_2649_33745_2082460_1_1_1_1,00.html, last accessed on 18 May 2007.
- 116 A review commissioned by the International Tax and Investment Organisation and The Society of Trust and Estate Practitioners conducted by E Stikeman *Towards a Level Playing Field: Regulating Corporate Vehicles in Cross Border Transactions* (2002) at 16.
- 117 Stikeman at 16.

on Eliminating Harmful Tax Practices” (MOU).¹¹⁸ This document provides the jurisdictions identified as tax havens, guidelines required by the OECD to demonstrate their commitment to transparency, non-discrimination, and effective co-operation.

A jurisdiction becomes a party to the MOU by, a press release announcement accompanied by details of the commitment. In addition, the MOU contains a “stand-still” provision, in terms of which a party to the commitment will refrain from introducing any new harmful tax practices. The question however is whether such formal commitments will be turned into real tax reforms.

In 2004, the OECD published another report on the progress made on its “harmful tax practices” project.¹¹⁹ Of the 47 preferential tax regimes listed in the 2000 report, 18 regimes had been abolished, 14 had been amended to remove any potentially harmful features and 13 had been found not to be harmful following further analysis.¹²⁰ The 2004 report also stated that by 2003, 33 jurisdictions outside the OECD had committed to the principles of effective exchange of information and transparency. These jurisdictions included Vanuatu and Nauru, which had shown no interest in ending harmful tax practices in 2002.¹²¹ Some of these jurisdictions, along with OECD member countries, also developed a “Model Agreement on Exchange of Information on Tax Matters” (the Model Agreement) which serves as a model for the negotiation of bilateral or

118 OECD “Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices”. Available at [http://www.oecd.org/olis/2000doc.nsf/c707a7b4806fa95c125685d005300b6/c125692700623b74c12569a100492e0c/\\$FILE/JT00100664.PDF](http://www.oecd.org/olis/2000doc.nsf/c707a7b4806fa95c125685d005300b6/c125692700623b74c12569a100492e0c/$FILE/JT00100664.PDF), last accessed 10 July 2007.

119 OECD “The OECD’s Project on Harmful Tax Practices: The 2004 Progress Report”. Available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf> last accessed on 18 May 2007.

120 OECD 2004 Progress Report in par 12.

121 OECD 2004 Progress Report in par 19; currently the list of uncooperative tax havens consist of Andorra, Liberia, The Principality of Liechtenstein, The Republic of the Marshall Islands and The Principality of Monaco. See OECD “List of Uncooperative Tax Havens”. Available at http://www.oecd.org/document/57/0,2340,en_2649_33745_30578809_1_1_1_1,00.html, last accessed on 3 July 2007.

multilateral agreements.¹²² The Model Agreement seeks to promote international cooperation in tax matters through exchange of information by making use of international standards on transparency and the effective exchange of information. By 2004, Andorra, the Principality of Liechtenstein, Liberia, the Principality of Monaco and the Republic of the Marshall Islands were the only jurisdictions that remained on the uncooperative tax havens' list. The 2004 report pointed out that the OECD still engaged in a constructive ongoing dialogue with a number of these jurisdictions and looked forward to future commitments to transparency and the effective exchange of information.¹²³

The 2004 report recognised that there are limits to the usefulness of unilateral and bilateral measures to deal with “harmful tax practices” - a problem that is inherently global in nature. The OECD therefore began to consider means of coordinating defensive measures to make them more effective in decreasing the negative effects of harmful tax practices.¹²⁴ Among the defensive measures that were identified were:

- Use of provisions that have the effect of disallowing any deductions, exemptions or credit in respect to all substantial payments made to persons located in jurisdictions engaged in harmful tax practices.
- Use of legislation like “thin capitalisation” provisions that restrict the deduction of interest payments to persons located in jurisdictions engaged in harmful tax practices
- Use of legislative and administrative provisions that require any resident who makes a substantial payment to a person located in such jurisdiction to report such payments or be subject to certain penalties.
- Use of legislation that taxes residents whose interest in such jurisdictions would substantially lower or defer taxes.
- Denial of exemptions or credits for foreign taxes paid.
- Use of legislative measures to ensure that withholding taxes at a minimum rate apply to all dividends, interest and royalties made to beneficial owners benefiting from harmful tax practices.
- Use of special audit and enforcement programs to coordinate enforcement activities involving entities and transactions in jurisdictions with harmful tax practices.

122 Par 2 of the Introduction to the “Model Agreement on Exchange of Information on Tax Matters” states that the Agreement was developed by the OECD Global Forum Working Group, which consisted of representatives from OECD member countries as well as delegates from Aruba, Bermuda, Bahrain, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino. In par 4 of the Introduction to the Agreement it is stated that the Agreement is not a binding instrument but contains models for bilateral agreements on exchange of information between countries. See OECD “Model Agreement on Exchange of Information on Tax Matters”. Available at ><http://www.oecd.org/dataoecd/15/43/2082215.pdf><, last accessed on 18 May 2007.

123 OECD 2004 Progress Report in par 27.

124 OECD 2004 Progress Report in par 28.

- Terminating and not entering into treaties with such jurisdictions.¹²⁵

In September 2006 the OECD published another report on the progress of its harmful tax practices project.¹²⁶ It reiterated that:

by promoting the implementation of principles of transparency and effective exchange of information, OECD countries seek to enable each country to retain sovereignty over national tax matters and to apply effectively its own tax laws. The decision on the appropriate rate of tax is a sovereign decision of each country. The OECD member countries do not seek to dictate to any country, either inside or outside the OECD, whether to impose a tax, what tax it should be or how its tax system should be structured. The aim of this work is to create an environment in which all countries, large and small, OECD and non-OECD, those with an income tax system and those without, can compete freely and fairly thereby allowing economic growth and increased prosperity to be shared by all. Transparency and international cooperation through exchange of information are important elements of such an environment.¹²⁷

Commenting on the OECD endeavours on curbing harmful tax practices among OECD member countries, the Chair of the OECD's Committee on Fiscal Affairs noted that,

The OECD countries embark on a difficult challenge when we commenced our work on countering harmful tax practices and this report reflects the success we have had in bringing about change. In 2000, we identified 47 potentially harmful preferential tax regimes in OECD countries. Of those regimes, 19 regimes have been abolished, 14 have been amended to remove their potential harmful features, 13 were found not to be harmful and only one has been found to be harmful. This Report, along with the report recently issued by the OECD Global Forum on Taxation on the transparency and exchange of information practices in 82 economies, shows that we are making real progress in addressing harmful tax practices. Further work is required to fully implement the standards we have set so that national tax laws in countries large and small can be fairly and effectively enforced.¹²⁸

The concluding remarks of the OECD in its 2006 progress report on harmful tax practices are:

This part of the project has fully achieved its initial aims and the mandate given by the Council on dealing with harmful preferential tax regimes in member countries has therefore been met. Future work in this area will focus on monitoring any continuing and newly introduced preferential tax regimes identify by member countries. This process permits any member country to request a review of any newly introduced preferential tax regime. It also permits any member country to request a review of any existing preferential tax regime to the extent it considers that the nature of the regime or the extent and manner of its use have changed in ways that may make it harmful under the

125 OECD 2004 Progress Report in par 30.

126 OECD "The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries". Available on ><http://www.oecd.org/dataoecd/1/17/37446434.pdf><, last accessed on 18 May 2007.

127 The OECD 2006 Progress Report in par 6.

128 P Ciocca, Chair of OECD Committee on Fiscal Affairs "Committee on Fiscal Affairs Releases Outcome of Review of Preferential Tax Regimes in OECD Member Countries". Available at >http://www.oecd.org/document/31/o.3343.en_2649_37427_37446047_1_1_1_37427,...<, last accessed 3 July 2007.

criteria established in the 1998 Report.¹²⁹

2.5 THE OECD CAMPAIGN AGAINST HARMFUL TAX PRACTICES: DOES IT MARK THE DEMISE OF “TAX-HAVEN JURISDICTIONS” AND “HARMFUL PREFERENTIAL TAX REGIMES”?

The OECD has to be commended for its onslaught against harmful tax practices. Although its recommendations are not binding in nature and only apply to member states, its project has shown the world that countries cannot encourage harmful tax practices without repercussions from the international community. As a result of the OECD initiative, a number of member countries have done away with their harmful preferential tax regimes.¹³⁰ Furthermore, a large number of tax-haven jurisdictions have agreed to cooperate with the OECD and implement transparency and exchange of information standards. The OECD has also called upon non-OECD member countries to associate themselves with its recommendations. Although the OECD may not have the power to stop specific jurisdictions from engaging in harmful tax practices (apart from appealing for their cooperation and urging other countries to issue sanctions against uncooperative countries), the most helpful thing that has come out of its initiative has been the exchange of information project which has given countries a tool for finding out whether their residents are involved in offshore tax avoidance. The “Model Agreement on Exchange of Information on Tax Matters” that the OECD developed, is now being used by a number of countries and it forms the basis for

129 The OECD 2006 Progress Report in par 16.

130 Paragraph 9 of the OECD 2006 Progress Report states that, “of the 47 preferential tax regimes that had been identified as potentially harmful, 18 regimes had been abolished and 14 had been amended to remove their potential harmful features. Another 13 were found not to be harmful on further analysis.” Paragraph 15 of the OECD 2006 Progress Report sets out a table of various harmful tax practices among OECD member countries that have either been abolished or amended. The table also sets out certain practices that are not considered harmful. In terms of this table, the countries that had abolished certain harmful tax practices are: Belgium, Canada, Finland, Greece, Hungary, Iceland, Italy, Ireland, Netherlands, Portugal Spain, Sweden, Switzerland and the United States. The countries that had amended some of their harmful tax practices are: Belgium, France, Germany, Luxembourg, Netherlands and Switzerland. However, Luxembourg still maintains certain harmful tax practices. Countries with certain practices which were considered not harmful are: Turkey, Portugal, Norway, Italy, Greece, Hungary, Canada, Australia, Austria, United Kingdom, Spain, Denmark and France.

several tax information exchange agreements between countries.¹³¹

Although the OECD may appear to have curtailed harmful tax practices in some countries, it is this author's view that this project has merely exposed the "tip of the iceberg" in the fight against offshore tax avoidance. The OECD cannot therefore confidently claim that it has fully achieved its initial aims and that it has fulfilled its mandate in dealing with harmful preferential tax regimes.¹³² A number of factors have limited the effectiveness of the OECD project.

It is worth pointing out that the OECD failed to acknowledge that for years its member nations have had dealings with tax havens and that they have lent credibility to many tax havens.¹³³ The OECD member nations have also failed to acknowledge that they have benefited from their involvement with tax havens.¹³⁴ It is likely that the governments of these nations may not really be interested in putting an end to harmful tax practices. Commenting on this aspect, Grundy¹³⁵ states that harmful tax practices could be stopped immediately if the major powers wished to. Cohn¹³⁶ also points out that "if the political will existed, the

131 OECD 2004 Progress Report in par 24. For example, on 2 March 2007, Antigua and Barbuda and Australia signed a bilateral agreement on the exchange of information for tax purposes. See OECD "OECD Welcomes Tax Information Agreement between Antigua and Barbuda and Australia". Available at >http://www.oecd.org/document/0/0,2340,en_2649_33745_38192448_1_1_1_1,00.html<, last accessed on 30 May 2007. See also OECD "OECD Welcomes Tax Information Exchange Agreements between The Netherlands Antilles and Australia and New Zealand". Available at >http://www.oecd.org/document/0/0,2340,en_2649_33745_38192448_1_1_1_1,00.html<, last accessed on 30 May 2007.

132 The OECD 2006 Progress Report in par 16.

133 Diamond & Diamond at INTRO 15 note that United Kingdom has for years lent credibility to many tax-haven jurisdictions by virtue of its affiliation with those jurisdictions. Examples are, Jersey Guernsey and Isle of Man which have the status of British Crown dependencies. See Foreign and Commonwealth Office "Partnership for Progress and Prosperity - British and Overseas Territories". Available at ><http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1018028164839><, last accessed 18 May 2007. See also Wikipedia: The Free Encyclopedia "British Overseas Territories". Available at http://en.wikipedia.org/wiki/Crown_colony#Current_Overseas_Territories, last accesses on 17 May 2007. Many British banks and citizens have established businesses in these tax havens which are affiliated to the UK.

134 Grundy at 2; Stikeman at 15-16.

135 Grundy at 6-7.

136 Il Cohn "Prepared Testimony of Reuven S. Avi-Yohan, Irwin I Cohn Professor of Law, University of Michigan Law School before the US Senate Permanent Subcommittee on Investigations, Hearing on Offshore Transactions" August 1, 2006. Available at <<http://hsgac.senate.gov/files/STMAviYonahUafMI.pdf#search=%22Prepared%20testimony%20of%20Avi-Yonah%20before%20permanent%20subcommitte%20>>, last accessed on 18 May 2007.

tax-haven problem could easily be resolved by the rich countries through their own action". For example, "they could eliminate the tax havens' harmful activities overnight by refusing to allow deductions for payments to designated non-cooperating tax havens or restricting the ability of financial institutions to provide services with respect to tax-haven operations".¹³⁷ Grundy further comments as follows:

Why does a ship of the Royal Navy not simply sail into the harbour of St Helier, and shut down the Jersey offshore business in one afternoon? Does the United Kingdom perhaps have something to gain from refraining from such action? The UK Treasury may think that Jersey is responsible for what is nowadays called 'tax leakage', but investment houses in the City (*London*) see the Channel Islands as a wonderful source of business, as Wall Street in the USA sees the Bahamas, and one may hazard the guess that the Paris Bourse might do better if the French learnt to use Monaco (or Madrid if the Spaniards used Gibraltar).¹³⁸ **Emphasis added.**

From the above, it appears that tax havens offer advantages to developed countries. It has been observed that funds cannot remain in tax havens and be productive; they should be reinvested into rich and stable economies in the world.¹³⁹ It may well be that a high percentage of most of the moneys used to fund investments such as shopping malls or finance companies are being channelled to these countries from tax-haven jurisdictions. Thus the OECD's emphasis on tax-base erosion, without acknowledging that OECD countries have benefited from tax havens, leaves the report open to the criticism that it is merely an attempt by the governments of powerful countries to protect their tax revenues even if their citizens would benefit from lower taxes.¹⁴⁰

Another factor that could reduce the effectiveness of the OECD project concerns its information gathering endeavour. While the exchange of information could be viewed as a powerful tool in the fight against harmful tax practices, there is also a need to protect individuals' right to privacy and confidentiality as information could get into the wrong hands and never even reach the governments that require it. It is doubtful whether the OECD's information gathering project is equipped to ensure that the recipient of the information can be trusted with it. It also appears that the rules that the OECD has come up with to facilitate the

137 Cohn in par (e).

138 Grundy at 6-7.

139 Cohn in par (e).

cross-border exchange of information are being developed with a mixed agenda which includes combating trans-national crimes such as money laundering.¹⁴¹ Such rules have the potential to distort trade patterns. The global sharing of information without regard for financial privacy and human rights could result in criminal access to such information at the weakest point of entry, thereby increasing the risk of unauthorised disclosure.¹⁴²

Concerns have been expressed as to whether the OECD project might be the forerunner of the formation of a “world tax organisation”.¹⁴³ Assuming all OECD member and non-member states abolish harmful tax competition, would this imply that the world would be heading towards a “world tax organisation”, where countries are allocated various shares of the world tax revenues, the aggregate amount of which is determined by collective agreement.¹⁴⁴ Such a development would be absurd as international tax competition is not limited to tax incentives; countries compete with one another on numerous other fronts. So if a worldwide pool of tax revenues were to be fixed, each country would try to enlarge its share by providing its “customers” with other non-tax incentives. International tax competition in its present form would simply take on a new character.¹⁴⁵ International tax competition is not unlike other forms of competition. Governments offer various goods and services and their citizens are free to choose a location that best satisfies their needs. In this regard, one wonders whether the OECD’s attempt to root out “harmful tax havens” and “preferential tax regimes” will achieve much success.¹⁴⁶

2.6 TO WHAT EXTENT DOES SOUTH AFRICA FOLLOW THE OECD RECOMMENDATIONS?

140 AW Wright “Review: OECD Harmful Tax Competition Report Falls Short” (1998) 17 *Tax Notes International* at 461 and 463.

141 Stikeman at 16.

142 Stikeman in the Executive Summary.

143 Avi-Yonah at 1662; AJ Cockfield “The Rise of the OECD as an Informal ‘World Tax Organisation’ Through National Responses to E-Commerce Tax Challenges” (2006) 8 *Yale Journal of Law & Technology* at 140.

144 M B Weiss “International Tax Competition: An Efficient or Inefficient Phenomenon?” (2001) 16 *Akron Tax Journal* (2001) at 126.

145 Weiss at 127.

Although South Africa is not a member country of the OECD, it was awarded OECD observer status in 2004.¹⁴⁷ It is worth noting that the OECD Guidelines have become a globally accepted standard.¹⁴⁸ Following these guidelines is an important means of helping South Africa curb offshore tax avoidance. South Africa has therefore associated itself with the OECD recommendations on removing harmful tax practices. In the 2001 OECD report¹⁴⁹ it is stated that the OECD has had discussions with the Southern African Development Community (SADC).¹⁵⁰

The OECD has recommended that countries should come up with lists identifying tax-haven jurisdictions and harmful tax regimes so as to ensure that links with those countries are not used to promote harmful tax competition. Some OECD member countries, such as the United States and the United Kingdom, have come up with such lists, but South Africa does not have specific anti-tax-haven legislation which identifies or blacklists tax havens.¹⁵¹ The closest that South Africa has ever come to compliance with this recommendation was the old section 9E(8) of the Income Tax Act which empowered the Minister of Finance to exclude specific forms of income derived from designated countries, the list of which was published by notice in the *Gazette*. This provision was, however, repealed with effect from 1 June 2004.¹⁵²

With respect to the recommendation that countries should have in place certain types of legislation that are necessary to curb offshore tax avoidance, South Africa has controlled foreign company (CFC) legislation, which is discussed in chapter 4 of this work. “Transfer pricing”¹⁵³ and “thin capitalisation”¹⁵⁴ legislation

146 Weiss at 124.

147 Olivier & Honiball at 8.

148 See SARS *Practice Note: No. 7* in par 3.2.1.

149 OECD: The OECD’s Project on Harmful Tax Practices: the 2001 Progress Report.

150 Ibid; Countries that make up the SADC are: Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe. See Institute for Security Studies “Profile: Southern African Development Community (SADC)” Available at >http://www.iss.co.za/AF/RegOrg/unity_to_union/sadcprof.htm<, last accessed on 17 May 2007. See also K Huxham and P Haupt *Notes on South African Income Tax* (2006) at 751.

151 Olivier & Honiball at 477.

152 S 9E was repealed by Revenue Laws Amendment Act 45 of 2003 with effect from 1 June 2004.

153 The South African Revenue Service (SARS) is convinced that following the OECD Transfer-Pricing Guidelines will help South Africa to promote tax equality and reduce the

is also in place in South Africa but a discussion of this legislation is beyond the scope of this work.

With regard to the OECD recommendation that countries should introduce programmes to intensify international cooperation and exchange of information concerning transactions that constitute harmful tax competition, South Africa has signed “Mutual Administrative Assistance Agreements” with the customs administrations of certain countries. These agreements cover aspects such as the exchange of information, technical assistance, surveillance, investigations and visits by officials. As at 12 December 2006, South Africa had mutual administrative assistance agreements in place with Algeria, China, France, Netherlands, the United Kingdom and the United States.¹⁵⁵ Agreements of this nature have been ratified in South Africa with the Democratic Republic of Congo, the Czech Republic, Iran, Mozambique, and Zambia. Similar agreements have been negotiated, but not yet signed with Angola, Brazil, Israel, Malawi, Nigeria, Tanzania, Uganda, and Zimbabwe. There is also an Agreement under negotiation with India.¹⁵⁶ It is hoped that entering into these agreements will help South Africa obtain the necessary information to curb the harmful tax practices that any of these countries may be involved in, even though they may not be tax havens themselves. It is recommended that South Africa considers negotiating similar treaties, with countries that are considered tax havens, especially those with which it has signed double taxation agreements. These countries are: Cyprus, Malta, Mauritius, Singapore, Seychelles and Luxembourg.¹⁵⁷ Negotiating

possibility of South Africa’s contributing to the establishment of a harmful preferential tax regime. See SARS Practice Note 7 in par 3.2.2.

- 154 The *First Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* recommended that these rules be based on the recommendations of the OECD report on thin capitalisation. See the Second Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structures of South Africa *Thin Capitalisation Rules* (1995) in par 1.1; OECD Issues in International Taxation No 2 *Thin Capitalisation: Taxation of Entertainers, Artists and Sportsmen* (1987) at 17.
- 155 South African Revenue Service “Current List of Customs Agreements on Mutual Administrative Assistance” (12 December 2006). Available at ><http://www.sars.gov.za/it/DTA/Customs%20Agreement/Current%20List.htm><, last accessed on 17 May 2007.
- 156 South African Revenue Service “Current List of Customs Agreements on Mutual Administrative Assistance” (12 December 2006). Available at ><http://www.sars.gov.za/it/DTA/Customs%20Agreement/Current%20List.htm><, last accessed on 17 May 2007.
- 157 See Olivier & Honiball at 24. These treaties are published in these Government Gazettes: Cyprus - 19638 dd 22/12/1998, Malta - 18461 dd 21/11/1997, Mauritius - 18111 dd

“Mutual Administrative Assistance Agreements” with these tax-haven countries will help South Africa, obtain the necessary information to curb the harmful tax competition that could be encouraged by these countries.

As regards the OECD recommendation that countries should consider terminating their tax treaties with tax-haven jurisdictions that are used to encourage harmful tax competition, it should be noted that, like many other countries, South Africa has treaties with countries that could be considered to encourage harmful tax competition. The treaty with Mauritius, for instance, contains a tax sparing clause,¹⁵⁸ which provides that, where Mauritius conducts business with South Africa, interest and royalties are not taxable in South Africa as Mauritius does not currently levy taxes at substantial rates.¹⁵⁹ A tax sparing clause of this nature could encourage South African residents to set up offshore companies in Mauritius to take advantage of the tax sparing benefits. It is worth noting, however, that Mauritius is not among the jurisdictions listed in the OECD 2002 list of tax havens. It is argued that Mauritius’ “free-trade zone”¹⁶⁰ programme which is designed to attract foreign investment for non-financial and non-services activities, especially in the manufacturing sector, does not fall into the category of harmful preferential tax regimes that the OECD initiative addresses. Furthermore, unlike investments in tax havens that do not require any substantial activity, Mauritius’s free-trade zone programme targets active investments like manufacturing; the programme is transparent and does not provide a shield against the scrutiny of foreign tax authorities.¹⁶¹

Nevertheless, Mauritius is considered an established treaty haven for offshore activities, particularly in India, China and South Africa.¹⁶² It has thus emerged as an offshore centre for the African and Indian Ocean region. Mauritius has

02/07/1997, Singapore - 18599 dd 02/01/1998, Seychelles - 25646 dd 30/10/2003, Luxembourg - 21852 dd 06/12/2000.

158 The term “tax sparing” means the allowance of a credit for the amount of foreign taxes that were not paid because of a tax incentive or holiday in the foreign country. See Arnold & McIntyre at 168; see also Olivier & Honiball at 489.

159 Olivier & Honiball at 471.

160 “Free-trade zones” are programmes that entail policies developed by governments aimed at stimulating industrial and general economic development and employment. See Schulze (1999) at 159.

161 Schulze (1999) at 203.

focussed the development of its offshore centre on the use of its growing network of double taxation agreements. Since 1992 the Mauritius offshore sector has operated in a conducive regulatory and fiscal environment. In 1992, Mauritius established a special regime to allow offshore business activities which were regulated by the Mauritius Offshore Business Activities Authority (MOBAA).¹⁶³ This authority regulated, licensed and supervised all non-banking offshore business activities.¹⁶⁴ This offshore regime allowed offshore companies to be established in Mauritius, with permission to access the Mauritius treaty network. Dividends, interest and royalties paid by the offshore company would thus not subject to withholding tax in Mauritius.¹⁶⁵ In 2001, under the Financial Services Development Act 2001, the Mauritian government established a Financial Services Commission and an Advisory Council. In the new structure, MOBAA ceased to exist and most existing laws bearing on offshore activities were replaced. The Financial Services Commission now monitors the country's stock exchange, offshore business activities, and the insurance industry.¹⁶⁶

Mauritius has been focussing on targeting the South African market. The gradual relaxation of exchange control measures in South Africa has triggered significant interest from South African based enterprises to set up their businesses in Mauritius. Mauritius is increasingly becoming an attractive location for captive insurance businesses, offshore banking, and as a head-quarter for multinational group operations.¹⁶⁷ Mauritius' close proximity to South Africa and its stated policy of preferring to conclude double tax agreements with African countries, along with its membership of regional bodies, such as the South African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA), makes it an ideal location for setting up offshore

162 R Rohatgi *Basic International Taxation* (2002) at 284.

163 MP Hampton MP & JP Abbot JP *Offshore Finance Centres and Tax Havens: The Rise of Global Capital* (1999) at 232; Rohatgi at 282.

164 Schulze (1999) at 185; Hampton & Abbot at 282.

165 Schulze (1999) at 185.

166 Lowtax Network (BVI) Ltd "Mauritius: Offshore Business Sectors". Available at ><http://www.lowtax.net/lowtax/html/jmuobs.html><, last accessed 28 May 2007.

167 Hampton & Abbot at 231; Lowtax Network (BVI) Ltd "Mauritius: Offshore Business Sectors". Available at ><http://www.lowtax.net/lowtax/html/jmuobs.html><, last accessed 28 May 2007.

entities.¹⁶⁸ Mauritius's low-cost professional skills and political stability also enhance the island's attractiveness as an important offshore jurisdiction for South African investments. Its extensive tax treaty network, particularly with African and Asian countries, offers South African residents the opportunity to route their investments into those regions via Mauritius.¹⁶⁹

The treaty with Ireland is another treaty that could encourage offshore tax avoidance.¹⁷⁰ Although Ireland is not considered to be a tax haven, it has fulfilled this purpose for South Africans. This is because the tax rates in Ireland are much lower than in South Africa, and so it has recently proved to be a popular investment country from which business is done with South Africa.¹⁷¹ Ireland lacks "transfer pricing" legislation, it has no "thin capitalisation" rules, and it has no "controlled foreign company" legislation. This set-up encourages the establishment of offshore entities in Ireland.¹⁷²

To curb tax avoidance that could result from dealings by South Africans with jurisdictions such as the above, South Africa should find a way to offset the harmful tax practices encouraged by these jurisdictions. Although the OECD recommends that countries should sever their treaties with jurisdictions that encourage harmful tax practices, from an economic point of view this may not necessarily be the right approach for South Africa. Tax treaties are not generally negotiated on tax considerations alone. Countries' treaty policies may take into account their political, social and other economic needs.¹⁷³ For example, a

168 Olivier & Honiball at 469.

169 Mauritius Offshore Business Activities Authority (MOBAA) "Mauritius: A Sound Base for The New Millennium" (5 July 1999). Available at ><http://www.mondaq.com/article.asp?articleid=7371&searchresults=1><, last accessed 28 May 2007. On MOOBA see also Schulze (1999) at 185-186.

170 Treaty published in *Government Gazette* 18552 of 15/12/1997.

171 See "Musical Chairs on Tax Havens: Now it's Ireland" *New York Times* of 3 August 2002 in Olivier & Honiball at 277.

172 M Barrett, HLB Nathans "Trading in Ireland: The Low Corporate Tax Regime" (2004) 146 *Offshore Investment.com* at 25. This article further points out that Ireland also has a system that facilitates the exploitation of intellectual property (IP) rights and this has been enhanced by the abolition of stamp duty on the transfer of IP and the introduction of a 20% tax credit for research and development expenditure in the Finance Act of 2004. However, the single biggest weapon that Ireland has in its tax armoury is the 12.5% tax rate on trading activities which is the lowest corporate tax rate in the EU and well below the EU average of 30%.

173 S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and the United States* (1998) at 257-260.

country may use its treaty network to attract foreign investment and to encourage offshore activities by its residents. For developing countries, treaties can also be used as a tax incentive to attract scarce foreign capital or technology by granting tax concessions exclusively to foreign investors over and above the domestic tax law provisions.

Notwithstanding the above, there may be instances where the loss of tax revenues is significant compared with the other non-tax benefits of a particular tax treaty. In such cases, it is necessary for tax authorities to make an effort to stamp out the ensuing tax avoidance. It is recommended that SARS should adopt a balanced approach, by evaluating the circumstances of the treaties concerned and taking relevant steps to prevent tax avoidance.

In the 2005 update of the OECD Model Tax Convention, the OECD introduced measures that countries could use to counteract any harmful tax practices introduced by a treaty partner after a treaty has been signed.¹⁷⁴ This may require South Africa to revise its old treaties so as to include these provisions. It is, however, worth pointing out that it is often very difficult to revise old treaties to suit the new update of the OECD Model.¹⁷⁵ According to paragraphs 33 up to 36 of the Introduction to the OECD Model Tax Convention, the current version of the Commentary should be used to interpret all tax treaties. The OECD is of the view that changes to the Commentary are normally applicable to the interpretation of existing treaties. In reality, this is not usually the case, especially when it comes to changes that go beyond mere clarifications of certain concepts. For example, entirely new provisions might be included in the Commentary. In such a case, a revision of the treaty may be necessary in order to accommodate the new provisions. The OECD does not, however, supply guidance to countries on this matter.¹⁷⁶ A detailed discussion of this issue is beyond the scope of this work.

174 Par 21.5 of the Commentary on art 1 of the OECD Model Tax Convention. See also AJM Jiménez "Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective" - PART 1 (2002) *Bulletin for International Fiscal Documentation* at 22.

175 Jiménez at 22.

176 K Vogel *Double Taxation Conventions* 3 ed (1997) at 46-47; AH Herbert & K van Rand *Essays in International Taxation* (1993) at 67-68; K Vogel "The Influence of the OECD Commentaries on Treaty Interpretation" (2000) 54 *Bulletin for International Fiscal Documentation* at 612.

2.6 CONCLUSION

Although the legitimacy and appropriateness of the OECD and other international initiatives against tax-haven jurisdictions have been debated in the international arena,¹⁷⁷ it remains to be seen how their recommendations will shape the existing international framework. Offshore tax avoidance is of great concern for all nations and it is doubtful whether it can even be resolved at an international level. The sceptics have observed that tax havens have been around almost as long as taxes. It was not until the 1970s that tax havens increased in number and in importance. This was when large corporations and international banks started developing sophisticated offshore financial markets out of the reach of the national regulators. The International Monetary Fund (IMF) estimates that at present as much as \$7 trillion in financial assets of various kinds is held offshore.¹⁷⁸ Regarding the question whether the recommendations of international organisations are likely to be able to regulate these practices, one cynic has observed that tax avoidance, “is like graffiti or pollution: if you want to get rid of it completely you will be disappointed”.¹⁷⁹

Although it is doubtful whether the initiatives targeting tax havens pose a threat to the existence of tax havens, it is submitted that these initiatives have at least made it clear to the international community that harmful tax practices that deplete other countries’ tax bases will not be tolerated. Taxpayers and their consultants are now aware that their tax avoidance schemes will be firmly opposed by the international community.

177 Salinas at 550; see also Diamond & Diamond at INTRO 16.
178 Gumbel at 23.
179 Gumbel at 23.

CHAPTER 3

INVESTING IN OFFSHORE COMPANIES

3.1 DEFINING A COMPANY

In terms of section 1 of the Companies Act,¹ a company is defined as including any association, corporation or company (other than a close corporation) incorporated in terms of the relevant provisions of the Act. This definition does not really define a company. A company has been generally defined in *Smith v Anderson*² as an association of persons for the common object of the acquisition of gain. Although this description does not apply to all companies, it applies to most companies.³ In terms of section 1(b) of the South African Income Tax Act,⁴ the definition of a company *inter alia* includes any association, corporation or company incorporated under the law of any other country apart from South Africa. In effect the Income Tax Act recognises offshore companies as companies for tax purposes.

From the time a company is incorporated or registered, it exists as a separate legal entity that exists apart from its members. It can thus own assets, be an em-

1 Act 61 of 1973.

2 [1880] 15 Ch 247 (CA) 273-74.

3 HS Cilliers, ML Benade, JJ Henning, JJ du Plessis, PA Delport, L de Koker & JT Pretorius *Corporate Law* 3 ed (2000) at 5.

4 In terms of s 1 of the Income Tax Act 58 of 1962, a company is defined as including:

- a close corporation,
- any association, corporation or company incorporated in South Africa,
- any association, corporation or company established under any South African law,
- any association, corporation or company incorporated under the law of any other country,
- any co-operative,
- any association (formed in South Africa) to serve a specified purpose beneficial to the public or a section of the public (e.g. charities and foundations even if they were not registered as companies),
- a collective investment scheme in securities (shares) per the Collective Investment Schemes Control Act 45 of 2002,
- an arrangement or scheme carried on outside South Africa, where members of the public invest in a collective investment scheme (the investors contribute to the scheme and hold a participation interest).

ployee or be party to a contract and it is entitled to sue and be sued.⁵ A company registered in a given jurisdiction may have a subsidiary or a base company in another jurisdiction. Usually the base company is used as a means of conducting business outside the country of incorporation of the parent company.⁶ The base company acts as a holder of the legal title that belongs to the parent company, which may be registered outside the country where the base company is registered.⁷ It is thus entitled to the foreign income or assets of the parent company (even though the parent company legally owns that income and is also able to direct its disposal). In most tax systems, however, the foreign source income of a base company is not subject to domestic tax since it is a foreign company incorporated and recognised as a separate juridical entity in that jurisdiction.⁸ This implies that the country where the parent company of the base company is registered cannot apply the “residence basis” (under which a country is entitled to tax the worldwide income of its residents) to tax the worldwide income of a parent company that is derived from its base companies incorporated in other countries until such income is distributed to the shareholders as dividends.⁹

3.2 WHY COMPANIES ARE USED FOR OFFSHORE TAX AVOIDANCE

5 *Salomon v Salomon & Co Ltd* [1897] AC 22; see also *Lategan v Boyes* 1980 (4) SA 191 (T) at 200; *RP Crees (Pty) Ltd v Woodpecker Industries (Pty) Ltd* 1975 (2) SA 485 (R) at 489; *J Louw and Co (Pty) Ltd v Richter* 1987 (2) SA 237 (N) at 241; *Utopia Vakansie-Oorde Bpk v Du Plessis* 1974 (3) SA 148 (A) at 176; *S v De Jager* 1965 (2) SA 616 (A) at 624-25. In essence, by virtue of this separateness, the assets of the company are its exclusive property and the members have no proprietary rights in them. Only on liquidation of the company are members entitled to share in a division of the assets of the company. The separateness also implies that the company estate is assessed apart from the estates of the individual members and so the debts of the company are the company's debts and not those of its members. Likewise, the profits of the company do not belong to the members but to the company itself. Only after the company has declared a dividend may the members, in accordance with their rights as defined in the articles association of the company, claim that dividend. See PM Meskin *Henochsberg on The Companies Act* (updated 31 March 2006) at 34; MS Blackman, RD Jooste & GK Everingham *Commentary on The Companies Act Vol 1* (2002) at 4-19.

6 J E Bischel & R Feinschreiber *Fundamentals of International Taxation* 2 ed (1985) at 83-85; P Roper *Offshore Options* (1999) at 2.

7 B J Arnold & M J McIntyre *International Tax Primer* 2 ed (2002) at 87.

8 Arnold & McIntyre at 87.

In order to avoid taxation, a base company can be incorporated in a low-tax or a tax-haven jurisdiction whereby its income is sheltered and not distributed among the shareholders where it could be subject to high taxes.¹⁰ As long as the income is sheltered in the base company and not distributed, it is deferred or postponed, implying that the taxes due currently are postponed to a future year. Deferral allows the base company to have the use of the funds that would have been paid in taxes during the deferral period.¹¹ The profits tied up in the low-tax jurisdiction where the base company is incorporated can then be cheaply accumulated offshore so that working capital can be used for further foreign investment instead of being repatriated to the parent company to be taxed.¹²

Although income can be sheltered in the base company for a long time, at some point it will have to be repatriated to the parent company when dividends are declared. The major tax burden on profit repatriation through dividends is the dividend withholding tax.¹³ The majority of countries in the world impose significant withholding taxes on dividends paid to non-residents. This can be a major loss of income for any offshore business.¹⁴ For instance, high withholding taxes can push up the cost of borrowing, as banks subjected to high withholding taxes will need to pay higher interest rates to compete with banks in low-tax

9 Arnold & McIntyre at 87.

10 A Ogley *Principles of International Tax* (1993) at 152; see also Arnold & McIntyre at 77.

11 L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 358; Arnold & McIntyre at 87; see also LJ Seidler & SS Karlinsky *Everything You Wanted to Know about Tax Havens but were Afraid to Ask* (1985) at 2.

12 WH Diamond & DB Diamond *Tax Havens of the World* (Release No 108 Jan 2002) vol. 1 at INTRO/1; E Tomsett *Tax Planning for Multinational Companies* (1989) at 11; see also A Jones *Tax Havens and Measures Against Tax Evasion and Avoidance in the EEC* (1974) at 7, where it is noted that where the parent company has other foreign subsidiaries, dividends derived from such subsidiaries can also be accumulated. And if such subsidiaries are disposed of or liquidated, the capital gains can be reinvested in other offshore projects where they will be subjected to minimum taxes.

13 J Ware & P Roper *Offshore Insight* (2001) at 179 define a withholding tax as a tax imposed by the country which is the source of the income, on income items such as dividends, interest and royalties. Specific tax treaties may reduce the rates of withholding taxes. See also S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and the United States* (1998) at 16, where it is noted that withholding taxes are levied on gross income rather than net income so they present heavy tax burdens that can be a barrier to international trade. See also M Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) at 11.

14 Hampton at 11.

jurisdictions.¹⁵ When a base company is set up in a tax-haven jurisdiction, the payment of withholding taxes can be avoided or significantly reduced, as most tax havens do not impose withholding taxes on the gross interest payable. The absence of indirect taxes is also advantageous for offshore businesses.¹⁶ If a base company is established in a territory that has a wide network of favourable double taxation treaties (for example the Netherlands and Switzerland), dividends may be subjected to minimum dividend withholding taxes.¹⁷

As mentioned above, the use of base companies in tax havens does not necessarily result in a complete avoidance of tax, but rather in a deferral of tax. When the parent company or the shareholders of the company receive the accumulated income in the form of dividends, these are taxable, possibly without there being a credit or other form of relief for foreign taxes paid in previous years in the country from which the income was originally derived.¹⁸ To avoid the taxes that could result when the income is eventually repatriated as dividends, secondary sheltering techniques can be employed. The main strategies utilised in this regard are the distribution of the income in a way that ensures that it is exempt from tax. This could be done by taking advantage of exemptions granted under any relevant tax treaty or under specific domestic legislation.¹⁹ For instance, in some countries' legislation, directors' fees and salaries are exempt from taxation. Other countries have affiliate exemption legislation that exempts from taxation dividends distributed by a subsidiary to its parent company.²⁰

Secondary sheltering can also be achieved when the base company reinvests its income abroad or when the income is "ploughed back" as a loan to the parent company.²¹ An example of such an operation is where a resident of a high-tax country who owns shares as debentures is able to transfer such shares to a base company in a tax-haven country, allowing the base company to use the sheltered

15 Hampton at 11.

16 Hampton at 11.

17 Tomsett at 11.

18 Tomsett at 6.

19 Tomsett at 6.

20 Tomsett at 6; Bischel & Feinschreiber at 83-85; Roper at 2.

21 Tomsett at 6.

income to buy other assets of the same kind in the tax-haven country.²² Secondary sheltering could also be achieved by the alienation of the capital holding in the base company. This could result in the shareholders realising a gain that could be exempt from tax or taxable at reduced tax rates.²³

3.3 EXAMPLES OF OFFSHORE COMPANIES

There are countless offshore-base companies and the number is increasing rapidly. This may be ascribed to the fact that they can be used for the same purpose as their counterparts in high-tax jurisdictions and yet they are subject to nil or minimum taxation in the offshore jurisdictions. The majority of offshore companies merely collect income consisting of dividends, loan interest or patent royalties and licence fees. Offshore companies may also hold investments and/or get involved in trading.²⁴ Examples of some categories of offshore companies are: offshore finance companies, offshore licensing and patent holding companies, offshore investment companies, offshore captive insurance companies and offshore shipping companies. The working of these types of companies and the ways in which they can be used to avoid taxes are described below.

International finance companies

International finance companies are companies that are established in low-tax or tax-haven jurisdictions for use as borrowing or lending intermediaries by the parent company or subsidiaries of a multinational group of companies.²⁵ Their function is to act as mediators between lenders and borrowers within a corporate group so that they can be used to provide member companies with loans, current account credit and bonds.²⁶ Borrowing finance companies may also be

22 Tomsett at 6.

23 Olivier & Honiball at 468; see also OECD Issues in International Taxation No 1 *International Tax Avoidance and Evasion* (1987) at 18.

24 Bischel & Feinschreiber at 83-85; Roper at 2.

25 A Ginsberg *International Tax Havens* 2 ed (1997) at 51.

26 A Rappako *Base Company Taxation* (1989) at 193 notes that the purpose of a finance company is to arrange capital for the members of a corporate group in the most efficient way. A finance company may be able to acquire capital at a lower price than the parent company or the operating subsidiaries. The capital is then injected either into the parent

used to borrow funds from other third parties that are used to finance the operations of other corporations in the multinational group.²⁷

The tax advantage of using international finance companies for borrowing is that the interest paid for the loans is generally treated as a tax-deductible expense for the subsidiaries which reside in a high-tax country. At the same time the interest received by the finance company in a low-tax country is often tax-free, or taxable at a very low rate.²⁸

International finance companies are also commonly used in the reduction or elimination of withholding taxes levied by other countries on the interest payment made by subsidiaries on their international borrowing or lending, especially when the finance company is located in a country with favourable tax treaty provisions.²⁹

Offshore licensing and patent holding companies

Cross-border transfer of intellectual property (eg royalties, patents, trademarks, copyrights, brand names or other industrial property rights like know-how on technical or administrative matters) often attracts high taxes. Furthermore, the deductions that various countries allow in respect of expenditure on research and development or on the acquisition of patents, licenses and know-how may differ greatly.³⁰ In order to avoid such high taxes, taxpayers often take advantage of the fact that intellectual property is intangible in nature and it can be easily moved from country to country through the use of planned licensing structures.³¹ A taxpayer can, for instance, establish a licensing and patent holding company suitably located offshore to acquire, exploit, license or sublicense intellectual

company or into the foreign subsidiaries for their use. This may result in tax saving. And the finance company may also make capital available as loan capital to the other members of the group.

27 Rappako at 193.

28 Rappako at 193.

29 BJ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 120; Ginsberg at 51; Rappako at 22 and at 194; Olivier & Honiball at 468.

30 Tomsett at 43.

31 Diamond & Diamond at INTRO /2.

property rights for its foreign subsidiaries in other countries.³² Profits can then be effectively shifted from the foreign subsidiary to the offshore patent owning company which may end up paying little or no tax on the royalties received.³³ Other intangible rights such as trademarks, copyrights, know-how and franchising rights can also be received in the form of royalties with tax advantages.³⁴

Another advantage of using a licensing and patent holding company located in a tax-haven jurisdiction to own the intellectual property is that the fees derived by the company from the exploitation of the intellectual property will be either exempt from tax or subject to a low tax rate in the tax-haven jurisdiction.³⁵

Offshore licensing and patent holding companies can also be used to avoid high withholding taxes that are usually charged on royalties flowing from the country in which they are derived.³⁶ In most cases, high withholding taxes can be reduced when countries enter into double taxation treaties.³⁷ But tax-haven jurisdictions usually have few or no double taxation treaties.³⁸ In order to benefit from the reduced withholding taxes that treaty countries enjoy, a royalty conduit company can be established in a low-tax jurisdiction. This is essentially an intermediary company with very narrow powers that is used to hold assets or rights as an

32 Diamond & Diamond at INTRO/2, where it is noted that tax havens can be used to designate a foreign base as a centre for administering patent and trademark agreements. See also P Roper & J Ware *Offshore Pitfalls* (2000) at 9; Olivier & Honiball at 467.

33 Rappako at 194; C Doggart "Tax Havens and Their Uses" *The Economist Publication* (1990) Special Report No 1191 at 36-37; DD Beazer in "The Mystique of 'Going Offshore'" (1996) 9 *The Utah Bar Journal* 20 notes that intellectual property can be owned or assigned to an offshore entity and then licensed or franchised to companies interested in exploiting the worldwide rights. The income derived can then be accumulated offshore and, through the selection of an appropriate jurisdiction, withholding taxes can be reduced. R King & B Victor *Law & Estate Planning Easiguide* (2006/2007) in par 19.4.3.

34 Ginsberg at 50; see also Doggart at 36-37.

35 Arnold at 121.

36 B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at LEX/26, where it is noted that a withholding tax is a tax which the payer of a dividend, royalty or interest payment must withhold from each such payment and must pay over to his own tax authorities. In the case of non-residents, a withholding tax may be a final tax or it may only constitute the advance payment of tax. Tax treaties frequently reduce the rates of withholding taxes. Certain jurisdictions qualify as tax havens by virtue of the exemptions or reductions in the rates of withholding taxes to which its residents become entitled in accordance with the provisions of one or more (or sometimes a network) of tax treaties.

37 Tomsett at 48-49.

38 A Starchild *Tax Havens for International Business* (1994) at 21.

agent or nominee would on behalf of another company.³⁹ The royalty conduit company can then be used to own license rights which it sublicenses to a second licensing company that is located in a territory with a favourable network of double-taxation treaties. The second licensing company will usually be responsible for the exploitation of the licensing rights from which it would earn only a small margin on the royalties (which would be subject to local corporate income tax) and the balance would be paid to the ultimate licensor. Setting up a royalty conduit company in one of the treaty countries can result in income being shifted from those countries by taking advantage of the tax concessions the treaty offers.⁴⁰ The Netherlands is an example of a country which has been utilised for establishing sublicensing companies with the aid of such structures.⁴¹

Offshore investment companies

In order to avoid taxes, residents of high-tax countries often establish investment companies in low-tax countries.⁴² These companies are often “open-ended”⁴³ in that they can be expanded by issuing new shares, or by buying back or cancelling shares. Their funds or assets may be a mixture of cash, securities or real estate.⁴⁴ Investment companies may include companies belonging to corporate groups or private companies incorporated in a tax-haven jurisdiction. They are usually used for holding and managing portfolio investments. Their aim is to avoid or minimise taxes on investment income (such as dividends, interest and rent). For instance, dividends received from such portfolio investments by the tax-haven company will be exempt from tax or subject to tax at a low rate in the tax-haven country.

39 Weeghel 72-73; H Becker & FJ Wurm “Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries” (1988) at 658; Rappako at 16.

40 Spitz & Clarke at 94 note that the use of tax treaties may permit the creation of a conduit whereby profits are transferred from one country via a third country, thus incurring the smallest possible total tax burden.

41 Ginsberg at 50; Doggart at 36-37; Tomsett at 48-49.

42 Doggart at 38.

43 Diamond & Diamond at glossary 15 define an “open ended investment company” as the corporate equivalent of a unit trust in which investors’ interests are represented by redeemable shares.

Offshore investment funds such as mutual funds or unit trusts can also be set up by resident taxpayers as a means of deferring domestic taxes.⁴⁵ In the absence of countermeasures, offshore investment funds can also be used to defer and avoid capital gains tax liability on the disposal of the shares of the fund. This can be done by converting what would be ordinary income into capital gains.⁴⁶ The tax advantage of this structure is that when a fund is based in a tax haven, there is usually no tax or only minimum taxation on capital gains.⁴⁷ Although the taxpayer is liable to pay capital gains tax in his country of residence, the taxes deferred will leave the income intact over a period of years.⁴⁸ Banks usually play a major role in encouraging investments in offshore investment funds. Groups of banks are often parent companies of offshore investment funds.⁴⁹ The bank secrecy provisions that are upheld by tax-haven banks attract individuals (such as expatriate employees of international corporations who earn substantial salaries, or independent professionals earning high fees), to invest in offshore investment funds where they can accumulate capital offshore and thus hide their wealth from “onshore” tax authorities.⁵⁰

Offshore captive insurance companies

A captive insurance company can be described as a foreign insurance subsidiary company established by a group of companies for the purpose of insuring the risks of the group as an alternative to the use of external insurance markets.⁵¹

44 Hampton at 26; Doggart at 38.

45 Rotterdam Institute for Fiscal Studies *International Tax Avoidance* Vol A (1979) at 81-82; Arnold at 120; see also Ogleby at 10, where it is noted that offshore investment funds are often set up in tax havens where investment income is often tax free, apart from the withholding taxes suffered in the country of source as well as any capital gains accruing to the fund.

46 Arnold at 123; Arnold & McIntyre at 86.

47 Hampton at 26.

48 Doggart at 38.

49 Arnold at 120; see also Ogleby at 10.

50 Ogleby at 10.

51 Tomsett at 67; Arnold at 119; see also Doggart at 51; Starchild at 22; Hampton at 31; Diamond & Diamond at Glossary 2; Roper & Ware at 9; Ogleby at 9; MWE Glautier & FW Bassinger *A Reference Guide to International Taxation: Profiting from Your International*

Foreign insurance subsidiary companies are often incorporated in tax-haven jurisdictions that impose nil or minimal tax on premiums on the worldwide risks of the parent company. The tax-haven company allows shareholders to build a financial bulwark against catastrophic claims at a much faster rate than if they insured with a company in their own country.⁵² This is because their location in a tax-haven jurisdiction ensures that they are often not subject to the same controls as insurance companies located in the country of the parent company, and they may invest surplus accumulations relatively freely without the burden of taxation.⁵³

In most jurisdictions, the insurance premiums paid by the parent company and its subsidiary are generally deductible for tax purposes and this can lead to considerable reductions in a group's overall tax burden.⁵⁴ This can be further augmented when a subsidiary company is established in a tax-haven country since the premiums earned by the tax-haven company and any income earned on the investment of the premiums are not taxed at all or are subject to a low tax rate in the tax haven.⁵⁵

Two of South Africa's largest insurers, Old Mutual and Liberty Life, have offshore subsidiaries in the Channel Islands and in London which have been used by many wealthy South Africans to insure their risks.⁵⁶

Protected cell companies

"Protected Cell Companies" (PCCs) are one of the relatively recent tools

Operations (1987) at 255; Spitz & Clarke at LEX/3; PM Kiffner & WD Rohrer "International Tax Planning Offshore Style: An Update Case" (1985) *Western Reserve Journal of International Law* 447; M Grundy *The World of International Tax Planning* (1984) at 53 notes that captive companies do not deal with the public at large but they insure the risks of a multinational group of enterprises doing business in various parts of the world. The captive is not only used as a vehicle for self insurance but also for buying insurance or reinsurance wholesale and selling it retail. The use of an offshore captive may thus give a multinational group a tax advantage.

52 Ginsberg at 60; see also Rappako at 28.

53 King & Victor in par 19.4.1.

54 Hampton at 32; Arnold at 119.

55 Arnold at 119.

available for corporate tax planning. Before describing the intricacies of the PCC, it is necessary to briefly explain the background which gave rise to this corporate structure. As explained above, available in the competitive offshore industry is the “captive insurance company”, which is basically an in-house self-insurance vehicle. The captive insurance industry does not however, cater for a company, which is not financially capable of self-insuring itself. In order to obtain self-coverage, the use of a “rent-a-captive structure” was introduced.⁵⁷ In terms of this structure, a company shares the services of a captive insurance company with other companies of relatively similar size, by “renting” part of the capital of the rented captive. Unrelated companies can then use the same captive to insure their risks.⁵⁸ Although the “rent-a-captive structure” has cost saving advantages, it also has some disadvantages. For example, there is no guarantee or assurance that the funds provided by one company participating in the rented captive structure would not be used to cover any unjustified claims unrelated to the risks such company wanted to insure through the rented captive. Furthermore, there is no asset protection provided for the companies participating in the “rent-a-captive structure” on an individual basis. In order to resolve the structural inefficiencies of the “rent-a-captive structure” and to circumvent the disadvantages that result from its single patrimony being exposed to unjustified third-party claims, the insurance industry developed the concept of the PCC.⁵⁹

A PCC is a special type of corporate body that consists of several companies referred to as “cells” within the same legal entity. Each cell functions as an independent unit within the umbrella of the PCC, whereby each cell has its own assets, liabilities, cellular capital and accounts. The segregation or ring-fencing of patrimonies helps to avoid the mingling of funds and assets of the different cells,

56 Ginsberg at 600.

57 Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at >
<http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm><, last accessed 25 February 2007

58 FP Ferreire “The Protected Cell Companies in a Nutshell”. Available at >
http://www.legalinfo-panama.com/articulos/articulos_41a.htm<, last accessed 25 February 2007.

59 Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at >
<http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm>< last accessed 25 February 2007

thus ensuring that no claim against one cell of the PCC would be covered by funds or assets of another cell.⁶⁰ The vital legal point is that the cells are not legal entities. The only legal entity is the PCC, which does all the operations with the outside world.⁶¹ The PCC's patrimony is composed of general assets ("non-cellular" assets), which are separate and distinct from each of the assets composing the protected cells, creating what is commonly known as the "core patrimony". The liabilities unrelated to a specific cell are covered by the non-cellular assets of the PCC.⁶²

Despite being relatively new to the corporate world, the flexibility of PCCs has encouraged their increased use as tax planning vehicles, especially in the insurance industry. Their structure has also made them an ideal entity for the cost-effective operation of umbrella mutual funds. This is because the structure of the PCC appears to create "an impenetrable wall" against creditors and prying eyes; thus it is viewed as a valuable vehicle for purposes of asset protection and financial privacy.⁶³

PCCs were first incorporated in Guernsey, under the Guernsey Protected Cell Companies Ordinance of 1997 (as amended by "The Protected Cell Companies (Amendment) Ordinance of 1998").⁶⁴ Since then, other jurisdictions, primarily the tax-haven countries, have enacted laws to facilitate the formation of PCCs.⁶⁵ The

60 FP Ferreire "The Protected Cell Companies in a Nutshell". Available at > http://www.legalinfo-panama.com/articulos/articulos_41a.htm< last accessed 25 February 2007.

61 Aamil Global Financial Services Mauritius "Protected cell Companies". Available at > http://www.aaamil.com/en/services_protected_cell_companies.aspx> last accessed 25 February 2007; Isle of Man Government, Insurance and Pensions Authority "Protected cell Companies". Available at ><http://www.gov.im/ipa/insurance/protectedcellcompanies.xml>> last accessed 25 February 2007. See also Coddan Company Formation Worldwide "Seychelles PCC Formation". Available at ><http://www.coddan.co.uk/s.-95-offshore-sycephless-ppc-formation.htm>< last accessed 25 February 2007.

62 Diamond & Diamond at Bermuda-34, where PCCs are referred to as companies that operate segregated accounts.

63 Coddan Company Formation Worldwide "Seychelles PCC Formation". Available at ><http://www.coddan.co.uk/s.-95-offshore-sycephless-ppc-formation.htm>< last accessed 25 February 2007

64 Coddan Company Formation Worldwide "Seychelles PCC Formation". Available at ><http://www.coddan.co.uk/s.-95-offshore-sycephless-ppc-formation.htm>< last accessed 25 February 2007.

65 V Kothari "The Protected Cell Companies" Available at >http://www.vinodkpthari.com/protectected_cell_companies.htm< last accessed 25 February 2007.

term “protected cell companies” is not always used in other jurisdictions, as there may be different legal issues that pertain to those entities. However, the relevant legislation of these jurisdictions has the same aim of cellular ring-fencing. The other offshore jurisdictions that have followed the path of Guernsey include the Cayman Islands with its Segregated Portfolio Companies; Bermuda, which passed the New Providence Mutual Ltd. Private Act that allows the establishment of PCC structures; Mauritius (which approved The Protected Cell Companies Act of 1999 [amended in 2000])⁶⁶; and St. Vincent and The Grenadines with their International Insurance (Amendments and Consolidation) Act of 1998, which allows the establishment of “protected premium accounts” that have elements of the PCC.⁶⁷ The Seychelles, PPCs are formed under the Protected Cell Companies Act of 2003.⁶⁸

Although the PCC was designed to fill a gap in the world of international business by improving the techniques for finance and for investment, inevitably, there are some ways in which taxes can be avoided by investing in these companies. Commenting on the tax advantages that can be derived from investing in PCC, it has been noted that:

The concept is that a life insurance company, authorised in an offshore jurisdiction, issues a single policy to a single investor, linked to assets in a particular cell. There is the idea, but the aim is an age-old aim. It is tax-free roll up. The investor is hoping that the final returns are either tax-exempt or taxed at a lower rate. If the protected cell company is aggressively structured, and if it is over-aggressively marketed, that goes over the line, it could end up being simply attacked as yet another colorful sham.⁶⁹

It is worth noting that the PCC structure can also be viewed as a means of avoiding “controlled foreign company” (CFC) legislation. Generally, this legislation ensures that the undistributed income of a controlled foreign company is not deferred, but it is taxed in the hands of its domestic shareholders on a

66 Alliance Mauritius “Protected Cell Companies”. Available at >www.alliance-mauritius.com/protected-cell-companiey.phy< last accessed 20 March 2007.

67 Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at ><http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm>< last accessed 25 February 2007.

68 Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at ><http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm>< last accessed 25 February 2007.

69 Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at ><http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm>< last accessed 25 February 2007.

current basis.⁷⁰ Since the PCC is a single legal entity, with one tax status, the cells in the PCC cannot be treated as companies for purposes of the CFC legislation.⁷¹

In Mauritius, PCCs can be used to obtain access to double taxation treaties by being structured as a Category 1 Global Business Company incorporated under the Financial Services Development Act 2001.⁷² In terms of this Act, a PCC can be used to carry out two types of global business, namely: global insurance business and investment funds (ie Collective Investment Schemes). The treaty benefits that a PCC registered in Mauritius would enjoy include the avoidance of capital gains taxes and the reduction of withholding taxes on dividends and interest.⁷³

Offshore shipping companies

Because the shipping industry is mobile, it is common for ship owners and operators to locate the ownership, operation, administration and registration of a ship in a tax-haven country. In some instances, the ownership and operation of a company may be located in two different countries; the administrative headquarters may be in a third country while the ship itself is registered somewhere else.⁷⁴ This is done in order to keep the global tax burdens of the particular shipping company low.⁷⁵ If a shipping company is registered in a tax-haven jurisdiction, that jurisdiction can be used as a “flag-of-convenience”⁷⁶

70 Olivier & Honiball at 358; B Arnold *The Taxation of Foreign Controlled Corporations: An International Comparison* (1986) at 131. See also Arnold & McIntyre at 91.

71 Alliance Mauritius “Protected Cell Companies”. Available at ><http://www.alliance-mauritius.com/protected-cell-companiey.phy>< last accessed 20 March 2007.

72 Aamil Global Financial Services Mauritius “Protected cell Companies”. Available at >http://www.aaamil.com/en/services_protected_cell_companies.aspx> last accessed 25 February 2007; In terms of the Financial Services Development Act 2001, a Category 1 Global Business Company is a company engaged in qualified global business and which is carried on from within Mauritius with persons all of whom are resident outside Mauritius and where business is conducted in a currency other than the Mauritian rupee. See also Alliance Mauritius “Protected Cell Companies”. Available at >www.alliance-mauritius.com/protected-cell-companiey.phy<, last accessed 20 March 2007.

73 Alliance Mauritius “Protected Cell Companies”. Available at >www.alliance-mauritius.com/protected-cell-companiey.phy<, last accessed 20 March 2007.

74 Daggart at 53.

75 Spitz & Clarke at LEX/18; Daggart at 54.

76 Spitz & Clarke at LEX/9 explain that the flag of a ship is the flag of the country of its registration. The term “flag of convenience” refers to the flag of a country which is chosen for ship registration in order to achieve fiscal benefits (for instance no income tax being

nation, which implies that its flag can be flown by non-resident shipping companies without their having to incur any fiscal or other controls by the flag country's government. The system is also known as open registry shipping.⁷⁷

When foreign ship owners register under the tax-haven flag, the worldwide taxation of the company can be reduced and the company can also avoid other economic restrictions and regulations in its country of residence.⁷⁸ The flag of convenience can also be used to keep the ship out of high tax countries' catchment areas so that the real owner's identity is concealed from the relevant tax authorities.⁷⁹ By the middle of the 20th century, Liberia and Panama were the most popular jurisdictions used for incorporating offshore shipping companies⁸⁰ but since the 1990s, the Isle of Man and Cyprus have been among the most popular jurisdictions for this purpose.⁸¹

levied by such countries on international shipping operations) and other non-tax advantages relating to lower labour costs and manning scales, officer and crew requirements and trade union practices. See also Doggart at 53; Olivier & Honiball at 469.

77 Doggart at 53.

78 Roper & Ware at 9; Ware and Roper at 25; Beazer at 20.

79 Beazer at 20, where it is noted that many South African-owned ships in the apartheid era and also that Israeli ships escaped boycott regulations in this way.

80 Ogley at 323 notes that the Liberian flag represents major shipping companies around the world and it is flown from almost every type of ocean-going vessel. Explaining how this works, the author notes that "Liberian maritime law requires Liberian flag ships to be owned by a Liberian entity using a non resident Liberian corporation or a Liberian foreign maritime entity. Foreign maritime entities are registered in Liberia so that a non-Liberian entity can qualify as the owner of a Liberian flag vessel. This registration allows a non-Liberian corporation, trust or partnership to own a Liberian vessel and meet the ownership requirements of the Liberian maritime law." See also Ginsberg at 67; Glautier & Bassinger at 253; Starchild at 19 also notes that Panama and Liberia were used as the major "flag of convenience" nations.

81 Isle of Man Treasury "In-Brief: Shipping Registry 'Best in World'" (Feb 2007) *Isle of Man Financial Review* at 1, where it is stated that the Isle of Man now occupies sole first position – rating it the best ship registry in the world; Isle of Man Treasury "2006 Companies Act Special Edition" (Nov 2006) *Isle of Man Financial Review* at 6, where it is noted that the Isle of Man shipping registry has a high reputation as a base for international shipping. It is also noted that the Isle of Man offers favourable tax status for ship ownership and ship management services. New Isle of Man tax rules allow shipping companies to apply for tax holidays of up to five years. During the "holiday period" all or part of their profits or income will be exempt from tax. Existing legislation already provides for temporary tax exemptions. This means that an owner, manager or other shipping operator moving to the Isle of Man can operate tax-free while establishing a new operation. See Anglo Irish Bank "Isle of Man: Shipping and Superyachts". Available at ><http://www.angloirishbank.co.im/about-iom/shipping-and-superyachts.asp><, last accessed 22 June 2007. Cyprus is also considered as one of the leading maritime centres of the world. See D Kassinopoullos, Chartered Accountant "Shipping Companies in Cyprus". Available at ><http://www.kassinopoullos.com/htmlsite/Cyprus%20Shipping.html>< last accessed on 18 May 2007; see also CG Vassiliades, Ledra Management Ltd "Cyprus: Shipping Companies – Part 1". Available at

3.4 JURISDICTION TO TAX INCOME FROM OFFSHORE COMPANIES

Before any country can tax the income of the offshore investments of its residents, a connection, or “tax nexus” must be established between the country and that income. The principles which establish nexus are associated with a physical or legal presence in a country. The main principles for taxation used in the world today are the “source” and the “residence” principles of taxation.⁸²

Under the source principle of taxation, persons are taxed on income that originates within the territorial jurisdiction or geographical confines of the country, irrespective of the taxpayer’s country of residence.⁸³ The justification for the source basis of taxation is that a taxpayer can be expected to share the costs of running the country which makes it possible for the taxpayer to produce an income.⁸⁴ Most African countries apply the source basis of taxation, presumably because it is easier to administer.

Under the residence principle of taxation residents are taxed on their worldwide income regardless of the source of the income.⁸⁵ The justification for the residence basis of taxation is that as a resident enjoys the protection of the state, he should contribute towards the cost of the government of the country in which he resides, even if income is earned outside that country. This basis of taxation is also justified by the fact that residents know that they can always return to the country of residence whenever they want and that they will have the protection of their government whenever they are abroad.⁸⁶

In general, the residence basis of taxation is internationally preferred as being

><http://www.mondaq.com/article.asp?articleid=40340&lastestnews=1>< last accessed 23 June 2007.

82 D Meyerowitz *Meyerowitz on Income Tax* (2006-2007) in par 7.1.

83 Ware & Roper at 107; L Edwards & C Waelde *Law and the Internet: Regulating Cyberspace* (1997) at 171; H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) 259.

84 *Kergeulen Sealing & Whaling Co Ltd v CIR* 1939 AD 487 at 507.

85 Olivier & Honiball at 51; L Olivier “Residence-based Taxation” (2000) 1 *South African Law Journal* at 20; Grundy at 3.

86 Meyerowitz in par 7.1.

most effective in curbing offshore tax avoidance.⁸⁷ This is because the residence basis of taxation ensures that the residents of a given jurisdiction are taxed on their worldwide income and this covers all their offshore activities. Thus taxpayers are prevented from channelling their income to countries with no tax or very low tax rates.⁸⁸ The working of the residence basis of taxation in respect of companies is discussed below.

3.5 JURISDICTION TO TAX (HISTORICAL DEVELOPMENTS IN SOUTH AFRICA)

The first income tax laws in South Africa were based on the principle that taxes would be levied only on income that was sourced in South Africa.⁸⁹ The predominant use of the source basis of taxation opened up numerous loopholes for offshore tax avoidance since income was taxed only when it was generated in South Africa. Any portion of the money generated that left South Africa was not taxed. Thus South Africans got involved in a wide variety of tax-efficient strategies involving offshore trusts and offshore companies and a number of offshore bank accounts were set up in tax-haven jurisdictions.⁹⁰

South Africa realised that a proper basis of taxation was necessary in order to curb offshore tax avoidance. Although the residence basis of taxation can be quite effective in curbing offshore tax avoidance as the worldwide income of residents is taxed, very few countries have the administrative capacity to cast their nets worldwide so this basis of taxation is usually adopted by developed and net capital exporting countries.⁹¹ South Africa is in a unique economic position, in that its economy is composed of a mixture of components typical of both a

87 Referring to the term “resident”, which is key to the understanding of the “residence basis” of taxation, art 4(1) of the OECD Model Tax Convention on Income and on Capital (2005 condensed version) at 26, provides that “the term ‘resident of a Contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature...”

88 Olivier & Honiball at 51.

89 Income Tax Act 58 of 1962 as amended by the Revenue Laws Amendment Act of 2000. See also Meyerowitz in par 7.3.

90 Ginsberg at 594-595.

91 Olivier & Honiball at 51.

developed and a developing economy.⁹² The developed component of the economy necessitated that a basis of taxation that puts South Africa in line with the trend in international taxation practices as applied by major developed countries be introduced, but the developing component of the economy posed administrative challenges that made it necessary to recruit specialised tax experts and being able to retain them.

A decision had to be made as to whether South Africa's tax system should be based on the residence or source basis of taxation. Over the years a number of commissions of inquiry were set up to look, amongst other issues, into this matter.⁹³ When South Africa rejoined the global economy after the democratic elections in 1994, the need to introduce the residence basis of taxation became even more pertinent. Since then, international interest in South Africa has also grown and this has encouraged South Africans to actively participate in and become reintegrated into the global economy. The heightened global trade competition and the mobility of capital in the modern world have also encouraged South African residents, both individuals and corporations, to make considerable investments offshore and also to look for ways of minimising their global tax

92 SARS "Discussion Paper on a Proposed System for Advance Tax Rulings" (2003) at 7. Available at

><http://sars.gov.za/legislation/Discussion20%Papers/Discussion%20proposed%20sytem20%Advance20%Tax20%Rulings.pdf><, last accessed 7 November 2007.

93 In 1951 the "Steyn Committee" recommended that the source basis of taxation be retained owing to the then perceived complexity of changing to a residence system. See the R Steyn (Chairman) *First Interim Report of the Committee of Inquiry into the Income Tax Act* ("Steyn Committee Report") UG No 75-1951 in par 69. In 1970, the "Franzsen Commission" recommended that the residence basis of taxation should be introduced as more income was beginning to flow out of South Africa without being taxed. This Commission pointed out that the introduction of the residence basis of taxation would not be such a complex procedure since the Income Tax Act had already deviated from a pure source basis through the introduction of various deeming provisions. See the DG Franszen (Chairman) *Commission of Inquiry into the Fiscal and Monetary Policy in South Africa: Taxation in South Africa, Second Report* RP 86/1970 in par 20 ("Franzsen Commission Report"). This matter was further investigated in 1987 by the "Margo Commission". This Commission highlighted the need to introduce a residence basis of taxation, noting that if exchange controls were lifted, a worldwide basis might be instrumental in curbing consequential tax avoidance. This Commission further pointed out that the "independent national states" that then existed (and to some extent the existence of other countries in the Rand monetary area) exposed the system to schemes of avoidance, which a worldwide system of taxation could help to counter. However the "Margo Commission" advised that as there are complexities in administering a residence based taxation system, the source basis should be retained and the existing deeming provisions be extended. See the CS Margo (Chairman) *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* ("Margo Commission Report") RP 34/1987 in par 26-30.

exposure. With these developments, “the Katz Commission”⁹⁴ was appointed in 1994 to inquire into the ability of the tax structure of South Africa to deal with the consequences of the globalisation of trade. The Katz Commission noted that when South Africa was barred from international trade owing to economic sanctions and stringent exchange control regulations, international trade in South Africa had dwindled. As a result, from a tax point of view, South Africa’s international tax principles had not developed to the same extent as those of its trading partners. Our international tax system had certain gaps and loopholes that were utilised by South African residents, as well as the residents of other countries, to avoid taxes.⁹⁵ These loopholes were augmented by the relaxation of exchange control regulations in mid-1997.⁹⁶ The Katz Commission recommended that the residence basis of taxation should not be introduced drastically, but that there should be a gradual adjustment of the source-based tax system in order to facilitate South Africa’s integration into the global economy. As a result of this recommendation, the source basis of taxation was applied on active income, and deeming provisions (which were essentially based on the residence principle) were applied on passive income.⁹⁷ It was presumed that this would provide an optimum balance between the effects of the residence and the source bases of taxation and that this would protect South Africa’s tax base until a residence based system was fully adopted.⁹⁸ Consequently as from July 1997, in the interim, awaiting the introduction of the residence basis of taxation, sections 9C and 9D of the Income Tax Act (now deleted) were enacted. These sections were introduced as anti-avoidance measures against South African residents intending to avoid South African tax by investing capital in offshore foreign entities. Taxes would be avoided by means such as recharacterising and converting the offshore income into non-taxable passive income (for example dividends), which could only be taxable in South Africa when they had been

94 MM Katz (chairman) *Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (1997) (“Katz Commission Report”) at 4.

95 For example, residents of countries like the United States of America and the United Kingdom whose international laws are well developed have advanced knowledge of the various schemes for circumventing anti-avoidance legislation. When residents of such countries got involved in international trade with South Africa, they could easily circumvent our anti-avoidance legislation which still lagged behind international developments.

96 VJ Maren *The Taxation of Foreign Sourced Investment Income in the Hands of South African Residents* (1999) at 21; Ginsberg at 597.

97 Ginsberg at 597.

remitted. However, such dividends would often not be remitted immediately, and as a result, taxation would be deferred by allowing this income to “roll up” in the foreign entity as long as possible. In terms of the then section 9C, investment income was defined as income in the form of any annuity, interest, rental income, royalty or any income of a similar nature.⁹⁹ Section 9D was designed to tax such foreign source investment income in the hands of South African residents.¹⁰⁰ However, these provisions could not effectively counter offshore tax avoidance, because they covered a wide scope and they were poorly drafted.¹⁰¹ As a result, many tax planning schemes were entered into, in order to take advantage of the loopholes in these provisions.¹⁰² There was thus a need to improve on these provisions if they were to be the foundation on which a new residence-based structure was to be built.

With the gradual phasing out of exchange controls, the introduction of a residence basis of taxation was inevitable. The tax authorities were convinced that the introduction of the residence basis of taxation would significantly broaden South Africa’s tax base, limit the opportunities for offshore tax avoidance and also bring South Africa’s tax system into line with international best practice.¹⁰³ Thus from the years of assessment commencing 1 January 2001, the residence based system of taxation was introduced in South Africa, ushered in by the Revenue Laws Amendment Act 59 of 2000 (the Amendment Act) which amended the Income Tax Act.¹⁰⁴ Under this new system, a distinction was made between the taxation of residents and non-residents.¹⁰⁵ Under the residence based system of taxation, the world-wide income of South African residents is taxable in South Africa, irrespective of whether or not it is earned in a low-tax jurisdiction.¹⁰⁶ The source basis of taxation was, however, not discarded. It is

98 Ginsberg at 597.

99 Olivier & Honibll at 360, see also Roper at 64, Ware & Roper at 17.

100 Maren at 11.

101 D Meyerowitz, TS Emslie & DM Davis “Editorial: The Revenue Laws Amendment Act” (2000) 49 *The Taxpayer* at 181.

102 Maren at 28.

103 Meyerowitz *et al* at 181.

104 S 1 of the Income Tax Act 58 of 1962.

105 The definition of “gross income” in s 1 of the Income Tax Act.

106 S 1 of the Income Tax Act.

used to tax the income of non-residents which is derived from a South African source.¹⁰⁷

3.6 THE RESIDENCE BASIS OF TAXATION: TAXING THE OFFSHORE INCOME OF SOUTH AFRICAN COMPANIES

Since this thesis deals partly with curbing offshore tax avoidance by companies resident in South Africa, it is necessary to consider the factors used to determine whether a company is a South African resident. The definition of a “resident” as defined in section 1 of the Income Tax Act divides South African residents into two categories: natural persons (individuals) and persons other than natural persons (for instance companies and trusts). For the purposes of this thesis, only the definition of persons other than natural persons is discussed.

A person other than a natural person is considered a “resident” of South Africa, if it is incorporated, established or formed in the Republic South Africa, or if it has a place of effective management in South Africa. However, in order to address any criticism that the world-wide test of residency would deter companies from setting up international headquarter companies in South Africa, an international headquarter company is excluded from the definition of a resident.¹⁰⁸ Although this definition appears to be very wide, the requirements of this definition are considered alternately. This means for example that a company which is incorporated in South Africa is a resident irrespective of where its place of effective management is. Conversely, a company which has its place of effective management in South Africa is a resident irrespective of where it is incorporated.¹⁰⁹ If a company is deemed a resident of another country in terms of a double-taxation agreement which South Africa has signed with that country, the company is deemed not to be a resident of South Africa.¹¹⁰

How to determine whether a company is incorporated, established or

107 Meyerowitz in par 7.3; Olivier & Honiball at 44; K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 294.

108 Par (b) of the definition of “resident” in s 1 of the Income Tax Act; see also A de Koker *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa* Vol 1 (2006 service 29) in par 5.2E.

109 Meyerowitz in par 5.19; see also Huxham & Haupt at 296.

formed in South Africa

The Income Tax Act does not define the terms “incorporated”, “established”, or “formed”. However, in terms of section 32 of the Companies Act,¹¹¹ if a company is formed and incorporated in the Republic, it is deemed to be a resident because of its formation and incorporation. Determining whether a company is incorporated, established or formed in the Republic does not present much difficulty as these are factual matters. A company’s activities and physical place of operation can be verified from the Registrar of Companies in terms of the Companies Act. In terms of sections 32, 63 and 64 of the Companies Act, a company comes into existence as a result of an application by the founders to the Registrar of Companies for its incorporation.¹¹² In terms of section 170 of the Companies Act, every company shall have recorded with the Registrar a postal address and a registered office to which all communications and notices may be addressed. Legal process may be served at the registered address and also at the company’s principle place of business. Once the registration requirements of the Companies Act have been complied with, the company is deemed to be a South African resident and is liable to tax in South Africa on its worldwide income.

How to determine the “place of effective management” of a company

The companies considered resident in South Africa are not only those that are incorporated, established or formed here. A company which has its place of effective management in South Africa is also considered a South African resident and its worldwide income is liable to tax in South Africa. It is this aspect of the definition of “resident” in respect to persons other than natural persons that is likely to create uncertainty and could be manipulated for offshore tax avoidance. This is because there is no statutory definition of the concept “place of effective management” in the South African Income Tax Act, nor is there any case law

110 Meyerowitz in par 5.19, see also Huxham & Haupt at 349.

111 And also s 64(1) and (2) of the Companies Act 61 of 1973; see also Cilliers *et al* at 67-68.

112 In terms of these sections, requirements such as registering a name for the company and submitting the company’s memorandum and articles of association have to be complied with before a certificate of its incorporation can be issued.

that provides guidance on the interpretation of the term. It is submitted that an understanding of the concept “place of effective management” is necessary if this concept is to be relied on as a basis for taxing the income of companies resident in South Africa.

The concept “place of effective management” is, however, commonly used in double taxation agreements as a so-called “tie-breaker” criterion that is used to determine the residence of an entity when it is dual resident.¹¹³ The purpose is to ensure that taxing authority in respect to such a company is granted to one country (if the two countries have entered into a double taxation agreement). In terms of Article 4(3) of the OECD Model Tax Convention,¹¹⁴ such a company is deemed to be a resident only of the state in which its place of effective management is situated. This implies that if there is a treaty between South Africa and a certain tax-haven jurisdiction, and a company incorporated in the tax-haven jurisdiction also has a place of effective management in South Africa, the company will be considered a resident of South Africa and South Africa will have the right to tax the company’s income.

Although the term “place of effective management” is commonly used in double taxation agreements as a “tie-breaker” criterion, internationally there is no uniform meaning of this term. In some states, the term is used in a sense similar to that of “central management and control”, that is management at the highest level, while in other states, the term is defined with reference to the day-to-day management of the company.¹¹⁵

Weizman¹¹⁶ notes that there is a lack of international guidance as to what kind of activities amount to a “place of effective management”. He notes further that in

113 Dual residence could arise from the fact that in different countries an entity’s liability to tax may be based on different factors, such as domicile, residence, place of incorporation, place of effective management or any other criterion of a similar nature. For example a company is considered dual resident if it is incorporated in State A and it has its place of effective management in State B. See art 4(1) of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version).

114 OECD Model Tax Convention on Income and on Capital (2005 Condensed Version).

115 See Olivier & Honiball at 79, quoting PITStart, a CD-based training tool.

116 L Weizmen “Taxing Remuneration form Employment aboard a Ship: Where is Place of Effective Management Situated?” (1996) *IBFD* 163.

non-continental jurisdictions the focus is on the location where the day-to-day management is carried out. The continental view appears to focus on a higher level of management.¹¹⁷ For instance, with regard to the position under German law, Vogel¹¹⁸ notes that:

According to case law, the place of management of an enterprise is where the management's important policies are actually made ... What is decisive is not the place where the management directives take effect but rather the place where they are given. This will normally be the place where the top manager(s) in chief has (have) his (their) offices. A place from which a business is merely supervised would not qualify. If the commercial and the non-commercial management are located at different places, the location of the commercial management will be controlling. If the place of effective management cannot be determined by application of these criteria, the top manager's residence will determine the residence of the company.

In an attempt to provide clarity on the "place of effective management" as a tie-breaker criterion, paragraph 24 of Commentary on article 4 of the OECD Model Convention was amended in 2000 to provide that:

The place of effective management is the place where the key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

In effect, the OECD presupposes that the determination of the place of effective management is based on three dominant factors: where the key management and commercial decisions are made in substance; where the most senior person or group of persons (eg a board of directors) makes its decisions and where the actions to be taken by the entity as a whole are determined. These three factors show that the determination of a place of effective management is a question of fact¹¹⁹ as these factors are based on identifying the place where the underlying policy intents of the company are formulated.¹²⁰ In ordinary circumstances, this would be the place where the directors meet to make decisions relating to the management of the company.

117 Weizmen 163.

118 K Vogel *Vogel on Double Taxation Conventions (1997) at 262.*

119 OECD "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' As a Tie Breaker Rule" (2001) par 13. Available at ><http://www.oecd.org/daoecd/46/27/1923328.pdf><, last accessed on 17 July 2007.

Paragraph 24 of the OECD Model Commentary makes it clear that no rule can be given regarding the definition of the term “place of effective management”. All the relevant facts and circumstances must be examined to determine the place of effective management. Vogel¹²¹ for example notes that if a controlling shareholder interferes with the usual conduct of the business of the company, if he/she is constantly informed of the various transactions of the company and his decisions have a decisive influence on how current transactions are dealt with, such a shareholder can be looked at in order to determine the place of effective management of a company.

Article 4(3) of the OECD Model Tax Convention states that there can only be one place of effective management, but there could be more than one place of management. The OECD’s interpretation of the term “place of effective management”, which emphasises the place of senior management could however be manipulated for tax avoidance purposes with the current technological advancements.¹²² This is especially so when trade is conducted electronically (e-commerce). It is thus necessary to consider the challenges e-commerce poses to the concept of “place of effective management”.

3.7 CHALLENGES POSED BY E-COMMERCE

What is e-commerce?

E-commerce is a term used to describe the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries.¹²³ This technology enables the transmission of voice,

120 OECD 2001 Report on the Impact of the Communications Revolution in par 63.

121 Vogel at 183.

122 H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) at 259.

123 R Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) at 3. E-commerce has also been defined as “commercial activities which are carried on by means of computers interconnected by telecommunications lines” and, more simply, as “business transactions conducted over the Internet”. See JW Fawcett, JM Harris & M Bridge *International Sale of Goods in the Conflict of Laws* (2005) at 493. See also SARS Discussion Document: *Electronic Commerce and South African Taxation* (March 2000) at 5; Department of Communications *Green Paper on E-commerce: Making it Your Business* (2000) at 9; RA Westin *International Taxation of Electronic Commerce* (2000) at 2; RL Doernberg, L Hinnekens, W Herrerstein & J Li *Electronic Commerce and Multi-*

data, images and video information to take place in cyberspace (sometimes called the “information highway”) by using the Internet.¹²⁴ The Internet can be described as a network of computers that allows people to communicate with other people from all over the world.¹²⁵ It has also been described as “the world-wide network of networks that are connecting each other into one single logical network all sharing a common addressing scheme”.¹²⁶

The Internet is growing faster than all communication technologies that preceded it.¹²⁷ It has been noted that in the world today, there are very few businesses remaining, mostly small and locally focussed, that have no Internet component. These businesses are often referred to as “bricks and mortar businesses”. With the internet, another category of business, commonly referred to as “dot-coms”, has become recognised. These are businesses that are involved in e-commerce on the Internet and do not have a physical presence.¹²⁸ The Internet provides an environment in which automated functions can undertake significant business with little or no physical activity.¹²⁹ These functions can be easily and quickly moved from one jurisdiction to another. E-commerce can ensure fast, efficient and relatively cheap distribution resources.¹³⁰ The nearly instantaneous transmission of information, the speed at which transactions are concluded and the increase in the bulk of transactions concluded, can encourage even the smallest e-commerce enterprise owned by an individual, to sell not only to national but also international markets.

jurisdictional Taxation (2001) at 9; Suddards at 257.

124 C Sher “Taxation of E-commerce” (2000) 39 *Income Tax Reporter* 172.

125 L Edwards & C Waelde *Law and the Internet: Regulating Cyberspace* (1997) at 12; SP Melvin *Cyber Law and E-commerce Regulation: An Entrepreneurial Approach* (2005) at 5.

126 J Benzine & B Gardand *Accessing and Using the Internet* (1995) at 26. See also C Chen “United States and European Union Approaches to Internet Jurisdiction and their Impact on E-Commerce” (2004) *University of Pennsylvania J of International Economic Law* 423 at 426-427; C Schulze “Electronic Commerce and Civil Jurisdiction, with Special Reference to Consumer Contracts” (2006) 18 No 1 *SA Mercantile Law Journal* at 31.

127 Schulze at 31; HB Stravitz “Personal Jurisdiction in Cyberspace: Something More is required on the Electronic Stream of Commerce” (1998) 49 *South Carolina Law Review* at 925; Westin at 2.

128 CW Pappas “Comparative US and EU Approaches to E-Commerce Regulation” (2003) 31 *Denver J of International Law & Policy* 325 at 326-327; Melvin at 13.

129 Suddards at 27.

130 Schulze at 33; ME Plotkin, B Wells & K Wimmer *E-Commerce Law and Business Vol II* (2003) in par 11.03A; JS Schwartz “Transfer Pricing and Electronic Commerce” (July 1999) *Bulletin for International Fiscal Documentation* 289; AW Oguttu “Transfer Pricing and Tax Avoidance: Is the Arm’s Length Principle Relevant in the E-commerce Era”

The Internet has however created a new route for the exchange of goods and services and the accessing of offshore facilities that has not been fully regulated.¹³¹ Global computer-based communications cut across territorial borders, creating a new realm of human activity and undermining the feasibility and legitimacy of laws based on geographic boundaries. Because the Internet ignores international boundaries, “place” has little meaning in the networked world.¹³² It is thus feared that e-commerce may change the distribution of taxable activities, alter the balance of taxing authority and result in the erosion of countries’ tax bases.¹³³ In the South Africa, the “Green Paper on E-commerce”¹³⁴ notes that:

Electronic commerce has, in many ways, created a marketplace without conventional rules; a marketplace, indeed, that challenges many of our preconceived notions and practices. It is also a marketplace that may seem to defy regulation yet at the same time requiring regulation as an enabling tool.¹³⁵

In addition, the highly mobile nature of e-commerce and the ability of residents to establish offshore companies could lead to a tax-driven migration of businesses to low-tax jurisdictions.¹³⁶ The anonymous nature of e-commerce also brings new challenges to tax compliance. E-commerce creates difficulties: in the identification and location of taxpayers, the identification and verification of taxable transactions and the ability to establish a link between taxpayers and their taxable transactions, thus creating opportunities for tax avoidance.¹³⁷

In chapter 1 of this thesis, it was pointed out that a study on the effectiveness of

(2006) 18 *SA Mercantile Law Journal* at 156.

131 Sher at 172.

132 DR Johnson & D Post “Law and Borders: The Rise of Law in Cyberspace” (1996) 48 *Stanford Law Review* at 1367 and at 1370-1371; N Cox “The Residence of Cyberspace and the Loss of National Sovereignty” (2002) 11 *Information & Communication Technology Law* 241 at 244-245; Melvin at 52.

133 Doernberg & Hinnekens at 341-343; Suddards at 255; JJB Hickey, R Mathew & C Rose *E-commerce: Law Business and Tax Planning* (2000) at 261.

134 Department of Communications *Green Paper on E-commerce: Making it Your Business* (2000) at 2; At pg 18 it is noted that the Green Paper was intended to provide a platform from which to translate topical issues around e-commerce into government policy.

135 For a further discussion on the Green/White paper on e-commerce see the discussion in chapter 4 par 4.8 under the heading “South Africa’s response to the challenges posed by e-commerce”.

136 R Buys & F Cronjé *Cyber law: The Law of the Internet in South Africa* 2 ed (2004) at 301; Suddards at 255.

legislation intended to curb offshore tax avoidance in today's world, will not be given proper justice if the challenges that e-commerce poses to the relevant legislation are not discussed. In the discussion below and in the chapters to follow, the challenges that e-commerce poses to the legislation that is used to prevent offshore tax avoidance, are pointed out.

Challenges that e-commerce poses to determining the “place of effective management”

Although article 4(3) of the OECD Model Tax Convention states that there can only be one place of effective management, the OECD's interpretation of the term “place of effective management” could result in multiple places of effective management when trade is conducted electronically.

In the past, the most senior managers of a company tended to operate from and meet in a single location, such as a head office of an enterprise, and so the determination of the place where the key management and commercial decisions were made was not too difficult. This is because the place where the top level management activities occurred would normally coincide with the place where the company was incorporated and had its registered office, or where the business activities were conducted and where the directors or senior managers resided.¹³⁸ And as paragraph 21 of the Commentary on Article 4 of the OECD Model Convention provides, it was rare in practice for a company to be subject to tax as a resident in more than one state. However, the telecommunications and technological advancements that the world faces today are fundamentally changing the way people run their business. The increased mobility of resources

137 SARS Discussion Document at 31; Hickey *et al* at 257; Suddards at 255; Buys & Cronjé at 307; Doernberg *et al* 388-389.

138 BA van der Merwe “Residence of a Company: The Meaning of ‘Effective Management’” (2002) 14 *SA Merc LJ* at 81-82 (“Van der Merwe (2002)”); OECD 2001 Report on the Impact of the Communications Revolution in pars 33-34.

that e-commerce brings about could result in the functions performed by enterprises being easily decentralised, leading to the erosion of the tax base.

E-commerce makes it easy to manipulate the principle of “place of effective management”, since it is governed by national sovereignty, having been developed in the days of “brick and mortar” where physical presence in a jurisdiction was necessary to enforce tax laws and where cross-border transactions involved mostly tangible products.¹³⁹ The Internet, on the other hand, provides the information and opportunities necessary to make residence a matter of deliberate choice rather than fate.¹⁴⁰

Buyts and Cronjé¹⁴¹ note that although the residence basis of taxation seems suitable and effective in curbing tax avoidance in an e-commerce environment, e-commerce potentially affects residence tests under domestic laws and under double tax treaties (such as the place of effective management) to the extent that reliance is placed on the location of management functions to determine a taxpayer’s residence.¹⁴² Commenting on the challenges of determining the residence of a company in the e-commerce era, it has been noted that;

The instantaneous and global facilities provided by the Internet are expected to allow residents to more easily influence the operations of their offshore subsidiaries (which would include tax-haven entities). There is no clear guidance as to where such a business would be regarded as being carried on. ... The possibilities of undetected, anonymous, or unverifiable nature of these transactions could make it even more difficult ... to obtain evidence of these activities should a taxpayer wish to conceal or disguise them.¹⁴³

With e-commerce, it is no longer necessary for a group of persons to be physically located in any one place to run a business. The cost and speed of message transmission on the Internet is almost entirely independent of physical location.¹⁴⁴ With the evolving communications technology, such as video

139 Suddards at 255; Westin at 2; see also the *Green Paper on E-Commerce* at 22.

140 Kohl-uta “The Horror-scope for the Taxation Office: The Internet and its Impact on ‘Residence’” (1998) 21 No 1 *The University of New South Wales Law Journal* at 436.

141 Buyts & Cronjé at 300.

142 Buyts & Cronjé at 300; see also Hickey *et al* at 257; Suddards at 259.

143 Australian Taxation Office “Electronic Commerce Project: Tax and the Internet” (1997) in par 7.2.21. Available at >http://www.cse.buffalo.edu/DBGROUP?nov6_taxinte.pdf<, last accessed on 25 July 2007.

144 Johnson & Post at 1367; Cox at 241.

conferencing or electronic discussion group applications via the Internet,¹⁴⁵ the senior managers of a company may adopt conferencing through the Internet as a key medium for making management and commercial decisions. If those managers are located in various countries, it may be difficult to determine a single place of effective management. This scenario may become more prevalent in the future as more companies list on multiple stock or securities exchanges.¹⁴⁶ The rapid telecommunications development may also result in increased mobile places of effective management. This situation could occur where the managing director of a company is constantly on the move. In extreme situations, that person may consistently be making company decisions while flying over the ocean or while visiting various sites in different jurisdictions where the company's business is conducted.¹⁴⁷ Similarly, a board of directors may arrange to meet in different places throughout the year. For example, the board of a multinational enterprise may agree to meet at the offices of the enterprise around the globe on a rotational basis.¹⁴⁸ As a result of such mobility, it may be difficult to determine where a company is effectively managed. Thus, with the current telecommunications development, the OECD interpretation of place of effective management cannot be relied on when determining the place of effective management of a company.

The OECD has recognised the limitations inherent in its interpretation of the term "place of effective management". In 2003, the OECD Technical Advisory Group¹⁴⁹ drafted a Discussion Paper to suggest changes to the interpretation of this term. The Discussion Paper is still in the proposal stage.

The first proposal seeks to refine the concept "place of effective management" by expanding on the OECD's Commentary as to how the concept should be

145 Buys & Cronjé at 300; Van der Merwe (2002) at 81-82; OECD 2001 Report on the Impact of the Communications Revolution in par 33-34; AW Oguttu & BA Van der Merwe "Electronic Commerce: Challenging the Income Tax Base" (2005) 17 *SA Mercantile Law Journal* at 311.

146 OECD 2001 Report on the Impact of the Communications Revolution in par 40.

147 OECD 2001 Report on the Impact of the Communications Revolution in par 43.

148 OECD 2001 Report on the Impact of the Communications Revolution in par 44.

149 OECD "Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention" (May 2003). Available at ><http://www.oecd.org/daoecd/24/17/9256428.pdf><, last accessed on 17 July 2007

interpreted. The suggested wording of the refined concept *inter alia* reads as follows:

The place of effective management is the place where the key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made, i.e. the place where the actions to be taken by the entity as a whole are, in fact, determined. All the relevant facts and circumstances must be examined to determine the place of effective management.

It appears that the proposal to refine the concept centres on the making of key management and commercial decisions, which take place “where the actions to be taken by the entity as a whole are, in fact, determined”. In effect, the 2003 Discussion Paper reiterates the current OECD interpretation of the term that relies on the location of superior management decision making.¹⁵⁰ As discussed above, the adequacy of the term “place of effective management” as a tie-breaker test based upon these factors has been questioned.

The second proposal puts forward an alternative interpretation of “place of effective management” by using a hierarchy of tests. This proposal includes three different options as possible tie-breaker tests, if the place of effective management cannot be determined. These options are:

- the place where the entity's economic relations are closer, or
- the place in which its business activities are primarily carried on, or
- the place in which its senior executive decisions are primarily taken.

If these options cannot be determined then the entity shall be deemed to be a resident of the State from which it derives its legal status. If the state from which the entity derives its legal status cannot be determined, then the competent authorities of the contracting states shall settle the question by mutual agreement.¹⁵¹

Commentators on these suggestions seem to be in favour of the second proposal as it takes into account the factors of production used by the company to derive its profits.¹⁵² This proposal considers the daily operational concerns of a

(“OECD 2003 Discussion Paper”).

150 BA van der Merwe “The Phrase ‘Place of Effective Management’ Effectively Explained?” (2006) 18 *SA Mercantile Law Journal* at 124 (“Van der Merwe (2006)”).

151 OECD 2003 Discussion Paper in par 8.

152 L Hinnekens “Revised OECD - Tag Definition of Place of Effective Management in Treaty Tie Breaker Rule” (2003) *Intertax* 314 at 317; OECD 2001 Report on the Impact of the

company which are normally dealt with at a single location, where the company carries on business, by its staff or directors individually, not as a board.¹⁵³

3.8 THE POSITION IN SOUTH AFRICA

The term “place of effective management” appears to have been introduced in South Africa in response to the recommendations of the 1997 Katz Commission Report,¹⁵⁴ which recommended the change of the South Africa’s tax system from a source-based to a residence-based system. The Report stated that:

The current definition of a domestic company is a company incorporated in South Africa, or a company ‘managed and controlled’ in South Africa. The main criticism of this definition is that it has proven to be subject to relatively simple, formalistic manipulation. This concept is also out of line with the commonly used, and much more substantial, tax treaty expression of ‘effective management’. The Commission recommends that the concept of effective management as referred to in article 4(3) of the OECD Model Tax Convention be used consistently to designate the tax residence of person other than natural person. This may perhaps be best achieved through an appropriate definition in section 1 of the Income Tax Act. Again, the change will have the benefit of employing international and, therefore, commonly understood terminology.

Currently, the concept “place of effective management” is used in section 1 of the Income Tax Act as one of the factors that are used to determine whether a person other than a natural person (for example a company) is resident in South Africa.¹⁵⁵ The Income Tax Act does not however define the concept “place of effective management”.

Since most of South Africa’s treaties follow to a large extent the OECD Mode Tax Convention,¹⁵⁶ the term “place of effective management” is also used in most of

Communications Revolution in par 59. See also Confédération Fiscale Européenne “Opinion Statement: Place of Effective Management – Suggestions for Changes to the OECD Model” (2003) at 5, available at >http://european-tax-adviser.com/wordpress/wp-content/uploads/2007/08/2003_07.pdf<, last accessed on 1 November 2007.

153 Van der Merwe (2002) at 81-82.

154 Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa Fifth interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (1997).

155 The definition of “resident” in s 1 of the Income Tax Act 62 of 1958.

156 Although different countries use various models for drafting their double tax agreements, there are three commonly used models for drafting double taxation agreements. Firstly, there is the Model Tax Convention on Income and Capital, published by the Organisation for Economic Co-operation and Development (“OECD”). This model was prepared by developed countries of the world and embodies rules and proposed by capital exporting countries. Then there is the United Nations Model Double Taxation Convention. This Model has been drafted between developed and developing countries and it attempts to reflect the interests of developing countries. Lastly there is the United States Model which

South Africa's treaties as a tie-breaker test for dual resident entities. It is however important to note that this test is not used consistently in the tax treaties entered into by South Africa. For example, in the United States treaty, the "place of incorporation" is the test applied to determine the residence of a company which is resident in both South Africa and the United States.¹⁵⁷

A literature survey reveals that earlier efforts by South African tax commentators on the interpretation of the term has not been consistent.¹⁵⁸ Meyerowitz¹⁵⁹ states that the place of effective management is where the board of directors meets to make key decisions, and not where the company business is carried on by its staff (unless the board's managerial functions have been delegated). Davis and others¹⁶⁰ note that effective management takes place where the "most vital" management actions of decision-making and the implementation of decisions occur. Olivier¹⁶¹ is of the view that the place of effective management is where the day-to-day activities of an entity take place. This need not be where its strategic and policy decisions are made and ultimately controlled. According to the editors of *The Taxpayer*,¹⁶² the place of effective management is interpreted as where the day-to-day running of the business takes place, which means that the business is controlled where its board of directors normally meets to transact its business operations. However, the above view of the editors of the *Taxpayer* is noted by Van der Merwe¹⁶³ to be confusing, as where a business is controlled is not necessarily the same as where its daily activities take place even though in some instances these locations may be the same.

Clarity on the meaning of "place of effective management" has however been offered by the South African Revenue Services (SARS) in the Income Tax

is followed by most treaties that the United States has signed with other countries including South Africa. See K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 357; Edward Nathan and Friedland "Residence Basis of Taxation: Double taxation agreements" (October 2001) http://www.saica.co.za/integritax/935_Double_taxation_agreements.htm last visited 2005/07/21.

157 Article 4(3) of the United States/South Africa Treaty. See GG No 18553 dd 1997-12-15.

158 Olivier & Honiball at 57-58.

159 Meyerowitz in par 5.19.

160 D Davis, L Olivier & G Urquhart *Commentary on the Income Tax Act* (1999/2000) ad s 35.

161 L Oliver "Residence based Taxation" (2000) 1 *Tydskrif vir die Suid Afrikaanse Reg* at 25.

162 (1995) 44 *The Taxpayer* 68.

Interpretation Note 6 (discussed below).¹⁶⁴ SARS makes a distinction between the place where:

- central management and control is carried out by the board of directors;
- executive directors or senior management execute and implement policy and strategic decisions made by the board of directors, and where they make and implement day-to-day operational management and business activities; or
- the day-to-day business activities are carried out or conducted.¹⁶⁵

Does SARS’s interpretation of the term “place of effective management” achieve the tie breaker purpose?

SARS uses three rules to determine the place of effective management. SARS’ Income Tax Interpretation Note 6,¹⁶⁶ states that the “place of effective management” is the place where a company is managed on a regular or day-to-day basis by the directors or senior managers of the company. That is the place where the board of directors executes and implements the policy and strategic decisions of the company, irrespective of where the overriding control is exercised, or where the board of directors meets. If management functions are exercised at a single location, that location will be the place of effective management. This is the first rule in determining the “place of effective management” of a company.

Referring to this rule, Van der Merwe¹⁶⁷ notes that SARS’s interpretation, which depends on where high-level management decisions are regularly implemented, may be susceptible to abuse. According to Olivier and Honiball,¹⁶⁸ the term “implemented” does not help in identifying or locating where particular decisions are implemented. What constitutes “implementation” may not be obvious in some

163 Van der Merwe (2002) at 82.

164 Income Tax Interpretation Note 6 of 26 March 2002.

165 SARS Interpretation Note 6 in par 3.1.

166 Income Tax Interpretation Note 6.

167 Van der Merwe (2006) at 126.

168 Olivier & Honiball at 56.

cases. Implementation may consist of several separate actions undertaken in various jurisdictions through virtual or mobile offices. This in turn may lead to a taxpayer having more than one place of effective management during a particular tax year.¹⁶⁹ This is illustrated in an example by Olivier and Honiball.¹⁷⁰

A decision is taken locally by a company director resident in South Africa to raise finance from a foreign bank. A phone call is made by the South African resident director while based locally to arrange for the finance. However, the director flies overseas to sign the finance agreement.

The question that arises from this example is whether the transaction was “implemented” locally or overseas.

If the place where the board of directors execute and implement the policy and strategic decisions of the company does not correspond with the place where the day-to-day business operations are actually carried out, the Interpretation Note provides a second rule, which is a practical approach to eliminating multiple residences. In terms of this rule, if management functions are not exercised in one place, due to management by way of distance communication, the place of effective management is deemed to be “where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented”.¹⁷¹ In other words, that is the place where business operations are actually carried out. Determining the place of effective management in this regard will generally not be too difficult to determine if the company is involved in the manufacture and/or sale of tangible goods, unless business activities, or parts or phases of such activities are conducted across the globe. But if a company deals in intangible goods and services, it could be possible to manipulate the place of effective management by conducting business operations and activities from various locations.¹⁷² Referring to this rule, Van der Merwe¹⁷³ argues that the SARS’ practical approach “will not necessarily result in a single place of residence, as a taxpayer may have several places across the world where operational and commercial decisions are implemented,

169 Van der Merwe (2006) at 126.

170 Olivier & Honiball at 56.

171 SARS Interpretation Note 6 in par 3.3.

172 Oguttu & Van der Merwe at 311; Note that, SARS’ solution for this type of situation, namely to determine the place with the strongest economic nexus, is not adequately explained; SARS Interpretation Note 6 in par 3.3.

and where the business activities, or parts or phases of such business activities, are carried out or conducted”.

The third approach that SARS uses is that where the business operations or activities are conducted from various locations, “one needs to determine the place with the strongest economic nexus”.¹⁷⁴ Van der Merwe¹⁷⁵ argues that this approach is not expressly linked to effective management, but it could be used as an alternative tool to determine residence and therefore its usefulness in determining the place of effective management is doubtful.¹⁷⁶ It is also worth noting that the Interpretation Note does not explain the phrase “economic nexus”, and does not provide guidance in this respect.¹⁷⁷ Although the phrase “economic nexus” is referred to by the OECD as a possible alternative for the replacement of effective management, or as one of the elements in a hierarchy of tie-breaker rules,¹⁷⁸ none of these options employs “economic nexus” as a means of determining effective management, but it regards it as a separate rule. It is also worth noting that applying “economic nexus” requires the ability to find the strongest or the closest economic nexus. Locating an entity’s closest or strongest economic relations would require examining and weighing several factors, for example, determining the state where the entity has most employees and assets; carries on most activities; where it generates most of its revenue; or where it has its headquarters.¹⁷⁹ Neither the OECD nor SARS Interpretation Note provide any guidance on the weight allocations to be given to these factors. This makes the “economic nexus” test quite difficult to apply.

173 Van der Merwe at 128.

174 SARS Interpretation Note 6 in par 3.3.

175 Van der Merwe (2006) at 128.

176 Note that in South Africa, “economic nexus” is not used as test of residence, in terms of s 1 of the Income Tax Act; an entity is resident if it is incorporated, established or formed or has a place of effective management in South Africa. It is however worth noting that “economic nexus” has strong links to “residence” as a means for determining the jurisdictional to tax income. For instance, RJ Vann “International Aspects of Income Tax” in V Thuronyi *Tax Law Design and Drafting* (1998) at 279, notes that “a person is a resident of a country if the person has close economic and personal ties to the country”. See also *Kergeulen Sealing & Whaling Co Ltd v CIR* 1939 AD 487 at 507. Van der Merwe (2006) at 129 however notes that there is uncertainty whether “economic nexus” is an appropriate test to confer residence or whether it should be merely used as a tie-breaker test that is similar to “centre of vital interest” - a tie-breaker tests that is used for individuals (art 4(2)(a) of the OECD Model Tax Convnetion). See OECD 2001 Discussion Paper in par 50.

177 Van der Merwe (2006) at 129.

178 OECD 2003 Discussion Draft in par 8c.

179 OECD 2003 Discussion Draft at 5.

SARS's Interpretation Note 6 acknowledges that management structures, reporting lines and responsibilities often vary from entity to entity, depending on the requirements of the entity, so no hard and fast rules can be laid down.¹⁸⁰ In such circumstances, SARS provides a non-exhaustive list of facts and circumstances that may be relevant when determining the place of effective management. Some of the circumstances (mentioned in Interpretation Note 6) that could be considered in determining the "place of effective management" are:

- where the centre of top management is located;
- the location of and functions performed at headquarters;
- where the business operations are actually conducted;
- where the controlling shareholders make key management and commercial decisions for the company;
- the place of incorporation, formation or establishment of the company and the location of its registered office;
- the residence of the directors or senior managers of the company who are responsible for its day-to-day management;
- the place where the company's directors or senior managers frequently hold company meetings;
- the actual activities and physical location of senior employees; and
- the scale of onshore as opposed to offshore operations.

The question that arises from the above is whether the listed factors should be viewed qualitatively or quantitatively. It is not clear whether they all carry the same weight.¹⁸¹

In general, it is reasoned that SARS's interpretation Note 6 may not necessarily result in identifying a single place of effective management, and may in some instance lead to the possibility of multiple places of residence.¹⁸² It is however, worth acknowledging that although South Africa does not have a statutory meaning of the term "place of effective management", SARS Interpretation Note

180 The Income Tax Interpretation Note 6.

181 Van der Merwe (2006) at 133.

182 Van der Merwe (2006) at 133.

6 may play a significant role in the determination of the meaning of the term for domestic law purposes. Sight should also not be lost of the fact that in South Africa, the words “place of effective management” as one of the tests of company residence, in section 1 of the Income Tax Act, replaced the previous test “managed and controlled” (i.e. where the board of directors meets).¹⁸³ It may therefore be argued that in a domestic context, the words “place of effective management” mean something different from “where the board of directors meets”.¹⁸⁴

It is also important to note that SARS Interpretation Note 6 gives valuable guidance to taxpayers, who often approach the subject of effective management in a simplistic manner. For example, often taxpayers assume that a company is effectively managed outside the Republic merely because the directors travel abroad from South Africa once or twice a year to hold a board meeting, when the true effective management, as contemplated in the Interpretation Note, is actually exercised in South Africa.¹⁸⁵ SARS has even taken practical steps to determine whether the place of effective management of some of these entities is actually in South Africa. According to a report in Finance Week of 20 July 2004, SARS sent out questionnaires to companies asking where the activities of their offshore companies are based. This is clearly to find out if these companies are effectively managed in South Africa.

The limitations of applying SARS’s interpretation of “place of effective management”

Despite the valuable guidance that Interpretation Note 6 gives in the interpretation of the “place of effective management”, it is trite that SARS’s Interpretation Notes are not law and in a number of cases it has been argued that SARS is not bound by its own Practice Notes and Interpretation Notes.¹⁸⁶ This implies that South African courts are not bound to follow SARS’s

183 Olivier & Honibal at 69.

184 Olivier & Honibal at 69.

185 K Mitchell & L Mitchell *Offshore Transactions and the World-wide Basis of Taxation* (2004) Tax Seminar Notes at 22.

186 *ITC 1675* (1998), 62 SATC 219 (G) at 229A.

Interpretation Notes.

Section 108(2) of the Income Tax Act provides that if the National Executive of South Africa enters into an agreement with the government of any other country to regulate the taxation of income, profits, gains and donations which may be taxable in both countries, as soon as the double tax agreement is ratified and has been published in the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act.¹⁸⁷ Most of South Africa's treaties largely follow the OECD Model Tax Convention on Income and on Capital,¹⁸⁸ although South Africa is not a member of the OECD.¹⁸⁹ In *CIR v Dowling*,¹⁹⁰ the court held that South Africa is bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention. Section 231 of the Constitution of the Republic of South Africa provides that courts are bound to apply customary international rules and practices.

But as noted above, unlike SARS's Interpretation Note 6, the OECD's interpretation of this concept can easily be manipulated for tax avoidance purposes in the current e-commerce era.¹⁹¹ An increasing number of businesses are now conducted trans-nationally; company management (whether it is the directors, a subcommittee, or the executive directors) can theoretically meet

187 Meyerowitz in par 30.10; Huxham & Haupt at 356. See also s 231 of the Constitution of the Republic of South Africa, 1996.

188 In principle, there are three models for drafting double taxation agreements, which have been developed over time. Firstly, there is the Model Tax Convention on Income and Capital, published by the OECD. This model was prepared by developed countries of the world and embodies rules and proposals by capital exporting countries. Then there is the United Nations Model Double Taxation Convention. This Model has been drafted between developed and developing countries and it attempts to reflect the interests of developing countries. Lastly there is the United States Model which is followed by most treaties that the United States has signed with other countries, including South Africa. See Olivier & Honiball at 7. See also Huxham & Haupt at 341.

189 Olivier & Honiball at 8; Huxham & Haupt at 341. There are 30 OECD member countries. Namely: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States. See OECD "OECD Member Countries". Available at http://www.oecd.org/document/58/0,2340,en_2649_201185_1889402_1_1_1_1,00.html, last accessed on 17 May 2007.

190 1975 (4) SA 518 (A) at 524.

191 Van der Merwe (2006) at 136.

anywhere in the world or via the Internet to decide on strategic policy issues concerning the company. By contrast, the daily operational concerns of a company are normally dealt with at a single location, where the company carries on business, by its staff or directors individually, not as a board.¹⁹²

Although the concept “place of effective management” can be manipulated by the emergence of e-commerce, this concept should not be replaced until a more feasible solution is found that provides legal certainty, accords with the actual economic activities of the company and is administratively practical.¹⁹³ As noted above, the OECD has recognised the limitations inherent in its interpretation of the term “place of effective management”. The OECD 2003 Discussion Paper¹⁹⁴ suggests that the OECD interpretation of term “place of effective management” should be refined or an alternative interpretation of “place of effective management” should be applied.¹⁹⁵ As stated above, commentators on these proposals seem to favour the second proposal since it takes into account the factors of production used by the company to derive its profits.¹⁹⁶ SARS’s interpretation appears to be in line with this proposal since it recognises day-to-day management by directors and senior managers as effective management. Although SARS’s interpretation has some unsatisfactory details that need to be clarified, it is a better tie breaker test than the alternative OECD interpretation that recognises central control as an indicator of effective management.¹⁹⁷

It is recommended that SARS’s interpretation should be refined and be given the force of law by inserting a subsection in section 1 of the Income Tax Act that defines the term “place of effective management”. It is worth noting that in 1997 Katz Commission Report¹⁹⁸ recommended that an appropriate definition of this should be inserted in section 1 of the Income Tax Act.¹⁹⁹ It is regrettable that this recommendation has not yet been followed. In this author’s view, a definition of

192 Van der Merwe (2002) at 81-82.

193 Van der Merwe (2006) at 125.

194 OECD 2003 Discussion Paper.

195 OECD 2003 Discussion Paper in pars 7 and 8.

196 Hinnekens at 317; Confédération Fiscale Européenne at 5.

197 Van der Merwe (2006) at 135.

198 Katz Commission Report in par 6.1.2.1.

199 For a suggestion as to how the definition of “place of effective management could read, see chapter 10 par 10.2.1.

the term “place of effective management” in the Income Tax Act would provide valuable guidance to taxpayers and tax authorities in determining whether a company is resident in South Africa by virtue of the fact that it is effectively managed in South Africa.

3.9 JURISDICTION TO TAX INVESTMENTS FROM OFFSHORE COMPANIES IN THE UNITED KINGDOM

The United Kingdom uses the residence basis of taxation²⁰⁰ to tax the worldwide income of its residents. The concept of residence is used to distinguish between taxpayers subject to tax on their worldwide income and non-resident taxpayers subject to tax only on income derived from United Kingdom sources.²⁰¹ In *Colquhoun v Brooks*,²⁰² it was held that the “Income Tax Acts impose a territorial limit, in that either the source from which the taxable income is derived must be situated in the United Kingdom, or the person whose income is to be taxed must be resident in the United Kingdom”. This implies that if income does not arise in the United Kingdom, it is not charged, unless the person to whom it accrues is resident in the United Kingdom.

Companies resident in the United Kingdom are subject to tax on their worldwide income.²⁰³ Company income tax, known as corporation tax, is imposed on the worldwide profits (income and capital gains) of companies resident in the United Kingdom subject to unilateral and treaty relief provisions.

Previously the test for determining company residence in the United Kingdom was based on the case of *De Beers Consolidated Mines Ltd v Howe*,²⁰⁴ where it was held that the test of company residence is where the central management

200 Spitz & Clarke at UK/4-10; R Helsby, J McMahon & B McCarthy *B Trouble with the Tax Man? Offshore Survival* 2 ed (1990) at 3.

201 *A Sumption Taxation of Overseas Income and Gains* 4 ed (1982) at 1-25.

202 (1889) 14 App Cas 493 at 503.

203 Ss 6(1) and 8(1) Income and Corporations Tax Act 1988.

204 [1906] AC 455; see also HJ Ault *Comparative Income Taxation: A Structural Analysis* (1997) at 372.

and control of the company's business actually resides. A company's central management and control would normally be exercised by its directors who make the fundamental policy decisions that constitute the exercise of central management and control of the company.²⁰⁵ The central management and control test of corporate residence was intended to prevent United Kingdom residents from establishing tax-haven companies that were controlled from the United Kingdom.²⁰⁶ The place where the directors' meetings were held was a very important factor in determining the residence of a corporation. However, with the developments in telecommunications, Inland Revenue realised that effective control of a company could be moved from place to place without difficulty. For instance, if a corporation was incorporated in the United Kingdom, but all or some of its directors were resident outside the United Kingdom and also board meetings took place and decisions on general and financial policy were made outside the United Kingdom, the corporation would have the income tax status of non-residence in the United Kingdom. Such non-resident companies would operate through branches or agencies in the United Kingdom and were only taxed on United Kingdom income (subject to any treaty provisions).²⁰⁷ Corporate residence became both difficult to determine and easily manipulated for tax purposes in that it enabled taxpayers to exploit double tax treaties in order to reduce taxes on international investments. The globalisation of financial markets also meant that multinational enterprises that were spreading across the world could manipulate the management and control test by placing senior management in a particular jurisdiction or having a corporation incorporated in a particular jurisdiction just to offer a basis for taxation in that jurisdiction.²⁰⁸

To curb the resultant tax avoidance, legislation was enacted to the effect that a company incorporated in the United Kingdom on or after 15 March 1988 is treated as a United Kingdom resident even if its management and control are exercised outside the United Kingdom.²⁰⁹ As a result, incorporation is at present

205 Helsby *et al* at 7.

206 Arnold at 302.

207 S 246(1) of the Income and Corporation Taxes Act 1970.

208 M Gammie "International Tax Avoidance: A UK Perspective" (2000) 172 *Intertax* 275.

209 S 66 and Schedule 7 Finance Act 1988; see also Spitz & Clarke at UK/4-10; see also Ault at 372; HJ Ault & BJ Arnold *Comparative Income Taxation: A Structural Analysis* 2 ed (2003) at 350. It is worth noting that previously South Africa also relied on the United

the test of residency for United Kingdom companies and case law on central management and control is of relevance only to companies registered abroad.

There are, however, two exceptions to the incorporation test:

- Firstly, a company will remain non-resident if it was carrying on business before 15 March 1988 and had become non-resident before then, pursuant to a general or a specific Treasury consent obtained under section 765 of the 1988 Income and Corporation Taxes Act. If the consent was a specific consent, the company can remain non-resident regardless of where it is based, and it only becomes a United Kingdom resident if it in fact becomes resident under the central management and control test.²¹⁰
- Secondly, when a company is a dual resident in that it is resident in the United Kingdom under United Kingdom domestic law, or it is liable to tax in some other state (by reason of residence, domicile, or place of effective management) and there is a double-tax treaty between the United Kingdom and that other state, the company is treated as resident in the other state for the purposes of the treaty.²¹¹ This is in line with the OECD Model Treaty, which provides under the tie-breaker rule that a company will be resident where its place of effective management is situated. Thus a dual company that is registered in a treaty country and has a place of effective management in the United Kingdom is deemed to be resident in the United Kingdom.²¹²

The meaning of “place of effective management” in the United Kingdom

In the United Kingdom, there is no clear distinction between the meaning of term “place of effective management” and the term “central management and control”.

Kingdom precedent as laid down in the *De Beers* case, whereby the test of company residence was where the central management and control of the company was based. But because this test is prone to tax avoidance, this test of residency for companies was also repealed in South Africa.

210 Summing up this exception, Ault at 372 notes that, although from 1988 companies incorporated in the UK are resident there, companies incorporated elsewhere were left liable to tax under the old UK residence status.

211 G Clarke *Offshore Tax Planning* 9 ed (2002) at 272.

212 S 249 Finance Act 1994; see also Spitz & Clarke at UK/4-10.

In *Wensleydale's Settlement Trustees v CIR*,²¹³ it was held that:

the place of effective management is not necessarily where a corporate body carries on business, but where the board of directors meets on the company's business which may differ from the place where the company's business is carried on or is managed by staff or directors individually and not acting as a board.

Owen²¹⁴ is of the view that "effective management" denotes a form of management lower than "central management and control". He²¹⁵ explains that although in practice the two forms of management often coincide, the place of effective management is "the place where you would expect to find the executives and senior staff who actually make the business tick". That is "the place where one would, for example, expect to find: the financial director, the sales director, and the managing director. As these executives would normally be on the board of directors, the location of the place of effective management will only differ from the place where "central management and control" is exercised, if the term "effective management" refers to where the directors normally reside and not where they hold board meetings."²¹⁶

According to Weizman,²¹⁷ the "place of effective management" is where the day-to-day management of a company is carried on, which may not be the place where the highest policy decisions of the company are taken.²¹⁸ This view appears to be rooted in the Inland Revenue Statement of practice 6/83 which provides in part that:

The parent will normally influence, to a greater or lesser extent, the actions of the subsidiary. Where that influence is exerted by the parent exercising the powers which a sole or majority shareholder has in general meetings of the subsidiary, for example to appoint and dismiss members of the board of the subsidiary and to initiate or approve alterations to its financial structure, the Revenue would not seek to argue that central management and control of the subsidiary is located where the parent company is resident. *However, in cases where the parent usurps the functions of the board of the subsidiary ... or where that board merely rubber stamps the parent company's decision without giving them any independent consideration, the Revenue will draw the conclusion that the subsidiary has the same residence for tax purposes as its parent.*

213 (1998) *The Taxpayer* 81.

214 P Owen "Can Effective Management be Distinguished from Central Management and Control?" (2003) *British Tax Review* at 300.

215 Owen at 300.

216 Owen at 300.

217 L Weizman "Taxing Remuneration for Employment aboard a Ship: Where is Place of Effective Management Situated?" (1996) *International Bureau of Fiscal Documentation* at 163. See also Olivier & Honiball at 67.

218 Weizman at 166. The Interpretation of the term "place of effective management" in the United Kingdom accords with South Africa's interpretation of this term as set out in SARS Income Tax Interpretation Note 6 of 26 March 2002.

... [T]here may be cases where a company is a member of a group having its ultimate holding company in another country which will not fall readily into either of the categories referred to above. In considering whether the board of such a subsidiary company exercises central management and control of the subsidiaries business, they have regard to the degree of autonomy which those directors have in conducting the companies' business. *Matters (among others) that may be taken into account are the extent to which the directors of the subsidiary take decisions on their own authority as to investment, production, marketing and procurement.*

... [I]t is now considered that effective management may in some cases, be found at a place different from the place of central management and control. This could happen, for example, where a company is run by executives based abroad, but the final directing powers rest with non-executive directors who meet in the UK. In such circumstances the company's place of effective management might well be abroad but, depending on the precise powers of the non-executive directors, it might be carefully managed and controlled (and therefore resident) in the UK. (Emphasis added).

From the above, it appears that there is no clear distinction between term “place of effective management” and the term “central management and control” in the context of a group of companies. Case law is also not clear on this matter. In a few cases, the courts have ruled that where the board of directors of a subsidiary stands aside altogether so that the parent company effectively usurps the function of the board of directors of the subsidiary, then it cannot be said that the “central management and control” of the subsidiary abides where the board of directors of the subsidiary meets. In *Unit Construction Co Ltd v Bullock*,²¹⁹ it was held that an African subsidiary whose directors met locally was nevertheless resident in the United Kingdom since its parent company in the United Kingdom had taken over the running of the subsidiary company due to difficult local conditions.

The situation is however different where a subsidiary's board of directors still exercises central management and control but does so under the influence of or with guidance from the parent company. This matter was dealt with in *Wood and another v Holden*.²²⁰ This case was concerned with a tax planning arrangement in the context of the sale of shares in a family business. The facts of the case were as follows: Mr and Mrs Wood were settlors of a number of non-resident settlements that were set up as a part of a scheme to avoid capital gains tax. The

219 [1960] AC 455.

220 [2006] EWCA Civ 26.

trustee of those settlements was the sole shareholder of Copeswood Investments Limited ("CIL"), a company registered in the British Virgin Islands. In July 1996 CIL sold some shares to Eulalia Holdings BV (Eulalia), a company incorporated in Netherlands. The scheme assumed that CIL and Eulalia were not merely incorporated outside the United Kingdom but were also resident outside the United Kingdom. The Special Commissioners challenged the efficacy of the arrangements on the basis that Eulalia was a resident of the United Kingdom. This would render ineffective the proposed tax planning arrangements devised by PricewaterhouseCoopers (Mr and Mrs Wood's Accountants).

The central issue in this case was whether CIL made a chargeable gain when it sold its share to Eulalia in July 1996. In terms of section 13 of the Taxation of Capital Gains Act (TCGA) 1992, the gains that arose to CIL (on the disposal of shares to Eulalia) would be attributed to the non-resident trustees who were participators in CIL. Further, in terms of section 86 of TCGA (which deals with the attribution of gains to settlors with interests in non-resident settlements), those gains would be attributable to, and chargeable on, the settlors, Mr and Mrs Wood. However, section 14 of the TCGA provides that for the purposes of section 13 of the TCGA no gain arises on a disposal by one company to another provided that both companies are in a non-resident group of companies (as defined in section 14(4)(a) of the TCGA).

It was not disputed that Eulalia and CIL were members of a group of companies. The issue was whether they were both not resident in the United Kingdom at the date of the disposal of the shares to Eulalia. If they were not United Kingdom residents, section 14 of the TCGA would apply and no gains would arise on CIL's disposal to Eulalia. The Revenue was of the view that while CIL was resident outside the United Kingdom, Eulalia was resident in the United Kingdom. Thus the gains made by CIL on the disposal of the shares were attributed to the trustee under section 13 of the TCGA. It was argued that Eulalia was resident in the United Kingdom, because the decision making process was not carried on by the company's Board of Directors. Its sole director was told what to do by Mr Wood and PriceWaterhouseCoppers and that in effect, no real decisions were

taken in the Netherlands. Mr and Mrs Wood were assessed to CGT in respect of those gains, which were treated as accruing to them under section 86 of the TCGA. When the matter was taken to the High Court, it was held that Eulalia was resident in the Netherlands and that there was no evidence that its powers had been usurped by PriceWaterhouseCoppers. The judge noted that although a board of directors may act under the influence of another person, that does not necessarily mean that the board of directors has ceased to exercise central management and control. The Revenue appealed the High Court's judgment.

In the Court of Appeal, Lord Justice Chadwick held that the High Court had been correct in holding that Eulalia was resident in the Netherlands. In seeking to determine where the "central management and control" of a company incorporated outside the United Kingdom lay, it was essential to recognise the distinction between:

- (a) cases where management and control of the company was exercised through its own constitutional organs (the board of directors or the general meeting); and
- (b) cases where the functions of those constitutional organs were "usurped", in the sense that management and control was exercised independently of, or without regard to, those constitutional organs.

In cases which fall within the first category, it is essential to recognise the distinction between (a) the role of an "outsider" in proposing, advising and influencing the decisions of the board of directors and (b) the role of an outsider who dictates the decisions which are to be taken. In regard to the *Wood v Holden* case, the Court of Appeal noted that the (Netherlands based) directors of Eulalia were not bypassed, but they signed or executed the documents relating to the sale and purchase of the shares. Although PriceWaterhouseCoppers set up the overall structure, it intended and expected the directors of Eulalia to take the decisions, which it in fact took. In light of the above, the High Court's decision to reverse the Revenue's findings as to the residence of Eulalia on the basis of the "central management and control" test was upheld.

Although the Court of Appeal found it unnecessary to decide whether a different conclusion could have been reached if the “place of effective management” test was applied, it remarked that “it is difficult to see how, in the circumstances of this case, the two tests could have lead to different answers”.²²¹ In effect, the Court of Appeal was of the view that the two tests were in essence one and the same.

The significance of the *Wood v Holden* case in the context of an international tax planning structure is that if an offshore subsidiary is only required to effect limited tasks and its offshore directors properly apply their minds to these tasks, there is no reason to find that the “place of effective management” of the offshore subsidiary is in the jurisdiction where the parent company is located.²²²

Another recent United Kingdom case that *inter alia* dealt with the meaning of “place of effective management” is *Indofood International Finance Ltd v JP Morgan Chase Bank*.²²³ The detailed facts of this case are dealt with further ahead in this chapter with respect to the discussion on “beneficial ownership”. In brief, the case revolved around the setting up of a conduit company structure. The parties had devised a financing structure, to benefit from the reduced withholding tax rate in the Indonesia/Mauritius double taxation treaty. When the treaty was terminated, one of the parties sought to set up a conduit company in the Netherlands to remedy the situation.

In determining whether the proposed conduit company in the Netherlands would be regarded as resident in the Netherlands, the Court of Appeal referred to article 4 of the Netherlands/Indonesia treaty, and the Commentary to the OECD Model Convention, which state that “the place of effective management is the place where key management and commercial decisions that are necessary for

221 [2006] EWCA Civ 26 in paragraph 43.

222 DM Davis “Place of Effective Management” 56 (May 2007) *The Taxpayer* at 84. See also M Hutton “Company Residence: Central Management and Control – Capital Tax Review” (June 2006). Available at ><http://www.taxationweb.co.uk/articles.article.php?id=346><, last accessed 2 April 2007; A Nathan “Determining Company Residence after Wood v Holden”. Available at [http://www.taxbar.com/documents/comoany Residence Wood v Holden AN 000.pdf](http://www.taxbar.com/documents/comoany%20Residence%20Wood%20v%20Holden%20AN%20000.pdf)<, last accessed on 28 June 2007.

223 [2006] EWCA Civ 158.

the conduct of the entity's business are in substance made". The Chancellor in the Court of Appeal did not doubt that the directors of Netherlands conduit company would make the decisions regarding the keeping of books, management of the audit, handling charges and what to do with equity capital. However, the Chancellor ruled that these could not be considered key decisions to ensure a "place of effective management" for treaty purposes. The Chancellor concluded that the conduit company in the Netherlands would not be considered a resident in the Netherlands, as the key decisions relating to its setting up would be taken by parent company in Indonesia.

3.10 JURISDICTION TO TAX INCOME FROM INVESTMENTS IN OFFSHORE COMPANIES IN THE UNITED STATES

Corporations that are incorporated in the United States are taxed on their worldwide income regardless of their geographical location.²²⁴ A corporation incorporated under the laws of another country is treated as a foreign corporation for United States tax purposes. Foreign corporations, like non-resident alien individuals, are subject to full United States tax only on their effectively connected income that has its source in the United States.²²⁵

In order to alleviate international double taxation that may arise as a result of the worldwide basis of taxation, a foreign tax credit is availed to United States domestic corporations which pay taxes on foreign income to other countries.²²⁶

Although the OECD recommends that countries use the "place of effective management" as a tie-breaker test for determining the residence of a dual resident company for tax purposes, the United States' observation under article

224 S 11 of the Internal Revenue Code as amended; see also W F O'Conner *An Inquiry into the Foreign Tax Burdens of US Based Multinational Corporations* (1980) at 24; see also Rappako at 46; see also Ault at 371; see also Ault & Arnold at 349 where it noted that all corporations organised under the laws of the United States or one of the Federal States are treated as "domestic", ie resident corporations regardless of any other connection to the jurisdiction.

225 IRC s 871, 881 and 882; see also Rappako at 46.

226 IRC s 33 and s 64(a); Rotterdam Institute for Fiscal Studies at 284 notes that the tax credit mechanisms are employed to ensure that the overall rate of tax imposed on those subject to US tax jurisdiction does not exceed the higher of the US rates or the average rate

4(3) of the OECD Model Convention is that it reserves the right to use the “place of incorporation” test to determine the residence of a corporation, failing that the United States denies dual resident companies certain benefits under the Convention. It is worth noting that while the “place of incorporation” test has the advantage of being easily understood and has minimal administrative and compliance costs, it can be argued that this test is not an effective tie-breaker test.²²⁷ In today’s environment, the act of incorporating an enterprise is relatively simple; many jurisdictions even allow online incorporation or establishment.²²⁸ As a result, it is possible that the only tie an enterprise may have to the jurisdiction in which it is incorporated or established is a formal tie. A company incorporated in country A may have its entire management, business operations and assets located in country B. Using the place of incorporation as a tie-breaker for companies would produce the same results as recognising the place of birth of a person as the sole residence test whereas a person may be born in a given country and yet be resident in another.²²⁹

3.11 CONCLUSION

In conclusion, it can be said that the test of company residence applied in South Africa seems to be in line with the test applied in the United Kingdom. Generally, in both countries the test for company residence is if the company is incorporated or if it has a “place of effective management” there. The United States only uses the place of incorporation as the test. Although it is more difficult to manipulate the “place of effective management” test because it is less artificial than the place of incorporation test, the possibility of tax avoidance even where the “place of effective management” test is used, is enhanced by the rise of e-commerce as “the Internet provides the information and opportunities necessary to make residence more a matter of deliberate choice rather than fate”.²³⁰ The heightened international competition may thus force companies to move their residences from high-tax jurisdictions to low-tax jurisdictions. This may force high-tax

imposed by the foreign countries in which a US taxpayer operates or invests.

227 OECD 2001 Discussion Paper in par 51.

228 OECD 2001 Discussion Paper in par 57.

229 OECD 2001 Discussion Paper in par 57.

230 Kohl-uta at 436.

countries to search for alternative criteria for determining entity residence.²³¹

In most jurisdictions, the residence basis of taxation has to be supplemented with specific anti-avoidance legislation, for example in respect of controlled foreign companies. This phenomenon is dealt with in the next chapter.

231 Van der Merwe at 81-82; Doernberg & Hinnekens at 371-273.

CHAPTER 4

CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN OFFSHORE COMPANIES: SOUTH AFRICA

4.1 INTRODUCTION

Historically, exchange control regulations have been used in a number of countries to prevent residents from investing or transferring funds abroad, but in the past few decades many countries have eliminated or relaxed their exchange control regulations. In addition to exchange controls, in many tax systems both statutory and judicial anti-avoidance doctrines, such as the sham and substance over form, have been used,¹ but these have also been found to be ineffective in preventing offshore tax avoidance.

With the growing use of international intermediaries and the development of preferential tax regimes, a number of countries have been prompted to enact specific legislation to reduce the risk of losing domestic tax revenue from international investment. Such legislation includes the “controlled foreign company” (CFC) legislation. The basic reason for this legislation is that in its absence it would be easy for a resident taxpayer to defer domestic taxation on its foreign income by simply interposing a foreign company in a territory with a lower level of taxation to receive such income, instead of remitting it to the home country.² CFC legislation ensures that the undistributed income of a controlled foreign company is not deferred, but it is taxed in the hands of its domestic shareholders on a current basis.³ The rationale is that as the income received by or accrued to a foreign company cannot be taxed directly, even if the foreign

1 OECD *Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation* (2000) at 18 (“OECD 2000 Report on CFC Legislation”).

2 OECD 2000 Report on CFC Legislation at 10.

3 L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 358; B Arnold *The Taxation of Foreign Controlled Corporations: An International Comparison* (1986) at 131; R Jooste “The Imputation of Income of Controlled Foreign Entities” 118 (2001) *The South African Law Journal* at 473-474; see also A de Koker *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa* Vol 1 (last updated December 2006) in par 8.10.2. See also BJ Arnold & MJ McIntyre *International Tax Primer* 2 ed (2002) at 91.

company is completely owned by residents of the particular state, the only alternative is to tax the residents controlling the foreign company on the basis that the income is presumed to have been distributed to them.

As the state in which the foreign entity is resident will also tax the income, the double taxation that might arise is often resolved by providing a foreign tax credit (for example section 6quat of the South African Income Tax Act⁴). When the income is eventually distributed in the form of dividends, the dividends are usually exempt from tax (eg section 10(1)(k)(ii) of the South African Income Tax Act).⁵

The Organization for Economic Cooperation and Development (OECD) supports the introduction of CFC regimes as a way of countering the transfer of profits to low-tax jurisdictions by targeting passive and low-tax income rather than the profits of the CFC itself. The OECD has stated that CFC rules are in line with articles 1, 7 and 10 of the OECD Model Tax Convention.

The decision whether to enact CFC legislation depends in part on whether a country's fiscal policy adheres to a doctrine of "capital import neutrality" or "capital export neutrality".⁶ "Capital export neutrality" refers to the choice that an investor resident in a home country has between investing his/her savings at home or in a foreign host country. Capital export neutrality requires that all residents of a country should face the same marginal effective tax rate, whether they invest in that country or abroad. In other words, the tax system should be neutral with regard to decisions to invest at home or abroad. CFC legislation reflects a capital export neutrality doctrine.⁷ "Capital export neutrality" is violated if, for example, both the home and the host countries fail to tax income from

4 Act 58 of 1962, as amended.

5 Olivier & Honiball at 358.

6 SE Shay "Revisiting US Anti-Deferral Rules" 74 (1996) *Taxes* at 1042.

7 D Sandler *Tax Treaties and Controlled Foreign Company Legislation Tax: Pushing the Boundaries* 2 ed (1998) at 14; L Lokken "Whatever Happened To SubPart F? U.S CFC Legislation After the Check-the-Box Regulations" 7 (2005) *Florida Tax Review* at 189; RS Avi-Yonah "Comment on Peroni, Fleming and Shay, 'Getting Serious About Curtailing Deferral of US Tax on Foreign Source Income'" 52 (1999) *SMU Law Review* at 222 ("Avi-Yonah 1999"); CR Sweitzer "Analysing SubPart F in the Light of Check-the Box" 20 (2005) *Akron Tax J* at 103.

investment in the host country, while an investment in the home country is taxed. This could happen when the home country grants deferral and the host country does not impose a tax on foreign investors. In that case, investors would prefer to invest in the host country rather than the home country even if the pre-tax yield on the domestic investment were higher.⁸ The recognition of a company as a separate entity from its shareholders gives rise to many opportunities to defer the payment of tax on foreign profits, leaving them in the hands of the foreign subsidiary that earned them. This is a breach of the capital export neutrality doctrine that the enactment of CFC legislation could address.⁹

“Capital import neutrality” requires that residents of one country who invest abroad should obtain the same after-tax rate of return as residents of the source country in which they invest.¹⁰ Capital import neutrality is violated if, for example, foreign investors in a host country are taxed on their investment income at the home country rate, while the host country does not levy an income tax on investment income. In that case domestic (host country) investors will have a different net return on their investments in the host country than foreign (home country) investors.¹¹ The result is that intertemporal marginal rates of substitution (that is, the choice between present and future consumption) will not be the same between countries, and the international allocation of world savings will be distorted.¹²

In summary, capital import neutrality encourages deferral of taxes since it encourages the host country’s demand for capital. On the other hand, capital export neutrality ensures that deferral does not occur and so it assures efficient allocation of world investment.¹³ CFC legislation is generally seen as an instrument to guard against the unjustifiable erosion of the domestic tax base by the export of investments to non-resident corporations.¹⁴ The reason why some countries have not introduced CFC legislation could be that the extent of

8 Avi-Yonah 1999 at 532.

9 J Tiley *Revenue Law* 5 ed (2005) at 1139.

10 Sandler at 14.

11 Avi-Yonah 1999 at 533.

12 Avi-Yonah 1999 at 533.

13 Avi-Yonah 1999 at 534.

14 OECD 2000 Report on CFC Legislation at 11.

avoidance of domestic tax by the use of non-resident corporations is not such a significant problem in their particular circumstances that it justifies legislation of this nature. Or they may not feel strongly committed to capital export neutrality (that resident taxpayers should pay the same tax on their domestic and foreign source investment income).¹⁵

Generally CFC legislation in the different countries where it has been introduced has followed two basic approaches: One of the approaches is the “jurisdictional approach”, sometimes referred to as the “entity approach”. This approach ends deferral for all of the income of the CFC. In effect, all of the income of the CFC is attributed pro rata to the domestic shareholders, but only if certain conditions are present.¹⁶ Possible conditions would be that the CFC is a resident of a tax haven, that its income is taxed below a certain rate, or that a certain percentage of its income is from tax-haven-type activities.¹⁷ Basically, under this approach the legislation and related administrative actions identify corporations that are to be considered tax-haven companies and shareholders are taxed on all the income of these corporations, regardless of its source or nature. The United Kingdom and Japan follow this approach.¹⁸

The other approach is the “transaction approach” or “tainted income” approach, under which only tainted income of the CFC is attributed pro rata to domestic shareholders.¹⁹ The legislation identifies particular kinds of income as tax haven income and taxes resident shareholders on only those types of CFC income. In general this covers passive income and base company income. Passive income would include dividends, royalties and interest as well as income from transactions with related parties. The US, Canada and Germany use this approach.²⁰

15 OECD 2000 Report on CFC Legislation at 11.

16 Sandler at 19; see also Arnold & McInyntyre at 94.

17 Arnold & McInyntyre at 94.

18 Lokken at 194.

19 Sandler at 19; Tiley at 1139.

20 Lokken at 194; R J Peroni, JC Fleming and SE Shay “Getting Serious About Curtailing Deferral of US Tax on Foreign Source Income” 52 (1999) *SMU Law Review* at 494; JM Gannon, TJ Calianese, MP Layden, K Moreland & SS Seo “Subpart F, Hybrid Entities and Other Little Things” 27 (1988) *Tax Notes* at 473.

The “entity/jurisdictional” approach and the “transaction approach/tainted income approach” both have strengths and weaknesses. Those who favour the “tainted income approach” point to the fact that the income tax laws of virtually every country have tax-haven features. This is the case where incentives are granted to attract foreign investment. An approach based on a sorting of countries between tax-haven countries and other countries may therefore miss tax-haven schemes utilising entities resident in countries not generally considered to be tax havens. However, the tainted income approach is vulnerable to tax planners’ creativity in crafting schemes that effectively shelter income in tax-haven countries without the income falling within any of the categories of tainted income. Legislation based on a “tainted entity” approach may avoid this trap by taxing resident shareholders on all income that has been shifted to an entity resident in a tax-haven country, regardless of its character.²¹ Neither approach is simple.²²

Most countries’ CFC legislation follows the same basic pattern. Deferral of domestic taxation on the income of a controlled foreign company until it is distributed to its shareholders is eliminated by ignoring the existence of the foreign company. The resident shareholders of the foreign company are taxed directly on a pro rata share of the company’s undistributed income.²³ Countries that have CFC legislation define a controlled foreign company in almost the same way. A controlled foreign company is a foreign company more than 50% of whose shares, voting power or value, is owned by domestic shareholders. Beyond this general provision, however, countries’ definitions appear to differ in minor ways.²⁴

There are generally three factors countries can apply as the basis for their CFC legislation, namely:

- The geographical location of the controlled foreign company is used as a criterion (income from blacklisted jurisdictions).
- The domestic shareholders must control or have a significant ownership

21 Lokken at 194; Peroni *et al* at 494.

22 Tiley at 1139.

23 Arnold at 131.

24 RL Doernberg, L Hinnekens, WR Hellertein & L Jinyan *Electronic Commerce and Multi-jurisdictional Taxation* (2001) at 323.

and interest in the foreign corporation.

- The nature of the activities engaged in is used to distinguish between controlled foreign corporations engaging in bona fide business operations and those used primarily to defer or avoid domestic tax.²⁵

The geographical location requirement is aimed at identifying those countries that impose little or no tax on income generated in their territory (tax-haven jurisdictions). In this respect, some countries follow a “designated jurisdiction” approach whereby the taxing authorities issue a list of tax-haven or non tax-haven countries to which the legislation will or will not apply. In some jurisdictions (such as Japan, Indonesia and New Zealand) a “black list” is compiled which names jurisdictions in which there is no income tax or the income tax is low compared with that of the home country.²⁶ Other countries compile a “white list” which designates jurisdictions in which the tax rate is not significantly below the rate of the home country. In yet other countries the approach is to set a particular tax rate as the boundary of a “low tax” jurisdiction. All countries with a nominal rate below the designated rate automatically qualify as “tax havens” under the controlled foreign company provisions. In South Africa, the designated country approach was previously used as one of the exclusions to the CFC provisions. Where a CFC had income that was or would be subject to tax in a designated country at a statutory rate of 13,5% in the case of capital gains and 27% in the case of other amounts (after taking into account the possible application of a double taxation agreement) and the designated country taxed such income on a similar basis to South Africa, the income of the CFC was not imputed to the South African resident. However with effect from 1 June 2004, this exemption has no longer been available.²⁷

25 Arnold at 407.

26 Doernberg *et al* at 326.

27 The list of designated countries that applied by June 2004, when investments in designated countries were still exempted from CFC rules, in terms of the then s 9E(8) of the Income Tax Act (now deleted), comprised: Algeria, Australia, Austria, Belgium, Canada, Croatia, the Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, the Republic of Korea, Lesotho, Malawi, Namibia, the Netherlands, Norway, Poland, Romania, Slovakia, Swaziland, Sweden, Thailand, Tunisia, the United Kingdom, the United States of America, Zambia and Zimbabwe. This list gave rise to much debate because of the omission of countries like Ireland and Singapore. This list was policed as a number of countries objected to not being on the list in circumstances where they have close political ties with South Africa and have concluded a double taxation agreement with

Even after it has been determined that a controlled foreign company exists in a tax-haven jurisdiction, a requirement of the CFC legislation of most countries is that it should be determined whether the income earned falls within the definition of income which is attributed to domestic shareholders on a current basis. In some countries, like Germany, Canada and Australia, the CFC provisions apply only to certain types of passive income and/or foreign company sales or service income.²⁸ In other countries, no distinction is made between passive income, active income sales and/or service income, but all the income is attributable. The United Kingdom, for example, attributes all income but it excludes capital gains.²⁹

When CFC legislation was first introduced in South Africa under the then section 9C of the Income Tax Act,³⁰ it applied only in regard to passive income. This has since been amended and now South Africa's CFC legislation applies to all income.

What follows below is a discussion of how this legislation works in South Africa. A comparative study of the CFC legislation in the United Kingdom and the United States of America is undertaken in chapter 5. Where South African legislation is found wanting, recommendations for reform will be made.

4.2 SOUTH AFRICAN CFC LEGISLATION

Apart from the fact that South African residents are taxed on a "residence basis of taxation", which ensures that South African resident companies are taxable on their worldwide income, South Africa also has legislation that prevents South African residents from deferring South African tax on foreign income that is derived from offshore companies. In order to bring into the taxing net the income

South Africa. The argument was that those countries that were not on the list were potentially blacklisted. See Olivier & Honiball at 120.

28 Doernberg *et al* at 328.

29 Doernberg *et al* at 328

30 58 of 1962 as amended.

earned by South African-owned foreign entities (like foreign subsidiaries) and to counter the deferral of taxes, the worldwide taxation of South African residents is extended in the Income Tax Act, in order to deem income of a foreign company to be that of South African residents, notwithstanding the fact that the actual income is received by or accrues to a foreign company.³¹ Through the use of CFC legislation, the delay or deferral of taxes is curbed by taxing the South African owners of foreign companies on the income earned by those foreign companies, as if they had repatriated their foreign income as soon as it was earned.³²

CFC legislation was first introduced in South Africa in 1997 under the then section 9D of the Income Tax Act (the Act). This initial section 9D was introduced as an anti-avoidance measure to prevent the avoidance of tax on investment income of a foreign company or trust. Investment income was defined in section 9C(1) (now repealed) as including any income in the form of any annuity, interest, rental income, royalty income or other income of a similar nature.³³ When South Africa changed to the residence basis of taxation in 2001, section 9C was repealed, with the result that for years of assessment commencing on or after 1 January 2001, not only investment income but all income, including capital gains that have accrued to or been received by a CFC, is attributed to South African residents.³⁴ Thus the current anti-avoidance measure under section 9D casts a wide net. For example, it covers situations where a resident invests capital offshore through an offshore company, thereby re-characterising taxable income and converting it into non-taxable income such as dividends, and also situations where taxation is deferred or avoided by accumulating or capitalising such income in a foreign company.³⁵

4.3 THE DEFINITIONS OF THE TERMS USED IN THE CFC LEGISLATION

In order to apply section 9D successfully, the following issues have to be

31 Jooste at 473-474; see also De Koker in par 8.10.2.

32 Jooste at 474.

33 For a critical review of s 9D before its amendment, see VJ Maren *The Taxation of Foreign Source Investment Income in the Hands of South African Residents* (1999).

34 S 9C was repealed by s 9 of the Revenue Laws Amendment Act 59 of 2000.

35 D Meyerowitz *Meyerowitz on Income Tax* (2006-2007) in par 9.114; see also Jooste at 476.

determined:

- whether the entity qualifies as a foreign company
- whether the foreign company qualifies as a CFC
- the net income of the CFC as determined in accordance with the Act
- what may be excluded in the determination of the net income of the CFC.

The complexity of section 9D cannot be underestimated. It is therefore necessary to define some of the concepts used in this provision. The starting point in determining whether an entity is a CFC is to establish whether it is a foreign company.

Defining a foreign company

A “foreign company” is defined in section 1 of the Income Tax Act (as amended) as any association, corporation, company, arrangement or scheme (as provided for in paragraph (a), (b) or (e) of the definition of “company” in section 1) that is not resident in South Africa, or if it is resident, it is treated as a non-resident in terms of an applicable double taxation treaty entered into by the Republic.³⁶ This definition identifies two aspects that must be established for a foreign company to exist. Firstly, the foreign entity concerned has to be a company and secondly, it has to be non-resident. Thus the CFC legislation will not apply if the foreign entity is a trust.³⁷ Income that accrues to a foreign trust will therefore not be attributed to South African beneficiaries. It will only be taxable in South Africa once it has been distributed to the beneficiaries. However, there is an exception to this general rule that CFC legislation does not apply to foreign trusts. The definition of the term “foreign company” includes a company as defined in section 1(e) of the definition of “company” the Income Tax Act. This definition covers “any arrangement or scheme carried on outside the Republic in pursuance of which members of the public are invited or permitted to invest in a portfolio of a collective investment scheme, where two or more investors contribute to and hold a participatory interest”. Essentially, this definition refers to a unit trust or

36 S 9D(1) of the Income Tax Act 58 of 1962; see also Meyerowitz in par 9.115; De Koker in par 8.10.2.

37 De Koker in par 8.7.1; Olivier & Honiball at 361.

mutual investment fund, the legal nature of which often takes the form of an offshore trust.³⁸ However, for CFC legislation to apply, an offshore unit trust has to meet the requirements of a “controlled foreign company” in section 9D, which are discussed below.

In general, CFC rules are not applicable foreign partnerships.³⁹ However, it is arguable that CFC legislation could apply to certain incorporated partnerships that are considered companies in certain foreign jurisdictions. Since the definition of the term company in section 1(b) of the Income Tax Act covers companies incorporated under foreign law, the legal status of a foreign company has to be determined according to foreign law.⁴⁰ Thus CFC legislation could potentially apply to “limited liability partnerships” (LLP) that are considered companies in the United Kingdom. Note however that for CFC legislation to apply to an LLP, the requirements of a controlled foreign company discussed below have to be met.⁴¹

However, in jurisdictions where limited liability partnerships are not considered incorporated legal entities (for instance in the Cayman Islands), CFC legislation would not apply since such entities would be considered “flow-through” or fiscally transparent entities.⁴²

In South Africa, the following companies qualify as foreign companies:

- associations, corporations, bodies corporate or companies incorporated or deemed to be incorporated under South African law;⁴³
- associations, corporations or companies or bodies corporate incorporated under foreign law;⁴⁴
- certain local and offshore collective investment schemes in securities (previously known as unit trusts)⁴⁵

38 Olivier & Honiball at 361.

39 Olivier & Honiball at 361.

40 Olivier & Honiball at 361.

41 For a detailed discussion of this issue see the discussion below in par 4.10 under the heading “Curbing tax avoidance that results from investing in offshore hybrid entities”.

42 For a detailed discussion of this issue see the discussion below in par 4.10 under the heading “Curbing tax avoidance that results from investing in offshore hybrid entities”.

43 Par (a) of the definition of company in s 1 of the Income Tax Act.

44 Par (b) of the definition of company in s 1 of the Income Tax Act.

45 Par (e) of the definition of company in s 1 of the Income Tax Act.

- a co-operative as defined in section 1 of the income Tax Act;
- a close corporation as defined in section 1 of the income Tax Act.

Note that co-operatives and close corporations were only included in definition of “foreign company”, by section 9 of the Taxation Laws Amendment Act 8 of 2007.

Defining a controlled foreign company

The next step is to determine whether a foreign company is a “controlled foreign company”. The definition of a CFC was amended by the Revenue Laws Amendment Act⁴⁶ which was promulgated on 1 February 2006. The amendments are deemed to have come into operation on 8 November 2005, and they apply in respect of any foreign tax year that commences on or after that date. The amendment to the previous definition of a CFC is the reintroduction of “voting rights” (as was the case in 2002) as a criterion for determining whether a foreign company constitutes a CFC. Before the amendment, “participation rights” was the criterion for determining whether a foreign company constitutes a CFC.

Subject to the provisos contained in the legislation, in terms of section 9D(1) a foreign company is now classified as a CFC if:

- one or more South African residents, directly or indirectly, hold more than 50% of the total participation rights of the company; or
- more than 50% of the voting rights of that foreign company are held (or exercisable) directly or indirectly by one or more residents.

The term “participation rights” refers to the right to participate in the share capital, share premium, current or accumulated profits or reserves of the foreign company. It is worth noting that it is not only shares that represent equity share capital that fall within the definition of “participation rights” but also other kinds of shares, such as non-participating preference shares.⁴⁷

46 Act 31 of 2005.

The reference to the phrase “directly or indirectly” in the definition of the term “controlled foreign company” means that the interests of both registered and beneficial shareholders have to be taken into account.⁴⁸ This implies that where for instance an individual resident in South Africa owns all the shares in a foreign company A, which in turn holds all the shares in another foreign company B, both companies A and B will be considered to be CFCs. However, a CFC will not exist where a foreign company A has issued 100 ordinary shares, 50 each to a South African company and a foreign individual, and all the shares of the South African company are owned by a South African individual.⁴⁹ This is because not *more* than 50% of the shares are held by South African residents.

An issue that could arise is whether a creditor who holds debentures or a mortgage bond over the CFC’s property could be considered to have participation rights. The view of the National Treasury is that interests’ such as convertible debentures and options (for example a right to obtain shares) do not qualify as participation rights until converted into shares.⁵⁰ However, the use of the word “indirect” in the definition of participation rights seems to indicate that participation rights are not limited to interests such as shares, but include indirect interests in the profits or reserves of a foreign company. A similar argument could be raised in the case of unsecured creditors of a company. An unsecured creditor cannot be said to have a direct right to participate in the profits or reserves of the company but merely an indirect right to do so.⁵¹ Does this imply that section 9D also applies to such unsecured creditors? The legislature needs to clarify this issue and make it clear that the word “indirectly” refers to holding through another company and not to conditional holdings.⁵² It is also worth pointing out that although the use of the word “indirectly” means that the interests

47 Olivier & Honiball at 364; De Koker in par 8.7.1.

48 Olivier & Honiball at 363.

49 Olivier & Honiball at 364.

50 National Treasury “National Treasury’s Detailed Explanation of Section 9D of the Income Tax Act” (June 2002) Available at ><http://www.treasury.gov.za/division/epifr/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf><, last accessed 6 November 2007; see also Jooste at 476.

51 Olivier & Honiball at 365.

52 In the United Kingdom the Finance Act 1998 amended s 749B(2) of the Taxes Act 1988 in order to exclude loan creditors. And in the United States Tax Code “control” is defined in relation to shareholders. See Olivier & Honiball at 365.

of both registered and beneficial shareholders have to be taken into account, section 82 of the Income Tax Act places the onus on the South African shareholder to prove such indirect involvement. In practice this may be difficult.

An issue which is not clear with respect to the word “indirectly” relates to a situation where a foreign company’s sole shareholder is a foreign trust whose beneficiaries are South African residents. As stated above, CFC legislation does not apply to foreign trusts. What is not clear is whether the legislation would apply to beneficiaries with interests in such a foreign trust. Where the beneficiaries have discretionary rights,⁵³ it may be argued that section 9D does not apply, as it cannot be said that the beneficiary has a direct or an indirect right to participate in the accumulated profits of the company. The rights belong to the trust. The beneficiary only has a right to participate in the income of the trust once it is distributed. Where the beneficiaries have vested rights,⁵⁴ it could be argued that the foreign company is a CFC as it would have to declare the dividends of the company (distributions) to the South African beneficiaries. Clarity on this matter is required. It is however worth noting that in any event, section 25B of the Income Tax Act would be applicable in the circumstances.⁵⁵

After the amendments introduced by the Revenue Laws Amendment Act 31 of 2005, various concerns arose regarding the inclusion of “voting rights” in the determination of whether a company should be regarded as a CFC. Some of these concerns were recorded in the “Responses to Written Representations by Organisations to the Portfolio Committee on Finance on the Draft Revenue Laws Amendment Bill, 2005”. There were, for instance, concerns about the exact meaning of “voting rights”. The response from South African Revenue Service (SARS) was that the “ordinary meaning of the concept” should prevail. Another concern expressed was that with the inclusion of “voting rights” in determining

53 The meaning of the term “contingent right” was described by Watermeyer CJ in *Durban City Council v Association of Building Societies* 1942 AD 27 at 33 as being “the conditional nature of someone’s title to the right”. In *ITC 76*, 3 SATC 68 at 70 the court defined the term “contingent right” as a mere *spes* - an expectation which might never be realised.

54 In *ITC 76*, 3 SATC 68 at 69, the court defined a vested right as “something substantial; something which could be measured in money; something which had a present value and could be attached.”

55 For a discussion of s 25B of the Income Tax Act, see the discussion in chapter 7.

whether a company is a CFC, income might be attributable to a resident, although that resident may never become entitled to that income. SARS submitted that the attribution of net income of a CFC using voting rights will be applied only where no person has any rights to the CFC's capital, profits or other reserves. The method will therefore apply only as a backup to attribute practical control and not to legal control, and the above problem would therefore not arise.

In effect, the importance of the distinction between "participation rights" and "voting rights" is that voting rights will only be taken into account where a company has no shares and only has voting rights. This often happens in certain hybrid companies. If a person has a right to participate in the equity of the company (no matter how simple) then the voting rights are disregarded.⁵⁶ If a foreign company is a listed company, or if the voting rights in that foreign company are exercisable indirectly through a listed company, voting rights will not be taken into account. In situations where any voting rights in a foreign company which can be exercised directly by any other CFC in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50% of the voting rights, then those rights are deemed for the purposes of the definition of a CFC to be exercisable directly by that resident. This is a type of look-through provision.

According to the Explanatory Memorandum to the Revenue Laws Amendment Bill 2005,⁵⁷ the purpose of the reintroduction of voting rights to the criteria for determining whether a company should be classified as a CFC is that the inclusion of voting rights was intended to bring these criteria closer to the permissible range of foreign investments in terms of the exchange control dispensation. It is further explained that voting rights might be a better indication of actual control in transactions involving preference shares and certain hybrid instruments.

56 K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 307.

57 Clause 14 Sub clause (a) of the Explanatory Memorandum on Revenue Laws Amendment Bill, 2005. Available at <http://www.SARS.gov.za/legislation/Bills/%Memos/2005/legislation/explanatory%/Revenue/2005%.pdf>, last Accessed on 7 June 2007.

In terms of the definition of a CFC, when determining whether a company qualifies as a CFC, consideration has to be given not only to direct voting rights but also to indirect voting rights. The effect of this new amendment is that, where a shareholder can exercise more than 50% of the voting rights, that shareholder is regarded as effectively controlling the relevant company. Therefore, where for example, a resident exercises 75% of the voting rights in a foreign company that can in turn exercise 75% of the voting in another foreign company, the indirect interest of the resident in the second foreign company is 75%.

From the above, it can be concluded that where a South African resident holds only 35% of the share capital of a foreign company, but also holds 65% of its voting control, such a company would be considered a CFC. However, this does not necessarily mean that the income of the CFC will be attributed to the resident, as the “participation rights” requirement also needs to be met for purposes of determining the net income of the company.⁵⁸ The effect of this is that where voting rights are considered, a South African resident will have to keep a copy of the financial statements of the CFC for submission to the Commissioner, when so requested in terms of section 72A(2), even though no income will ever be attributed to him. This is to ensure that SARS can be able to review a discrepancy (if any) between the “participation rights” and the “voting rights” of the resident in the foreign company.⁵⁹

Sub-clause (c) of the definition of a CFC describes certain scenarios in which a person is deemed not to be a resident for the purposes of determining whether residents directly or indirectly hold more than 50% of the participation rights or voting rights in a foreign company. The definition of a CFC excludes residents who are connected persons, who in aggregate hold more than 50% of the participation rights or voting rights in a foreign listed company⁶⁰ or a foreign collective investment scheme or arrangement, but individually hold less than 5%

58 As discussed below, the net income attribution rules are set out in s 9D(2) of the Income Tax Act.

59 Oliver & Honiball at 364-365.

60 In terms of par (e)(ii) of the definition of “company” in the Income Tax Act, a listed company is defined as a company whose shares or depository receipts for its shares are listed on a stock exchange or a stock exchange in another country recognised by the minister. See De Koker in par 5.44.

of the participation rights or voting rights in the listed company or “foreign collective investment scheme” or arrangement⁶¹ (or a so-called “equity unit trust” as contemplated in paragraph (e) (ii) of the definition of a company in section 1).

Paragraph (e)(ii) of the definition of a company⁶² refers to offshore investments in which members of the public (at least two) are invited or permitted to invest in a portfolio of a collective investment scheme. South African banks often open up foreign collective investment schemes or equity unit trusts overseas in order to accommodate South African residents who wish to utilise their exchange control foreign investment allowances.⁶³ In such cases it is possible that more than 50% of the participation rights or voting rights in the foreign collective investment scheme may be held by South African residents. However, only residents who individually hold 5% or more of the participation rights or voting rights in such a scheme will be regarded as participating in a CFC for the purposes of section 9D. This exclusion is intended to lessen the administrative burden on tax authorities as it is often difficult to determine the identity of those who own shares in large-scale entities where the interest is less than 5%.⁶⁴ Furthermore, in terms of section 72, which requires strict reporting of the participation rights or voting rights of South African residents in a CFC, it is not easy to obtain information in respect of a shareholding of less than 5%.⁶⁵ These exclusions do not apply, however, where connected persons collectively own more than 50% of the foreign company. This is intended to ensure that the provision cannot be circumvented by a group of economically linked parties arranging their affairs so as to stay clear of the 5% and 50% thresholds respectively.

This matter is for instance relevant in determining whether CFC legislation would apply in the context of offshore “protected cell companies” (PCCs). As discussed in chapter 2, a PCC is a special type of corporate body which consists of several companies referred to as “cells” within the same legal entity.⁶⁶ The cells are not

61 S 9D(1) of the Income Tax Act; see also Olivier & Honiball at 364.

62 S 1 of the Income Tax Act.

63 Olivier & Honiball at 364.

64 Olivier & Honiball at 364.

65 Olivier & Honiball at 364.

66 See chapter 2 par 3.3 the discussion under the heading “Protected cell companies”. See also Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at >

legal entities. The only legal entity is the PCC.⁶⁷ CFC legislation may not apply to the cells since they are not considered legal entities in themselves. However, CFC legislation can apply to the PCC itself. Where a number of South African residents own some of the cells in the PCC, it may be possible to avoid CFC legislation if each of the individual cells of the PCC holds less than 5% of the “participation rights” or “voting rights” in the PCC.

Country of residence

In relation to a CFC the country of residence means the country where the company has its place of effective management.⁶⁸

Net income

In terms of section 9D(2), when it has been established that a CFC exists, the net income of the CFC is attributed to the South African residents. “Net income” is defined in section 9D(2) in relation to a CFC to mean an amount equal to the taxable income of the company determined in accordance with the provisions of the South African Income Tax Act as if the company had been a South African resident taxpayer.⁶⁹ The net income of the CFC is calculated at the end of the foreign tax year of the country in which the CFC is resident and is included in the resident’s income at the end of the South African year of assessment.⁷⁰ In calculating the net income of the CFC, the CFC is dealt with as if it were a South African resident (section 9D(2A)). The provisions of the Income Tax Act in terms of which a CFC is deemed to be a resident are as follows:

- The definition of “gross income” in section 1, requires the CFC to include

<http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm> last accessed 25 February 2007.

67 Aamil Global Financial Services Mauritius “Protected cell Companies”. Available at >http://www.aaamil.com/en/services_protected_cell_companies.aspx> last accessed 25 February 2007; Isle of Man Government, Insurance and Pensions Authority “Protected cell Companies”. Available at ><http://www.gov.im/ipa/insurance/protectedcellcompanies.xml>> last accessed 25 February 2007. See also Coddan Company Formation Worldwide “Seychelles PCC Formation”. Available at ><http://www.coddan.co.uk/s.-95-offshore-sycehless-ppc-formation.htm>< last accessed 25 February 2007.

68 This definition was inserted in the Act by the Revenue Laws Amendment Act 20 of 2006.

69 De Koker in par 8.10.2.

70 Olivier & Honiball at 368-369.

in its gross income, its worldwide receipts and accruals.

- In terms of section 7(8), if the CFC makes a disposition and that disposition causes income to accrue to a non-resident, this income is deemed to accrue to the CFC.
- In terms of section 10(1)(h), the CFC will not enjoy the exemption for interest earned on ESKOM (and similar) stocks.
- In terms of section 25B, the CFC will be treated as a resident “donor” or as a resident beneficiary in relevant circumstances.
- In terms of paragraph 2(1)(a) of the Eighth Schedule, all the assets of a CFC will be subject to capital gains tax.
- In terms of paragraph 12 of the Eighth Schedule, the deemed disposal and deemed re-acquisition provisions will apply.
- In terms of paragraph 24 of the Eighth Schedule, if a foreign company becomes a CFC after valuation date (1 October 2001), the base cost of its assets will be determined under the provisions of paragraph 24.
- In terms of paragraphs 70, 71, 72 and 80 of the Eighth Schedule, the CFC will be treated as a resident beneficiary or as a resident donor in the relevant circumstances.

However, the above provisions of the Income Tax Act are applied to the CFC’s taxable income, subject to the following conditions:

- In terms of section 9D(2A)(a), any deductions and allowances that may be claimed or any amount that may be set off against a CFC’s income in terms of the Income Tax Act are limited to the amount of that income.
 - In terms of section 9D(2A)(b), where the deductions of the CFC exceed its income and the result would be an assessed loss, the assessed loss may not be set off against income received by the South African resident from other trades outside the Republic, but must instead be carried forward to the immediately succeeding foreign tax year to be offset against future income of the CFC.⁷¹
 - In terms of section 9D(2A)(c), no deduction is allowed for interest, royalties, rental or income of a similar nature paid or payable by the
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company to another CFC. This would include amounts adjusted for transfer pricing purposes (section 31) or any exchange difference determined under section 24I. These amounts are deemed not to be attributed to the South African resident in terms of section 9D(9)(fA).

- There are certain capital gains tax (CGT) implications. In terms of section 9D(2A)(e) where a foreign company becomes a CFC after 1 October 2001 (when CGT was introduced), the valuation date for CGT purposes is the date the company became a CFC.
- In terms of section 9D(2A)(f), if the controlling resident is a natural person, special trust or an insurer, the inclusion rate for purposes of CGT is 25%. Furthermore, where there has been a capital gain or loss that arose from the disposal by a CFC of an interest in another CFC, it has to be added to the base cost of the interest the resident has in the foreign company, minus certain foreign dividends that were exempt from tax during any tax year (section 9D(2A)(j)).
- For the purposes of section 31(that deals with transfer pricing and thin capitalisation) any transaction, operation or scheme between the CFC and any of its connected persons is deemed to be an international agreement as defined in section 31(1) and for the purposes of section 31(3)(a)(i)and (ii) the CFC is deemed to be a resident.
- For the purposes of section 24I, “local currency” in relation to the exchange item of a CFC that is not attributed to a permanent establishment of the CFC means any currency used by the CFC for the purposes of its financial reporting.
- For the purposes of paragraph 43 of the Eighth Schedule, “local currency” of a CFC other than in relation to a permanent establishment of the CFC, means the currency used by it for the purposes of its financial reporting (Proviso (k) to section 9D(2A).

Generally in calculating the net income of a CFC, companies have to keep two sets of books, one for the country in which the CFC is a resident and one for South African tax purposes. This obligation places a compliance burden on

companies, as a full audit of each company is required. A form has to be completed and submitted to the South African Revenue Service (SARS) for each CFC, which is almost as burdensome as completing a tax return for each respective company. From an administrative point of view, it can be concluded that compliance with section 9D is a costly exercise.

An issue that deserves clarification relates to the capital gains tax implications of CFCs referred to above in section 9D(2A)(e)

CFCs and capital gains tax implications

The Eighth Schedule to the Income Tax Act contains the rules for the determination of a person's taxable capital gain or assessed capital loss for a year of assessment. Any taxable capital gain so determined must, in terms of section 26A of the Act, be included in a person's taxable income for the relevant year of assessment. Capital gains and losses must be determined in respect of all "disposals" of "assets" that take place on or after the valuation date, namely 1 October 2001.⁷²

The rules for determining whether a disposal has taken place for purposes of CGT are set out in paragraphs 11 and 12 while the rules for determining when a disposal is treated as having taken place are set out in paragraph 13. An asset is defined very widely in paragraph 1 and includes, for purposes of CGT:

- (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- (b) a right or interest of whatever nature to or in such property.

A disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset. It includes, inter alia, the alienation or transfer of ownership of an asset (e.g. a sale, donation, cession, etc.), the expiry or abandonment of an asset, the scrapping, loss or destruction of

72 Par 2 read with par 1 of the Eighth schedule to the Income Tax Act.

an asset, the granting, renewal, extension or exercise of an option, and the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement. In terms of paragraph 2, a resident is subject to CGT on the disposal of any asset as defined, whether situated in or outside the Republic.

The Eighth Schedule also contains some deeming provisions in terms of which a person is treated as having disposed of an asset for a specific amount. For instance, In terms of paragraph 12(2) of the Eighth Schedule to the Income Tax Act, where a person ceases to be a resident, that person will be deemed to have disposed of his assets (subject to specific exclusions) at market value. The tax arising from this disposal is often referred to as an “exit charge”.

Until 2005, uncertainty existed whether a foreign company which ceases to be a CFC during the tax year also ceases to be regarded as a South African resident for the application of certain provisions. This uncertainty was removed by an amendment to paragraph 12(2) of the Eighth Schedule which makes it clear that the termination of the South African resident status has CGT consequences.⁷³ Paragraph 12(2)(a) of the Eighth Schedule provides that when a South African tax resident ceases to be a resident by virtue of the application of the provisions of a tax treaty entered into by South Africa with another jurisdiction, the resident must be treated as having disposed of all his/her assets. However, excluded from the deeming provision is immovable property situated in South Africa and assets that are attributable to a permanent establishment of the resident through which a trade is carried on in the Republic. In terms of paragraph 13(1)(g) of the Eighth Schedule, the deemed disposal is effective at the time when the person ceases to be a South African tax resident. The result of the above is that when a company which is incorporated in South Africa moves its “place of effective management” offshore (such that in terms of an applicable tax treaty, it is deemed to be resident in the country in which it has its effective management), a deemed disposal arises. It is however worth noting that in practice, it may not be that easy to determine exactly when a company has ceased to be a South African resident, in the event of it moving its place of effective management

offshore.⁷⁴

The Revenue Laws Amendment Act 31 of 2005 also amended section 9D to provide that an exit charge would apply to a CFC that became a non-CFC by virtue of having been disposed of to a non-resident. The Explanatory Memorandum to the Bill that preceded the Act sets out the following in respect of the amendment:

The revised paragraph 12(2) also restates existing law concerning the treatment of controlled foreign companies. As under the old law (by virtue of the reference to paragraph 12 in section 9D(2A) of the Income Tax Act), the shift from CFC status to non-CFC status triggers an exit charge (for the loss of taxing jurisdiction over passive and other tainted assets held by the CFC).⁷⁵

Where a person moves residence offshore after 1 October 2001 (the day CGT became effective), the base cost of assets acquired prior to this date is determined in terms of paragraph 25 of the Eighth Schedule. This paragraph provides that the base cost of an asset acquired prior to 1 October 2001 is the sum of the value of the asset and allowable expenditure as listed in paragraph 20 of the Eighth Schedule, incurred after the valuation date. However, a problem could arise when a CFC ceases to be a CFC for purposes of section 9D of South Africa's Income Tax Act. Section 9D(2A) provides that, for purposes of section 9D, the net income of a CFC must be calculated as if the CFC had been a resident. This would cover paragraph 12 of the Eighth Schedule. It can thus be said that when the CFC ceases to be a CFC, it simultaneously ceases to be a resident for purposes of the net income calculation. Following this argument, there is a deemed disposal for CGT purposes in terms of paragraph 12 of the Eighth Schedule.

It is worth noting that in terms of paragraph 64B of the Eighth Schedule, a capital gain is disregarded in circumstances where any interest in the equity share

73 Olivier & Honiball at 69.

74 Olivier & Honiball at 69.

75 See South African Revenue Service "Republic of South Africa Explanatory Memorandum on the Revenue Laws Amendment Bill, 2005" at 46. Available at ><http://www.sars.gov.za/legislation/Bills%20Memos/Memos/2005/Legislation%20-%20Explanatory%20Memo%20on%20the%20Revenue%20Laws%20Amendment%20Bill%20-%202005.pdf>>, last accessed 18 May 2007.

capital of any foreign company is disposed of in certain circumstances. While this CGT exclusion is very wide, it is arguably not wide enough to cover the paragraph 12 deemed disposal. It is submitted that this anomaly requires legislative amendment.⁷⁶

Exchange rate

Section 9D(6) provides that the amount to be included in the income of a resident must be translated to the currency of the Republic. The section provides that the net income of a CFC must be determined in the currency used by it for the purposes of its financial reporting and must, for the purposes of determining the amount to be included in the income of any resident during any year of assessment under the provisions of section 9D, be translated to the currency of the Republic by applying the average exchange rate for that year of assessment as contemplated in section 25D.⁷⁷

- Proviso (a) to this provision states that any capital gain or loss of that CFC must, when applying the provisions of paragraph 43(4) of the Eighth Schedule, be determined in the currency of the Republic and that capital gain or loss must be translated to the currency used by it for purposes of its financial reporting by applying the average exchange rate.
- Proviso (b) to this provision states that any amount to be taken into account in determining the net income of that CFC for the disposal of any foreign equity instrument must, when applying the provisions of section 9G, be determined in the currency of the Republic and that amount must be translated to the currency used by the Republic by applying the average exchange rate.

4.4 EXEMPTIONS TO THE CFC PROVISIONS

In certain instances, the net income of a CFC is excluded from the ambit of section 9D and will not be attributed to the residents who hold the participation rights in the entity concerned.

76 Olivier & Honiball at 71.

4.4.1 The foreign business establishment exemption

The CFC rules do not apply when the net income of a CFC is attributable to a “foreign business establishment”⁷⁸ (including the disposal of any assets forming part that business establishment) of a company in a country other than the Republic.⁷⁹ Note that previously section 9D referred to a “business establishment”, but this term was deleted from the Act and replaced by the term “foreign business establishment” by the Revenue Laws Amendment Act 20 of 2006. In granting this exemption, the legislature attempted to create a balance between granting an exemption to income derived from legitimate business activities and that derived from illusory business undertakings (like mobile and diversionary business income and mobile passive income).⁸⁰ In terms of section 9D(1), a “foreign business establishment” in relation to a controlled foreign company refers to:

- (a) A place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used by that controlled foreign company for a period of not less than one year, whereby the business of such company is carried on, and where that place of business;
 - (i) is suitably staffed with on-site managerial and operational employees of that controlled foreign company and which management and employees are required to render services on a full time basis for the purposes of conducting the primary operations of that business;
 - (ii) is suitably equipped and has proper facilities for such purposes; and
 - (iii) is located in any country other than the Republic and is used for bona fide business purposes (other than the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other Act administered by the Commissioner).
- (b) Any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations.
- (c) A site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities.
- (d) Agricultural land in any country other than the Republic used for bona fide farming activities directly carried on by that controlled foreign company.
- (e) A vessel, vehicle, aircraft or rolling stock used for the purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of

77 De Koker in par 5.48 at 5-64.

78 S 9D(9)(b) of the Income Tax Act.

79 S 9D(9)(b) of the Income Tax Act.

80 Olivier & Honiball at 373.

natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company.

From the above, it appears that for a place of business to qualify as a “foreign business establishment” there must be an “economic substance” and “a business purpose”.⁸¹ For there to be “economic substance”, the foreign business must not exist merely on paper and not in substance. The foreign business must maintain a presence consisting of persons who make the day-to-day management decisions. In *SIR v Downing*,⁸² it was pointed out that the use of independent agents does not qualify a business as a business establishment. The “business purpose” requirement ensures that there must be permanence and economic substance; the exemption will not be granted if the business activities are not conducted for bona fide business purposes, but to obtain a tax benefit.⁸³ In determining whether the business conducted outside South Africa is being run for *bona fide* business purposes, the Commissioner does not have to prove the requirements under the general anti-avoidance provision under section 80A-80L of the Income Tax Act. It is sufficient if, on the facts, the reason for moving the business outside South Africa was to avoid, postpone or reduce tax.

As an anti-avoidance measure, this exemption does not apply to certain diversionary transactions between a CFC and a connected person.⁸⁴ In general, the rules relating to diversionary business transactions distinguish between transactions subject to transfer pricing provisions (section 9D(9)(b)(i)), and those that are not subject to transfer pricing provisions, but where the possibility of price manipulation still exists (section 9D(9)(b)(ii)). Where the net income falls within the first category, the denial of the exclusion from attribution may result in a transfer pricing adjustment under section 31 of the Income Tax Act. Where the net income falls in the second category, the so called “reversionary rules” are used to apply to the transaction. In that case, no transfer pricing adjustment is

81 Olivier & Honiball at 374.

82 1975 (4) SA 518 at 525 (AD).

83 Olivier & Honiball at 374.

84 According to s 1 of the Income Tax Act, the definition of “connected person” in relation to a company (as amended by the Revenue Laws Amendment Act 20 of 2006) includes its holding company as defined in s 1 of the Companies Act 61 of 1973 and any other

made, but the income is excluded from attribution if it meets the requirements set down in the relevant subsection.

4.4.1.1 The rules that relate to diversionary activities

In terms of section 9D(9)(b)(i), no exemption is granted where the net income of a “foreign business establishment” of a CFC is derived from transactions with its connected person (who is a resident) for to the supply of goods or services by or to the CFC, which do not reflect an arm’s length price in terms of section 31 of the Income Tax Act.⁸⁵ This could for example cover transactions where income has been diverted to a tax haven by means of transactions that do not reflect an arm’s length price (ie diversionary business income where the possibility of price manipulation exists).⁸⁶ Where this is the case, severe penalties may arise and the price of goods may be adjusted by the Commissioner in terms of section 31 to reflect an arms length price. In cases where excessive interest is charged, a deemed dividend distribution could arise for the purposes of secondary tax on companies.

4.4.1.2 The reversionary rules

Section 9D(9)(b)(ii) deals with the so called reversionary rules. These rules provide for three different scenarios:

- sale of goods by the CFC to South African resident connected persons (the so called “CFC in-bound sales” covered under section 9D(9)(b)(ii)(aa));
- sale of goods by a CFC which were bought from South Africa resident connected persons, to persons other than South African resident connected persons (the so called “CFC out-bound sales” covered under

85 company that would be part of the same group of companies as that company. The expression “dealing at arm’s length” is used to describe a transaction between independent unrelated parties where each party strives to get the utmost possible benefit from the transaction. See South African Revenue Services (‘SARS’) *Practice Note No 7 Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing (s 31 of the Income Tax Act No. 58 of 1962)* 6 August 1999 in par 7.1; art 9 of the OECD Model Tax Convention on Income and on Capital (2005 condensed version).

86 S 31 and s 9D(9)(b)(i) of the Income Tax Act.

section 9D(b)(ii)(bb));

- services performed by the CFC to South African resident connected persons (the so called “CFC South African connected services” covered under section 9D(b)(ii)(cc)).

Net income falling within these categories is exempt from CFC rules if a higher business activity standard than the standard laid down for the purpose of a “foreign business establishment” is present. This higher business standard is intended to ensure that income is exempt from attribution only if the transaction has a non-tax economic *nexus* within the country in which the CFC is a resident, or the transaction is unlikely to contain elements of transfer pricing. The reason for laying down a higher standard above the foreign business establishment test is to ensure that where transactions take place between a CFC and a connected South African resident, the offshore business is of substance.⁸⁷ However, in terms of section 9D(10), the Minister of Finance has a discretion to waive the higher business standard. By notice in the *Gazette*, Minister may also exercise his discretion to treat a number of foreign countries as one, if the foreign countries comprise a single economic market, provided this treatment will not lead to an unacceptable erosion of the tax base.⁸⁸ He may also, in consultation with the Commissioner, grant exemption to any person from the application of this provision to the extent that this does not unreasonably prejudice national economic policies or South African international trade, and the exemption does not lead to an unacceptable erosion of the tax base.⁸⁹ For example, the Minister may exercise his discretion and treat the European Union as a single economic market to the extent that the countries impose a comparable income tax rate. Thus a CFC in the European Union could satisfy the higher business activity test when on behalf of a connected South African resident, it acts as a distributor of goods to customers located within several European countries.⁹⁰

The following is a discussion of the three above mentioned scenarios in respect to the reversionary rules under section 9D(9)(b)(ii)

87 Olivier & Honiball at 376.

88 S 9D(10)(a) of the Income Tax Act.

89 S 9D(10)(b) of the Income Tax Act.

CFC in-bound sales

In terms of section 9D(9)(b)(ii)(aa), a “CFC in-bound sale” occurs when a CFC sells goods to a connected South African resident. The general rule is that income arising from a CFC in-bound sell does not qualify for the “foreign business establishment” exemption unless the sale falls into one of the following four categories:

- Local purchases in the country where the CFC has its place of effective management from an unconnected person.
- Local production of goods that involve more than minor assembly or adjustment, packaging, repackaging, and labeling.
- Sales of significant quantities of comparable goods to unconnected persons, ie where the goods sold to a connected South African resident are of the same, or similar nature, to goods sold to unconnected persons at comparable prices after taking into account whether the sales are wholesale or retail, volume discounts, and other geographical differences such as costs of delivery to different locations.
- The same or similar goods are purchased by the CFC mainly within the state in which the CFC has its place of effective management from persons who are not connected persons in relation to the CFC.

In general, it appears that the qualifying business activities are not artificial. The reason for granting an exemption to local purchases and the production of goods is that if the local country is in position to produce goods, it probably has sufficiently good infrastructure. Countries with such infrastructure do not tax their local sales at artificially low tax haven rates. It is assumed that the CFC is situated in the foreign country not for tax reasons, but for non-tax business reasons. In situations where comparable sales are involved, it is assumed that transfer pricing does not occur because outside pricing is fully available. In addition, sales to unconnected persons by the CFC demonstrate viable business

operations outside South Africa.⁹¹

CFC out-bound sale of goods

In terms of section 9D(9)(b)(ii)(bb), a “CFC out-bound sale of goods” exists when a CFC sells goods to foreign residents or unconnected South African residents, in circumstances where those goods were initially purchased from connected South African residents. The general rule is that income arising from a CFC out-bound sale of goods does not qualify for the “foreign business establishment” exemption unless the sale falls into one of the following four categories.

- the goods or tangible intermediary inputs purchased from its connected persons who are residents amount to an insignificant portion of the total tangible intermediary inputs of the goods (ie insignificant South African purchases);
- the creation, extraction, production, assembly, repair or improvement of goods undertaken by the CFC amount to more than minor assembly or adjustment, packaging, re-packing and re-labeling (ie local production) or;
- the products are sold by the CFC to persons who are not its connected persons for delivery within its country of residence (ie local sales); or
- the products of the same or similar nature are sold by the CFC mainly to persons who are not its connected persons for delivery within its country of residence (ie the CFC is selling its products mainly to local customers).

It appears that the reason for this exemption is that the business activities that give rise to the income are in all likelihood not artificial. The rationale behind granting an exemption to local purchasers and the production of goods is that if the local country produces the goods it is likely that it has a good infrastructure. Such a country would not normally tax its local sales at artificially low tax-haven

91 Oliver & Honiball at 378.

rates. Thus a CFC situated in such a foreign country would probably be there not for tax reasons but for business reasons.⁹² Where insignificant amounts of intangible goods are purchased from connected South African residents, independent value is added. As a result, it is assumed that the business was established for non-tax purposes.

CFC connected services

In terms of section 9D(9)(b)(ii)(cc), a “CFC connected service” exists where the CFC performs services for a connected South African resident. The general rule is that income arising from CFC connected services does not qualify for the “foreign business establishment” exemption unless the service falls into the following two categories:

- the service relates to the creation, extraction, production, assembly, repair or improvement of goods used in countries outside the Republic; or
- the services relate directly to the sale or marketing of goods belonging to its connected person who is a resident and the goods are sold to persons who are not its connected person in the country of residence of the CFC.

In terms of this exemption, it can be deduced that income derived from services of a general nature, such as management fees, internal accounting fees, and fees to guarantee loans, never qualifies for this exemption as the possibility of manipulating prices is high and such services rendered by a company outside South Africa will most likely have no business reason for their existence other than to reduce tax liability. Where the services are not connected to South Africa, the possibility of price manipulation is diminished. Although the goods are delivered within South Africa, the income will be exempt, as shipping the products offshore for foreign servicing and then repatriating them to South Africa does not make commercial sense.⁹³ The income derived from the sale of related services is exempt on the basis that the country in which the CFC is resident has

92 Olivier & Honiball at 378.

an economic connection to the consumer's market.

4.4.1.3 Mobile passive income

In terms of section 9D(9)(b)(iii) the “foreign business establishment” exemption will not apply to net income that is attributed to any amounts derived from mobile passive income of an enterprise. This includes income such as dividends, interest, royalties, rental, annuities, insurance premiums, capital gains and foreign currency gains under section 24I. The reason why such mobile passive income does not qualify for the exemption is that no active business activities are performed and no direct competitiveness concerns are at stake.⁹⁴ The provision will, however, not apply where the income and capital gain attributed to those amounts do not exceed 10% of the income and capital gain of the CFC attributed to that foreign business establishment (other than income or capital gains to which any of the provisions of section 9D(9)(e) to (fB) apply). The reason for this exception is most likely to alleviate the administrative burden of complying with the CFC rules.⁹⁵ This provision will also not apply when the amounts arising from the principle trading activities of the CFC are banking or financial services, insurance or rental businesses. The reason for this exclusion is to ensure that these entities remain internationally competitive.⁹⁶ It is however worth noting that the terms “banking business” and “insurance business” are not defined in the Act. This omission is a shortcoming that may result in litigation.⁹⁷

In terms of section 9D(9)(b)(iii), the passive receipts and accruals of a CFC that conducts banking or financial services, and any insurance or rental business in a “foreign business establishment” will however, be subject to section 9D if these receipts and accruals are derived by a company that is a “foreign financial instrument holding company” (“FFIHC”) at the time they were so derived. In terms of section 41 of the Act, a FFIHC “means any foreign company as defined in section 9D, where more than the prescribed proportion of all the assets of that

93 Olivier & Honiball at 379.

94 Olivier & Honiball at 379; De Koker in par 8.10.3.

95 Olivier & Honiball at 379.

96 Olivier & Honiball at 381; De Koker in par 8.10.3.

97 Olivier & Honiball at 381.

company, together with the assets of all influenced companies in relation to that company, consist of financial instruments”.⁹⁸ This proviso acts as an anti-avoidance provision in that the exclusion from the “foreign business establishment” exemption of a FFIHC would cover foreign financial holding companies that are located in tax havens.⁹⁹ It is worth noting that the Revenue Laws Amendment Act 31 of 2005 amended the licensing and registration requirements of an FFIHC and replaced them with a requirement that the FFIHC should “mainly conduct business in the country of residence of that company” for it to qualify as an FFIHC. This amendment will certainly affect the criteria for determining which companies qualify as FFIHCs and therefore in which situations income such as; interest and royalties, will be excluded from the

98 S 41 of the Income Tax Act as amended by s 37(1)(d) of the Revenue Laws Amendment Act 31 of 2005 . A financial instrument is defined in s 1 of the Act as to include:

- (a) a loan, advance, debt, stock, bond, debenture, bill, share, promissory note, banker’s acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;
- (b) any repurchase or resale agreement, forward purchase arrangement, forward sale arrangement, futures contract, option contract or swap contract;
- (c) any other contractual right or obligation, the value of which is determined directly or indirectly with reference to-
 - (i) a debt security or equity;
 - (ii) any commodity, as quoted on an exchange; or
 - (iii) a rate index or a specified index;
- (d) any interest-bearing arrangement; and
- (e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset;

However, the following financial instruments should not be taken into account:

(1) Financial instruments that consist of debts due to the foreign company, or to any controlled group of company in relation to the foreign company, in respect of goods sold or services rendered by that foreign company or the controlled group company, as the case may be, where;

- (a) the amount of the debt is or was included in either the foreign company or the controlled group company; and
- (b) the debt is an integral part of a business conducted as a going concern by the foreign company or controlled group company.

(2) Any financial instrument arising from the principal trading activities of the foreign company or of the controlled group company in relation to the foreign company which is a bank, insurer, dealer or broker with a license or registration that allows the foreign company or controlled group company to operate in the same manner as a company that mainly conducts business with clients who are residents in the same country of residence as the foreign company. To qualify for the exemption, the foreign company or controlled group company has to:

- Either regularly accept deposits or premiums for the general public or effect transactions with the general public; or
- Derive more than 50% of its income or gains from principal trading activities with persons who are not connected persons to the foreign company.

(3) Any financial instrument held by a controlled group company in relation to the foreign company if the foreign company is a specified regulated controlled group company.

99 See Olivier & Honiball at 382; See also De Koker in par 8.8.3.

calculation of the net income of the CFC.

An overview of the foreign business establishment exemption clearly shows that it incorporates many exceptions to the granting of exemption. It is evident that these will be cumbersome to interpret and apply in practice. In fact the provisions are so complicated that the cost of compliance is likely to be very high.

4.4.2 The insurance policy exemption

In terms of section 9D(9)(c), the CFC provision will not apply to income which is attributed in respect of any policy issued by a company licensed to issue any long-term policy as defined in the Long-term Insurance Act.¹⁰⁰

4.4.3 Exemption of South African taxable income

CFC rules do not apply to the net income of a CFC where it is included in the taxable income of the company in the Republic and has not or will not be exempt or taxed at a reduced rate in the Republic as a result of the application of any double taxation agreements.¹⁰¹ An example would be where the income of the company is derived from a source in or deemed to be in the Republic. This prevents the possibility of tax becoming payable in the Republic by both the CFC and the resident on the same amount of net income. This provision is intended to prevent double taxation.¹⁰²

4.4.4 Exemption of foreign dividends

In terms of section 9D(9)(f), CFC rules do not apply to the extent that the net income of a CFC is attributed to any foreign dividend declared or deemed to have been declared to that CFC by any other company from an amount which relates to an amount of income that has been or will be included in the income of a

100 No 52 of 1998.

101 S 9D(9)(e) of the Income Tax Act; see also De Koker par 5.47 at 5-60.

102 Huxham & Haupt at 317; see also Olivier & Honiball at 382-383.

resident in terms of section 9D.¹⁰³ For example, if a foreign dividend is declared to a CFC (A) by another company (B) and a portion of the net income of B is attributed to a resident, section 9D will not apply to the portion of the net income of A which relates to the dividend distributed by B. The rationale for exempting dividends declared by a company to a CFC is that the profits out of which the dividend is declared have already been attributed to the South African resident or qualify for exemption under section 9D(9). The aim of this exemption is to avoid double taxation.

4.4.5 Exemption of income from interest, royalties, rentals and similar amounts

In terms of section 9D(9)(fA), CFC rules do not apply in relation to the net income of a CFC where it is attributed to interest, royalties, rental or income of a similar nature paid or payable or deemed to be paid or payable to it by another foreign company.¹⁰⁴ The reason for this exemption is that such amounts, including similar amounts that are adjusted for transfer pricing purposes (section 31) and exchange differences under section 24I, which are paid or deemed to be paid by a CFC to another CFC are not allowed as a deduction in terms of section 9D(2A)(c), and will not be attributed to the South African resident provided that both CFCs belong to the same group of companies.¹⁰⁵ This means that a resident holding participatory rights in a CFC that derives any interest, royalties, rentals, or other income of a similar nature and any exchange differences in terms of section 24I from a “related” foreign company will not be taxed on his proportionate amount of the interest, royalties or rentals or other income of a

103 De Koker par 5.47 at 5-61; see also Huxham & Haupt at 317; Olivier & Honiball at 383.

104 S 9D(9) (fA) of the Income Tax Act; De Koker par 5.47 at 5-62; see also Huxham & Haupt at 312; Olivier & Honiball at 383.

105 The term “group of companies” as defined in s 1 of the Act
 “means two or more companies in which one company (hereinafter referred to as the ‘controlling group company’) directly or indirectly holds shares in at least one other company (hereinafter referred to as the ‘controlled group company’), to the extent that -
 a) at least 75 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
 b) the controlling group company directly holds 75 per cent or more of the equity shares in at least one controlled group company.”

similar nature and any exchange differences in terms of section 24I.¹⁰⁶

4.4.5 Capital gains

In terms of section 9D(9)(fB), the provisions of section 9D will not apply to the net income of a CFC that is attributable to any capital gain of the CFC that is determined for the disposal of any asset as defined in the Eighth Schedule (other than any financial instrument or intangible asset as defined in paragraph 16 of the Eighth Schedule¹⁰⁷), when the asset was attributable to a business establishment of the controlled foreign company or any other foreign company that forms part of the same group of companies.¹⁰⁸

It is important to note that previously section 9D did not apply to the receipts and accruals (other than those of a capital nature) or capital gains of a CFC if the receipts or accruals would be subject to tax on income in a “designated country”. However, with effect from 1 June 2004, this exemption is no longer available.

4.5 ELECTIONS

In terms of section 9D(12), a resident who, together with his connected persons, holds at least 10% but not more than 25% of the participation rights and voting rights of a CFC may elect that all the provisions of section 9D(9) will not apply to the net income determined for a relevant foreign tax year of any CFC in which he holds participation rights. In other words, the South African shareholder who holds from 10% to 25% in a CFC can elect to treat his entire *pro rata* share of CFC income as taxable under section 9D, even if he would have been granted an exemption under section 9D(9).

106 K Mitchell & L Mitchell *Offshore Transactions and the Worldwide Basis of Taxation* (2004) Tax Seminar at 32.

107 The term ‘financial instrument’ bears the same meaning as in footnote 83 above. The term “Intangible asset” (excluded from the exemption) is defined as including goodwill, patents designs, trademarks, copyrights, models, plans, formulae, or any intellectual property right or property of a similar nature.

108 The term “same group of companies” bears the same meaning as in footnote 90 above.

This section allows the South African shareholder to be taxed currently on foreign income so as to receive the benefit of section 6quat rebates (but no excess rebates can be granted as a result of his election by virtue of section 6quat(1B)). This election may be made annually. The 10% to 25% threshold takes into account the interests of connected persons, regardless of whether these connected persons choose to make use of the election contained in this provision.¹⁰⁹

Section 9D(13) provides that any resident who, together with his connected persons, holds at least 10% but not more than 25% of the participation rights of a foreign company may elect that this foreign company be deemed to be a CFC in relation to him for any of its foreign tax years. The 10% to 25% threshold takes into account the interests of connected persons, even if these connected persons do not choose to use the election under this provision. The effect of this election is to allow South African shareholders to be taxed on the distribution of the profits of the foreign company in the form of a foreign dividend. This enables the resident to avoid the economic double taxation of profits distributed and taxed as a foreign dividend when no underlying foreign tax credits may be claimed.¹¹⁰ This election should not, however, be used to bring foreign tax credits in excess of the South African tax liability into the tax system in a manner that would shield other sources of low-taxed foreign income. Therefore, in this instance the excess foreign tax credits would be forfeited. This election, like the one above, may be made yearly.¹¹¹

Where the foreign entity becomes a CFC during the foreign tax year,¹¹² or where the CFC ceases to be a CFC at any time during the foreign tax year,¹¹³ the South African resident's proportionate share of the CFC's income can be dealt with in

109 For examples of how this election works, see The Explanatory Memorandum to the Revenue Laws Amendment Bill 2003 at 45; see also De Koker in par 5.51; see also Mitchell & Mitchell at 32.

110 De Koker par 5.51; see also Mitchell & Mitchell at 33.

111 For examples of how this election works, see The Explanatory Memorandum to the Revenue Laws Amendment Bill 2003 at 45-46; Mitchell & Mitchell at 33.

112 S 9D(2)(a)(ii) of the Income Tax Act.

113 S 9D(2)(b) of the Income Tax Act.

two ways. Either the income that accrued to or was received by the CFC during the days of the foreign tax year when the company was a CFC¹¹⁴ can be included or an amount proportionate to the number of days the company was a CFC can be included.¹¹⁵ The choice depends, however, on whether the relevant financial records were kept in terms of section 72 of the Income Tax Act (dealt with below).

4.6 DISCLOSURE REQUIREMENTS

Section 72A(1) of the Income Tax Act imposes a duty on every South African resident who has shares in a CFC to submit to the Commissioner together with the return contemplated in section 66 such information as may be prescribed by the Commissioner. According to section 72A(2), the information that has to be disclosed in relation to the CFC includes the following:

- its name, address and country of residence, and the description of the various classes of participation rights,
- the percentage and class of its participation rights held by the resident whether directly or indirectly with connected persons,
- the percentage and class of participation rights held by other connected South African residents who directly or indirectly hold 10% or more of the participation rights of the CFC,
- a description of the receipts and accruals of the CFC that are included in or are exempt from the income of the South African resident under section 9D and
- a description of any amount of tax that the CFC paid to any other country and the underlying profits to which the foreign tax relates.

In addition to the above information, where an amount has to be included in the income of the South African resident, a copy of the CFC's financial statements for the foreign tax year, prepared in accordance with generally accepted accounting practice (GAAP), but not necessarily in Rands, has to be submitted to SARS.

114 S 9D(2)(a)(ii)(aa) of the Income Tax Act.

In terms of section 72A(3), where a person fails to comply with the above reporting requirements, the proportional amount to be included in the person's taxable income pursuant to section 9D will be with reference only to the receipts and accruals of the CFC. Accordingly, the exemptions provided for in subsections 9D(9)(b)-(h) will not be taken into account in the determination of the net income of the CFC and this may also result in penalties under section 75 for failing to furnish the required documentation. In addition, the rebates that would be granted in terms of section 6quat will not apply to amounts already taxed in any other country.

4.7 THE COMPATIBILITY OF SOUTH AFRICA'S CFC LEGISLATION AND ITS TAX TREATIES

Whereas South Africa's CFC legislation can be viewed as an important tool in curbing offshore tax avoidance, it is worth pointing out that the applicability of this legislation can be challenged on the basis of being in conflict with South Africa's double taxation agreements. A number of commentators have questioned the validity of CFC legislation in so far as it contradicts some of the basic principles of double taxation treaties based on the OECD Model Tax Convention.¹¹⁶ As most of South Africa's treaties largely follow the OECD Model Tax Convention on Income and on Capital,¹¹⁷ it is important to point out the aspects of tax treaties that are considered to be in conflict with CFC legislation.

Aspects of double tax treaties that are considered to be in conflict with CFC legislation

Tax treaties generally deal with four main issues, the allocation of the jurisdiction to tax various types of income, the elimination of double taxation, administrative issues and non-discrimination.¹¹⁸ Some of these issues entail certain

115 S 9D(2)(a)(ii)(bb) of the Income Tax Act.

116 Sandler at 112-118; T Rosembuj "Controlled Foreign Corporations – Critical Aspects" (1998) 26 *Intertax* at 335; B J Arnold "Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model" (2004) 58 *Bulletin for International Fiscal Documentation* at 252.

117 Olivier & Honiball at 17. See also Huxham & Haupt at 341.

118 See par 7 of the Commentary on art 1 of the OECD Model Convention

fundamental principles of tax treaties that could be in conflict with CFC legislation.

Bilateral tax treaties based on the OECD Model Tax Convention uphold the principle that a corporation is treated as a separate taxpayer from its shareholders. Thus, a foreign corporation is only subject to tax in the resident country of its shareholders, if it derives income that has a source in that country. Any foreign source income of the foreign company is excluded from tax. This principle, is clearly brought out in article 5(7) of the OECD Model Convention which provides as follows:

The fact that a company that is a resident of a contracting State controls or is controlled by a company which is a resident of the other contracting State, or which carries on business in that State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

In effect, in a cross-border environment, a parent corporation and its wholly owned subsidiary constitute separate legal and taxable entities, notwithstanding that one may manage the business of the other. Thus, the profits of a subsidiary company in one treaty country, in which it is resident, are not subject to tax in the other treaty country. It can only be taxed in the hands of its shareholders in the other treaty country when dividends are distributed.¹¹⁹ It is however contended that CFC legislation ignores this fundamental principle that a foreign company is a different legal person separate from its parent company, as resident shareholders of a CFC are subject to tax on their pro rata share of the income of the CFC, when it arises rather than when it is distributed.¹²⁰ CFC legislation effectively consolidates the profits of a parent and its wholly owned subsidiary.¹²¹ The consolidation approach that is entailed in the CFC legislation, in effect, contradicts the basic structure of tax treaties.¹²² Vann notes:

Under CFC legislation a parent corporation is effectively taxed on the profits of a subsidiary resident, and deriving profits in another country. The OECD recognises the separate existence of subsidiaries and ... assumes the separate taxation of corporations in a group... CFC legislation is effectively a consolidation of corporation [sic] accounts in accounting terms. In this case the domestic legislation is seeking to bring tax treatment back into line with accounting treatment, but the effect is to render the associated enterprises article, and for that matter the dividend article, in the Model treaty

119 Arnold & McIntyre at 87.

120 Rosembuj at 335.

121 Sandler at 96.

122 Sandler at 2.

irrelevant.¹²³

As mentioned above, double taxation treaties also have as one of their objectives, the prevention of double taxation.¹²⁴ Double taxation results when two or more countries tax the same entity or the same income. It could either be juridical or economic double taxation.¹²⁵ The term “juridical double taxation” is generally defined as the imposition of comparable taxes in two (or more) countries on the same taxpayer in respect of the same subject matter and for identical periods.¹²⁶ Juridical double taxation arises when the same income is subject to tax in both the source country of the income and the resident country of the taxpayer. Juridical double taxation can also arise if two countries treat the same entity as resident therein, for example, a company incorporated in one country with its central management and control located in another country, or if the country taxes the worldwide income of its citizens even if resident in another country.¹²⁷

Economic double taxation arises when the same economic transaction, item, or income is taxed in two or more jurisdictions during the same period, but in the hands of different taxpayers.¹²⁸ For example, economic double taxation arises if, the law of one country taxes by reference to the legal owner of capital, while another country taxes by reference to the person in possession, or control of the capital. Economic double taxation also arises where one country taxes a legal entity and attributes its income, or capital for tax purposes, to a resident who has an interest in the entity.¹²⁹ The taxation of a company’s profits by one country, and its distributed profits (ie dividends) by another country, is generally considered to be a form of economic double taxation, regardless of the length of time that separates the taxation of the profits and the payment of the dividend. CFC provisions could give rise to economic double taxation in that, while the

123 RJ Vann “A Model Tax Treaty for the Asian-Pacific Region?” (1991) 45 *Bulletin for International Fiscal Documentation* 99.

124 Arnold & McIntyre at 105.

125 N Boldman “International Tax Avoidance” (1981) 35 *Bulletin for International Fiscal Documentation* at 443; M Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) at 12.

126 Arnold & McIntyre at 29; R Rohatgi *Basic International Taxation* (2002) at 12.

127 Sandler at 15-16.

128 Arnold & McIntyre at 29; Rohatgi at 12.

129 Sandler at 16.

resident country of the shareholders does not necessarily disregard the foreign company, its CFC legislation allocates the company's income pro rata amongst the resident shareholders.¹³⁰ Vann notes:

The increasing use of more and more extensive legislation in the CFC area will also inevitably lead to economic double taxation of the same income.¹³¹

There is, however, the view that the OECD Model Tax Convention is only concerned about “juridical double taxation” and not “economic double taxation” (which could be potentially caused by the CFC rules).¹³² Therefore, that where a non-resident company is taxed in one state, while the resident shareholders are taxed in the other state there is no compatibility problem with the OECD Model Convention. However, this makes little sense in the “real world” where economic double taxation is of concern to taxpayers.¹³³ Paragraph 7 of the Commentary on article 1 of the OECD Model Convention provides in part that

the purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and person; they should not, however help tax avoidance or evasion.

This paragraph does not explicitly say that it does not cover economic double taxation.¹³⁴ The argument that the OECD Model Convention does not deal with economic double taxation, flies in the face of the fact that the OECD Model contains certain provisions for the relief of economic double taxation, if the profits of one enterprise are simultaneously subject to tax in the hands of another enterprise.¹³⁵ An example is article 9 of the OECD Model, which is generally a transfer pricing provision. In assessing transactions between related enterprises, this article, allows a country to include in the profits of a resident enterprise, such profits as would have been included had the enterprises dealt with each other at arm's length. Thus, if one country increases the profits of its resident enterprise, and no compensating adjustment is made by the other country, then economic double taxation would result because the same profits would be taxed in both

130 Sandler at 16.

131 Vann at 99.

132 M Lang, HJ Aigner, U Scheurerle & M Stefaner *CFC Legislation Tax Treaties and EC Law* (2004) at 631.

133 Lang *et al* 624.

134 Sandler 99-100.

135 AJM Jiménez “The 2003 Revision of the OECD Commentary on the Improper Use of Tax treaties: A Case for the Declining Effect of the OECD Commentaries?” (2004) *Bulletin for International Fiscal Documentation* at 24.

countries. Article 9(2) provides that, where double taxation occurs because one country makes an adjustment under article 9(1) to the profits a resident enterprise, the other state, assuming it agrees to the alteration shall make appropriate adjustments to the amount of tax charged on those profits. The gist of this article shows that the OECD also deals with economic double taxation.¹³⁶

It is further reasoned that the methods that a country uses to eliminate double taxation conflict with CFC legislation. Article 23A and 23B of the OECD Model Convention provide two methods by which double taxation can be eliminated. These are the so called: “credit method” and the “exemption method”. Under the credit method, a resident taxpayer is entitled to a tax credit for the foreign tax paid or payable on foreign source income.¹³⁷ The credit is generally limited to the amount of domestic tax otherwise payable in respect of that income.¹³⁸ Under the exemption method, income from foreign sources is not subject to tax in the resident country (although it may be relevant in determining the rate of tax payable on domestic income in a progressive rate structure).¹³⁹

In those countries that apply a credit method, CFC legislation prevents the deferral of domestic taxation. In those countries that apply the exemption methods, CFC legislation is necessary in order to prevent the outright exclusion from domestic tax of certain foreign-source income.¹⁴⁰ Thus, CFC legislation operates as an exception to the exemption in particular circumstances. Within a purely domestic context, the CFC legislation forms a rational and defensible part of the overall tax regime. However, difficulties can arise because of the operation of tax treaty provisions that are designed to eliminate double taxation, and are not necessarily compatible with the operation of the CFC legislation.¹⁴¹ An exemption provision in a treaty can undermine the efficacy of a country’s CFC legislation, if the distributive rules in a tax treaty exempt certain income from tax in a particular country. The imposition of tax on that income by that country would

136 Jimenez 2004 at 24; Sandler at 100.

137 For example s 6*quat* in the South African Income Tax Act 58 of 1962 as amended.

138 Sandler at 17.

139 Sandler at 17.

140 Sandler at 17.

be considered a breach of the tax treaty.¹⁴²

It is also argued that CFC legislation conflicts with the rules that deal with the allocation of the jurisdiction to tax certain types of income, in terms of the OECD Model Tax Convention.¹⁴³ The existence and the extent of the conflict may depend on the characteristics of the particular CFC legislation. As pointed out above,¹⁴⁴ there are two broad approaches that countries use: On the one hand there is the “entity approach”, under which all of the income of the CFC is attributed pro rata to domestic shareholders.¹⁴⁵ Then, on the other hand there is the “transaction approach”, under which only tainted income (eg passive income) of the CFC is attributed pro rata to domestic shareholders.¹⁴⁶ It is argued that CFC legislation that utilises an entity approach may be contrary to the “business profits” article (article 7(1)) of a double tax treaty between the country imposing the CFC regime and the CFC’s country of residence. Article 7(1) of the OECD Model Convention states the following:

The profits of an enterprise of a contracting State shall be taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to that permanent establishment.

In summary, article 7(1) stipulates that a country cannot tax the profits of an enterprise which is not resident in that country unless the profits are derived from a permanent establishment situated therein. It is argued that this is precisely what CFC legislation does when the entity approach is applied. It taxes the resident shareholders on their pro rata share of the profits of a non-resident enterprise. Thus, where in accordance with article 7 of the OECD Model Tax Convention, a tax treaty between a shareholder’s country of residence and the CFC’s country of residence gives the latter the exclusive jurisdiction to tax the CFC’s income, or to limit the jurisdiction of the former to tax such income, this may result in conflicts between the CFC legislation and the tax treaty.¹⁴⁷

141 Sandler at 17.

142 Sandler at 19.

143 Sandler at 39.

144 See par 4.1 above.

145 Sandler at 19.

146 Sandler at 19.

147 Arnold (2004) at 252; Jiménez (2004) at 24.

There are, however, some arguments that CFC legislation is not contrary to article 7(1). It is claimed that the main function of article 7(1) is to limit the jurisdiction of the source country, to the taxation of the profits of a non-resident enterprise's permanent establishment located therein. CFC legislation on the other hand, has nothing to do with taxation in the source country, but rather imposes a tax based on the nationality or residence of the shareholder.¹⁴⁸

It is also argued that CFC legislation that employs the entity approach, conflicts with article 10(5) of the OECD Model Convention. This article provides as follows:

Where a company which is a resident of a contracting State derives profits or income from the other contracting state, that other state may not, ... subject the company's undistributed profits to a tax on the company's undistributed profits, even if ... the undistributed profits consist wholly or partly profits or income arising in such other state.

In summary, article 10(5) stipulates that the source country cannot tax the undistributed profits of a corporation resident in the other country even if the undistributed profits consist wholly, or partly, of profits, or income arising from the source country. It is argued that this is precisely the result when a country uses its CFC legislation to tax the profits of the CFC that are sourced in that country.¹⁴⁹ Some commentators however argue that article 10(5) does not conflict with CFC legislation, because this article precludes the source country from imposing a tax on the CFC itself and yet under CFC legislation, the tax is imposed on the resident shareholders of the CFC, not on the CFC's undistributed profits.¹⁵⁰

For those countries that apply CFC legislation that follows the "transaction approach", there are arguments that the conflict between CFC legislation and articles 7(1) and 10(5) may be more limited.¹⁵¹ If the tainted income of the CFC can be characterised as profits under article 7(1), or undistributed profits under article 10(5), then the same arguments made with respect to the "entity-

148 Jiménez (2004) at 23; Arnold (2004) at 252-253.

149 Sandler at 103; K Vogel *Klaus Vogel on Double Taxation Conventions* 3 ed (1997) at 260; M Lang "CFC Regulations and Double Taxation Treaties" (2003) 57 *Bulletin for International Fiscal Documentation* at 56.

150 Arnold (2004) at 253.

approach” CFC legislation may preclude the application of the “transaction-approach” CFC legislation. However, article 7(7) of the OECD Model Tax Convention provides that “where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article”. As article 7(1) refers to “the profits of an enterprise”, if the tainted income of the CFC retains its original character as passive income such as, interest, dividends, rent, royalties or capital gains, that do not fall within article 7(1) or 10(5), but are dealt with in separate treaty provisions, then neither article 7(1) or article 10(5) wholly precludes the application of the CFC legislation. The reason why these articles cannot apply is that it is not “profits” or “undistributed profits” of the CFC that are subject to tax.¹⁵²

Generally, countries that are against the contentions that CFC legislation conflicts with articles 7(1) and 10(5) of the OECD Model Convention, hold the view that neither article 7(1) nor article 10(5) precludes a country from taxing its residents on their income, even if the income is measured by reference to their share of undistributed profits of an entity resident in the other country.¹⁵³ It is further reasoned that CFC rules are anti-avoidance rules, and taxpayers should not be able to rely on the provisions of tax treaties, such as article 7(1) and 10(5), to prevent a country from protecting its domestic tax base.¹⁵⁴ Furthermore, that tax treaties are not intended to harmonise competing tax systems, rather they deal with particular aspects of cross-border income flows. In addition to the prevention of double taxation, tax treaties are also directed at the elimination of fiscal evasion and tax avoidance.¹⁵⁵ CFC legislation may in this respect not be considered in breach of international tax treaties. This legislation is generally designed to preserve equity within a domestic tax regime. As an anti-avoidance legislative mechanism, it cannot be said to breach the spirit of bilateral tax treaties as both serve the same purpose.¹⁵⁶

151 Sandler at 20.

152 Sandler at 20.

153 Arnold (2004) at 253

154 Arnold (2004) at 253.

155 Par 7 of the Commentary on art 1 of the OECD Model Convention.

The OECD's views on the conflict between CFC legislation and tax treaties

The OECD recognises implicitly that controlled foreign corporations do not raise treaty problems.¹⁵⁷ The Commentaries on the OECD Model Tax Convention that deal with the conflict between CFC legislation and tax treaties, were incorporated in 1992, and were based on the 1987 OECD Report on base companies.¹⁵⁸

Paragraph 43 of this Report states:

Under existing counteracting measures (subpart F type measures), the country imposes a tax on residents who are shareholders in the foreign base company. The foreign company as such is not taxed; generally the income which gives rise to the taxation does not originate in the country of the base company but in the taxing country itself or in a third country. A tax treaty between the country using the counteracting legislation and the country of the base country usually protects, however, income flows only between these two countries. The first-mentioned country may therefore claim that the tax imposed under the counteracting legislation does not come under the scope of the said tax treaty.

Paragraph 45 of the Report articulates the arguments against the suggestion that CFC legislation constituted a breach of the general structure and spirit of tax treaties. The paragraph states the following:

- (a) On the technical level, counteracting measures can attribute the activities – and thus income – to a shareholder, which is not contrary to tax treaties. If the counteracting measures have the effect of taxing a deemed dividend of the base company, this is well within the taxing rights conferred on the taxpayer's country of residence under the rules of tax treaties regarding taxation of dividends (cf. Articles 10, 23A and 23B of the OECD Model).
- (b) On the tax policy level, counteracting measures pierce only the "umbrella effect" of the taxpayers' arrangement. This effect and the consequent possibilities for an independent deferral are not guaranteed by tax treaties which were never intended to prohibit national safeguards for the equity and neutrality of a country's tax law;
- (c) On the international level, as long as some countries regard it as a sovereign right to shape their fiscal systems in a way which might negatively affect other countries, tax authorities in these other countries must safeguard their sovereign right to preserve the equity and neutrality of their tax systems. It has never been intended that tax treaties would replace national sovereign rights with international co-operation to safeguard the integrity of tax systems.

The 1987 OECD Report shows that the majority of the OECD member countries do not consider CFC rules to be contrary to the underlying principles of the OECD Model Convention.¹⁵⁹ However, paragraph 46 of the Report points out that

156 Sandler at 221.

157 Par 23 of the Commentary on art 1 and par 37 of the Commentary on art 10 of the OECD Model Convention.

158 OECD "Double Taxation Conventions and the Use of Base Companies" in *International Tax Avoidance and Evasion – Four Related Studies* (1987).

159 Switzerland was the only country to register an observation on the 1987 OECD Report on Base Companies. According to Switzerland, certain domestic anti-avoidance rules (e.g transfer pricing and substance-over-form rules) were contrary to the spirit of tax treaties because they result in the extra-territorial application of domestic legislation. Switzerland

[w]hile counteracting measures as described above are not inconsistent with the spirit of tax treaties, there is agreement that member countries should carefully observe the specific obligations clearly evidenced in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be adequate to grant him the protection which the treaty network would have provided if the taxpayer had not used the base the company. .

In this respect it can be argued that the rationale of the 1987 Report is rather confusing. On the one hand the Report suggests that the CFC legislation does not breach the spirit of tax treaties. On the other hand the Report adds that there should be limits on counteracting measures in order to avoid conflicts with certain basic principles of international taxation evidenced in tax treaties.¹⁶⁰

The findings of the 1987 OECD Report were incorporated in the 1992 Commentary on the OECD Model Tax Convention.¹⁶¹ Paragraph 23 of the 1992 Commentary on article 1 stated that CFC rules “are not addressed in tax treaties and are therefore not affected by them”. Paragraph 24 of the Commentary on article 1 provided that CFC rules “do not have to be confirmed in the text of the convention to be applicable”. The 1992 Commentary, however, was unclear in respect of the conflict between CFC legislation and tax treaties. For instance, the Commentary on article 1 dealt collectively with CFC rules and substance-over-form rules.¹⁶² Although paragraph 25 of the Commentary on article 1 acknowledged that CFC rules “are not inconsistent with the spirit of tax treaties”, it went on to indicate that “it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation”. The Commentary attempted to make it clear that most OECD member countries consider domestic anti-abuse rules to be consistent with the provisions of tax treaties. However, it also seemed to recognise the views of the minority of OECD

noted that, such domestic anti-avoidance rules should be applied only after consultation with a country’s treaty partner, and after taking the treaty partner’s interests into consideration. Although this observation did not refer to specifically to CFC legislation, the concerns raised apply equally to CFC legislation. See par 95 and 96 of the 1987 OECD Report on Base Companies.

160 Sandler at 91; AJM Jiménez “Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective – Part II” (2002) *Bulletin for International Fiscal Documentation* at 624.

161 AJM Jiménez “Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective – Part I” (2002) *Bulletin for International Fiscal Documentation* at 548.

162 Arnold (2004) at 252.

member countries, and to emphasise the limits imposed by tax treaties on the application of domestic anti-avoidance rules in order for them to be consistent with treaties.¹⁶³ On the whole, the 1992 Commentary on article 1 was confusing.

In the 1998 OECD Report on Harmful Tax Competition,¹⁶⁴ the OECD acknowledged that:

[I]n several reports, the conclusions of which have been incorporated into different parts of the Commentaries to the OECD Model, the Committee has discussed the interaction of internal anti-abuse measures (e.g thin capitalisation, CFC, general anti-abuse norms) with double taxation conventions and has concluded in general that these measures are compatible with double taxation conventions.¹⁶⁵

The 1998 Report conceded, however, that these conclusions are sometimes not clear or are expressed in a mitigated form. It recommended that “the Commentary on the Model Tax Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention”.¹⁶⁶

In 2003 changes were made to the Commentary on the Model Tax Convention. The Commentary on article 1, clarifies the relationship between CFC rules and tax treaties. Paragraph 23 of the Commentary on article 1 asserts that CFC rules have been adopted by a significant number of OECD member and non-member countries and that they “are now internationally recognised as a legitimate instrument to protect the domestic tax base”. Furthermore, that CFC rules are not addressed in tax treaties and are therefore not affected by them.¹⁶⁷

In response to the arguments that CFC legislation contradicts article 7(1) and article 10(5) of the OECD Model Convention, paragraph 23 of the Commentary on article 1 states that these articles are not being read in context. Paragraph 10(1) of the Commentary on article 7(1) explains that, the purpose of this article is to provide limits to the right of one contracting state to tax the business profits of

163 Arnold (2004) at 246.

164 OECD *Harmful Tax Competition: An Emerging Global Issue* (1998).

165 Par 123 of the Harmful Tax Competition Report.

166 Par 48-49 of the 1998 OECD Report on Harmful Tax Competition.

167 This position was not changed from the pre-2003 Commentary.

enterprises that are residents of the other contracting state. The paragraph does not limit the right of a contracting state to tax its own residents under controlled foreign company provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other contracting state that is attributable to these residents' participation in that enterprise. Tax so levied by a state on its own resident does not reduce the profits of the enterprise of the other state and may not, therefore be said to have been levied on such profits.

Paragraph 37 of the commentary on article 10 explains that

it might be argued that where the taxpayer's country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder".

Paragraph 23 of the Commentary on article 1 of the OECD Model Convention further provides that

whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.

The only caveat to applying CFC rules in the context of tax treaties is found in paragraph 26 of the Commentary on article 1, which provides that CFC rules "as general rule ... should not be applied, where the relevant income has been subject to taxation that is comparable to that in the country of residence of the taxpayer."¹⁶⁸

168 Arnold (2004) at 254. Five countries (Belgium, Ireland, Luxembourg, the Netherlands and Switzerland) made observations on the statement in the commentary that, there is no conflict between CFC rules and tax treaties. Portugal entered a general observation that, it will not adhere to the Commentary concerning the relationship between tax treaties and domestic anti-avoidance rules, "whenever, the prevailing hierarchy of tax conventions regarding internal law, is not respected". Belgium holds the view that, CFC rules are contrary to art 5(7), 7(1) and 10(5) of the OECD Model Convention because, they disregard the legal personality of foreign corporations. Luxembourg's position is similar although, it applies to all domestic anti-avoidance rules, including CFC rules. According to Luxembourg, unless a treaty includes an explicit provision, authorising the application of domestic anti-avoidance rules, such rules can be applied only after recourse to the mutual agreement procedure. Ireland, the Netherlands and Switzerland take the position that, there might be a conflict between CFC rules and tax treaties depending on the particular countries' CFC rules, and the relationship between tax treaties and domestic law in the particular country. See pars 27.4, 27.5, 27.6 27.7 and 27.9 of the Commentary on art 1 of the OECD Model Convention.

The changes brought about by the 2003 Commentary on the OECD Model Convention removed the ambiguity of the previous versions on the issue of the interaction between CFC rules and tax treaties.¹⁶⁹ However, these changes have been criticised, in that, by removing the ambiguities, the OECD got rid of the minority view that CFC rules are not compatible with tax treaties.¹⁷⁰ Despite the 2003 changes, it is still arguable that CFC rules are subject to the general provisions tax treaties, especially where the treaty itself contains provisions aimed at countering its improper use. Although CFC legislation can be used to prevent tax avoidance, international law requires that such measures do not breach international obligations included in treaties. For example, article 26 of the Vienna Convention to the Law of Treaties 1969 provides that every treaty in force is binding upon the parties to it and must be performed by them in good faith. Article 27 of the Convention furthermore provides that a party may not invoke the provisions of domestic law as justification for its failure to comply with the conditions of a treaty. More importantly, in as far as efficacy is concerned; the legislation cannot breach rules of international law that take precedence in the event of a conflict between the two.¹⁷¹

The OECD's reasoning in paragraph 24 of the Commentary on the 2003 Model Tax that anti-abuse rules such as CFC legislation are part of domestic tax laws for determining the taxable event, and therefore these rules are not affected by treaties, has also been criticised.¹⁷² Jiménez¹⁷³ argues that the link between anti-abuse rules and taxable events is not a powerful argument for concluding that because anti-abuse rules and tax treaties operate in two different spheres, one does not affect the other. Furthermore, that in some instances, "tax treaties do affect taxable events". Jiménez¹⁷⁴ is of the view that "general anti-abuse clauses simply seek to ensure the correct application of a legislative measure or

169 Jiménez (2004) at 23.

170 Jiménez (2004) at 23.

171 Sandler at 222.

172 This reasoning seems to rest on the basic proposition that domestic anti-avoidance rules (such as CFC rules) establish the facts to which tax treaties apply. Domestic anti-avoidance rules may be applied determine the character of amounts or transactions for domestic tax purposes. The provisions of the tax treaty then apply to the amounts or transactions as characterised pursuant to such domestic anti-avoidance rules. See Arnold (2004) at 249-250.

173 Jiménez (2004) at 23.

a treaty, by giving the tax administration the power to take into account elusive elements in the process of assessing tax. In contrast, specific anti-abuse clauses (eg CFC rules, domestic rules on imputing image rights, etc) do extend the taxable event (or the range of conduct that gives rise to tax liability), and this extension may be affected by tax treaties". It is notable that in the 2005 version of the Commentary on the OECD Model Tax Convention, paragraph 24 and 25 of the Commentary on article 1 were deleted.

Whether CFC legislation constitutes a breach of countries tax treaties is not free from doubt. The interaction between CFC legislation and treaties is an unsettled issue and there have been a few cases internationally that have challenged this state of affairs.¹⁷⁵ Jiménez¹⁷⁶ notes that, from an international perspective, virtually every state that has CFC legislation is confronted with this problem and the solution to it cannot be found by referring only to international law, which permits a "non-literal" interpretation of treaties, but is not helpful in establishing an international anti-abuse standard. As long as anti-abuse standards differ from country to country, and treaties do not have the same status in all countries, the problem of the compatibility of CFC legislation with treaties has to be solved in the national arena.¹⁷⁷ Vogel¹⁷⁸ notes that in order to determine the authority and relationship between domestic law (eg CFC legislation) and double taxation agreement, the specific legal framework of the relevant country has to be considered. Vann¹⁷⁹ also notes the following:

It necessarily follows that the priority of the treaty rules over other domestic tax rules derives from and is itself subject to domestic law. It may be that the treaty has some special status in domestic law which automatically prevails over other domestic law. More often than not the treaty has the same status as other domestic tax law and it is possible that a treaty could have a status which is inferior to other domestic tax law ...

The position in South Africa

As explained above, when calculating the net income of a CFC, the proportionate net income to be included in the resident's income is the net income of the CFC

174 Jiménez (2004) at 23.

175 These cases are referred to in chapter 5 fn 63.

176 Jiménez Part II at 626.

177 Jiménez Part II at 626.

178 Vogel in the Introduction in par 30.

as determined in accordance with the Income Tax Act.¹⁸⁰ Accordingly, the amount is the product of an artificial calculation and not a proportion of the CFC's actual profits. In essence, the effect of this provision is that on a notional basis, a portion of the net income of the CFC will be deemed to constitute income in the hands of a resident and will thus be taxed as part of the resident's taxable income. The concept "notional amount" is one of the complex and artificial aspects of this legislation that is quite difficult to understand.

This notion was borrowed from the United Kingdom after the decision in *Bricom Holdings Ltd v Inland Revenue Commissioners*.¹⁸¹ Briefly,¹⁸² the facts of the case were that Bricom Holdings as sole shareholder in a Dutch subsidiary, Spinneys International BCV (the CFC), was potentially liable for a portion of the interest income of the CFC which accrued to the CFC from moneys lent to the Bricom Group Ltd, a company which was resident in the United Kingdom. The Commissioner calculated the "chargeable profits" (in South African terms, the "net income") of the CFC on a wholly notional amount, arguing that the tax levied is not a corporation tax but a fiscal tax *sui generis* introduced to cover a specific form of tax avoidance. Bricom Holdings Ltd, however, relied on a provision of the Netherlands/United Kingdom double tax treaty which provided that interest arising in one of the states which is derived and beneficially owned by a resident of the other state shall be taxable only in the other state, thus preventing the Commissioner from taxing Bricom Holdings Ltd on income which included exempt United Kingdom source interest. By implication, this required an answer as to whether CFC provisions contravene double taxation agreements. The court held that the treaty did not apply, because the interest had lost its character as interest, and that what was actually taxed was a notional amount derived from a hypothetical calculation. It was held further that the double tax agreement pertained to "interest" only, but that the amount included in the calculation of the net income of the CFC was only "similar" to interest. The *Bricom Holdings Ltd* case is discussed in detail in chapter 5.

179 Vann at 6.

180 See par 4.3 above under the heading "Net Income".

181 1977 STC 1179.

182 The facts of this case are discussed in detail in chapter 5 where the United Kingdom provisions are dealt with.

As a result of the decision in *Bricom Holdings Ltd*, section 9D in South Africa's Income Tax Act was amended by the Revenue Laws Amendment Act 30 of 2000. Before the amendment section 9D provided *inter alia* that there shall be included in the income of any resident contemplated in the definition of a CFC, a "proportional amount of any investment income received by or accrued to such entity ...". These amendments resulted in the inclusion of the wording "an amount equal to the proportional amount of the net income of such entity for the foreign tax year". It may thus be argued that before the amendment of section 9D the actual foreign investment income itself and not an amount calculated with reference to that foreign investment income would be included in the income of the South African resident.¹⁸³ After the amendment the wording of the section now refers to "net income" as an amount equal to the taxable income of such entity determined in accordance with the Act. This implies that it is not the actual income but an amount equal or similar to such which is included in the income of a controlling resident as if it had been a resident for certain specified sections of the Act. This would accord with the United Kingdom decision in *Bricom Holdings Ltd*.

As South Africa's legislators have amended the CFC provisions to suit the decision in the *Bricom Holdings* case, South African residents are now taxed on notional amounts. It may thus be argued that it is unlikely that a South African court will hold that a South African resident will be entitled to rely on a double taxation agreement on the basis that the same amounts are effectively being taxed twice.¹⁸⁴

Olivier & Honiball¹⁸⁵ however note that even after the amendment of section 9D, the issue of the conflict between CFC legislation and tax treaties is still unclear. It is reasoned that it is not clear whether the income attributed to the South African residents retains its nature as business profits or whether it is merely a notional amount. If it is a notional amount, the applicability of article 23 of the OECD

183 Olivier & Honiball at 389-390.

184 Olivier & Honiball at 396-397.

185 Olivier & Honiball at 397.

Model Convention, to the attributed income is confusing. As discussed above,¹⁸⁶ article 23 of the OECD Model Convention deals with the exemption and credit methods as means of eliminating double taxation. A literal interpretation of article 23 to the attributed income does not lead one to the conclusion that there is a clear treaty override.¹⁸⁷

It is also argued that as the amendments to section 9D were as a result of the United Kingdom *Bricom Holdings* case, it is arguable whether section 9D can override a tax treaty as this case is a foreign court case that does not have binding force. It only serves as persuasive authority.¹⁸⁸ Meyerowitz¹⁸⁹ notes that although foreign cases such as English cases have influenced the development of the South African income tax jurisprudence to a considerable extent, these decisions cannot be followed without qualification. If the wording of the statutory provision with which the case deals is not similar to the South African one, the decision cannot be applied.¹⁹⁰ Oliver and Honiball¹⁹¹ also note that if a foreign court decision is from a constitutional environment that is different from the one in South Africa,¹⁹² for instance where tax treaties have a privileged status, it would not be directly relevant to the debate on treaty/CFC conflict in South Africa, but would merely be persuasive.

It can thus be said that despite the amendment of section 9D as explained above, an interpretation of this section in the context of a tax treaty shows the issue of the conflict of CFC legislation and tax treaties is not a settled matter in South Africa. In order to resolve this matter, it is important to note that tax treaties are international agreements and they must be considered both within their international context, as well as within the domestic legal framework of the relevant countries.¹⁹³ It has indeed been argued that the manner in which a domestic court will resolve the conflict between CFC legislation and a tax treaty,

186 See discussion with reference to fn 122 and 123 above.

187 Olivier & Honiball at 397.

188 Olivier & Honiball at 396-397. See also *CIR v Simpson* 1949 (4) SA 678 (A) at 700.

189 Meyerowitz in par 3.26 and 3.30.

190 Meyerowitz in par 3.26.

191 Olivier & Honiball at 396.

192 For details on the constitutional environment in South Africa, see the discussion in the preceding paragraphs.

193 Olivier & Honiball at 29.

depends on whether it is the CFC legislation or the tax treaty that takes precedence.¹⁹⁴ In order to determine the status and domestic application of treaties in South African law, the provisions of the Constitution of the Republic of South Africa¹⁹⁵ and the Income Tax Act must be considered. Section 2 of the Constitution provides that the Constitution is the “supreme law of the land”. This implies that South African law, which includes statute law, common law, international customary law and international law, are subject to the Constitution. Section 231(4) of the Constitution provides as follows:

Any international agreement becomes law in the Republic when it is enacted into law by national legislation; but a self-executing provision of an agreement that has been approved by Parliament is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.

In effect, an international agreement or treaty does not become part of domestic law until it is enacted into law by national legislation.¹⁹⁶ There are three principle methods employed by the legislature to transform treaties into municipal law. Firstly, the provisions of a treaty may be embodied in the text of an Act of Parliament; secondly, the treaty may be included as a schedule to a statute; and thirdly, an enabling Act of Parliament may give the executive the power to bring a treaty into effect in municipal law by means of proclamation or notice in the *Government Gazette*.¹⁹⁷

Section 108(1) of the Income Tax Act read with section 231 of the Constitution provide *inter alia* that the national executive of South Africa may enter into an agreement with the government of any other country to regulate the taxation of income, profits, gains and donations which may be taxable in both countries. As soon as the double tax agreement is ratified and has been published in the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act.¹⁹⁸ This implies that treaty provisions and any other provision in the Income Tax Act (eg section 9D) have equal status under South

194 Sandler at 99.

195 Of 1996.

196 J Dugard *International Law: A South African Perspective* 3 ed (2005) at 61; GE Devenish *The South African Constitution* (2005) at 416.

197 Dugard at 61.

198 Olivier & Honiball at 395; Meyerowitz in par 30.11; Huxham & Haupt at 356. See also AW Oguttu “Curbing ‘Treaty Shopping’: The ‘Beneficial Ownership’ Provision Analysed from a South African Perspective” (2007) XL *CILSA* at 252.

African law, even if the Income Tax Act contains a provision that is inconsistent with the treaty.¹⁹⁹ Indeed, in a number of cases, although decided in a different context, it has been held that tax treaties do not have a special or privileged status under South African law.²⁰⁰ Thus, a court may not automatically assume that a treaty overrides domestic legislation.²⁰¹ It is however worth noting that in 2003, the Supreme Court of Appeal in *AM Moola Group Ltd and Others v CSARS and Others*²⁰² held as follows:

If there were to be an apparent conflict between general provisions of the statute and particular provisions of an agreement, difficulties of interpretation might arise. The Act must, of course, prevail in such a case: the agreement once promulgated is by definition part of the Act. It must follow that where words which are defined in the Act occur in the agreement; they must be given the meaning assigned to them by the Act unless the context indicates the contrary.²⁰³

This case dealt with a conflict between a trade agreement and the Customs and Excise Act 91 of 1964. Section 49 of this Act provides that a trade agreement is deemed to be enacted into law when it is published in the *Government Gazette*. Note however that this case dealt with the interpretation of a conflict between a trade agreement and the general provisions of the Customs and Excise Act, as well as the words defined in the Act. Reference to this case may therefore not be relevant in resolving a conflict between a tax treaty and the specific CFC legislation in the Income Tax Act.

From the above, it can thus be said that the Constitution sets out the procedure for the incorporation of treaties into the Income Tax Act, but the Act does not provide a solution where there is a conflict between a treaty and a particular provision of the Act.²⁰⁴ In order to resolve the conflict between treaties and CFC legislation a court will have to consider the object the purpose of the relevant provisions. In this regard, a court would consider South African common law

199 Olivier & Honball at 30.

200 *Pan American World Airways Inc v SA Fire and Accident Insurance Co Ltd* 1965(3) SA 150 (A); see also *South Atlantic Inlands Development Corporation Ltd v Buchan* 1971 (1) SA 234 (C). Note also that under the United States Constitution, treaty obligations rank equal to internal federal legislation. Treaty obligations may also be overridden by internal federal legislation. See Olivier & Honball at 31.

201 Olivier and Honball at 30. "Treaty override" refers to a situation where the domestic legislation of a state overrules provisions of either a single treaty or all treaties hitherto having had effect in that state. See OECD *Report on Tax Treaty Override* (2000) at 1.

202 2003 (6) SA 244 (SCA).

203 *AM Moola Group Ltd and Others v CSARS and Others* 2003 (6) SA 244 at 250E (SCA).

rules of interpretation of statutes as well as international interpretation rules in so far as they are relevant.²⁰⁵

South African rules of interpreting statutes

Since tax treaties have the same status as any other provision in the Income Tax Act, tax treaties have to be interpreted in terms of the normal rules regarding the interpretation of statutes in order to make sense of any conflicts.²⁰⁶ In *ITC 1544*²⁰⁷ the following was held:

The terms of a double tax Convention to which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby.²⁰⁸

In South Africa, common law rules for the interpreting of statutes require that the actual words of the relevant provision have to be interpreted in context.²⁰⁹ This rule was pointed out in *Norden & Another NNO v Bhanki & Others*²¹⁰ where the court held the following:

However sophisticated the methods of construction of a statute employed by any court, the object of interpretation must ever be the ascertainment of the meaning of the language in its context.

In terms of this rule, the purpose or object of the legislation is the prevailing factor in interpretation.²¹¹ It may thus be argued that as the object of a treaty in general is to avoid the same income being taxed twice, any domestic legislation which has the effect that the same income is taxed twice, will be subordinate to the treaty provisions.²¹² It is reasoned that support for this view is found in section 108(1) of the Income Tax Act which *inter alia* provides that

204 Olivier & Honiball at 30.

205 Olivier & Honiball at 33.

206 Olivier & Honiball at 33.

207 SATC 456 at 460.

208 Olivier & Honiball at 38 note that although this decision was made under the old Constitution, even under the current Constitution, where a treaty ranks equally with domestic law, this decision can still apply

209 LM Du Plessis *Re-interpretation of Statutes* (2002) at 15; GE Devenish *Interpretation of Statutes* (1992) at 57 ("Devensih (1992)"). LC Steyn *Uitleg van Wette* (1981) at 4.

210 1974 (4) SA 647 (A) at 655B. see also *Ebrahim v Minister of the Interior* 1977 (1) SA 665(A) at 667.

211 C Botha *Statutory Interpretation: An Introduction for Students* 4 ed (2005) at 50; Du Plessis at 16.

212 Olivier & Honiball at 31.

The National Executive may enter into an agreement with the agreement of any other country, whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains ... under the said laws of the Republic and of such country.

The wording of this section makes it clear that the aim of tax treaties from a South African point of view is to prevent economic and juridical double taxation.²¹³ Olivier and Honiball²¹⁴ note the following:

In terms of this view, even if tax is payable in respect of particular income, profits or gains under South African domestic law, if in terms of the provisions of a treaty the relevant tax is not payable in South Africa, or only a part of that tax is payable, then the treaty automatically takes precedence and overrides the relevant domestic law in terms of the tax is payable. This view holds that s 108(1) presupposes a liability for tax under the laws of laws of South Africa and provides for the conclusion of a treaty to prevent, mitigate or discontinue that liability. Under this view it would be absurd to interpret s 108 as meaning that a treaty cannot or does not apply where the Income Tax Act imposes a liability for tax, or cannot override the provisions of the Income Tax Act, as such an interpretation would have the result that provisions in a treaty providing for the prevention, mitigation or discontinuance of a liability for tax would be meaningless and would serve no purpose.

Support for the view that a treaty overrides domestic law is also found in some court cases. For example, in *ITC 1544*²¹⁵ the court held the following:

The effect of section 108(2) of the Act is to grant statutory relief in certain circumstances where the South African imposes a tax, where the provisions of a double-tax Convention grant an immunity or exemption from such tax to persons governed by the Convention. Tax is not payable to the extent to which an immunity or exemption from tax is granted in terms of a binding tax Convention which has been proclaimed and thus has statutory effect.

It should be noted that these court decisions were made before the 1996 Constitution. Therefore, their interpretative relevance is uncertain in light of the fact that currently a treaty ranks equally with domestic law.²¹⁶ A counter argument to above views is that a treaty only eliminates double taxation in circumstances specifically mentioned in the treaty. It is therefore doubtful whether the mere existence of a treaty leads to the conclusion that an amount may not be taxed under domestic legislation, if under the provisions of the relevant treaty the same amount is taxed in the other contracting State.²¹⁷

A rule of interpretation that is internationally accepted and could be relevant in

213 Olivier & Honiball at 32. Note however, that there are arguments that tax treaties generally only eliminate juridical double taxation. See Lang *et al* at 631.

214 Olivier & Honiball at 32.

215 54 SATC 456 at 460.

216 Olivier & Honiball at 32.

217 Olivier & Honiball at 32.

resolving the conflict between CFC legislation and tax treaties is *lex posterior derogate legi priori* (“later in time” rule). In terms of this rule, a statute that was promulgated last in time will prevail. The later statute is deemed to have impliedly repealed the earlier one.²¹⁸ In applying this rule, a court would look at the respective dates that the treaties came into force and the date that domestic legislation was introduced. In respect to the use of this rule, the OECD²¹⁹ explains that

If treaty obligations are considered as having ... at the most ... the same rank as domestic law, they may, within some national legal systems be subject to the rules “*lex posterior derogate legi priori*” (ie later law override prior law). However, the situation is less simple to determine in practice since this principle applies only when inconsistencies arise between the new law and the prior law and it is well known that courts are reluctant to construe treaties as inconsistent with domestic law (and vice versa).

If a country does not grant special status to treaties and it applies the “*lex posterior derogate legi priori*” rule, the provisions of a treaty may be overridden by domestic legislation subsequently enacted.²²⁰ South Africa does not grant special status to treaties and it applies the *lex posterior derogate legi priori* rule.²²¹ One argument against applying the *lex posterior derogate legi priori* rule is that using domestic law to override a treaty provision creates problems as a treaty represents a binding contract between the two contracting states. It may thus be argued that domestic law cannot subsequently be enacted to override a treaty provision as such legislation may be in conflict with a State’s international obligations.²²²

It is also worth noting that it is not clear as to what weight the courts will attach to the *lex posterior derogate legi priori* rule in the light of the other interpretation rules. For instance, there is the *generalia specialibus non derogant* rule which is applicable to the resolution of conflicts between general and special laws.²²³ In terms of this rule, a general statute should not be interpreted in such a way as to alter specific provisions of an earlier statute or of the common law.²²⁴ This rule

218 Du Plessis at 34; Devenish (1992) at 283.

219 OECD Report on Tax Treaty Override at 8-9.

220 Olivier & Honiball at 40.

221 Olivier & Honiball at 41; Steyn at 188.

222 Olivier & Honiball at 41.

223 Du Plessis at 41; Devenish (1992) at 280.

224 Devenish (1992) at 280.

may justify a departure from the *lex posterior derogate legi priori* rule.²²⁵ In *R v Gwantshu* it was held:

When the legislature has given attention to a separate subject and made provision for it the presumption is that a subsequent general enactment is not intended to interfere with a special provision, unless it manifests that intention very clearly. ... Where general words in a later Act are capable of reasonable and sensible application without extending them to subjects specifically dealt with by earlier legislation, that earlier and special legislation is not to be ... altered ... merely by force of such general words, without any indication of a particular intention to do so.²²⁶

In terms of the *generalia specialibus non derogant* rule, it could be said that a treaty entered into after the introduction of domestic legislation is a subsequent general enactment not intended to interfere with the specific domestic legislation.²²⁷ It could however be reasoned that as tax treaties are international agreements, they should be interpreted much more widely than domestic legislation. This may require taking international interpretation rules into consideration. This reasoning could influence the courts to apply the *lex posterior derogate legi priori* rule (discussed above) since it is an international interpretation rule for tax treaties as is evident in the above quotation from the OECD Report on treaty override.

International interpretation rules

When interpreting domestic legislation, South African courts are constitutionally bound to follow an interpretation consistent with international law. Section 232 of the Constitution of South Africa provides that “[c]ustomary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament”. Section 233 of the Constitution states that

“[w]hen interpreting legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law”.

Internationally, treaties are classified as international agreements, which have to be interpreted by customary international law interpretation rules.²²⁸ In interpreting tax treaties, a South African court would have to take into

225 Olivier & Honiball at 41; Steyn at 188.

226 1931 EDL 29 at 31 as quoted from Devenish (1992) at 280.

227 Devenish (1992) at 280.

228 Vogel in the Introduction in par 28.

consideration, two particular aspects of customary international law: firstly, the Vienna Convention on the Law of Treaties, 23 May 1969 and secondly, the Commentary on the OECD Model Tax Convention.²²⁹

Although South Africa is not a party to the Vienna Convention, South African courts are guided by this Convention in respect to South Africa's treaty relations. The Vienna Convention is largely a codification of customary international law; it applies to all treaties and not only to countries that have signed the convention.²³⁰ Article 31 of the Vienna Convention provides *inter alia* that

[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given of the terms of the treaty in their context and in light of its objects and purposes.

This implies that a treaty should be interpreted in a way that will prevent double taxation or avoid inappropriate double exemption of tax.²³¹ In light of this article, it may be argued that if a tax treaty between South Africa and a country in which a CFC is situated, gives the latter the exclusive jurisdiction to tax the CFC's income, the application of South Africa's CFC legislation to tax the distributed profits of the CFC, may be viewed as a form of double taxation that could be in conflict with the tax treaty. However, some of the principles in the Vienna Convention may not be applicable in respect to tax treaties. An example is article 27 of this Convention which provides that a party may not invoke the provisions of its national law as justification for its failure to perform a treaty. This is because there could be domestic legislation (for example CFC rules) that could be in conflict with the provisions of a tax treaty.²³²

As most of South Africa's tax treaties are based on the OECD Model Convention, the Commentary on the OECD Model Tax Convention can be applied in interpreting treaty provisions in South Africa. The OECD Commentary on the application and interpretation of the Model Tax Convention has become widely accepted and is generally followed by countries which use the OECD Model Tax

229 Olivier & Honiball at 395.

230 Olivier & Honiball at 28.

231 OECD Report on Tax Treaty Override at 8-9; Oguttu (2007) at 250.

Convention as a basis for their treaties and as an interpretational aid in applying their tax treaties. Although South African is not an OECD member country and although the Commentary is not legally binding, South African courts have recognised and applied the OECD Commentary.²³³ In *ITC 1503*²³⁴ it was held that a treaty must be interpreted according to the common law rules pertaining to the interpretation of statutes as well as the OECD Commentary.

The OECD Commentary provides as follows:

The principle purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.²³⁵

Where taxpayers are tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws the OECD provides that

Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.²³⁶

The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy.²³⁷

The implication of the above statements is that if an anti-avoidance domestic legislation conflicts with a treaty, the conflict must be resolved in the terms of, or in the provisions of a treaty. Thus, if a treaty was concluded before the introduction of the domestic legislation, it would have to be re-negotiated to allow for the operation of such legislation if there was a conflict.²³⁸

It is however worth noting as discussed above, that the Commentary on the OECD Model Convention holds the view that CFC legislation is not in conflict with tax treaties. Note however, that not all OECD member countries ascribe to

232 Olivier & Honiball at 28.

233 *SIR v Downing* 1975 (4) SA 518 at 525 (AD).

234 53 SATC 342 at 348.

235 Par 7 of the Commentary on art 1 of the OECD Model Convention.

236 Par 7.1 of the Commentary on art 1 of the OECD Model Convention.

237 Par 9.6 of the Commentary on art 1 of the OECD Model Convention.

this view.²³⁹ Olivier and Honiball²⁴⁰ also note that the OECD Commentaries are not always decisive. If other arguments are more persuasive, an interpretation deviating from the view in the Commentaries can be followed. Since the compatibility of CFC legislation and tax treaties is still a debatable matter internationally,²⁴¹ the OECD Commentary on this matter may not be so helpful in finding a solution to a potential conflict in South Africa.

From the above, it has been made clear that CFC legislation and tax treaties have equal status in South Africa. In case of a conflict between the two, the Income Tax Act does not provide any solution. In order to solve this problem, a South African court could attempt to interpret the relevant provisions in order to resolve the conflict. A court would thus have to consider domestic rules of interpreting statutes and international interpretation rules (in so far as they are relevant). However, as explained above, an attempt to interpret the treaty provisions using the various interpretation rules may not be effective in resolving the conflict between CFC rules and tax treaties as some of these interpretation rules may not be helpful in resolving this conflict.

Since CFC legislation and tax treaties have equal status in South Africa, it has been recommended that potential conflicts could be resolved if South Africa comes up with a safeguarding clause that authorises its CFC legislation to override its tax treaties.²⁴² Alternatively, South Africa could insert a specific CFC clause in the new treaties it negotiates as is recommended by the OECD Commentary.²⁴³ The problem in the existing and older treaties could be resolved

238 Olivier & Honiball at 37.

239 See discussion with respect to fn 155 above.

240 See Olivier & Honiball at 29 who in this respect refer to Deitmer, Dorr and Rust "Invitation Seminar on Tax Treaty Rules Applicable to Permanent Establishments" in Memoriam of Prof, Dr Berndt Runge" (2004) *Bulletin for International Fiscal Documentation* at 183.

241 See discussion in chapter 5 fn 63 where reference is made to international court decisions where the conflict between CFC legislation and tax treaties was dealt with.

242 Olivier & Honiball at 392-393.

243 Par 9.6 of the Commentary on article 1 provides that "The potential application of general anti-avoidance provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy". Note that French tax authorities have insisted on including a clause allowing for the application of CFC legislation in all new treaties negotiated. See art 23(1)(b)(iii) of the France/South Africa

by re-negotiation.

The issue of the compatibility of tax treaties and CFC legislation is discussed further in chapter 5 where reference is given to other jurisdictions²⁴⁴ which have dealt with the conflict between CFC rules and tax treaties.

4.8 CHALLENGES E-COMMERCE POSES TO SOUTH AFRICA'S CFC LEGISLATION

In chapter 3,²⁴⁵ it was discussed that the development of e-commerce has opened up a new route of accessing offshore facilities that challenges current jurisdictional requirements that are based on geographical location. E-commerce also poses to challenges to the effectiveness of the CFC legislation that is used to curb the deferral of taxes. In order to determine how e-commerce challenges CFC legislation, it is necessary to reconsider the aspects of South Africa's CFC legislation and consider whether they are affected by e-commerce.

Challenges in determining the geographical location of the controlled foreign company

In order to attribute the income of a CFC to South African residents, the starting point is to determine whether a foreign company exists in a given situation. Traditionally, proof of the existence and the location of a foreign company can be verified from the documents that relate to its incorporation in the foreign country.

Although the growth of electronic commerce may not pose major problems with regard to companies which are classified as controlled foreign companies,²⁴⁶ e-commerce may make it difficult to prove the existence and location of a foreign company. Unlike traditional companies, often referred to as "bricks and mortar

treaty published in Government Gazette No 16681 dd 1995-09-27. The intention is to prevent France's art 209B of its Tax Code (which is similar to CFC provisions) from being challenged as being in conflict with the treaty.

244 See footnote 63 in chapter 5.

245 Par 3.6 under the title "How to determine the 'place of effective management' of a company"

246 RL Doernberg, L Hinnekens, W Herrerstein & J Li *Electronic Commerce and Multi-*

businesses” in that they are located at a certain location, businesses that are involved in e-commerce on the Internet do not have a physical presence.²⁴⁷ With e-commerce, significant business activities can be undertaken with little or no physical activity,²⁴⁸ and electronic functions can be easily and quickly moved from one jurisdiction to another without detection.²⁴⁹ An Internet address (domain name) does not necessarily prove that a given business is located in a certain jurisdiction.²⁵⁰ Although the domain name initially assigned to a given computer may be associated with an Internet address that corresponds to that machine’s physical location, (for example, a “.za” domain name), the machine may be physically moved without affecting its domain name. The owner of a domain name may also have it associated with an entirely different computer, in a different location. A server with a “.za” domain name need not be located in South Africa; and a server with a “.com” domain name may be anywhere.²⁵¹ The fact that electronic addresses do not necessary signify a geographical connection, makes it difficult to localise a business to any transaction in any single country.²⁵² This implies that many e-commerce enterprises can avoid the CFC rules if they take care not to create any taxable presence in any country. The mobility of e-commerce may also result in the setting up of more CFC arrangements that circumvent the legislation.²⁵³

Challenges in determining the domestic shareholders control or interest in the foreign company

Even where it may be possible to ascertain that a foreign company exists in a given situation, for that foreign company to qualify as a CFC in terms of section

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- jurisdictional Taxation* (2001) at 331.
- 247 CW Pappas “Comparative US and EU Approaches to E-Commerce Regulation” (2003) 31 *Denver J of International Law & Policy* 325 at 326-327; SP Melvin *Cyber Law and E-commerce Regulation: An Entrepreneurial Approach* (2005) at 13.
- 248 H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) at 27.
- 249 Doernberg *et al* at 331; LM Jennings “Finding Legal Certainty for E-Commerce” (2005) 44 *Washburn Law Journal* at 382.
- 250 DE Hardesty *Electronic Commerce: Taxation and Planning* (2000) at 1-8; J Ware & P Roper *Offshore Insight* (2001) at 71.
- 251 M Berliri “E-Commerce: Law and Jurisdiction” in D Campbell & S Woodley *E-Commerce: Law and Jurisdiction (The Comparative Law Yearbook)* (2003) at 2-3; C Schulze “Electronic Commerce and Civil Jurisdiction, with Special Reference to Consumer Contracts” (2006) 18 *SA Mercantile Law Journal* 31 at 33.
- 252 Schulze at 33.

9D of the Income Tax Act, one or more South African residents should directly or indirectly hold more than 50% of the total participation rights or voting rights of that foreign company.

In traditional commerce, determining the percentage of participation rights or voting rights may not be very difficult, as this can be proved from the legal documents of the company. Paper trail of the necessary records can be consulted and these are normally reliable and cannot easily be altered without detection. Sometimes, however, relevant information may not be easily accessible, or it may be difficult to interpret. Some of the information may not even be easily obtainable because of confidentiality concerns, or geographical reasons, or it may simply not exist.²⁵⁴ In the e-commerce era these matters are made more complicated as there is usually no paper trail of e-commerce transactions. The available information may not be as reliable, as it can easily be altered without leaving a trace if the object is tax avoidance. Taxpayers could for instance alter information regarding participation or voting rights in a CFC and their percentage holding in a CFC so as to avoid being caught by the CFC rules.²⁵⁵

The reference to “indirect” participate rights, or voting rights in a foreign company, is another aspect that can be manipulate in e-commerce to avoid this legislation. Currently, there is lack of clarity as regards the ambit of indirect participation rights. As explained above, it is not clear whether the word “indirectly” refers to holding through another company, and not to conditional holdings, such as those of unsecured creditors.²⁵⁶ With the anonymous nature of e-commerce, taxpayers could manipulate the lack of clarity in this aspect of the legislation to avoid the CFC rules. This is even made worse by the fact that section 82 of the Income Tax Act places the onus of proof on the South African shareholder to prove such indirect involvement.

253 Doernberg *et al* at 331.

254 OECD Report of the Committee on Fiscal Affairs “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators” (1994) 172 *Intertax* 318 at 325 in par 28-29.

255 Olivier & Honiball at 386.

256 Olivier and Honiball at 365. See discussion in par 4.3 above under the heading “Defining a Controlled Foreign Company”.

Challenges to the exclusions to the CFC rules

In terms of sub-clause (c) of the definition of a CFC, residents who are connected persons, who in aggregate hold more than 50% of the participation rights or voting rights in a foreign listed company, or a foreign collective investment scheme or arrangement, but individually hold less than 5% of the participation rights or voting rights in the listed company, or a foreign collective investment scheme, or arrangement (equity unit trust), are excluded from CFC rules. As mentioned above, the purpose of this exclusion is to lessen the administrative burden on tax authorities, as it is often difficult to determine the identity of those who own shares in large-scale entities where the interest is less than 5%.²⁵⁷ However, even in traditional commerce, it is not easy to obtain information in respect of a shareholding of less than 5%.²⁵⁸ With e-commerce, these problems are magnified, thus making it possible to manipulate this provision so as to avoid the CFC rules. E-commerce also makes it possible to manipulate this provision so as not to comply with the strict reporting requirements of South African residents with the participation rights or voting rights in a CFC, in terms of section 72 of the Act.

Apart from the challenges of determining the percentage of participation rights as explained above, e-commerce makes it difficult to determine whether for purposes of this exclusion, the relevant residents are connected persons. Section 1 of the Income Tax Act defines the term “connected person” in relation to a company to include: its holding company, its subsidiary and any other company where both such companies are subsidiaries of the same holding company. Determining whether residents are connected to each other may not pose major challenges in traditional trade. In e-commerce, if a CFC is resident in a tax-haven jurisdiction where banks have strict secrecy provisions, it may be difficult to determine whether a resident has a connection to a particular CFC.²⁵⁹ This may be manipulated to take advantage of the CFC rules.

257 Olivier and Honiball at 365.

258 Olivier and Honiball at 365.

259 Doernberg *et al* at 388-389; see also R Buys *Cyber Law: The Law of the Internet in South*

Currently, it is not easy to link activities on the Internet to the parties associated with such activities. Indeed, as one of the benefits of trading electronically is the ability to reach global markets, traders are often not interested in knowing their customer's physical location. Determining, or verifying a party's identity online is not an easy task, especially, if the parties wish to conceal certain information.²⁶⁰ An Internet address only indicates who is responsible for maintaining that address; it provides no links to the computer, its user who is corresponding on that address, or even to the place where the computer is located.²⁶¹ Internet users often have no control over, and no interest in, the specific paths their data travels in reaching other computers connected to the Internet, or in the physical location of the computer or computers from which they retrieve information.²⁶² Although users may connect to the Internet through phone lines, they also may do so using cable systems and wireless forms of communication. Moreover, connecting computers to, or disconnecting them from the Internet are tasks that are easily accomplished, as is moving a website from a server in one physical location to a server in another, without any appreciable effect on online service.²⁶³ With the anonymous nature of e-commerce, it may be difficult for tax administrators to prove that certain parties to an e-commerce transaction are connected and are involved in diversion activities. In this way e-commerce can be used to take advantage of the "foreign business establishment" exemption to the FC rules in order to avoid the CFC rules.

Challenges of determining the net income of a CFC

In terms of the CFC provisions, the net income of the CFC is attributed to the South African residents. The net income is an amount equal to the taxable income of the foreign company determined in accordance with the provisions of the Act as if the company had been a South African resident taxpayer.²⁶⁴ The net income of the CFC is calculated at the end of the foreign tax year of the country in which the CFC is resident and is included in the resident's income at the end

Africa (2000) at 246.

260 Melvin at 53.

261 Hardesty at 1-8; Ware and Roper at 71.

262 Melvin at 52.

263 Melvin at 52.

of the South African year of assessment.²⁶⁵ This implies that in calculating the net income of a CFC, companies have to keep two sets of books, one for the country in which the CFC is a resident and one for South African tax purposes. A full audit of each company is thus required and a form will have to be completed and submitted to SARS for each CFC.²⁶⁶ As explained above, in traditional commerce, reliable paper audit trails can be consulted to determine a company's net income. In the e-commerce determining the net income of a company may be difficult because there is usually no paper trail of e-commerce transactions. Electronic records can easily be altered without trace, or may be encrypted in order not to reveal transaction information if the object is tax avoidance.

Challenges e-commerce poses to the some of the exemptions to CFC rules

As discussed above, there are certain exemptions to the CFC rules where taxpayers engage in certain activities. Of particular importance to this discussion is the "foreign business establishment exemption" to the CFC rules. The workings of this exemption face challenges in the e-commerce era that can be manipulated to avoid taxes.

As explained above, in terms of section 9D(1) of the Income Tax Act, a "foreign business establishment" *inter alia* refers to a place of business with an office, shop, factory, warehouse or other structure which is used by a controlled foreign company. This is in line with the definition of the term "permanent establishment" as set out in article 5 of the OECD Model Tax Convention on Income and on Capital.²⁶⁷ Thus, the understanding of the concept "foreign business

264 De Koker in par 5.44.

265 Olivier and Honiball at 366.

266 Olivier & Honiball at 369.

267 Art 5 of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version) defines a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes a place of management, a branch, an office, a factory a workshop, a mine, an oil or gas well, a quarry, or any other place for the extraction of natural resources, but excludes the use of facilities for activities of a preparatory or auxiliary character such as storage, display or delivery. A fixed place of business will exist where any premise, facility, installation or space is used regularly by the enterprise for business purposes. A permanent establishment will also be deemed to exist where a non resident person habitually transacts business in South Africa through an authorised dependent agent, in respect of any income attributable to the dependent agent's activities.

establishment” requires one to refer to the interpretation of the term “business establishment” as it is used in the OECD Model Convention. In *CIR v Dowing*,²⁶⁸ the court held that South Africa is bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention. Although article 5 of the OECD Convention refers to a “fixed place of business”, or “agency presence” in a given jurisdiction, to establish a permanent establishment, it is the definition that relates to a “fixed place of business” that is of relevance in discussing the challenges that e-commerce poses to the “foreign business establishment” exemption to the CFC rules.

One of the reasons why e-commerce poses challenges to this exemption is because the rules used to establish whether a foreign business establishment exists are based on geographical location, whereas e-commerce takes place in cyberspace.²⁶⁹ Take the example of a CFC that sells software through a website that is hosted on a server located in a tax-haven jurisdiction. The parent company that created the CFC is resident in South Africa. Customers can purchase the software by accessing the CFC’s website and downloading the software on their own computers. Setting up a server in a tax-haven jurisdiction where customers can download the parent company’s software may be much easier than incorporating a more traditional business establishment in the tax haven.²⁷⁰ The question that arises is whether the website or the server located in the tax-haven jurisdiction qualifies as a “foreign business establishment”²⁷¹ for it to be exempted from the CFC rules.

An Internet website consists of the software and the electronic data that are stored on a server. The website is what appears on the computer screen and

268 1975 (4) SA 518 (A) at 524.

269 C Schulze “Electronic Commerce and Civil Jurisdiction, with Special Reference to Consumer Contracts” (2006) 18 *SA Mercantile Law Journal* 31 at 33; See also DR Johnson & D Post “Law and Borders – The Rise of Law in Cyberspace” (1996) 48 *Stanford Law Journal* at 1367 and 1370-1371; N Cox “The Regulation of Cyberspace and the Loss of National Sovereignty (2000) 11 *Information & Communication Technology Law* at 244-245.

270 Doernberg *et al* at 331.

271 R Buys & F Cronjé *Cyber law: The Law of the Internet in South Africa* (2004) at 313; Suddards at 262.

allows an enterprise to interact with its customers. However, it is not like a “brick and mortar office” and so it has been referred to as a “virtual office”.²⁷² Through the website, an enterprise can have direct access to any customer who has access to the Internet. By logging onto the website customers can select products for purchase from an online catalogue and buy them by filling out a form and charging the purchase on their personal credit card.²⁷³ Since a website is a virtual office, it is intangible property. It is not physical and therefore it cannot be deemed to be a “foreign business establishment” for purposes of the CFC rules.²⁷⁴

On the other hand, a server is an automated equipment on which an Internet website is stored and through which the website is accessible. Since a server is a piece of equipment, it has a physical location.²⁷⁵ Often the website through which the enterprise carries on its business may be hosted on the server of an Internet Service Provider.²⁷⁶ This hosting arrangement usually takes the form of the provision of an amount of disk space for the website for the storage of its software and data.²⁷⁷ The issue then is whether the server creates a business establishment for an enterprise by virtue of the hosting arrangement. In other words, can the server be considered to be at the disposal of the enterprise?

When an enterprise conducts its business through a website that is hosted on a

272 Arnold & McIntyre at 153; AW Oguttu & B Van der Merwe “Electronic Commerce: Challenging the Income Tax Base” (2005)17 *SA Mercantile Law Journal* at 85-86. WJ Craig “E-commerce: Where to Go with Taxation” in A Schulz *Legal Aspects of an E-Commerce Transaction: International Conference in The Hague 26 and 27 October 2004* (2006) at 231.

273 Arnold & McIntyre at 153.

274 OECD Committee on Fiscal Affairs “Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5” (22 December 2000) at 5. Available at ><http://www.oecd.org/dataoecd/46/32/1923380.pdf><, last accessed 26 June 2007. Simmons & Simmons Communication Practice *E-commerce Law: Doing Business Online* (2001) at 165; C Gringras *The Laws of the Internet* 2 ed (2003) at 406; ME Plotkin, B Wells & K Wimmer *E-commerce Law and Business* (2003) in par 15.06.

275 Oguttu & Van der Merwe at 318.

276 OECD 2000 Report on the Application of the Permanent Establishment Definition in E-commerce at 5; Schulze at 31, notes that, each internet user must access the internet by way of an Internet Service Provider (ISP), which itself is a network. The ISP connects to larger regional networks, which, in turn, connect to high capacity networks called “backbones”. This network of networks links computers and users worldwide. See also C Chen “United States and European Union Approaches to Internet Jurisdiction and their Impact on E-Commerce” (2004) *University of Pennsylvania Journal of International Economic Law* at 426-427; Plotkin *et al* in par 15.06.

277 Oguttu & Van der Merwe at 318; Suddards at 262.

server, such hosting arrangements do not necessarily result in the server and its location being at the disposal of the enterprise. This is because the enterprise does not have a physical presence at the location of the server since the website through which it operates is not tangible.²⁷⁸ However, if the enterprise carrying on business through a website has the server at its own disposal, for instance if it owns (or leases) and operates the server on which the website is stored and used, then the place where that server is located could constitute a permanent establishment of the enterprise. This is however still subject to three conditions. Firstly, the server must be “fixed” at some location for a sufficient period of time in order to constitute a permanent establishment.²⁷⁹ Secondly, the meaning of permanent establishment still requires that the business of the enterprise should be wholly or partly carried on through the place where the server is located.²⁸⁰ Thirdly, a server will only be considered a permanent establishment of the enterprise, if the specific exclusions stated in article 5(4) of the OECD Model Convention do not apply. In terms of this article, no permanent establishment may be considered to exist where the e-commerce activities carried on through a server in a given location are restricted to preparatory or auxiliary activities.²⁸¹ However, where such functions in themselves are the core functions of the enterprise, or they are an essential and significant part of its business activities, these would go beyond preparatory or auxiliary activities and so a permanent establishment would be deemed to exist. For example, some internet service providers are in the business of operating their own servers for the purpose of

278 Par 42.2 of the 2005 Commentary on art 5 of the OECD Model Convention; see also Buys & Cronjé at 303; Suddards at 262; Oguttu & Van der Merwe at 318; Simmons & Simmons at 165; Plotkin *et al* in par 15.06.

279 The fact that equipment might be moved around within a general location such as an office is not relevant, nor is it relevant that the equipment moved to some other location unless it is actually moved. See par 42.4 of the Commentary on art 5 of the OECD Model Tax Convention; Arnold & McIntyre at 153.

280 However the fact that the enterprise does not require personnel at the location for the operation of the equipment does not in itself mean there is no permanent establishment. See par 42.6 of the Commentary on art 5 of the OECD Model Tax Convention; Buys & Cronjé at 303.

281 Such activities would include, the providing of a communication link between supplier and customer, advertising of goods or services (such as the display of a catalogue of certain products), relaying of information through a mirror server for security and efficiency purposes, gathering market dates for the enterprise and supplying such information. See OECD 2000 Report on the Application of the Permanent Establishment Definition in E-commerce at 5; see also Arnold & McIntyre at 155; Simmons & Simmons at 165; Suddards at 263.

hosting websites or other applications for other enterprises.²⁸²

From the above, it can be concluded that a physical permanent establishment will only be deemed to exist when the enterprise carries on business through a website that has a server at its own disposal, in a fixed location and the business of the enterprise is not of a preparatory or auxiliary nature. Where that is the case, an e-commerce business could claim that it has a foreign business establishment, and if the exceptions to the foreign business establishment exemption do not apply to that particular situation, it could be exempted from the CFC provisions.

It is, however, worth noting that in terms of the “foreign business establishment” exemption to the CFC rules, the “foreign business establishment” must be run for *bona fide* business purposes. Where a server is maintained in a tax haven jurisdiction, from which software or interactive customer service programmes can be downloaded by customers, it may be difficult to determine whether these online activities are sufficient to meet the test of a *bone fide* “foreign business establishment” and are not a mere tax avoidance scheme designed to escape CFC rules.²⁸³

In term of the CFC rules, the “foreign business establishment” exemption cannot be granted, if the CFC is involved in diversionary activities. This implies that, if the net income of a “foreign business establishment” of a CFC is derived from transactions with its connected person (who is a resident), and if the supply of goods or services by or to the CFC does not reflect an arm’s length price in terms of section 31 of the Act,²⁸⁴ this exemption will not be granted. In the e-

282 Pars 42.8 - 42.9 of the Commentary on art 5 of the OECD Model Tax Convention; see also Buys & Cronjé at 303; Gingras at 406.

283 JS Hiller & R Cohen *Internet Law and Policy* (2002) at 265.

284 An arm’s length price is a price set in the marketplace for transfers of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction. See South African Revenue Service (SARS) Practice Note: No. 7 - 6 August 1999 s 31 of the Income Tax Act 1962 (the Act): *Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* at 7.1; See also D Hay, F Horner, J Owens “Past and Present Work in the OECD on Transfer Pricing and Selected Issues” (1994) 10 *Intertax* 424; VH Miesel, HH Higinbotham, and CW Yi “International

commerce, the difficulties of determining whether the relevant parties are connected parties have already been discussed above. In respect to this particular exemption to the CFC rules, the anonymous nature of e-commerce,²⁸⁵ may make it difficult for tax administrators to prove that certain parties to an e-commerce transaction are connected and are involved in diversion activities. In this way e-commerce can be used to take advantage of the “foreign business establishment” exemption, in order to avoid the CFC rules. Likewise, e-commerce makes it difficult to determine whether the price charged between the connected parties is a non-arm’s length price.²⁸⁶ Finding the prices set between connected parties that deal with each other, is not as problematic in traditional commerce, as the parties concerned often keep paper records of the transactions they are involved in. The anonymous nature of e-commerce may make makes it difficult to determine whether the prices charged in a given transaction are arm’s length prices.²⁸⁷ Finding the price of goods or services is further complicated by the electronic money or digital cash which is used to effect payment.²⁸⁸ Electronic tokens²⁸⁹ can be downloaded from an on-line bank, and purchases can be made leaving no paper or electronic trace as to the date and value of the transaction.²⁹⁰ The anonymous nature of electronic money also makes it easy for CFCs and residents to instantaneously and secretly engage in diversionary activities that cannot be caught by the CFC provisions.

Transfer Pricing: Practical Solutions for Inter-Company Pricing - Part 11” (2003) 29 *International Tax Journal* 1. OECD Report of the Committee on Fiscal Affairs “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators” (1994) 172 *Intertax* 318 in par 12.

285 Doernberg *et al* at 390; Buys at 248.

286 A non-arm’s length price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction. SARS’ Practice Note No 7 in par 7.1; art 9 of the OECD Model Tax Convention on Income and on Capital (2005 condensed version).

287 Buys & Cronjé at 306; AW Oguttu “Transfer Pricing and Tax Avoidance: Is the Arm’s-Length Principle Still Relevant in the E-Commerce Era” (2006)18 *SA Mercantile Law Journal* at 154.

288 Hardesty at par10.01-10.4; JJB Hickey, R Mathew & C Rose *E-commerce: Law Business and Tax Planning* (2000) at 257. Electronic money constitutes an electronic mechanism for the transfer of funds without, the use of a deposit taking institution (like a bank) or a third party, the process being characterised by the transfer of value as such. See Buys at 301.

289 Electronic coins are in the form of digitally signed numbers which are used in exchange for money from the user’s bank account. See Buys at 300.

Challenges to the character of income

In jurisdictions where CFC legislation is applied only to specific types of income (eg passive income), e-commerce may make it possible to manipulate the character of that income so that it falls outside the ambit of the CFC legislation.²⁹¹ In the past South Africa's CFC rules applied to passive income, but not to active income.²⁹² Through e-commerce, a CFC may modify its electronic products, so that the character of income that arises from the transaction is viewed as active income, not passive income which is caught by the CFC rules.²⁹³

Although South Africa's CFC rules were amended not only to cover passive income but all income, some of the exceptions to the foreign business establishment exemption may create situations that encourage the manipulation of the character of the income concerned so that the particular exception is rendered inapplicable.²⁹⁴ For example, section 9D(9)(b)(iii) of the Income Tax Act provides that the "foreign business establishment" exemption will not apply to net income that is attributed to any amounts derived from mobile passive income of an enterprise. This includes income such as dividends, interest, royalties, rental, annuities, insurance premiums, capital gains, and foreign currency gains under section 24I. For example, if a CFC resident in a tax-haven jurisdiction licences software (created by its parent company in South Africa) to customers in other countries in exchange for a royalty, the transfer of the software could be characterised as a sale of goods or the licensing of an intangible. If the latter view is adopted, income received from the transaction would be royalty income that does not qualify for the foreign business establishment exemption to the CFC rules. E-commerce may however allow the CFC to modify the software before licensing it, so that the royalties constitute active business income that could possibly qualify for the foreign business establishment exemption to the

290 Buys at 247 and 297; Oguttu at 154.

291 Doernberg *et al* at 331.

292 See the discussion above about the former s 9C and s 9D that were repealed when the residence basis of taxation was introduced in 2001.

293 Buys & Cronjé at 313.

294 Doernberg *et al* at 331.

CFC rules.²⁹⁵

Similarly, a CFC could maintain an investment information database and charge fees to customers in other countries for accessing the database. The employees providing the information found on the database, could for example, be located in South Africa where the parent company is located. Since the CFC is rendering services for the parent company, it has to be determined whether the income received is for the right to access the information on the database (i.e. for services rendered), or for the information contained on the database (i.e. for a licence).²⁹⁶ If the income is considered royalty income, the foreign business establishment exemption to the CFC rules may not be granted, but if it is considered to be income from services rendered, it may be possible to claim the foreign business exemption to CFC rules.

It is, however, worth noting that the exemptions to the CFC rules are granted to South African residents, if the extensive disclosure requirements in terms of section 72(A) of the Income Tax Act are complied with. If financial statements, or information regarding the percentage holding in participation rights, are not submitted, all the receipts and accruals of the CFC will be attributed to the South African resident, irrespective of actual shareholding. In order to comply with these information requirements, the taxpayers need to keep pertinent records of their transactions. Where taxpayers are involved in e-commerce, there may be practical difficulties in obtaining information regarding this legal provision. This provision may prevent taxpayers involved in e-commerce from manipulating the exemptions to CFC rules to avoid taxes.

It should also be noted that even if e-commerce poses challenges to CFC legislation it only provides the controlling South African residents with a deferral of taxes, as any dividends repatriated from offshore e-commerce will be subject to taxation in South Africa. Where e-commerce income generated in a tax haven is reinvested into the business, or is kept outside South Africa, a permanent deferral can be achieved. Ultimately, however, any e-commerce profit that is

295 Buys & Cronjé at 313.

repatriated to South Africa will be subject to tax here.²⁹⁷

On the whole, it can be concluded that the ability of taxpayers to sell electronic goods and services, and the ability to manipulate the character of the ensuing income for tax avoidance purposes, may make it necessary to re-examine controlled foreign company provisions to ensure that they are sufficient in their current form to achieve their intended purpose. If CFCs can engage in extensive e-commerce through websites or computer networks located in a tax haven, it may become increasingly difficult to enforce existing CFC legislation, partly because of the difficulty of detection.²⁹⁸

South Africa's response to the challenges posed by e-commerce

The Katz Commission²⁹⁹ recognised the need to protect South Africa's tax base and noted that e-commerce impacts on the basic methods of today's international taxation, making irrelevant the concept of physical presence in order to trade.³⁰⁰ It was noted that current legislation can be manipulated through hyper-mobility of an entire office or management capacity. It was further noted that, the manner in which goods and services can be contracted for, advertised and even delivered via electronic means, can lead to the erosion of South Africa's tax base. However, the Commission recommended, that South Africa should not seek to pioneer a whole new tax regime to cope with the changes brought about by e-commerce, but that it should internationalise its laws affecting international trade and investment.³⁰¹

In devising an e-commerce policy for South Africa, a green/white paper process

296 Doernberg *et al* at 336.

297 Buys & Cronjé at 314.

298 Doernberg *et al* at 336.

299 Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa *The Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) at 31 ("Katz Commission Report (1997)").

300 Katz Commission Report (1997) at 31.

301 Katz Commission Report (1997) at 31.

was developed that would culminate into legislation.³⁰² In the Green Paper on E-commerce,³⁰³ a consultative document on the government policy formulation process on e-commerce, it was pointed out that the legal framework in South Africa is currently insufficient to deal with e-commerce issues. The current legislation was basically tailored for paper-based commercial transactions and there was therefore a need to formulate a new legal framework that includes electronically concluded transactions. In order to resolve some of the challenges posed by e-commerce, the Green Paper³⁰⁴ suggested that policy recommendations be formulated and the necessary action be taken to ensure that the e-commerce environment in South Africa is fair and equitable for all stakeholders. With respect to resolving some of the challenges e-commerce poses to the administration of legislation, the Green Paper noted that accurate identification of the party responsible for paying a particular tax is a fundamental requirement of any taxation system. Tracing the physical owner of a website inadequately identified can be a time-consuming process often with reliance having to be placed upon a third party.³⁰⁵ The Green Paper suggested that since there is a blurring of the actual trading capabilities of electronic enterprises, attention should to be given to drafting a minimum standard in respect of identification requirements of websites. Furthermore, that a minimum standard of on-line contact information must be required of enterprises using a website. Such information would include: the trading name of the business; the physical as well as the postal address of the business; an e-mail address; telephone or other contact information and the statutory registration number of the enterprise. The Green Paper noted that many tax administrations consider such information as the only means of identifying businesses engaged in e-commerce.³⁰⁶

As regards the use of “Electronic Money”, the Green Paper suggested that principles governing access to the records of electronic money issuers need to

302 M Groenewald & D Lehlkoe “Towards an Electronic Commerce Policy for South Africa”. Available at >http://www.isoc.org/inet99/proceedings/1g/1g_4.htm< last accessed on 1 October 2007.

303 Department of Communications’ Green Paper on E-commerce *Making it your Business* (November 2000) at 10-14.

304 Department of Communications’ Green Paper on E-commerce at 37.

305 Department of Communications’ Green Paper on E-commerce at 37.

306 Department of Communications’ Green Paper on E-commerce at 37.

be developed.³⁰⁷ With respect to the development of efficient tax collection mechanisms, the Green Paper noted that most tax collection mechanisms usually make use of a leverage point. A common example is PAYE where employers collect the taxes on behalf of SARS from the taxpayers. However, e-commerce tends to eliminate the “middleman”, so tax collection efficiency is reduced. To ensure efficient collection of taxes, the Green Paper suggested that a greater degree of international co-operation in revenue collection is required.³⁰⁸

As a result of the green/white paper process that forged an e-commerce policy for South Africa,³⁰⁹ in 2002, the Electronic Communications and Transactions Act³¹⁰ was enacted. This Act repealed the Computer Evidence Act of 1983.³¹¹ In 2003, section 74(1) of the Income Tax Act was amended, to allow for electronic record keeping.³¹² However, the Income Tax Act does not contain provisions that can be used to verify whether a particular electronic document or information is linked to a particular taxpayer. Thus electronic records can easily be altered without trace, or maybe encrypted, in order not to reveal transaction information.³¹³

The preamble to the Electronic Communications and Transactions Act³¹⁴ *inter alia* states that it was enacted to provide for the facilitation and regulation of electronic communications and transactions. This Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce. For instance, section 23 requires a disclosure of the time and place of communication, despatch, and receipt of information. Section 24 deals with the expression of intent between the originator and the addressee, and section 25 deals with the attribution of data messages to

307 Department of Communications' Green Paper on E-commerce at 38.

308 Department of Communications' Green Paper on E-commerce at 37-38.

309 M Groenewald & D Lehlokoe “Towards an Electronic Commerce Policy for South Africa”. Available at >http://www.isoc.org/inet99/proceedings/1g/1g_4.htm< last accessed on 1 October 2007.

310 Act 25 of 2002.

311 57 of 1983.

312 S 67 of the Revenue Laws Amendment Act 45 of 2003 amended s 74(1) of the Income tax Act to provide that a “document” includes any printout of information generated, sent, received, stored, displayed or processed by electronic means. And that “information” includes electronic representations of information in any form.

313 Oguttu & Van der Merwe at 321; see also Doernberg *et al* at 390, Buys & Cronje at 308.

the originator. Section 38 provides that the authentication of the products or services of service providers will only be accredited, if the electronic signature to which the authentication products or service relates, is uniquely linked to the user and can be used to identify the user. The electronic signature should be created using means that can be maintained under the sole control of that user, and will be linked to the data message to which it relates, so that any change of the data can be detected. Sections 27 and 30 contain provisions relating to cryptography so as to ensure the authenticity, integrity and reliability of Internet data. Sections 42 and 43 provide that a supplier of electronic good and services must display certain information on the website where the goods are offered. Sections 80 and 81 deal with the appointment of cyber inspectors, who have the power to inspect any website activity, and information in the public domain. Then sections 85 and 86 deal with the penalties of cyber crime. On the whole, however, the Act does not provide for taxation issues in respect of e-commerce transactions.

The South African government encourages the development of e-commerce and it is of the view that access to the Internet and information technology is crucial to the upliftment of its people, especially those in rural areas and those involved in small or medium sized enterprises.³¹⁵ It is, however, important to realise that while the upliftment of the people is undoubtedly important, e-commerce provides a means for not only big enterprises, but also for small companies and individuals to engage in international trade, with the possibility of circumventing CFC legislation. If e-commerce is not regulated and taxed, the loss of revenue could be tremendous. Therefore, there is a need for government policies to strike a balance between development and the taxation of e-commerce. Since the challenges brought about by e-commerce affect the international community,³¹⁶

314 Act 25 of 2002.

315 Green Paper on E-commerce at 67-68.

316 For further discussion on how the international community has responded to the challenges of e-commerce, refer to chapter 5 where reference is given to reports such as: OECD Ministerial on Electronic Commerce: Ottawa Canada (October 1998) "A Borderless World". Available at ><http://www.ottawaoecdconference.org/English/conference-program/agenda.pdf><, last accessed on 4 June 2007; OECD 6th Global Forum "Taxation Aspects of E-commerce: Addressing the Challenges and Opportunities" (September 2001). Available at ><http://www.oecd.org/dataoecd/38/42/2349701.pps#279,1,6thAnnualGlobalForum><, last accessed on 4 June 2007; OECD Committee on Fiscal Affairs "Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5" (22

South Africa should work hand-in-hand with developed and developing nations, in order to come up with a feasible way of taxing e-commerce transactions, so that the tax avoidance loopholes that e-commerce has created in legislation such as the CFC legislation can be curbed.

It should however be acknowledged that e-commerce is growing at a fast rate, and as a result, countries tax bases could be depleted in absence of counteracting measures. Since most of the challenges that e-commerce poses to CFC legislation relate to difficulties of identifying the location of taxpayers and their business transaction, it is recommended that, while awaiting international consensus on how e-commerce should be taxed, South Africa should come up with means of resolving some of these identification problems. Since the Income Tax Act has been amended to provide for electronic record keeping, it is recommended that this Act be further amended to provide that the provisions of the Electronic Communications and Transactions Act be taken into account for detection and identification purposes, so as to ensure tax compliance for taxpayers involved in e-commerce.

4.9 HOW THE COMPLEXITY OF SOUTH AFRICA'S CFC LEGISLATION AFFECTS ITS EFFECTIVENESS

The analysis of South Africa's CFC legislation shows that this legislation is quite difficult to understand, comply with, and administer. However, not much has been written on how the complexities in this legislation can be resolved. A mention of CFC legislation gets most tax practitioners commenting on its complexity and wondering when simplicity in this legislation will happen. The simplicity of taxes is one of principles of a good tax system.³¹⁷ In regard to this principle, Adam Smith noted that³¹⁸

the tax which each individual is bound to pay ought to be certain, and not arbitrary. The

December 2000). Available at ><http://www.oecd.org/dataoecd/46/32/1923380.pdf><, last accessed 26 June 2007.

317 A good tax system should entail the principles such as equity, efficiency, certainty and simplicity. See RM Sommerfeld, SA Madeo, KE Anderson & BR Jackson *Concepts of Taxation* (1993) at 10; WA Raabe & JE Parker *Taxation Concepts for Decision Making* (1985) at 14.

318 A Smith *An Inquiry Into The Nature And Causes Of The Wealth Of Nations* (1976) 350-351, Vol.2 edited by RH Campbell, AS Skinner & WB Todd.

time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor.....

Simplicity of tax is required in three aspects: policy simplicity, form simplicity and action simplicity.³¹⁹ “Policy simplicity” requires simplicity of the type of tax sought to be implemented, and its incidence. “Form simplicity” requires simplicity in the manner in which government policies appear in statute form.³²⁰ This requires that taxpayers, tax advisers and tax administrators understand the intentions of government as expressed in the statute books. “Action simplicity” requires that the actions which are required of taxpayers in complying with a tax statute, and the actions required of the administration in administering the statute, are as simple as possible and do not place excessive burdens upon all parties involved.³²¹

South Africa’s CFC legislation appears to be generally lacking in the three aspects of simplicity described above, that are required for a good tax system. An analysis of South Africa’s CFC legislation shows that the complexities in the legislation derive mainly from the following.

There are difficulties of comprehending the various terms used in the legislation. Some of these terms are ambiguous and they create certain interpretation difficulties.³²² An example is the term “Country of residence”, that was introduced in 2006, under the Revenue Laws Amendment Act 20 of 2006. In terms of the Taxation laws Amendment Act 8 of 2007, “Country of residence in relation to a foreign company means the country whether it has its place of effective management”. Note however that, when this term was introduced in 2006, it referred to the definition of a “country of residence” in relation to a *controlled foreign company*. According to the Explanatory Memorandum to the Revenue Laws Amendment Bill of 2006, it was important to come up with a definition of a “country of residence”, as most of the anti-diversionary rules in the CFC rules

319 PA Harris *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* (1996) at 8.

320 Harris at 8.

321 Harris at 8; Raabe & Parker at 15.

322 Olivier and Honiball at 228; Buys & Cronjé at 314.

depend on whether a CFC operates within that CFC's country of residence. It was explained that potential problems would arise where more than one country has a claim on the tax residence of a CFC and each of the countries has a different meaning for a CFC's country of residence. It was proposed that the definition of "country of residence" should refer to where the CFC is effectively managed as opposed to the country of incorporation, as the effective management test is the one often utilised as a final tie breaker for treaty purposes. The Explanatory Memorandum goes on to provide that as far the meaning of the term "place of effective management", the South African tax law interpretation of the term prevails. Now, this is quite confusing because, as explained in chapter 3, there is no statutory definition of the concept "place of effective management" in the South African Income Tax Act, nor is there any case law that provides guidance on the interpretation of the term. Needless to say, this is bound to cause interpretation problems. Considering that South Africa is bound to take cognisance of the interpretation of this term as used in the OECD Model Convention, which (as explained in chapter 3) is different from SARS's interpretation of the term.³²³

Another complex aspect of the CFC legislation concerns the determination of the net income of a CFC. In calculating the net income of the CFC, the CFC is dealt with as if it is a South African resident.³²⁴ Thus, various sections of the Income Tax Act have got to be taken into consideration when calculating the net income of a CFC. For tax administrators, calculating the net income of a CFC can be quite cumbersome, as one is expected to consider various applicable and non-applicable provisions of the Act. The numerous provisions that have to be referred to, create a large number of boundaries and legal uncertainties. In addition to the above, generally in calculating the net income of a CFC, two sets of books have to be kept, one for the country in which the CFC is a resident and one for South African tax purposes. This obligation places a compliance burden on companies, as a full audit of each company is required. A form will have to be completed and submitted to SARS for each CFC, which is almost as

323 See discussion in chapter 3 par 3.7 under the heading "SARS's Interpretation of "Place of Effective Management".

324 S 9D(2A) of the Income Tax Act.

burdensome as completing a tax return for each respective company. From an administrative point of view, it can be concluded that complying with the requirements of the CFC legislation is a costly exercise.

Apart from the above, another complex issue about calculating of the net income of a CFC is that, the amount is the product of an artificial calculation, and not a proportion of the CFC's actual profits. In essence, the effect of this provision is that on a notional basis, a portion of the net income of the CFC will be deemed to constitute income in the hands of a resident and thus taxed as part of the resident's taxable income. The concept of "notional amounts" is one of the complex, and artificial aspects of this legislation, that is quite difficult to understand and to reconcile with income tax. It is difficult to reconcile the idea that the net income of a CFC is a manufactured or purely notional sum, and yet on the other hand have the same distinctive meaning for South African income tax purposes.

Another difficult aspect of the CFC legislation is that, in terms of section 9D(6), the amount to be included in the income of a resident, must be translated to the currency of the Republic by applying the average exchange rate for that year of assessment as contemplated in section 25D of the Income Tax Act.³²⁵ Proviso (a) to section 9D(6) states that any capital gain or loss of that CFC must, when applying the provisions of paragraph 43(4) of the Eighth Schedule, be determined in the currency of the Republic and that capital gain or loss must be translated to the currency used by it for purposes of its financial reporting by applying the average exchange rate. Proviso (b) to section 9D(6) states that any amount to be taken into account in determining the net income of that CFC for the disposal of any foreign equity instrument must, when applying the provisions of section 9G, be determined in the currency of the Republic and that amount must be translated to the currency so used by it by applying the average exchange rate.

325 In terms of s 1 of the Income Tax Act, "average exchange rate" in relation to a year of assessment means the average determined by using the closing spot rates at the end of

Applying the average exchange rate rules in terms of section 25D, may create some problems of interpretation. Section 25D provides in part that persons other than natural persons (this covers companies) must convert all income and expenditure and losses in foreign currency) to rands by using the spot rate,³²⁶ on the date that the income is received, or accrued or the expenditure or loss is incurred. The section also provides that, income or expenditure of a permanent establishment (of a South African resident) outside the Republic must be determined in the currency used by the permanent establishment (for financial reporting). The rules contained in this section only apply in absence of a specific section containing its own currency rules. In practice, it may be difficult to determine how the provisos to the specific exchange rate provisions in the CFC fit into the general currency conversion provisions in section 25D. Olivier and Honiball³²⁷ note that “many aspects of the tax treatment of amounts incurred and derived in foreign currency as well as foreign exchange gains and losses are shrouded in uncertainty. The impression is often gained that the legislature itself did not have clarity before its thoughts were given legislative effect.”

The exemptions to the CFC legislation are another aspect of this legislation that complicates it further. For example, “foreign business establishment exemption” to the CFC rules is one of the lengthy and complicated parts of the CFC rules. This exemption is rife with various exclusions which are also difficult to interpret and apply. Take, for example, section 9D(9)(b)(iii), that exempts a “foreign financial instrument holding company” from CFC rules. An understanding of this exemption requires one to understand the term “foreign financial instrument holding company”. A reading of this term requires one to have an understanding of the terms “group of companies”, and “controlled group company”, that are referred to in the definition of the first term. It is also necessary to have an understanding of term “financial instrument”, which is defined in section 24J which deals with the taxation of interest. After these terms have been understood, one then has to deal with the exclusions to this exemption which are

daily, weekly or monthly intervals during that year of assessment which must be consistently applied within that year of assessment.

326 In terms of s 1 of the Income Tax Act, the “sport rate” means the appropriate quoted exchange rate at a specific time by an authorised dealer in foreign exchange for the delivery of currency.

quite difficult to understand.

The “foreign business establishment” exemption to the CFC rules is also complicated by the fact that its application brings into play various other sections of the Income Tax Act. A clear understanding of their applicability is necessary in order to interpret how they fit into section 9D. Of particular importance are the transfer pricing provisions in section 31(2) of the Act, that are necessary in order to prevent diversionary transactions between a CFC and a connected person. Now, “transfer pricing” provisions and the rules the Commissioner uses to adjust an amount in order to arrive at an arm’s length price are another contentious and rather complicated provision of the Income Tax Act, for which SARS had to come up with an Interpretation Note.³²⁸ The inter-play between section 31(2) and the CFC provisions can be quite difficult in practice. The costs of complying with this exemption are likely to be very high.

In general, the complexities of the “foreign business establishment” exemption to the CFC rules derive from both provisions that favour taxpayers and those that are designed to restrict tax benefits. Where the exemption appears to favour taxpayers involved in a particular category of income, an additional rule is set up to police the boundaries of the favoured category of income. The number and scope of these “preferential” rules makes this exemption difficult to understand.

The elections in the CFC rules are another aspect of the CFC legislation that makes these rules complicated. A South African shareholder who together with connected persons holds 10% to 25% of the participation rights or voting rights in a CFC can elect to treat all his pro rata share of CFC income as taxable under section 9D, even if he would have been granted an exemption under section 9D(9). Alternatively, under section 9D(13), any resident who, together with connected persons, holds 10% up to 25% of the participation rights or voting rights of a foreign company may elect that this foreign company be deemed to be a CFC in relation to him for any of its foreign tax years. These elections complicate the CFC rules because they bring into play the applicability of section

327 Olivier & Honiball at 228.

6quat of the Income Tax Act, which allows a rebate against South African tax, any foreign tax in respect of foreign income included in South African taxable income. Section 6quat has got its own rules of applicability. These rules describe the type of income that will give rise to a rebate (section 6quat (1), how the rebate is determined (section 6quat (1A), and also certain limitations as to how much of the rebate can be granted (section 6quat (1B)). It is necessary for a taxpayer to understand the ambit of these rules in order to determine how they will be applied in relation to the CFC rules. For instance, the CFC rules specify that no excess rebates in terms of section 6quat (1B) can be granted where an election is made in terms of section 9D. It can thus be said that, although the elections are potentially advantageous to taxpayers, they also increase the complexity of the CFC legislation.

It is worth noting that internationally, CFC legislation has been introduced by countries with more advanced tax systems, like the United Kingdom and the United States of America.³²⁹ South Africa is the only Southern African Development Community state and also the only African country which has to date introduced CFC legislation.³³⁰ CFC legislation was introduced in South Africa in 1997, under the then sections 9C and 9D (now deleted as discussed above). This was long before the introduction of the “residence-based taxation” system in 2001. Since it was only after the democratic elections of 1994 that South Africa returned to the international arena the introduction of CFC legislation in 1997 was rather too soon. When South Africa was barred from international affairs, her international trade dwindled. As a result, South Africa’s international tax principles had not developed to the same extent as those of its trading partners.³³¹ Expatriates from abroad had to be called in to draft this legislation. Thus the legislation was largely tailored around the way it worked in these developed countries, and possibility minimal consideration was given to the conditions prevailing in South Africa. For instance, the initial sections 9C and 9D

328 SARS Interpretation Note No. 7.
329 Olivier & Honiball at 359.
330 Olivier & Honiball at 359.
331 Katz Commission Report (1997) at 4.

were designed to curb deferral of taxes only in respect to investment income.³³² The provisions were found to cover too wide a scope, they were poorly drafted,³³³ and open to many tax planning schemes.³³⁴ This required complex amendments to the rules to cover the loopholes. However, it appears that most of the amendments that are adopted since then, are versions imported from various developed countries in an endeavour to find what will work well for South Africa. The legislators have also acknowledged that “since the introduction of the CFC regime in 1997, a number of adjustments have taken place to account for practical realities. However, it appears that some anomalies remain”.³³⁵ For example, there have been various amendments to certain concepts used in the rules; new concepts have been introduced, some of which are then later deleted only to be reintroduced into the legislation. This is the case with the concept of “voting rights” which was re-introduced by the Revenue Laws Amendment 31 of 2005, as was the case in 2002. The exclusions to the CFC legislation have also seen some changes. Previously, one of the exclusions to the CFC rules related to receipts and accruals (other than those of a capital nature) from a “designated country”. This exclusion was deleted by Revenue Laws Amendment Act 45 of 2003 with effect from 1 June 2004. In almost all the Revenue laws Amendment Acts that have been enacted since the inception of this legislation, there is an amendment to section 9D. The lack of reasonable stability in this legislation is one of the factors that make taxpayers and practitioners alike, unsure about the scope of this legislation. As they get acquainted with the working of a current provision, a new complicated provision is introduced.

This work does not favour over-emphasising simplicity in the design of the CFC legislation. Although CFC rules should be drafted simply, this may not always be adequate to address complex situations, as simple rules might undermine administratability. Simplicity should not be an end in itself and it should not come

332 The provisions appear to have been a replica of how the United States Subpart F regime works (for the discussion of the United States Subpart F rules, see chapter 5).
 333 Editorial “Taxation Laws Amendment Act of 2000” (2000) 49 *The Taxpayer* at 181.
 334 Maren at 28.
 335 Explanatory Memorandum to the Revenue Laws Amendment Bill of 2006 at 52.

at an unacceptable cost in relation to other policy objectives.³³⁶ A balance must be struck. Care should be taken to note that simplicity is not easily taken advantage of by sophisticated taxpayers. Indeed, one of the reasons for the complexity of CFC legislation is because of the ingenuity of taxpayers and their advisers, who always find ways of circumventing these provisions so as to avoid taxes. The complexity of the legislation is thus necessary to achieve favourable results in the case of sophisticated planning.³³⁷ However, although the weight of the technical complexity and the administrative burden of CFC rules fall primarily, on the largest and most sophisticated taxpayers in the country, the costs of compliance may be a substantial deterrent to the international operations of smaller corporations.³³⁸ Generally, simpler tax rules facilitate taxpayer's compliance. The more complicated a tax legislation is, the more time consuming the process of attempting to comply with it.³³⁹ Complex rules may also create traps for the unwary taxpayers, and penalise poorly advised taxpayers.³⁴⁰ To the extent that a tax system avoids penalising poorly advised taxpayers or rewarding those who engage in sophisticated tax planning techniques, the overall tax burden is apportioned more fairly among taxpayers.

The complexity of CFC legislation has also turned out as a night mare for tax administrators, who continuously find it harder to trap the well advised taxpayers who have a foot ahead of them. The OECD has also noted that, CFC legislation imposes considerable costs on tax administration.³⁴¹ It has to be acknowledged that although the costs of raising revenue for government services are productive expenditures, these costs, both direct and indirect by reason of the distortion of taxpayer behaviour, become unproductive when they are disproportional to the benefit achieved. Thus in designing CFC rules, not only tax revenue but also compliance costs should be considered. The compliance costs that flow from over complicated legislation should be weighed up against the revenue derived

336 Report of the Task Force "International Tax Reform" 59 *Tax Lawyer* (2006) at 662. Also available at ><http://www.abanet.org/tax/pubs/taskforceintltaxreform.pdf><, last accessed 15 September 2006.

337 Report of the Task Force on International Tax Reform at 663.

338 OECD 2000 Report on CFC Legislation at 94.

339 Payne *et al* at 168; Ernst & Young *Business Day* Issue No. 1755 of 31 January 2007.

340 Report of the Task Force on International Tax Reform at 662.

341 OECD 2000 Report on CFC legislation at 94.

from taxing foreign entities.³⁴² In attempting to counter the avoidance or deferral of taxes, South Africa needs to strike a balance. Although on one hand it has to protect its tax base against erosion, on the other hand, it is important not to overlook the fact that complicated tax laws may make it difficult for taxpayers to compete internationally, and this may encourage them to give up their residence status, in favour of residence in a jurisdiction with more favourable tax rules.³⁴³ The challenge for South Africa is to come up with a CFC regime that does not stifle foreign investment.

Needless to say, the complexity of this legislation creates numerous anomalies and tax ambiguities that SARS needs to resolve.³⁴⁴ It is recommended that SARS issues an Interpretation Note on section 9D. Although the National Treasury has issued a detailed explanation of the section, it is unclear to what extent, if any, SARS considers itself bound by this explanation.³⁴⁵

4.10 CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN OFFSHORE HYBRID ENTITIES

The term “hybrid entity” generally refers to a legal relationship that is treated as a corporation in one jurisdiction and as a transparent (non-taxable) entity in another.³⁴⁶ However, the term “hybrid entity” should not be confused with the term “hybrid instrument”, which refers to a situation where a financial instrument may be treated as debt instrument in one country but as a preferred share in another.³⁴⁷ Although hybrid instruments are also widely used for tax planning,³⁴⁸ for purposes of this work, only hybrid entities are discussed. It should be noted that hybrid entities can be located in a high tax or in a tax-haven jurisdiction.³⁴⁹

342 Olivier & Honiball at 358.

343 Olivier & Honiball at 359.

344 Buys & Cronjé at 314.

345 Oliver & Honiball at 228.

346 BJ Arnold & MJ McIntyre *International Tax Premier 2* ed (2002) at 144; Olivier & Honiball at 464-465.

347 See Arnold & Mclyntre at 144.

348 See Arnold & Mclyntre at 144.

349 Olivier & Honiball at 465.

Discussing the taxation of hybrid entities, Essers and Meussen³⁵⁰ note that “the taxation of hybrid entities in cross-border transactions has proved to be exceptionally complicated and is perhaps one of the most difficult issues in the application of rules on international tax law”. Whether or not a particular entity is a hybrid entity depends on the domestic laws of the countries involved that classify the entities for tax purposes.³⁵¹ The difficulties of dealing with hybrid entities arise from the fact that different countries may classify an entity differently in their domestic law.³⁵²

The classification of an entity for income tax purposes is need by the source state in which another state’s entity is doing business in order to determine whether to tax the entity or its members, the rate of tax and the taxable income. Classification is required by the residence state of the participators in an entity formed in another state so as determine the nature of the taxable income, the timing of taxation, and whether a foreign tax credit is available on the distributed income.³⁵³ In the context of a tax treaty, the classification of an entity is important to determine whether the entity is a resident of the other contracting state. This is necessary for instance to ensure that the treaty rates of withholding tax on dividends, interest and royalties apply.³⁵⁴

Generally, states have rules for classifying entities in the body of their general law. Thus classification problems do not often arise internally. Dealings with other states’ entities have to be fitted into the internal law classifications. Often this is done by examining the characteristics of the entity under the general law governing them, and determining the closest equivalent internal law.³⁵⁵ However, this approach fails to deal with the fact that the other states’ entities may be inherently different from one’s own. Hybrid entities usually take the form of trusts

350 P Essers & GTK Meussen “Taxation of Partnerships/Hybrid Entities” in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives* (2004) 415.

351 See Arnold & Mclyntre at 144.

352 Arnold & Mclyntre at 144.

353 A Jones “Characterisation of other States’ Partnerships” (2000) 56 *Bulletin for International Fiscal Documentation* at 288.

354 Jones at 288.

or partnership structures³⁵⁶ In this thesis, only partnership structures are dealt with.

Partnership/corporate hybrid entities

Most countries recognise the concept of “company” and of “partnerships” for tax purposes, although the definitions of these two concepts may vary. There are however, there are certain entities that may not be uniformly classified in one of these categories. For example, one country may treat the entity as a partnership or “pass-through”³⁵⁷ entity, while the other country may treat the entity as a company.³⁵⁸ The differences in classification may lead to completely different tax results in the countries involved. In countries where an entity is classified as a partnership, it is treated as transparent for tax purposes (not taxable).³⁵⁹ In the countries where the entity is classified as a company, it is normally treated as

355 FA Engelen & FPG Potgens “Report on ‘The Application of The OECD Model Tax Convention to Partnerships’ and the Interpretation of Tax Treaties” (2000) 4 *European Taxation* at 250; Jones at 288; Essers & Meussen at 415.

356 See Arnold & Mclyntre at 144 for other examples of hybrid entities. For instance, they explain that under the laws of France a *société en nom collectif* (SNC) has separate legal personality although the partners are jointly and severally liable for its debts. However, under French tax laws, a SNC can elect to be taxed as a corporation. If another country treats the French SNC as a partnership, then residents of that country with interests in the SNC would be treated as partners. Thus, if a French SNC borrows funds for use in its business, the interest will be deductible in computing the SNC’s income. If the owners of the SNC are residents of a country that treats the SNC as transparent, the interest deduction will also be avoidable to those owners in their country of residence. In effect, the SNC can be used to obtain an interest deduction in both countries, thereby reducing the after-tax cost of financing significantly. This type of planning is an example of a double-dip financing structure through the use of a hybrid entity. The other example of a hybrid entity that Arnold & Mclyntre point out is the “silent partnerships” that are recognised in some jurisdictions like German. For details on “silent partnerships” see the discussion of the *Memec Plc v IRC* [1998] STC 754 in chapter 5 par 5.1.11.

357 H J Ault & B J Arnold *Comparative Income Taxation: A Structural Analysis* 2ed (2004) at 336.

358 P Lassard, C Kyres & C Gagnon “Treaty Benefit Entitlements of Trusts, Partnerships and Hybrid Entities” (1997) 49 *Tax Conference Report of the Canadian Tax Foundation*, Chapter 33; R Tremblay & K Wharram “Partnerships, Trusts, and Other Entities: Treaty Benefits” in B Arnold & J Sasseville *Special Seminar on Canadian Tax Treaties: Policy and Practice* (2000) chapter 11; A Eason “Entity Entitlement to Treaty Benefits: A Conceptual Approach to Some Practical Problems” in B Arnold & J Sasseville *Special Seminar on Canadian Tax Treaties: Policy and Practice* (2000) chapter 12; R Critchfield, N Honson & M Mendelowitz “Pass-through Entities, Income Tax Treaties and Treaty Overrides” (1999) *Tax Notes International* at 587; Essers & Meussen at 416; Jones at 289.

359 Par 3 of the Commentary on art 1 of the OECD Model Convention. See also Arnold & Mclyntre at 144.

non-transparent for tax purposes (taxable).³⁶⁰ There is no uniform global treatment of foreign partnerships for tax purposes.³⁶¹

At the 1995 Congress of the International Fiscal Association, it was noted that “there are almost no laws, rulings or authoritative statements on most of the issues concerning the taxation of partnerships”.³⁶² It is submitted that this statement remains largely true even today. Although in 1999 the OECD issued a Report on Partnerships,³⁶³ problems still arise if a partnership is situated in one state (the source state), while the partners are resident in another state (residence state). The reason is that in certain circumstances, the legal status of the partnership may be alien to the residence state.³⁶⁴ Since domestic laws differ in the treatment of partnerships, this creates difficulties when applying tax treaties to partnerships.³⁶⁵ These difficulties are analysed below.

Are partnerships entitled to treaty benefits?

Article 1 of the OECD Model Convention provides that “[t]his Convention shall apply to persons who are resident of one or both of the contracting states”. Thus, only persons who are residents of the contracting states are entitled to the benefits of the treaty. With respect to partnerships, the following questions arise from this article:

- (a) Is a partnership a “person” for treaty purposes?
- (b) Is a partnership a “resident” of a contracting state?

In terms of article 3(1)(a) of the OECD Model Convention, the term “person” is said to include an individual, a company, and any other body of persons. In paragraph 2 of the OECD Commentary on article 3(1)(a), it is stated that, “this definition is not exhaustive and it should be used in a very wide sense”. Thus, a

360 Par 3 of the Commentary on art 1 of the OECD Model Convention. See also Arnold & McLyntre at 144; F Engelen “International Double Taxation Resulting from Differences in Entity Characterization: A Dutch Perspective” (1998) *Intertax* 38.

361 Essers & Meussen at 415.

362 I Otsuka “International Income Tax Problems of Partnerships” (1995) LXXXa *Cahiers de Droit Fiscal International* at 332; see also Y Masui “Taxation of Partnerships in Japan” 54 (2000) *Bulletin for International Fiscal Documentation* at 150.

363 OECD *The Application of the OECD Model Tax Convention to Partnerships* (1999). (“OECD Report of Partnerships”).

364 Essers & Meussen at 415.

partnership (being an association of persons for the purpose of sharing benefits from a joint undertaking) can be designated as a body of persons.³⁶⁶ The term “body of persons” can be interpreted as meaning a unified group or association of individuals and/or bodies corporate.³⁶⁷ In the United Kingdom case *Padmore v Inland Revenue*,³⁶⁸ the High Court held that the term “body of persons” includes a partnership, because a partnership is a body of persons within the ordinary meaning of the expression.

The definition of the word “company” in article 3(1)(b) of the OECD Model Convention also has certain implications for partnerships. In terms of this article, the term “company” is defined as any body corporate or any entity that is treated as a body corporate for tax purposes. Paragraph 2 of the commentary on article 1 provides that “partnerships will also be considered to be “persons” either because they fall within the definition of “company”, or because they constitute other bodies of persons.” However, paragraph 3 of the commentary on article 3 states that the term “company”, in addition, “covers any other taxable unit that is treated as a body corporate according to the tax laws of the contracting state in which it is organized”. The definition of the term “company” in article 3(1)(b) and the commentary on this article in paragraph 3 appear to be ambiguous. On the one hand, any legal entity appears to be a company, whether or not the legal

365 Par 2 of the Commentary on art 1 of the OECD Model Convention.

366 J Schaffner “The OECD Report on the Application of Tax Treaties to Partnerships” (2001) *Bulletin for International Fiscal Documentation* 220; M Clayson “OECD Partnerships Report: Reshaping Treaty Interpretation?” (2000) *British Tax Review* 75; D Tillinghast “Tax Treaty Issues” (1996) 50 *University of Miami Law Review* 483 at 468; See also R Loengard “Tax Treaties, Partnerships and Partners: Exploration of a Relationship” (1975) 29 *Tax Lawyer* 36. P Baker “The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities”. Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.

367 AHM Daniels *Issues in International Partnership Taxation* (1991) at 141.

368 1987 STC 36. See also Swiss decision of the Conseil d’Etat in SA Quartz d’Alsace Decision of 6th May 1996, No 154 217, reported at RJF 6/96 No 731, Droit Fiscal 1996 No 30 comm.988. The case concerned a Swiss partnership – originally formed as a société en commandite, but later becoming a société en nom collectif, which owned 54% of a French company. Under Swiss law the partnership had no legal personality. The Swiss partnership sought repayment of the avoir fiscal on dividends under article 11(3) of the France-Switzerland Convention of 9th September 1966. This paragraph extended the avoir fiscal to physical persons and to companies (sociétés) owning less than 20% of French companies. The Conseil d’Etat held that the Swiss partnership was a person within the terms of the Convention since it constituted a body of persons. However, it was not a physical person for the purposes of article 11(3) and could not benefit from the repayment of the avoir fiscal.

entity is a taxable unit. On the other hand, the reference in the commentary to “any other taxable unit” indicates that a body corporate can only be classified as a company when it is treated as a taxable unit. From the foregoing, it can be concluded that a literal reading of the term “company” implies that any body corporate is a company. However, according to an interpretation based on paragraph 3 of the commentary on article 3, a partnership would only be a company for treaty purposes if it is treated as a taxable unit “according to the tax laws of the contracting state in which it is organised”.³⁶⁹

In a treaty context, an entity will only be liable to tax if it is a “resident” of one of the contracting states. Article 4(1) provides that the term “resident of a contracting state” means any person who, under the law of that state, is liable for tax therein by reason of his domicile, residence, place of effective management, or any other criterion of a similar nature.

From the foregoing, it can be concluded that although the inclusion of a partnership as a “body of persons” makes it a “person” for treaty purposes,³⁷⁰ this inclusion does not necessarily make a partnership a “resident of a contracting state”, though it may be an “enterprise” of a contracting state if it is carried on by residents of that state.³⁷¹ A partnership can only be considered a resident of a contracting state if it is liable to tax therein.³⁷² Generally speaking, a partnership is liable to tax in a contracting state if it is treated as a legal person (a company), that is a resident of that state. In that respect, it is entitled to treaty benefits in terms of article 4(1) of the OECD Model Convention. However, when a partnership is treated as fiscally transparent in a state, it is not “liable to tax” in

369 Par 4 of the Commentary on art 1 of the OECD Model Convention. See also Daniels at 141.

370 A Easson “Taxation of Partnerships in Canada” (2000) 54 *Bulletin for International Fiscal Documentation* at 169.

371 Easson at 169.

372 In this respect, the French Supreme Court (*Conseil d'État*) in a decision of 13 October 1999, SA *Diebold Courtage*, ruled that a Netherlands closed limited partnership (*besloten commanditaire vennootschap*) because of its fiscal transparency and its lack of legal personality, could not be considered a resident within the meaning of article 4 of the tax treaty between France and Netherlands. The Supreme Court however held that the limited partners were residents of the Netherlands within the meaning of the tax treaty and were therefore entitled to the treaty benefits. For details on the discussion of this case see Engelen & Potgens at 251.

that state within the meaning of article 4(1) and so it cannot be a resident thereof for purposes of the Convention. In such a case, the provisions of the treaty cannot apply to the partnership unless a special rule covering partnerships is provided for in the particular treaty.³⁷³ It should be noted that the phrase “liable to tax” does not mean that the person must be actually paying tax in the state; entities which enjoy a complete exemption from tax are still residents of a state so long as that state could assert jurisdiction to tax the entity.³⁷⁴

However, that does not mean that the actual tax treatment in the state of residence is completely irrelevant. On the contrary, claiming treaty benefits in the state of residence requires being treated as a taxable entity there. Therefore, one has to distinguish between the tax treaty treatment in the state of residence and in the state of source. Claiming treaty benefits in the state of source, such as applying a withholding tax reduction there, requires treatment as a taxable entity there. Claiming treaty benefits in the state of residence, such as exempting foreign income or crediting foreign taxes, requires treatment as a taxable entity in that state.³⁷⁵

The OECD³⁷⁶ has however admitted that it is not that simple to qualify a partnership as transparent or non transparent. There is a range of different tax treatments applicable to partnerships. In a number of jurisdictions, partnerships are not treated in the same way as taxable entities, but on the other hand are not completely treated as transparent.³⁷⁷

The taxation of partners in a treaty context

As stated above, the domestic laws differ in the treatment of partnerships.

373 M Lang *The Application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the OECD Report Prepared by the OECD Committee on Fiscal Affairs* (2000) at 35.

374 K Vodel *Vogel on Double Taxation Convention* (1997); Lang at 38; Baker “The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities”. Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.

375 Lang at 38-39.

376 OECD Report on Partnerships in par 70. See also Lang at 37.

377 Lang at 38.

Although some states treat partnerships as legal entities that are liable to tax, other states treat partnerships as fiscally transparent (not liable to tax) and thus not entitled to treaty benefits within the meaning of article 4(1) of the OECD Model Convention. In that case, the partners are entitled to the treaty benefits to the extent that the partnership's income is allocated to them for the purposes of taxation in their state of residence.³⁷⁸ Where a partnership is treated as resident of a contracting state, the provisions of the treaty that restrict the other contracting state's right to tax the partnership on its income do not apply to restrict that other state's right to tax the partners who are its own residents on their share of the income of the partnership.³⁷⁹

When taxing a partner's share of the partnership's profits, article 7 of the OECD Model Convention is applicable. This article provides that the profits of an enterprise of a contracting state are taxable only in that contracting state, unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. An enterprise of a contracting state is defined in article 3(1)(d) as an enterprise carried on by a resident of a contracting state. Since the partnership itself is not considered a resident, each participant in the enterprise is considered as a separate enterprise. In terms of article 3(1)(c), an enterprise "refers to the carrying on of a business"; thus each partner in a partnership is considered as carrying on the business of the partnership. The imputation of the partnership's business to the partnership implies the imputation of the permanent establishment of the partnership to the partners.³⁸⁰

378 Par 5 of the Commentary on art 1 of the OECD Model Convention; see also Engelen & Potgens at 251.

379 Par 6.1 of the Commentary on art 1 of the OECD Model Convention.

380 Daniels at 145. See also the Dutch decision of the Hoge Raad of 10th March 1993, BNB 1993/227. This case concerned a partnership - *commanditaire vennootschap* (CV) – formed between a Swedish company and two Dutch companies. The Swedish company was a limited or silent partner; one of the Dutch companies was the general partner. The CV was a closed CV which is treated as fully transparent under Dutch fiscal law; the general and limited partners are taxed directly on their share of the profits. The Swedish company argued that its share of the income was exempt from tax in the Netherlands under the business profits article of the Netherlands-Sweden double taxation convention of 12th March 1968. The Hoge Raad noted that the Swedish company held its participation in the CV as part of its worldwide business, and concluded that the income was derived through a permanent establishment in the Netherlands: the income was not, therefore, exempt under the convention. For a commentary on this S van Weeghel "Recent Case Law" (1994) *Bulletin for International Fiscal Documentation* 637-644.

Despite the above, the tax treatment of partnerships (as corporate structures) and the taxation of partners creates the possibility of tax avoidance, double taxation and non-taxation of income.

The possibility of avoiding “controlled foreign company” legislation

Arnold and Mclntyre³⁸¹ explain that where one country classifies an entity as a partnership for tax purposes (with the result the members or partners are taxable on their share of the entity’s income) and yet another classifies the entity as a legal person (with the result that the entity itself is subject to tax on its income), the different treatment of the entity in the two countries creates many tax planning opportunities.³⁸² Taxes can be avoided by exploiting the differences between the tax treatment of taxpayers or transactions in the two countries.³⁸³

When an entity is classified as a corporation, the taxation of income may be deferred if the company does not distribute dividends to its shareholders. The deferral of taxes occurs when a country has controlled foreign company (CFC) legislation. Where the foreign entity is classified as a partnership, CFC legislation may not be applied to the entity. Instead, the partners are taxed on their share of the profits of the partnership.³⁸⁴ The different tax treatment of the entities in the relevant countries can be manipulated to avoid taxes.

The differences with respect to the entitlement to treaty benefits may also be manipulated to avoid taxes

Where the entitlement to treaty benefits is different for the partnership and for the partners, this can be manipulated to avoid taxes. Davis³⁸⁵ gives the following example: EP is a partnership organised under the laws of state E. EP is treated as a taxable corporation under the laws of state E. EP carries on a business and

381 See Arnold & Mclntyre at 144.

382 Arnold & Mclntyre at 144.

383 See R Edmonds, International Tax Planning Association “Limited Partnerships”. Available at <http://www.itpa.org/open/summaries/cannes2003s.html> last accessed on 20 March 2007.

384 Daniels at 50.

385 Daniels at 50.

receives income sourced from state S. Under the classification rules of state S, EP is classified as a transparent partnership, with the result that state S regards the partners of EP as taxpayers. In terms of the treaty between state S and state E, EP is considered a resident of state E. Consequently, EP will be entitled to the benefits of the tax treaty for its income from state S. For instance, interest arising in state S and paid to EP would be subject to the reduced 10% of withholding tax under article 11(2), provided EP is the beneficial owner of the interest and the interest is not effectively connected with a permanent establishment of EP in state S. The perspective of state S under its domestic tax laws will, however, be completely different. Under the income attribution rules of state S, the business profits are attributed to the partners of EP and not to EP itself. Likewise, interest income arising in state S will be attributed to the partners of EP. The differences in the treaty benefits in the above scenarios can be manipulated to avoid taxes.

Clarifying on how tax avoidance could arise in these circumstances, the Commentary on article 1 also points out that where the state of source treats a partnership as fiscally transparent, a partner that is resident in a state that treats the partnership as a company would not be able to claim the benefits of the treaty between the two states with respect to his share of the partnership's income that the state of source taxes in his hands. Although this income is allocated to the person claiming the benefits of the treaty under the laws of the source state, that income is not similarly allocated for purposes of determining the liability to tax on that item of income in the state of residence of that person.³⁸⁶ The differences in the way the income is allocated may be manipulated to avoid taxes.

These are also differences in the entitlement to treaty benefits where partnership cases involve three states. These differences can also be manipulated to avoid taxes. This often happens where a partner is a resident of one state, the partnership is established in another state and the partners share in partnership income arising in a third state. In such cases, the Commentary on article 1 of the OECD Model Convention provides that a partner may claim the benefits of the

386 Par 6.2 of the Commentary on art 1 of the OECD Model Convention.

treaty between his state of residence and the state of source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his state of residence. If the partnership is taxed as a resident of the state in which it is established, then the partnership may also claim the benefits of the treaty between the state in which it is established and the state of source. In such a case of "double benefits", it is possible to take advantage of the different tax rates provided in the two treaties to avoid taxes.³⁸⁷

The possibility of double taxation of income

Classification conflicts can also result in the double taxation of income. When partners reside in a different state from that in which the partnership has been established, partners may face being liable for tax both in the residence state and in the source state.³⁸⁸ Take the example above where EP set up in state E and it is recognised as a company, whereas in state S, it is recognized as a partnership. Since the taxation of business profits is governed by article 7, from the perspective of state S, business profits may be taxed by state S to the extent that they can be attributed to a permanent establishment of the participators in state S. According to article 23, state E will provide double taxation relief to the entity for the income which, under article 7, may be taxed by S. Where there is a permanent establishment in state S, and state E does not provide for double taxation relief at the level of EP, the participants in the entity in state S could be subjected to double taxation because the income of EP would not be subject to tax in state S in the hands of the entity itself, but instead in the hands of the participators.³⁸⁹

387 Par 6.5 of the Commentary on art 1 of the OECD Model Convention.

388 Essers & Meussen at 416.

389 Daniels at 155. An example of a case where the possibility of double taxation arose is the Dutch decision of the Hoge Raad of 23rd March 1994 BNB 1994/192; (1994) VN 1442. The case concerned a Belgian resident individual who was a limited partner in a Dutch closed partnership –commanditaire vennootschap. The Belgian resident was entitled to a share of the profits and to interest on his capital and current accounts; he contended these were exempt from tax in the Netherlands. The Belgian-Netherlands double taxation convention of 19th October 1970 contained an express provision stating that limited partnerships formed under Netherlands law, whose place of management is in the Netherlands, are regarded as residents of the Netherlands. Reasoning from this, the Hoge Raad concluded that the Netherlands could tax the profit share and interest on the capital of the silent partner since these were profits of an enterprise carried on by a

The possibility of non-taxation of income

Classification conflicts can also result in the non-taxation of income.³⁹⁰ From the above example, non-taxation of income could for instance arise if state E applies the exemption method to provide for double taxation relief.³⁹¹ Under this method, the country of residence taxes its residents on their domestic source income and exempts them from domestic tax on their foreign source income. In effect the jurisdiction to tax rests exclusively with the country of source.³⁹² If EP carries on a business in state S through a permanent establishment, the profits allocatable to such permanent establishment may be taxed in state S and state E will provide double taxation relief. If EP for instance, finances the business carried on in its S permanent establishment, with loans taken from the participators, it is likely that state S will allow the interest expense as a deduction in computing the profits allocatable to S permanent establishment. From the perspective of state E, the interest income of the E resident participators could, however, be treated as interest income effectively connected with the S permanent establishment. Consequently, while interest would not be subject to taxation in state S, it could still be exempt from taxation in the hands of the E resident participators.³⁹³

To resolve problems of double non-taxation of income, the OECD Partnership Report³⁹⁴ suggested that a provision be added to article 23A of the OECD Model Tax Convention to read as follows:

The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a contracting state where the other contracting state applies the provisions of the convention to exempt such income or capital from tax applies the provision of paragraph 2 of article 10 or 11 to such income.³⁹⁵

Solutions to resolve some of the classification problems

390 Netherlands resident.
 390 Engelen & Potgens at 252.
 391 See article 23A of the OECD Model Convention.
 392 Arnold & McIntyre at 33.
 393 Daniels at 156.
 394 Par 113 of the OECD Partnership Report.
 395 This provision now appears in article 23A(4) of the OECD Model Convention.

Commentators³⁹⁶ on this topic have pointed out three possible solutions to reduce the problems of classifying entities. First, the partner's residence state should follow the partnership state's tax classification.³⁹⁷ This implies that the partner's residence state should accept to treat the partnership the way it is treated in the state in which it is resident. It is reasoned that if this suggestion is followed, no significant difficulties arise in applying the treaty.³⁹⁸ Furthermore, that CFC rules would prevent tax avoidance, if the choice to be treated as non-transparent would lead to no or a nominal corporate income tax.³⁹⁹ Following this approach is in line with the 1999 OECD Report on Partnerships, which states that in case of classification conflicts (due to differences in the domestic law between the state of source and the state of residence), the classification under the law of the source state should be binding upon the residence state.⁴⁰⁰ This solution appears to be based on the wording of article 23 of the OECD Model Convention which requires that where an item of income may be taxed, "in accordance with the provisions of the convention", the state of residence has the treaty obligation to relieve double taxation either through the exemption or credit methods.⁴⁰¹ The OECD Report states that the meaning of the phrase "in accordance with the provisions of this convention" implies that

[w]here due to differences in the domestic law between the state of source and the state of residence, the former applies, with respect to a particular item of income, provisions of the convention that are different from those that the state of residence would have applied to the same item of income, the income is still being taxed in accordance with the provisions of the convention, in this case as interpreted by the state of source. In such a case, therefore, article 23 requires that relief from double taxation be granted by the state of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.⁴⁰²

Engelen and Potgens⁴⁰³ are however of the view that the effectiveness of this approach can only be achieved if a specific provision to that effect is included in

396 Jones at 288; Engelen & Potgens at 253; Daniels at 169.

397 Daniels at 169; Engelen & Potgens at 253.

398 Daniels at 169.

399 Jones at 314.

400 OECD Partnership Report in par 105; see also par 32.2 of the Commentary on article 23 of the OECD Model Tax Convention.

401 Lang at 40. Under the exemption method, the country of residence taxes its residents on their domestic-source income and exempts them from domestic tax on their foreign-source income. In effect the jurisdiction to tax rests exclusively with the country of source. Under the credit method, foreign taxes paid by a resident taxpayer on foreign-source income generally reduce domestic taxes payable by the amount of the foreign tax. See Arnold & McIntyre at 33 and at 36.

402 OECD Partnership Report in par 105.

a tax treaty. The Netherlands also subscribes to this view. Its Observation to the OECD Report on Partnerships in respect to this solution is that it can only be applicable to the extent that it is explicitly stated in a specific tax treaty.⁴⁰⁴

The second solution that some commentators suggest is to rely on the tax treaty to provide for the classification of the partnership.⁴⁰⁵ This suggestion would however require amending the OECD Model Tax Convention in order to make a clear distinction between companies (non-transparent) and partnerships (transparent). It is argued that this approach may not be feasible, as treaty classification needs to be sufficiently flexible towards changes in national tax laws.⁴⁰⁶

The third solution is the acceptance of the source state's classification, but also to include in the treaty specific provisions that require the source state to follow the classification of the partner's residence state.⁴⁰⁷ This is in line with paragraphs 6.3 and 6.4 of the Commentary on article 1 of the OECD Model Tax Convention, which provides that regardless of the source state's internal law classification, the source states should apply the classification of the partner's residence state if that state treats the partnership as transparent.⁴⁰⁸

Of the three solutions mentioned above, the first one appears to be the most feasible in resolving partnership classification problems. Under this approach, the country where the partnership is situated is determinative.⁴⁰⁹ In support of this approach, Essers & Meussen⁴¹⁰ state that the country where the partnership is situated has the strongest position in determining the tax position of the partnership. Although part of the tax authority of the country of residence of the partners would be removed (since it has to follow the classification of the state of

403 Engelen & Potgens at 252.

404 See Engelen & Potgens at 252.

405 Jones at 316.

406 Essers & Meussen at 424.

407 Jones at 316.

408 According to the Netherlands, this solution is only applicable to the extent that it has been explicitly laid down in a specific tax treaty provision or in an internal rule of policy. If this is not the case, then reliance has to be placed on the mutual agreement procedure.

409 Essers & Meussen at 425.

410 Essers & Meussen at 425.

residence of the partnership), this may be appropriate in light of the goal of preventing double taxation or double non-taxation of income.⁴¹¹

Curbing tax avoidance that results from investing in partnership/corporate hybrid entities: South Africa

Generally, the foreign structures in which South African residents invest are largely driven by commercial considerations, or by the tax interests of non-resident foreign investors (for example in the case of a minority stake in a joint venture). South African taxpayers often have little choice as to the legal form of the entity in which they invest.⁴¹² Many jurisdictions, especially tax havens, have legislation which provides for flexible corporate structures, for example structures which combine a partnership with corporate characteristics which may not be fiscally transparent.⁴¹³

In South African law, a partnership is not a legal person distinct from the individual partners who comprise the partnership.⁴¹⁴ A partnership is also not a taxable person for the purposes of the Income Tax Act.⁴¹⁵ The general rule regarding the taxation of partnerships (whether local or foreign) is that where a South African resident has an interest in a tax-transparent foreign partnership, he or she is taxed in South Africa on his or her share of the partnership income. Section 24H(5) of the Income Tax Act provides that the income of the partnership is taxed in the hands of the individual partners at the time it accrues to or is received by the partnership. In terms of section 66(15) of the Income Tax Act, each partner is separately and individually liable for rendering the joint return. In terms of section 77(7), the partners are liable to tax in their separate individual capacities, and separate assessments are made upon each partner.

Classification of partnership/corporate hybrid entities in the Income Tax

411 Essers & Meussen at 425.

412 Olivier & Honiball at 464-465.

413 J Freedman "Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?" in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives* (2004) at 293.

414 *R v Levy* 1929 AD 312; *Muller en Andere v Pienaar* 1968 (3) SA 195 (A).

415 Meyerowitz in par 16.61.

Act: Anomalies created by the definition of “company”

The definition of the word “company” in section 1 of the Income Tax Act causes certain anomalies with respect to the taxation of foreign incorporated partnerships. This definition covers both companies incorporated in South Africa and those incorporated outside South Africa. In terms of section 1(b) of the Income Tax Act, a company is defined to include “any association, corporation or company incorporated under the law of any country other than the Republic, or any body corporate formed or established under such law”. From the wording of this definition, it appears that the legislature could have intended to establish consistent treatment for entities that would otherwise be recognised as corporate entities under South African law by virtue of them being recognised as separate legal personalities under foreign law. However this definition is so wide, that it gives rise to interpretation problems in relation to foreign entities which fall within the South African tax definition of a company. This is the case with respect to certain partnerships with corporate personality that are incorporated under the company law of certain jurisdictions. An example is the “limited liability partnership” (LLP), which originated in the United States,⁴¹⁶ and which is becoming internationally popular but is foreign to South African law.⁴¹⁷ The LLP structure also exists in the United Kingdom and it has been noted that several South African tax residents have interests in United Kingdom LLPs.⁴¹⁸ It is necessary to briefly describe the nature of the United Kingdom LLP, in order to effectively discuss how this structure can be used to avoid South African taxes.

In terms of section 1(2) of the United Kingdom’s Limited Liability Partnership Act 2000 (LLPA), “a limited liability partnership is a body corporate (with legal personality separate from that of its members)”. Explaining the intricacies of the United Kingdom LLP, Morse⁴¹⁹ states the following:

In essence it is a body corporate with limited liability in the sense that its members are not personally liable for its debts beyond their financial interests in the LLP itself, but with unlimited capacity. It is incorporated by registration with an incorporation document thus

416 Freedman at 293.

417 Olivier & Honiball at 464.

418 Olivier & Honiball at 464.

419 G Morse “Limited Liability Partnerships Law Reform in the United Kingdom” in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives* (2004) 317 at 324.

fulfilling the role of memorandum of association and subject to many of the accounting and disclosure requirements and other controls applicable to companies. But it has no shareholders or share capital, no directors, and no specific requirements as to meetings or resolutions.

Since the definition of “company” in section 1(b) of South Africa’s Income Tax Act covers companies incorporated under foreign law, the legal status of a foreign entity has to be determined according to foreign law. It is irrelevant whether or not the foreign entity qualifies as a company under South African law.⁴²⁰ For example, the issue whether a particular LLP may be incorporated in the foreign jurisdiction or not, must be determined under the relevant law of that foreign jurisdiction. The result of the application of section 1(b) of the Income Tax Act is that a United Kingdom LLP qualifies as a company in South Africa.

Challenges of applying South Africa’s CFC legislation to partnership/corporate hybrid entities

If a South African resident and a United Kingdom resident decide to incorporate an LLP in the United Kingdom, can South African CFC rules be applied to tax the South African shareholder? The answer to this question is not clear. It may be argued that since section 1(b) of the definition of “company” in section 1 of the Income Tax Act covers foreign companies, CFC rules could potentially apply to the LLP. It is however worth noting that for the CFC legislation to apply it is required that South African residents hold more than 50% of the total participation or voting rights in the foreign company.⁴²¹ The unique nature of the United Kingdom LLP makes this aspect of the South African CFC legislation difficult to apply. Although the LLP comes into existence upon incorporation,⁴²² the participants in an LLP are referred to as members.⁴²³ It has no shareholders

420 Olivier & Honiball at 434.

421 S 9D(1) of the Income Tax Act.

422 Freedman at 304; Jones et al at 292; D Armour *Tolley’s Limited Liability Partnerships: The New Legislation* (2001) at 2.

423 Freedman at 304.

or share capital.⁴²⁴ In this respect, it is doubtful whether CFC legislation can be applied to the members of a United Kingdom LLP.⁴²⁵ It is submitted that this anomalous situation could be manipulated to avoid taxes.

It should however be noted that there are other jurisdictions that have LLPs that are not incorporated. An example is the Cayman Islands.⁴²⁶ In terms of the definition of company in section 1(b) of the Income Tax Act, the Cayman Islands' LLP cannot be considered a company but a transparent partnership.⁴²⁷

Another example of an offshore hybrid entity is the United States "limited liability company" (LLC). The United States' LLC has been described as a hybrid form of business organisation that has some attributes of a partnership and other attributes of a corporation. LLCs are recognised as corporate entities in the United States, but they are treated as partnerships for tax purposes.⁴²⁸ This tax treatment implies that the taxable income of the LLC passes through to owners, thereby avoiding corporate tax.⁴²⁹ It is worth noting that although under the United States Check-the Box Regulations of 1996,⁴³⁰ a partnership may elect to be taxed as a company for United States tax purposes, most entities elect to be taxed as partnerships.

It is important to note that even though the LLC is disregarded for United States tax purposes, it is still regarded as a company for South Africa tax purposes. In South Africa, there is no specific law that characterises a hybrid entity on the basis of its tax treatment in another country.⁴³¹ Since the definition of "company" in section 1(b) of the Income Tax Act recognises foreign companies, the relevant

424 Morse at 324.

425 Olivier & Honiball at 434.

426 Olivier & Honiball at 434.

427 Olivier & Honiball at 434.

428 G Whittenburg & M Altus-Buller *Income Tax Fundamentals* (2007) in par 10.8.

429 Whittenburg & Altus-Buller in par 10.8.

430 L Lokken "What Happened to Subpart F? US CFC Legislation after the Check-The-Box Regulation" (2005) 7 *Florida Tax Review* at 194; RS Avi-Yonah "To End Deferral As We Know It: Simplification Potential Of Check-The-Box" (1997) 74 *Tax Notes* at 219; CR Sweitzer "Analysing Subpart F in Light of Check-The-Box" (2005) 20 *Akron Tax Journal* at 7-8.

431 Olivier & Honiball at 465.

United States law that has to be considered is company law and not tax law.⁴³² As the LLC qualifies as a foreign company in South African law, it is arguable that CFC legislation can potentially be applied to South African residents who hold more than 50% of the total participation or voting rights of the LLC.

Although a United States LLC is regarded as a company for South Africa tax purposes, this domestic law interpretation is overridden by the application of the United States tax treaty, which specifically provides that for purposes of the application of the tax treaty, the United States tax treatment of the entity must determine the tax treatment in South Africa.⁴³³

Challenges in determining the residence status of partnership/corporate hybrid entities

In terms of section 1 of the income Tax Act, a person other than a natural person (for example a company) is considered a “resident” of South Africa, if it is incorporated, established or formed in the Republic South Africa, or if it has a place of effective management in South Africa. This means for example that a company which is incorporated in South Africa is a resident irrespective of where its place of effective management is. Conversely, a company which has its place of effective management in South Africa is a resident irrespective of where it is incorporated.⁴³⁴

When an entity such as the United Kingdom LLP is considered a company in South Africa in terms of section 1(b) of the of the definition of “Company” in the Income Tax Act, it is not clear whether LLP can be considered a South African resident if it is effectively managed in South Africa. The reason is that the LLP concept is foreign to South African law. It is submitted that this anomalous

432 Olivier & Honiball at 465.

433 The United States Technical Memorandum issued by the IRS at the time of concluding the treaty. See also Olivier & Honiball at 434.

situation requires the amendment of the definition of the term “company” in the Income Tax Act.⁴³⁵

It is worth noting that in South Africa, there are hardly any cases that have dealt with the hybrid entity problem. One case that comes close to explaining how this situation could arise is the case *ITC 1819*.⁴³⁶ Although the case was based on the implications of the double taxation agreement, and not specifically hybrid entities, the facts of the case are an example of how the different tax treatment of entities in two countries can be manipulated to avoid taxes. The appellant in the case was a partner in a firm of attorneys which was registered as a partnership in Lesotho and which did business from a permanent establishment in Lesotho. The firm was registered in Lesotho as a tax entity and was required to file a partnership return, but the profits of the partnership were taxed in Lesotho in the hands of the individual partners. SARS however included those profits in the appellant’s taxable income for the years 2002 and 2003, but credited him with the amounts of tax paid thereon in Lesotho. The appellant contended that his share of the profits from the Lesotho firm was taxable only in Lesotho and exempt from tax in South Africa in terms of article 7.1 of the tax treaty between the two countries. The said article provides that:

The profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributed to that permanent establishment.

It was held that the appellant’s reliance on article 7.1 to claim that the profits of the Lesotho firm were taxable only in Lesotho was unacceptable. Further that a proper application of article 7.1 leads to a different conclusion from the appellant’s contention. The court held that this article specifically deals with the profits of an enterprise. An enterprise of a contracting state means an enterprise carried on by a resident of a contracting state. Further that a resident of a contracting state in Lesotho is a person who is liable to tax in Lesotho. The question therefore was whether the firm was liable to tax in Lesotho. The facts

434 Meyerowitz in par 5.19; see also Huxham & Haupt at 296.

435 Olivier & Honiball at 434

436 69 SATC 159.

showed that although the firm was registered as a tax entity, it was not liable to tax in Lesotho. The court pointed out that the position in respect to the taxation of partnerships in Lesotho appears to be similar to the position of partners in the South Africa Income tax Act.

In terms of article 7.1 of the tax treaty, the appellant carried on an enterprise in respect of a firm in Lesotho, together with others. Section 24H(2) of South Africa's Income Tax Act provides that where any trade or business is carried on in the form of a partnership, each member of such partnership shall be deemed to be carrying on the trade or business of the partnership. Since the appellant was resident in South Africa, his involvement in the firm was considered as an enterprise of South Africa that carried on business in Lesotho through a permanent establishment therein. Therefore in terms of article 7.1, the profits of the enterprise carried on by the appellant may be taxed in Lesotho, but taxes so paid should be deducted from taxes due by the appellant in South Africa, in terms of article 23 of the tax treaty. It was thus held that the assessments in question cannot be deducted. The appeal was dismissed and the assessments were confirmed.

Although this case deals mainly with tax treaty implications, the facts portray the difficulties that arise out of the different classification and tax treatment of entities in two different countries.

In summary, it can be said that there are a number of uncertainties about the taxation of hybrid entities in South Africa. In order to create legal certainty, it is recommended that South Africa's tax legislation be amended to specifically provide for the treatment of hybrid entities as tax transparent limited partnerships under the Act.⁴³⁷ However, this proposal should not be implemented without careful consideration and analysis. Specific mechanisms exist in other jurisdictions (such as the United Kingdom and the United States), which ensure the equitable

437 S Zaiman "Paragraph (b) of the Definition of Company: Anomalies Arising in Respect of Certain Foreign Incorporated Entities" (February 2007, Issue 12) *KPMG International Tax Newsletter* at 4.

tax treatment of the partners of these entities.⁴³⁸ This is currently not the case under South Africa's tax law.

4.11 CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN CONDUIT COMPANY STRUCTURES (TREATY SHOPPING)

Countries often enter into bilateral tax treaties⁴³⁹ with their trading partners in order to alleviate double taxation.⁴⁴⁰ Although the network of tax treaties that countries enter into encourages international trade and investment, it also opens up opportunities of exploiting the treaties for tax avoidance purposes.⁴⁴¹ The tax avoidance scheme which is employed in respect to tax treaties is commonly referred to as "treaty shopping", a term which refers to the use of double tax treaties by the residents of a non-treaty country in order to obtain treaty benefits that are not supposed to be available to them.⁴⁴² This is mainly done by interposing or organising a "conduit company"⁴⁴³ in one of the contracting states so as to shift profits out of those states.⁴⁴⁴ When a conduit company is set up in a

438 Zaaiman at 4.

439 R L Reinhold "What is Tax Treaty Abuse? (Is Treaty Shopping an Out Dated Concept?)" (2000) 53 *The Taxpayer* at 673 where it is noted that a tax treaty is an agreement between two countries that sets out rules for the taxation for transactions and relationships between persons resident in the two countries.

440 N Boldman "International Tax Avoidance" (1981) 35 *Bulletin for International Fiscal Documentation* at 443; M Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) at 12; B J Arnold & M J McIntyre *International Tax Primer* (1995) at 29 where it is noted that double taxation may be economic or juridical. Economic double taxation refers to a double tax on the same income in the hands of different persons. Juridical double taxation is the imposition of the same comparable taxes by two or more states on the same taxpayer in respect of the same subject matter and for identical periods. See also R Rohatgi *Basic International Taxation* (2002) at 12.

441 C Wolman "Computer Guide to Tax avoidance" (1985) 10 *Financial Times* at 113.

442 H Becker & F J Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) at 1; S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) at 119 notes that treaty shopping means that a taxpayer "shops" into the benefits of a treaty which normally are not available to him and to this end he generally incorporates a corporation in a country that has an advantageous tax treaty. J Ware & P Roper *Offshore Insight* (2001) at 179 notes that as the name indicates, "treaty shopping" is a technique used to choose tax treaties which best suit the person to enable structuring international transactions in such a way as to take advantage of (shop for) certain tax treaties; C Daggart "Tax Havens and Their Uses" *The Economist Publication* (1990) Special Report No. 1191 at 91.

443 Defined below.

444 After setting up the conduit company structure, other "stepping stone" strategies can also be applied to shift income from the contracting countries. This could be done by changing the nature of the income to appear as tax deductible expenses such as commission of service fees. See F J Wurm *Treaty Shopping in the 1992 OECD Model Convention*

tax-haven jurisdiction, this can result in tremendous loss of revenue for the countries that have signed the treaty.⁴⁴⁵ It should however be noted that even for those countries that have no treaties with tax-haven jurisdictions, the same result can occur if the tax rates of the country where the conduit is situated are relatively low.

The definition of a conduit company and a description of a conduit company structure

The term “conduit company” refers to an intermediary company with very narrow powers, which is used for holding assets or rights as an agent or nominee on behalf of another company.⁴⁴⁶ If a third country resident sets up a conduit company in one of two treaty countries that has an advantageous tax treaty,⁴⁴⁷ income can be shifted from the treaty countries by taking advantage of the tax concessions that the treaty offers.⁴⁴⁸

For example, countries A and B enter into a tax treaty that entitles their residents to benefit from income derived from either country. The treaty also creates a favourable tax environment for the two countries that encourages foreign investment. Country C has no or a less favourable treaty with country A, but does have a favourable treaty with country B. When a resident of country C forms a conduit company in country B, this conduit company being a resident of country

Intertax (1992) at 658; S M Haug “The United States Policy of Stringent Anti-treaty shopping Provisions: A Comparative Analysis” (1996) 29 *Vanderbilt Journal of Transnational law* at 196; E Tomsett *Tax planning for Multinational companies* (1989) at 149; Arnold and McIntyre at 114-115.

445 See OECD Issues in International Taxation No. 1 *International Tax Avoidance and Evasion* (1987) at 20; see also Anthony Ginsberg *International Tax Havens* 2nd edition (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000) at 5.

446 Weeghel at 72-73.

447 Wurm at 658; A Rappako *Base Company Taxation* (1989) at 16.

448 Rappako at 16.

B⁴⁴⁹ is entitled to benefits under the bilateral treaty between countries A and B.⁴⁵⁰ The benefits may include treaty concessions that could be granted to the conduit company by virtue of the treaty between countries A and B.⁴⁵¹

Factors which encourage “conduit company treaty shopping” and why It should be curbed

“Conduit company treaty shopping” is encouraged by the fact that not all states maintain treaty relationships with each other. An investor whose country of residence does not have a treaty with the country in which the investor wants to do business, can get involved in schemes whereby he/she uses that other country’s treaty to obtain the benefits of that treaty.⁴⁵² It is not only the absence of a tax treaty that promotes treaty shopping, but also differences in tax relief offered by other countries’ tax treaties.⁴⁵³ Such differences among tax treaties provide an incentive for international investors to use the most beneficial treaty for their transactions.

A conduit company may for instance enable an international investor to qualify for reduced rates of withholding taxes offered by the treaty countries.⁴⁵⁴ A withholding tax is a tax which the payer of interest, dividends or royalty payment must withhold from such payment and pay over to the tax authorities.⁴⁵⁵ The majority of countries in the world impose significant withholding taxes on interest, dividends and royalties paid to non-residents.⁴⁵⁶ For multinational companies

449 A company incorporated in a given jurisdiction is a separate juridical entity recognised as such in that jurisdiction. HS Cilliers, ML Benade, JJ Henning, JJ Du Plessis, PA Delpont, L De Koker & JT Pretorius *Corporate Law* 3 ed (2000) at 3.

450 Example adopted from OECD Issues in International Taxation No. 1 at 88; see also Haug at 205; Ginsberg at 39; see also A Ogle *Tolley’s Tax Havens A Practical Guide to the Leading Tax Havens of the World* (1990) at 32 and 42.

451 OECD Committee on Fiscal Affairs *Double Taxation Conventions and the Use of Conduit Companies* (1987) at pars 4(2) and 5(d). See also Haug at 206; Ginsberg at 40; Rohatgi at 230.

452 Haug at 201; Tomsett at 149.

453 D Williams *Trends in International Taxation* (1991) at 3; AW Oguttu “Curbing ‘Treaty Shopping’: The ‘Beneficial Ownership’ Provision Analysed from a South African Perspective (2007) XL *The Comparative and International Law Journal of Southern Africa* at 241.

454 B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at LEX/26.

455 Spitz & Clark at LEX/26

456 United Nation Ad hoc group of Experts on International Co-operation in Tax matters: *Guidelines for International Co-operation against the Evasion and Avoidance of Taxes*

involved in cross-border investments, withholding taxes can cause a major loss of revenue.⁴⁵⁷ The payment of high withholding taxes is usually relieved when a double taxation agreement has been signed between two countries. By virtue of such an agreement, the investors in the treaty countries can benefit from the reduced rates of withholding taxes.⁴⁵⁸ If a taxpayer's income is reduced by high withholding taxes in a particular country and that country has no treaty with his home country, it may be possible for the taxpayer to work through conduit company in a third country which has a treaty with his/her home country and take advantage of the reduced withholding taxes.⁴⁵⁹

Treaty shopping is however undesirable because it frustrates the spirit of a treaty.⁴⁶⁰ When treaties are concluded, the assumption is that a certain amount of income will accrue to both countries involved in the treaty. The anticipated capital flows are distorted if the treaty is used by third country residents. Furthermore, the underlying principle of all bilateral tax treaties is the principle of reciprocity⁴⁶¹ which is impeded when third country residents derive benefits from a treaty intended to serve only the interests of residents of the contracting states. Also when unintended beneficiaries are free to choose the location of their businesses, then treaties designed to eliminate double taxation end up being used to eliminate taxation altogether.⁴⁶² Rohatgi⁴⁶³ notes that treaty shopping makes a bilateral treaty function largely as a "treaty with the world" that may result in tremendous loss of revenue for the contracting states.⁴⁶⁴ Treaty shopping is also undesirable because no effective exchange of information can

(with specific reference to *Taxes on Income, Profits, Capital and Capital gains*) (1984) at 37; M W E Glautier & F W Bassinger *A Reference Guide to International Taxation: Profiting from your International Operations* (1987) at 263.

457 Rohatgi at 206.

458 Spitz & Clarke at LEX/26; United Nations Ad hoc group of Experts on International Co-operation in Tax Matters at 37; Glautier & Bassinger at 263.

459 R A Westin *International Taxation of Electronic Commerce* (2000) at 184. See also AJM Jimenez "Domestic Anti- Abuse Rules and Double Taxation Treaties: A Spanish Perspective - Part 1" (Nov. 2002) *Bulletin for International Fiscal Documentation* at 543. United Nations Ad hoc group of Experts on International Co-operation in Tax Matters at 37; Glautier & Bassinger at 263.

460 OECD 1987 Report.

461 Haug at 216; Weeghel at 121; Oguttu at 241.

462 Weeghel at 121.

463 Rohatgi at 363.

464 Haug at 218; Weeghel at 121 states that treaty shopping also results in the state of residence of the treaty shopper having no or little incentive to enter into a treaty with the state of source because the residents of the state of residence can indirectly receive treaty benefits from the state of source without the state of residence having to provide

take place between the countries that have signed the treaty.⁴⁶⁵

Use of general anti-avoidance provisions to curb treaty shopping

Paragraph 7.1 of the Commentary on article 1 of the OECD Model Convention provides that where taxpayers are tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws, such attempts may be countered by jurisprudential rules that are part of the domestic law of the state concerned. In other words, the onus is placed on countries to adopt domestic anti-avoidance legislation to prevent the exploitation of their tax base and then to preserve the application of these rules in their treaties.⁴⁶⁶

There have however been controversies about the use of domestic anti-avoidance rules in a treaty context. The pre-2003 Commentary on article 1 was quite unclear about the relationship of tax treaties and domestic anti-avoidance rules and the OECD Member countries were not in agreement on this matter. Some of the reasons for the disagreements were that in some cases, tax treaties may impose limits on the application of domestic anti-avoidance thus making the domestic rules inconsistent with treaties.⁴⁶⁷

To resolve these controversies, the 1998 OECD Report on Harmful Tax Competition⁴⁶⁸ recommended that the Commentary on the OECD Model Tax Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention.⁴⁶⁹ In 2003, changes were made in paragraph 22 of Commentary on article 1 which make it explicitly clear that when base companies are used to abuse tax treaties domestic anti-avoidance rules such as "substance over form",⁴⁷⁰ the "sham

reciprocal benefits; Oguttu at 242.

465 Olivier and Honiball at 352.

466 Arnold at 245.

467 Arnold at 246.

468 OECD *Harmful Tax Competition - An emerging Global issue* (April 1998).

469 Recommendation 10 of the 1998 OECD report on Harmful Tax Competition'; See also International Fiscal Association *The OECD Model Convention - 1998 and Beyond; The Concept of Beneficial Ownership in Tax Treaties* (2000) at 25; See also Jimenez at 549.

470 Ware & Roper at 77 where the "substance over form" doctrine is described as a doctrine which permits the tax authorities to ignore the legal form of a tax arrangement and look at

principle⁴⁷¹ and “economic substance”⁴⁷² can be applied to prevent the abuse of tax treaties.⁴⁷³ Paragraph 22.2 of the Commentary on article 1 provides that domestic anti-avoidance rules do not conflict with tax conventions, as the domestic anti-avoidance rules merely establish the facts to which tax treaties apply.⁴⁷⁴

Apart from using domestic general anti-avoidance rules to curb treaty shopping, the Commentary on article 1 of the OECD Model Tax Convention suggests specific clauses that can be inserted in tax treaties to curb conduit company treaty shopping.

Specific treaty provisions suggested by the OECD to curb “conduit company treaty shopping”

The OECD suggests a range of specific provisions that countries could opt to insert in their tax treaties in order to curb conduit company treaty shopping. However, it is not within the scope of this work to discuss all these methods in detail. In brief the methods are: The “look through” method in terms of which, treaty benefits are not allowed where a company is not owned, directly or indirectly, by residents of the state in which the company is a resident.⁴⁷⁵ Then there is the “subject-to-tax” provision that provides that treaty benefits in the state of source can be granted only if the income in question is subject to tax in the state of residence.⁴⁷⁶ There is also the “channel approach”, in terms of which a provision is inserted in the treaty that singles out cases of improper use of the treaty through the employment of conduit arrangements.⁴⁷⁷ There is also the “limitation-of-benefits” provision, which is aimed at preventing persons who are

the actual substance of the relevant transaction.

471 In terms of this principle, the true nature of a transaction is disguised for purposes of tax avoidance thus it is referred to as a “sham”. See Olivier & Honiball at 235.

472 This principle requires that a business exists in substance and not merely on paper. See Olivier & Honiball at 374.

473 This position seems to be based on the 1987 OECD Report on the Use of Base Companies which states in par 38 that anti-abuse rules or rules on “substance over form” can be used to conclude that a base company is not the beneficial owner of an item of income.

474 Arnold at 260.

475 Para 13 of the Commentary on article 1 of the OECD Model Convention. See also Jimenez at 21; Oguttu at 242.

476 Para 15 and 16 of the Commentary on article 1 of the OECD Model Convention.

477 Par 17 of the Commentary on article 1 of the OECD Model Convention.

not residents of the contracting states from accessing the benefits of a treaty through the use of an entity that would qualify as a resident of one of the States.⁴⁷⁸ The OECD also suggests the use of the “beneficial ownership” provision, which is discussed in detail below. The relative importance of the other clauses suggested by the OECD is somehow reduced by the fact that the OECD has shaped the “beneficial ownership” provision in such a way that it is considered the most effective provision that can be used to exclude conduits from treaty benefits.⁴⁷⁹

The “beneficial ownership” provision

Paragraph 10 of the Commentary on article 1 of the OECD Model Convention suggests the use of a “beneficial ownership” provision as one of the anti-abuse provisions that can be used to deal with source taxation of specific types of income set out in articles 10, 11 and 12 of the OECD Model Convention. For instance article 10(2) provides that

... dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed...⁴⁸⁰

This provision has the effect of denying treaty benefits to a conduit company, unless the beneficial owner is a resident of one of the contracting states.⁴⁸¹ In order to determine the effectiveness of such a provision in curbing “conduit company treaty shopping”, it is necessary to have an understanding of the concept “beneficial ownership”.

The meaning of the “beneficial ownership” concept

The use of the “beneficial ownership” provision to curb treaty shopping has been a source of major controversy among OECD member countries. This is because the term “beneficial ownership” is not explicitly defined in OECD Model Tax

478 Par 20 of the Commentary on article 1 of the OECD Model Convention.

479 Jimenez at 21; Oguttu at 243.

480 Article 10(2) of the OECD Model Convention

481 Par 12.2 of the Commentary on article 10 of the OECD Model Convention.

Convention or its Commentary.⁴⁸² The first use of this term in article 10, 11 and 12 was in the 1977 OECD Model Tax Convention.⁴⁸³ But ever since then, there is limited information as to the intended use of the term and reasons why it was decided to incorporate the term “beneficial ownership”, as opposed to some other notion. However, the term seems to have been earlier in use, as evidenced from article III of the 1945 United Kingdom/United States treaty on the estates of deceased persons.⁴⁸⁴

It is worth noting that the OECD Model Commentary provides two guidelines for the determining meaning of the term. These guidelines can be gleaned from paragraph 12.1 of the OECD Commentary on article 10 in respect to dividends, par 10 of the Commentary on article 11 in respect to interest and paragraph 4.1 of the Commentary on article 12 in respect to royalties, all worded in a similar language. The first guideline provided in the above mentioned paragraphs is that:

where an item of income is received by a resident of a contracting state acting in the capacity of agent or nominee, it would be inconsistent with the object and purpose of the Convention for the state of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other contracting state.⁴⁸⁵

The implication is that a nominee or agent who is a treaty country resident may not claim benefits, if the person who has all the economic interest in, and all the control over, property (the beneficial owner), is not also a resident. On the other hand, if the beneficial owner is a resident of the contracting State, then treaty benefits are available even if the agent or nominee who holds title to the property and is legally entitled to collect the income from the property resides elsewhere.⁴⁸⁶ It is worth noting that although the Commentary uses the terms

482 OECD Model Tax Convention on Income and on Capital (Condensed version) (2005). For the remark see International Fiscal Association’s 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 15.

483 J D B Oliver, J B Libin, S van Weeghel & C Du Toit “Beneficial Ownership and the OECD Model” (2000) 1 *British Tax Review* at 27-28.

484 Evidence of earlier use of the term also appears in the 1968 UK/Netherlands treaty, the 1969 Australia/Japan treaty, the 1975 UK/Spain treaty and the 1968 Ireland/France treaties and the 1968 protocol amending the 1947 UK/Antigua treaty. See Oliver & Honiball at 29.

485 Par 12.1 of the OECD Commentary on article 10 in respect to dividends, par 10 of the Commentary on article 11 in respect to interest and par 4.1 of the Commentary on article 12 in respect to royalties.

486 The International Fiscal Association’s 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 22.

“nominee” or “agent” to explain the term “beneficial ownership”, it does not set out the features of a nominee or agent that could make it possible to differentiate someone who is just nominee or agent from technical nominees or agents, where the technical ownership is nonetheless disregarded in favour of a beneficial owner.⁴⁸⁷

The second guideline to the meaning of the term “beneficial ownership” that is provided in above mentioned paragraphs of the OECD Model Commentary is that

it would be equally inconsistent with the object and purpose of the Convention for the state of source to grant relief or exemption where a resident of a contracting state, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned.

Explaining this guideline, the OECD Report on Conduit companies⁴⁸⁸ states that a conduit company cannot normally be regarded as a beneficial owner if, through the formal owner, it has as a practical matter, very narrow powers which render it in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties (such as the shareholders of the conduit company).⁴⁸⁹ It is however worth noting that not every conduit company can be denied the ability to be a beneficial owner on those grounds. In certain instances, conduit companies are usually more than mere legal owners and they usually have full power over the underlying asset that produces dividends royalties or interest. So it may not be evident that they are not the beneficial owner of income received. Paragraph 23 of the OECD Report on Conduit companies points out that “legal ownership” is not enough to constitute beneficial ownership. This is because in some cases the conduit company’s connection in legal terms with the income in issue may not be so clear. This Report explains that the fact that the conduit company’s main function is to hold assets or rights, is not itself sufficient to categorise it as a mere intermediary. This indicates that further examination of

487 The International Fiscal Association’s 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 22.

488 OECD 1987 Report on the Use of Base Companies in par 14(b); see also par 12.1 of the OECD Commentary on article 10 in respect to dividends, par 10 of the Commentary on article 11 in respect to interest and par 4.1 of the Commentary on Article 12 in respect to royalties.

489 OECD 1987 Report on the Use of Base Companies in par 14(b).

the matter may be necessary.⁴⁹⁰ For instance, a holding company that simply owns investment assets on behalf of its shareholders may not be the beneficial owner of the income received by it. It is however unlikely that sufficient information would be available in most cases to deny treaty benefits to a holding company. For this reason, the OECD Commentary suggests that countries may include specific provisions in their treaties to deal with such holding companies.⁴⁹¹

From the above, and also from what was noted in the 2002 OECD Report entitled “Restricting the Entitlement to Treaty Benefits”,⁴⁹² it appears that the concept of beneficial ownership is difficult to interpret. What transpires is that the OECD Committee on fiscal affairs considers a conduit company, which has very narrow powers, as a nominee or agent and thus not as a beneficial owner to which treaty benefits should be granted. Apart from the exclusion of agents and the nominees, it has been argued that the term “beneficial ownership” has not been fully defined.⁴⁹³ Furthermore, there are remarkably few court cases on the tax treaty meaning of the term and few statements from governments about the international meaning of the term.⁴⁹⁴

Commentators also hold differing views on the meaning of the term. For instance, Vogel⁴⁹⁵ holds the view that a “beneficial owner” is the person who is free to decide whether or not the capital or assets of an entity should be used or made available for use by others. Du Toit⁴⁹⁶ states that the term is only known in common law states. He⁴⁹⁷ is however of the view that in interpreting bilateral tax treaties in the context of royalties, “the beneficial owner is the person whose ownership attributes outweigh that of any other person”.⁴⁹⁸ Eyanatten⁴⁹⁹ points

490 Oliver *et al* at 58.

491 Par 22, 8 and 7 of the OECD Commentaries on articles 10, 11, and 12 respectively.

492 OECD 2002 Report: Issues in International Taxation No.8 in par 23.

493 Oliver *et al* at 20.

494 Oliver *et al* at 31-32.

495 K Vogel *Vogel on Double Taxation Conventions* (1997) at 562.

496 C Du Toit “Beneficial Ownership of Royalties in Bilateral Tax Treaties” (1999) *Internal Bureau for Fiscal Documentation* at 243.

497 Du Toit at 247.

498 Du Toit at 247.

499 W Eyanatten “The Concept of ‘Beneficial Ownership’ under Belgian Tax Law: Legal Interpretation is Maintained” (2003) *Intertax Kluwer Law International* at 523.

out that the term “beneficial ownership” is a well-known concept in the domestic systems of common-law countries, but that it is foreign to civil law countries. He⁵⁰⁰ however holds the view that the term “beneficial ownership” refers to the right a person has to the benefits arising from certain assets. Further that “beneficial ownership” of assets is different from “legal ownership”, which is characterised by control over those assets. Although there seem to be various opinions to the meaning of the term, Olivier & Honiball⁵⁰¹ argue that managers, representatives, or nominees cannot be regarded as beneficial owners of assets. According to Eynatten,⁵⁰² this conclusion should be extended to every intermediary who acts in the name of and on account of a third party.

Notwithstanding the above, the term “beneficial ownership” has a meaning in the domestic legislation of some countries.⁵⁰³ There has thus been an inclination by some of those countries to apply their domestic meaning of the term in a treaty context.⁵⁰⁴ The reason for this is based on article 3(2) of the OECD Model Convention, which provides that where a term is not defined in the Convention, unless the context otherwise requires, a contracting state can make use of the meaning of the term under its laws that are used for the purposes of the taxes to which the Convention applies.⁵⁰⁵

What is the scope of using the domestic meaning of the term?

As noted above, article 3(2) of the OECD Model Tax Convention, permits countries to apply the domestic meaning of a term that is not fully defined in the OECD Model Tax Convention and its Commentary. For this to be done it is necessary to determine the scope for the application of article 3(2). In other

500 Eynatten at 526.

501 Olivier & Honiball at 476.

502 Eynatten at 539.

503 See the discussion in respect to the United Kingdom in chapter 5 par 5.2. In the United States case of *Montana Catholic Missions v Missoula County* 200 US 118 (1906), at 128, it was held that beneficial ownership in property means a right to enjoyment of property that exists where the legal title is in one person and the right to the beneficial interests in the property is in another. Such a right to beneficial interest in property is recognised by law, can be enforced by the courts.

504 In this regard see the position in the United States as discussed below under the heading “Reasons against the use of the domestic meaning of the term”.

505 See also the International Fiscal Association’s 2000 Report on the OECD Concept of

words, it is necessary to determine the relevant law of the contracting state that must be used in interpreting the term. Is it tax law, commercial law in general, or is it the domestic law on which the treaty application arises?

Article 3(2) makes it clear that the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of the relevant provisions of the domestic law of a contracting state. Furthermore, the meaning under the applicable tax laws of that state should prevail over a meaning given to the term under the other laws of that state. Further clarity is provided in paragraph 13(1) of the Commentary on article 3(2) which states that reference to the meaning of a term may be derived from any relevant provision of the domestic law of the contracting state, even if it is not a tax law. But where the meaning of the term is defined differently for the purposes of the different laws of a contracting state, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws.⁵⁰⁶

Reasons against the use of the domestic meaning of the term

In coming up with an international meaning of the term “beneficial ownership”, countries should not unilaterally relying on article 3(2) and apply the domestic meaning of the term. The reason is that this would result in the loss of the international uniformity in the interpretation of the term and it would also result in uncertainty and loss of reliability for taxpayers.⁵⁰⁷

Sight should not be lost of the fact that in some states, there may not be any meaning of the term at all.⁵⁰⁸ It appears to be internationally accepted that article

Beneficial Ownership in Tax Treaties at 15.

506 Oliver *et al* at 43; Vogel at 10; see also JFA Jones “The 1992 Model Tax Treaty: Article 3(2) of the Convention and the Commentary to it: Treaty Interpretation” (1993) *European Taxation* at 253.

507 Oliver *et al* at 45.

508 For example, Oliver *et al* at 49 note that Japanese internal tax law or non tax law does not have a meaning of beneficial ownership. It however has meaning for the concept beneficiary in the context of a trust. On page 51 it is stated that in Sweden the notion “beneficial ownership” has neither been discussed or analysed in the Swedish legal doctrine. On page 50 it is stated that Switzerland does not have a coherent beneficial

3(2) cannot apply where the source state does not use the term in its domestic law.⁵⁰⁹ There could also be a situation where even if there is a meaning in the domestic law of the two contracting states, the meaning could be different in each of the two states. Disputes would then arise as to whether someone is a beneficial owner under the law of the source state or under the law of the state of residence.

The problem of using the domestic meaning of the term is evidenced by the United States' controversial anti-conduit regulations which are defended by the theory that it is merely exercising its prerogative as the source state in terms of article 3(2) to define the term beneficial ownership.⁵¹⁰ For instance, in the treaty with Switzerland, the United States combined general anti-abuse provisions, such as the "substance over form"⁵¹¹ principle, with the beneficial ownership provision to curb conduit company treaty shopping.⁵¹² It is argued that using the beneficial ownership provision together with other anti-abuse provisions is not the solution.⁵¹³ Commentators on how the United States applies the "beneficial ownership" provision are of the view that the use of this provision was never intended to open a very wide door to unilateral domestic anti-abuse measures.⁵¹⁴

A suggestion for the way forward in finding an international meaning of "beneficial ownership"

The original drafters of the "beneficial ownership" provision (in the 1977 OECD

ownership policy.

509 JFA Jones "The 'One True Meaning' of a Tax Treaty" (2001) *Bulletin for International Fiscal Documentation* at 221.

510 The International Fiscal Association's 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 17 and 27.

511 The "substance over form" doctrine permits tax authorities to ignore the legal form of a tax arrangement and look at the actual substance of the relevant transaction. See Ware & Roper at 77.

512 The International Fiscal Association's 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 17 where it is noted that in the technical explanation of the United States treaty with Switzerland that the OECD authorizes member countries to deny benefits, in the way the US does under the anti-conduit rules, to mere nominees under "substance over form" principles.

513 The International Fiscal Association's 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 20.

514 The International Fiscal Association's 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 16-17.

Model Convention) had a specific meaning in mind, which seems to be a treaty-based definition that prevails over the domestic meaning of the term.⁵¹⁵ Commentators on this issue are also of the view that it is better to develop an international meaning to the term that would be understood and used by all countries that adopt the OECD Model Convention.⁵¹⁶ For example, Baker⁵¹⁷ points out that the term is not intended to be employed in the OECD Model Convention in a limited, technical sense that it may have in the domestic context of a particular jurisdiction. Vogel⁵¹⁸ argues that the term should be interpreted with reference to the context of the treaty, and particularly with a view to the purpose pursued by the relevant restriction. Du Toit⁵¹⁹ is of the opinion that the term can properly be classified as international tax language.

It is however notable that since its inception, in the OECD Model Convention in 1977, 29 years later, the OECD has not offered a meaningful interpretation of the term. Sight should not be lost of the fact that double taxation agreements are generally governed by the Vienna Convention on the Law of Treaties.⁵²⁰ Article 31(1) thereof provides that treaties should be interpreted in good faith, in accordance with the ordinary meaning of the terms of the treaty read in their context, and in light of the purpose of the treaty (which is to prevent tax avoidance). If countries apply article 3(2) of the OECD Model Convention unilaterally in interpreting the term “beneficial ownership”, this may defeat the treaty purpose of preventing tax avoidance.

In finding an international meaning to the term “beneficial ownership”, it should be noted that the OECD has at least offered some guidance that countries may rely on. The guidelines in the Commentaries on articles 10, 11, and 12 indicate that a recipient of interest, dividends or royalties could be a mere intermediary acting as an agent or nominee for some other party. Such an intermediary

515 The International Fiscal Association’s 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 16-17.

516 Oliver & Honiball 42 at 46; The International Fiscal Association’s 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 20.

517 P Baker *Double Taxation Conventions and International Law* (2005) in par 10B-13.

518 Vogel at 562.

519 Du Toit at 243.

520 Vienna Convention on the Law of Treaties UN Doc. A/Conf. 39/27 signed in Vienna on 23 May 1969.

cannot be a “beneficial owner” and is not entitled to treaty benefits. When relying on article 3(2) to interpret the term, these guidelines should serve as a guide towards establishing the meaning of the term.⁵²¹ By providing such guidance, the OECD made it clear that throwing the interpretation of the term to a variety of domestic law interpretations would not be fruitful.⁵²² It should further be noted that the OECD Commentary specifically provides that the term “beneficial ownership” is not to be used in a narrow technical sense; rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.⁵²³ It appears that the OECD’s intention in making this statement is to persuade the tax authorities and courts of a given country, which have a narrow domestic meaning of “beneficial owner”, to prefer a broad treaty meaning.⁵²⁴ It can thus be concluded that where the domestic interpretation of the term is not in line with the guidelines offered by the OECD, that interpretation cannot be relied on, as it would go against international consensus.

Curbing conduit company treaty shopping: The “beneficial ownership” provision from the South African perspective

Although most of South Africa’s treaties follow to a large extent the OECD Model Convention,⁵²⁵ South Africa is not a member of the OECD.⁵²⁶ South Africa uses the “beneficial ownership” provision in most of its tax treaties to curb conduit company treaty shopping. However, in the treaty with the United States, the “limitation of benefits” provision is applied, as the United States chooses to use this provision in its double taxation agreements.

As mentioned above, the term “beneficial ownership” was taken from the

521 D Ward *Ward’s Tax Treaties* (1994-1995) at 26; Oguttu 250.

522 Oliver *et al* at 47.

523 The Commentary on article 10 par 2(12), Commentary on article 11 par 9, and the Commentary on article 12 par 4.

524 B J Arnold “Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model” (2004) *Bulletin for International Fiscal Documentation* at 258.

525 Huxham & Haupt at 357.

526 Huxham & Haupt at 357 in par 16.9.4; Olivier & Honiball at 8.

common law states and incorporated into the OECD Model Convention.⁵²⁷ Although South Africa is a member of the Commonwealth and formerly a Dominion Territory of the British Empire, it is not generally regarded as a common law state, since its legal system is based on the Roman-Dutch legal system.⁵²⁸ There are however significant English law influences, for example in the law of trust and in company law.⁵²⁹ The term “beneficial ownership” as found in the English-influenced common law states, namely the United Kingdom, the United States, Canada, Australia and New Zealand, is unknown in South African law.⁵³⁰ In *CSARS v Metlika Trading Ltd and Others*,⁵³¹ the court held that the term “beneficial owner” does not constitute a clearly defined juristic concept, but that the term is appropriate in the context of a situation where it is alleged that someone who is the ostensible owner of property is in fact not its real owner.⁵³²

It is however worth noting that the term “beneficial ownership” is used in South African company law in respect of the ownership of shares. In order to understand the use of this term, it is necessary to provide some further explanation. In South African company law, a person becomes a member of a company only when his name is entered in the register of members. Once a member, the person acquires rights attached to his shares, but not every holder of shares registered as such in a company’s share register is the true holder of the rights attached to the share.⁵³³ A member could for instance sell or cede the rights attached to the shares by passing “the property” in them to a purchaser who may not be registered as a member of the company.⁵³⁴ The purchaser owns

527 Du Toit at 20.

528 Olivier & Honiball at 413.

529 Olivier & Honiball at 413.

530 Olivier & Honiball at 413.

531 66 SATC 346.

532 See also *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 (1) SA 441 (AD) at 453A-B.

533 HS Cilliers, ML Benade, JJ Henning, JJ Du Plessis, PA Delport, L De Koker & JT Pretorius *Corporate Law* 3 ed (2000) at 242. Note that in terms of section 1 of the Income Tax Act, a shareholder is in relation to a company *inter alia* means the registered shareholder in respect of any share, except that where some person than the registered shareholder is entitled, whether by virtue of any provision in the memorandum or articles of association of the company or under the terms of any agreement or contract, or otherwise, to all or part of the benefit of the rights of participation in the profits, income or capital attaching to the share so registered, that other person shall, to the extent that such other person is entitled to such benefit, also be deemed to be a shareholder.

534 Cilliers *et al* at 242.

the shares whereas the seller is the member of the company in respect of the shares and he alone (the seller) can enforce the rights attached to the shares against the company (but this he does in the interest of the purchaser). In such a situation, the purchaser is usually described as the “beneficial owner”⁵³⁵ of the shares and the registered member is referred to as the beneficial owner’s nominee.⁵³⁶ The term “nominee” is not defined in the Companies Act.⁵³⁷ However in *Samuel v President Brand Gold Mining Co Ltd*,⁵³⁸ it was held to mean a person nominated or appointed by another to hold shares in his name on that other’s behalf. In *Dadabhay v Dadabhay*,⁵³⁹ it was held that the expression “nominee” is a commercial rather than a legal one, and that it denotes that the registered shareholder holds the shares subject to the instructions of the beneficial owner of the shares.⁵⁴⁰ In *Standard Bank of South Africa Ltd v Ocean Commodities Inc*,⁵⁴¹ it was held that a registered member of a company who sells or cedes his shares to another (who is not a registered member) is considered a nominee or agent of the purchaser who is actually the beneficial owner of the shares.

By referring to terms like “nominee or agent”, the South African company law interpretation of the term “beneficial ownership” seems to be in line with the guidelines offered by the OECD in interpreting the term.

It appears that there is a vague reference to the term “beneficial ownership” with regard to the definition of “shareholder” in section 1 of the Income Tax Act.

535 Cilliers *et al* at 242. See also *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 (1) SA 441 (AD) at 453A-B.

536 MS Blackman, RD Jooste & GK Everingham *Commentary on the Companies Act* Vol 1 (2002) in par 98. See also *Moosa v Lallo* 1956 (2) SA 237 (D) at 239. Cilliers *et al* at 243 it is stated that the purpose of the system of nominee shareholders in our company is to recognise the legitimate purposes of setting up nominee shareholders but it also covers situations which call for greater transparency. This enables a company to effectively communicate with its real shareholders so that it is not ignorant of a build-up of shareholding towards a takeover control. In that regard, s 140A of the Companies Act, *inter alia* requires a registered holder of securities who is not the holder of the “beneficial interest” to disclose to the company at the end of every quarter of the year the identity of the person on whose behalf the securities are held.

537 Act 61 of 1973.

538 1969 (3) SA 629(A) 668.

539 1981 (3) SA 1039 (AD) at 1047.

540 Unlike in English Law, in South African company law there is no distinction between legal ownership and beneficial or equitable ownership. The rights attached to the shares vest in the “beneficial owner” and in him alone. See Cilliers *et al* at 243.

541 1983 (1) SA 276 (AD) at 289.

Paragraph (a) of this provision reads:

In relation to any company referred to in paragraph (a), (b), (c), or (d) of the definition of “company” in this section, means the registered shareholder is in respect of any shares, except that where some person other than the registered shareholder is entitled, whether by virtue of any provision in the memorandum or articles of association of the company or under the terms of an agreement or contract, or otherwise, to all or part of *the benefits of the rights of participation in the profits, income or capital attaching to the share so registered*, that other person shall, to the extent that such other person is entitled to such benefit, also be deemed to be a shareholder. (Emphasis added.)

The words “the benefits of the rights of participation in the profits, income or capital attaching to the equity share” are also used in section 41 of the Income Tax Act, with respect to the meaning of “shareholder” in the group restructuring relief provisions.

Apart from the above vague references to the term in the Income Act, the Act does not provide a meaning to the term “beneficial ownership”. In terms of section 108(2) of the Income Tax Act,⁵⁴² read together with section 231 of the Constitution of South Africa,⁵⁴³ when the national executive of South Africa enters into a double tax agreement with the government of any other country, and the agreement is ratified and published in the Government Gazette, its provisions are as effective as if they had been incorporated into the Income Tax Act. This implies that constitutionally, tax treaties rank equally with domestic legislation. In order to interpret the meaning of the term “beneficial ownership”, section 233 of the Constitution states that

[w]hen interpreting legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

Internationally treaties are classified as international agreements, which have to be interpreted by customary international law rules of interpretation⁵⁴⁴ In interpreting tax treaties, a South African court would have to take into consideration, two particular aspects of customary international law: firstly, the Vienna Convention on the Law of Treaties, 23 May 1969 and secondly, the Commentary on the OECD Model Tax Convention.⁵⁴⁵

542 Act 58 of 1962.

543 Of 1996.

544 K Vogel *Klaus Vogel on Double Taxation Conventions* 3 ed (1997) in par 28 of the introduction.

545 Olivier & Honiball at 395.

Although no South Africa court has to date specifically decided whether a tax treaty must be interpreted in accordance with the principles of international law or domestic law, the Appellate division in *SIR V Downing*⁵⁴⁶ held the following:

The Model Convention for the Organisation for European Economic Co-operation and Development (OECD) has served as the basis for a veritable network of double taxation Conventions existing between the Republic of South Africa and other countries and between many other countries.

The South African courts have also referred to foreign international tax courts cases and academic authors with approval to support their conclusions. In *ITC 1473*,⁵⁴⁷ the court referred with approval to German case law in order to determine the intention of the contracting states when interpreting the double taxation agreement between South Africa and Germany. In *ITC 1503*⁵⁴⁸ which dealt with the question of whether interest income was part of income from an international airline business, the court relied on the OECD Commentary in reaching its findings. Although international law can be applied to interpret the “beneficial ownership”, the problem as discussed above is that the OECD Commentary provides little guidance on what the term means. Even among those authors who are of the view that beneficial ownership should be given its international meaning, there is no agreement as to what it means.

It is worth pointing out also that when interpreting terms in used in a tax treaty; courts are obliged to consider domestic interpretive rules. Such include reference to the ordinary meaning of the term “beneficial ownership” both in the context of the term itself and in the context of the tax treaty. The context of inserting the term beneficial ownership in a tax treaty is to prevent tax avoidance (“treaty shopping”).⁵⁴⁹ Thus the term is to be interpreted in accordance with its purposes and the mischief against which it is directed.⁵⁵⁰ This is in line with article 31 of the Vienna Convention which provides *inter alia* that:

[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to given of the terms of the treaty in their context and in light of its objects and purposes.

546 1975 (4) SA 518 (A) at 525.

547 52 SATC 128.

548 53 SATC 342(T).

549 J Schwartz *Tax Treaties: United Kingdom and Practice* (2002) par 11.23.

Although South Africa is not a party to the Vienna Convention, South African courts are guided by this Convention in respect to South Africa's treaty relations. The Vienna Convention is largely a codification of customary international law; it applies to all treaties and not only to countries that have signed the convention.⁵⁵¹

Olivier and Honiball⁵⁵² submit that by concluding tax treaties which contain the concept "beneficial ownership", knowing that it does not have a domestic tax law meaning of the concept, South Africa has intended that an internationally accepted meaning of the concept must apply.⁵⁵³ It is this author's submission that although there is no clear international meaning for this term, any attempt to define it in a treaty context should be in line with the guidelines offered by the OECD.

As explained above, the South African company law meaning of the term "beneficial ownership" seems to be in line with the guidelines offered by the OECD. It is recommended that our legislators should take cognise of the meaning in company law, refine it, and come up with a meaning of the term in the Income Tax Act which can be more readily applied in the context of our tax treaties. Care should however be taken to ensure that the meaning is not limited to a narrow South African interpretation, but that it should carry a wide international meaning that is in line with the guidelines offered by the OECD.

Some queries about the effectiveness of the "beneficial ownership" provision in curbing treaty shopping in South Africa

Despite the fact that the concept "beneficial ownership" has not been given a clear treaty meaning, South Africa has made use of "beneficial ownership" clauses in its recent treaties to curb treaty shopping (see discussion above). Such a clause usually provides that the exemptions pertaining to interest,

550 Olivier & Honiball at 417.

551 Olivier & Honiball at 28.

552 Olivier & Honiball at 350.

royalties and dividends would apply only to the extent that the recipient in the other country is in fact the “beneficial owner” thereof.⁵⁵⁴ For instance, article 11(1) of the South Africa/United States treaty provides that interest derived and beneficially owned by a resident of a contracting State shall only be taxed in that State.⁵⁵⁵ This implies that if the interest is not beneficially owned by a resident of the United States, South Africa would be entitled to tax it.

In the South Africa/Cyprus treaty,⁵⁵⁶ article 10(1) provides that “dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state shall be taxable only in that other state provided such resident is the beneficial owner of such dividends.” Note however that the South Africa/Cyprus treaty uses the words “shall be taxable only” in the residence state, whereas the OECD Model uses the words “may be taxed” in the residence state and then continues in article 10(2) to limit the source state’s taxing rights, provided the recipient is the beneficial owner. Hence, in terms of the Cyprus treaty the source state may not charge withholding or other taxes in respect of dividends if the recipient is the beneficial owner, whereas in terms of the OECD Model the source state may charge these taxes, but only to a limited extent. The limitation does not apply if the recipient is not the beneficial owner. This provision is intended to prevent the use of Cyprus as a conduit for treaty shopping purposes.⁵⁵⁷

There have been concerns that the “beneficial ownership” provision in South Africa’s double taxation treaties does not benefit South Africa in preventing the use of conduit company treaty shopping. This concern is based on the fact that South Africa does not impose withholding tax on dividends and interest earned

553 Olivier & Honiball at 350.

554 Olivier & Honiball at 246.

555 Treaty published in Government Gazette No 18553 of 15-12-1997.

556 Published in Government Gazette No 19638 of 22-12-1998.

557 Examples of other treaties where the beneficial ownership provision is applied is in article 12(1) of the South Africa /Mauritius and also article 12(1) of the South Africa/UK treaties both refer to the payment of interest to a resident of the other Contracting state if he is the beneficial owner of the interest (the treaties are published in Government Gazette No 18111 of 2-7-1997 and Government Gazette No 24335 of 31-1-2003 respectively). Then the South Africa/Australia treaty, in articles 10(1), 11(1) and 12(2) dealing with dividends, interest and royalties respectively provide that the relevant income arising in a Contracting State and paid to a resident of the other Contracting State shall be taxed only in the other State if such resident is the beneficial owner of the relevant income (the treaty is published in Government Gazette No. 20761 of 24-12-1999).

by non-residents from a South African source.⁵⁵⁸ South Africa only has a formal withholding tax in regard to royalties. Section 35 of the Income Tax Act provides that a withholding tax on royalties is levied on non residents for the right of use in South Africa of any patent, design or trademark or copy right. The lack of withholding taxes on interest and dividend earned by non-residents from a South African source could thus be viewed as a loophole in our law that can be exploited for treaty shopping purposes.

It has been suggested that in order to tax dividends and interest earned by non-residents from a South African source, South Africa has to phrase the articles in its treaties in such a way that they do not specifically refer to a withholding tax, but to the fact that the state of source will be entitled to tax up to a limited extent.⁵⁵⁹ This suggestion is based on the fact that articles 10 and 11 (which relate to dividends and interest respectively) of the OECD Model Tax Convention do not specifically refer to withholding taxes, but only to the fact that the state of source will be entitled to tax up to a limited extent. On this basis, dividends or interest could be potentially taxable in South Africa even though South Africa does not levy withholding taxes on dividends or interest. An example of a treaty where this approach is applied is the South Africa/Netherlands treaty which provides in article 10(2)(a) and article 11(2) that dividends and interest (respectively) may also be taxed in South Africa subject to a maximum percentage.⁵⁶⁰

It is also worth noting that although South Africa does not levy a withholding tax on dividends, this seeming loophole in the law is covered by the fact that South Africa presently still charges Secondary Tax on Companies (STC) which effectively results in a withholding tax being applicable in the context of dividends even though STC is not formally considered a tax on dividends.⁵⁶¹ Basically STC is a tax payable by companies separate from and in addition to normal tax on companies. In terms of section 64(C) of the Income Tax Act, STC is charged

558 Olivier & Honiball at 294; Oguttu at 254.

559 Olivier & Honiball at 298-299.

560 Published in Government Gazette No 3153 of 18-6-1971. See also Nathan & Friedman at 4.

561 Olivier & Honiball at 147; Oguttu at 255.

when a company declares a dividend.⁵⁶² Section 64C(2) is an anti-avoidance provision which deems certain transactions or distributions as dividends declared for purposes of STC. For example in terms of section 64(2)(c), any amount which in terms of section 31(3) of the Income tax Act is disallowed as being excessive interest is deemed to be a dividend distributed and so STC is payable. In a nutshell, although non-resident companies that derive dividends and interest in South Africa are not liable to withholding taxes in South Africa, South Africa does not necessarily lose this tax base as the imposition of STC ensures that dividends declared by such companies are taxed in South Africa.

It is however worth noting that it was announced in the 2007 National Budget⁵⁶³ that dividend withholding tax at a rate of 10% would be introduced with effect from 1 October 2008, which would be applicable to both resident and non-resident companies. This proposed dividend withholding tax will replace STC. It is however important to point out that some of South Africa's treaties do not allow the residence state to impose any dividend withholding tax. Examples are the treaties with Cyprus⁵⁶⁴ and Ireland.⁵⁶⁵ Article 10(1) of the treaty with Cyprus and the treaty with Ireland that is worded in a similar manner states:

Dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state shall be taxable only in that other state, provided such resident is the beneficial owner of such dividends.⁵⁶⁶

In these treaties, the exclusive taxing rights are given to the state that receives the dividends.⁵⁶⁷

Other tax treaties allow the residence state to impose a withholding tax, but the percentage is not consistent and varies considerably. For example, article 10(2) of the treaty with Belarus states that:

...if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so

562 STC is however not deductible from the dividend declared and it is not payable by a shareholder. A company wishing to declare a dividend would therefore have to allow for STC in determining the amount to be paid as a dividend. See Huxham & Haupt at 236.

563 TA Manuel (Minister of Finance) "Budget Speech 2007". Available at <http://www.sars.gov.za/home.asp?pid=4346>, last accessed February 2007.

564 See Government Gazette No 19638 dd 1998-12-22.

565 See Government Gazette No 18552 dd 1997-12-15.

566 See the treaty with Cyprus, Government Gazette No 19638 dd 1998-12-22 and the treaty with Ireland, Government Gazette No 18552 dd 1997-12-15.

567 Olivier & Honiball at 168.

charged shall not exceed:

- (a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds at least 25 per cent of the capital of the company paying the dividends; or
- (b) 5 per cent of the gross amount of the dividends in all other cases.⁵⁶⁸

Article 10(2) of the treaty with Uganda states that:

... if the recipient is the beneficial owner of the dividends, the tax so charged shall not exceed:

- (a) 10 per cent of the gross amount of the dividends if the beneficial owner is a company which holds at least 25 per cent of the capital of the company paying the dividends; or
- (b) 15 per cent of the gross amount of the dividends in all other cases.⁵⁶⁹

It is submitted that these variations can be manipulated for treaty shopping purposes. It is however worth noting that pursuant to the introduction of the proposed new dividend withholding tax of 10%, South Africa is in the process of re-negotiating those tax treaties where the withholding tax is eliminated completely, to 5%.⁵⁷⁰

The seeming loophole in the law due to fact that South Africa does not levy withholding taxes on interest income is also covered by section 31(3) of the Income Tax Act, which is essentially a “thin capitalization” provision.⁵⁷¹ The section applies where any a non-resident investor has directly or indirectly granted financial assistance to a South African connected person. By virtue of such financial assistance, the non-resident is entitled to participate in not less than 25 per cent of the dividends, profits or capital of the recipient, or is entitled to directly or indirectly exercise not less than 25 per cent of the votes of the recipient. If the Commissioner is of the opinion that the aggregate value of all the financial assistance is excessive in relation to the fixed capital of the South African connected person, the cost of the financial assistance (any interest, finance charge or other consideration payable in respect of the financial assistance), which is considered excessive, is not allowed as a deduction in the hands of the South African connected person. In terms of SARS Practice Note

568 Government Gazette No 25914 dd 2004-01-15.

569 Government Gazette No 22313 dd 2001-05-24.

570 Olivier & Honiball at 168.

571 This term is used to describe the use of unusual proportions of loan to equity capital in order to gain a tax advantages. See The Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structures of South Africa *Thin Capitalisation Rules* (1995) at par 1.1; M Van Blerck “Transfer Pricing and Thin Capitalisation” (1995) 8 SA

⁵⁷² the Commissioner can apply the thin capitalization provision when the financial assistance/fixed capital exceeds a 3:1 ratio.

4.12 CONCLUSION

In order for South Africa's CFC legislation to be an effective measure in curbing offshore tax avoidance, it is important for the legislators to take South Africa's unique circumstances into consideration. South Africa's economy portrays aspects of both a developing and a developed economy.⁵⁷³ The developed aspect of the economy makes it necessary for South Africa's legislation to be in line with the trends in international taxation practices that are applied by major developed countries to curb offshore tax avoidance. This is necessitated by the fact that international interest in South Africa has grown, and this has encouraged South Africans to actively participate in the global economy. The heightened global trade competition and the mobility of capital in this modern world have also encouraged South African residents – both individuals and corporations – to make considerable investments offshore, and to also look for ways of minimising their global tax exposure.⁵⁷⁴ However, the developing aspect of the economy is reflected in the general lack of administrative capacity to handle complex legislation.⁵⁷⁵ This has required South Africa to recruit specialised tax experts from developed countries to administer the legislation.⁵⁷⁶ Coupled with this, there is the challenge of having to retain such foreign experts, and also that of employing and retaining South African professionals capable of administering the legislation. Indeed the OECD noted that the effective administration of the CFC legislation is hampered in most countries by

Tax Review at 44; Oguttu at 257.

572 GN 584 GG 17194 of 24 May 1996 as amended by GN 746 GG 23407 of 17 May 2002.

573 SARS "Discussion Paper on a Proposed System for Advance Tax Rulings" (2003) at 7. Available at ><http://sars.gov.za/legislation/Discussion20%Papers/Discussion%20proposed%20sytem20%Advance20%Tax20%Rulings.pdf><, last accessed 7 November 2007. See also AW Oguttu "Resolving Transfer-pricing Disputes: Are 'Advance Pricing Agreements' the Way Forward for South Africa?" (2006) 18 *SA Mercantile Law Journal* at 473.

574 Katz Commission Report (1997) at 4.

575 Olivier & Honiball at 359.

576 Olivier & Honiball at 359. See also USAID/South Africa "Annual Report" (16 June 2005) at 5. Available at >http://www.usaid.gov/locations/sub-saharan_africa/countries/southafrica/<, last accessed on 6 July 2007.

insufficient staff and a possible lack of expertise in international tax.⁵⁷⁷

The issue of the compatibility of CFC legislation and tax treaties has not received much attention in South Africa. Even though, under the CFC legislation, South African residents taxed on notional amounts, in line with *Bricom Holdings* case,⁵⁷⁸ the question of the compatibility of South Africa's CFC legislation with tax treaties is not a settled matter. If this conflict is not resolved, South Africa may be faced with a litany of court cases that challenge the applicability of its CFC legislation in a particular treaty situation.

The effectiveness of South Africa's CFC legislation also faces challenges in the e-commerce era. If e-commerce is not regulated and taxed, the loss of revenue could be tremendous. Therefore, there is a need for government policies to strike a balance between development and the taxation of e-commerce. South Africa should work hand-in-hand with developed and developing nations, in order to come up with a feasible way of taxing e-commerce transactions; so that the tax avoidance loopholes that e-commerce has created in the CFC legislation can be curbed.

The problems that complexity of the CFC poses need to be addressed, if this legislation is to be effective as an offshore anti-tax avoidance measure. Although this legislation is important in the sphere of corporate financial transactions involving foreign companies, its complexity may hinder its objective of curbing offshore tax and instead, lead to an increase in specialised tax structuring that circumvents its application.

With regard to the use of partnership/corporate hybrid structures to avoid taxes, it has been pointed out that there are a number of uncertainties about the taxation of hybrid entities in South Africa. In order to create legal certainty, it is recommended that South Africa's tax legislation be amended to specifically provide for the taxation of these entities.

577 OECD 2000 Report on CFC Legislation at 95.

With regard to the use of the “beneficial ownership” provision is curbing conduit company treaty shopping, it has been explained that there is no clear international meaning of the term “beneficial ownership”. The OECD has however provided some guidelines for interpreting the term. If South Africa is to effectively apply the term “beneficial ownership” to curb conduit company treaty shopping, it is recommended that our legislators should make use of the guidelines provided by the OECD and come up with a meaning of the term in the Income Tax Act. Since the company law meaning of the term “beneficial ownership” is in line with the OECD guidelines, this meaning should be refined and set out in the Income Tax Act.

578 See discussion in par 4.7 under the heading “The position in South Africa”.

CHAPTER 5

CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN OFFSHORE COMPANIES: THE UNITED KINGDOM AND THE UNITED STATES

5.1 THE UNITED KINGDOM CFC LEGISLATION

In the United Kingdom, section 482 of the Income and Corporations Taxes Act (“ICTA”) of 1970¹ had for years been the main weapon used by the Inland Revenue of the United Kingdom to counter international tax avoidance in the corporate sector.² This was reinforced by exchange controls, which imposed constraints on international transfers. With the abolition of exchange controls in 1979,³ section 482 became insufficient to counter the increasing accumulation of profits and income of United Kingdom companies in tax-haven subsidiaries.⁴

In 1981, the United Kingdom government issued a consultative document entitled “Tax Havens and the Corporate Sector”.⁵ This was the first stage of the attempt to combat tax avoidance by the use of foreign companies controlled by United Kingdom residents.⁶ In 1982 another document entitled “Taxation of International Business”⁷ was issued in which the government identified a number of arrangements that were being used to avoid tax liability in the United Kingdom.⁸

1 Repealed by the Income and Corporations Taxes Act of 1988. See Office of Public Sector Information “Income and Corporations Taxes Act of 1970”. Available at >http://www.opsi.gov.uk/ACTS/acts1988/Ukpga_19880001_en_102.htm#sdiv31<, last accessed 14 June 2007.

2 IFG Baxter “The United Kingdom and Tax Havens: A Comparative Comment” (1985) *The American Journal of Comparative Law* at 709. S 482 provided that a resident company can not cease to be so, or transfer trade or business to a non-resident without treasury consent.

3 Great Britain: Board of Inland Revenue *Tax Havens and the Corporate Sector: A Consultative Document* (1981) at 1.

4 Baxter at 709; Great Britain: Board of Inland Revenue *Tax Havens and the Corporate Sector: A Consultative Document* (1981) at 1.

5 Great Britain: Board of Inland Revenue (1981) at 1.

6 A Brown, CCH British Tax Reporter *Taxation of Companies* Vol 7 (updated 30 July 2006) at 646,101.

7 Great Britain: Board of Inland Revenue *Taxation of International Business* (1982) at 13.

8 These arrangements are: firstly, the “money-box” companies which are companies set up in tax havens in which in United Kingdom companies invest funds that yield tax-free returns or the income is taxed at a low rate. Secondly, the “dividend trap” companies

This culminated in the enactment of controlled foreign company (CFC) legislation under the Finance Act (“FA”) 1984.⁹ The provisions were later consolidated and are now located in sections 747-756 and Schedules 24-26 to ICTA 1988 (all further references to the ICTA are references to this statute). The legislation was subsequently tightened up by the FA of 1994 and again by the FA of 1996. Then, in 1999, the CFC rules were brought into line with the regime for self-assessment for companies that will be discussed in more detail later in this chapter.¹⁰

5.1.2 THE MEANING OF A CFC IN THE UNITED KINGDOM LEGISLATION

In terms of section 747(1) and (2) of the ICTA, a CFC is defined as a company that is resident outside the United Kingdom, is controlled (or deemed to be controlled) by persons resident in the United Kingdom and is subject to a lower level of taxation in the territory in which it is resident.

If a company is a dual resident (in that it is deemed to be a resident of both the United Kingdom and another treaty country), the United Kingdom uses the so-called “tie-breaker” rules which are enshrined in the OECD Model Tax Convention to determine in which country the company will be resident for purposes of the treaty. In terms of section 249 of the FA 1994, a company which is treated as non-resident by virtue of a treaty is deemed to be non-resident in the United Kingdom for all corporation tax purposes. Legislation was introduced in 2002, however, to limit the effect of this rule in the context of CFCs.¹¹ Thus, a company treated as non-resident for corporation tax purposes is disregarded for

which are holding companies resident in tax havens which receive and invest dividends from overseas trading subsidiaries of United Kingdom companies. Thirdly, the “offshore captive insurance” companies, which are companies established in a tax haven to insure the risks of other members in the same group. Fourthly, there are the “sales distribution or service” companies, which are companies established in tax havens to enable the selling, distribution or service by its United Kingdom parent company to be attributed to them although in practice they make little contribution to the business of the parent companies. Fifthly, there are the “patent holding companies”, which are companies established in tax havens to hold patent rights originally established by United Kingdom companies, thereby preventing the incidence of United Kingdom tax on royalties. See Great Britain: Board of Inland Revenue (1982) at 13; see also Brown at 646,101.

9 M Lang, HJ Aigner, U Scheurerle & M Stefaner *CFC Legislation Tax Treaties and EC Law* (2004) at 609; JS Schwarz “Controlled Foreign Companies and Tax Treaties” Dec (1997) *Bulletin for International Fiscal Documentation* at 554.

10 Par 5.1.6 below.

11 S 90 of FA 2002.

CFC purposes.¹² The purpose of this provision was to bring section 249 of the FA 1994 in line with the CFC legislation.

Section 747(4) of the ICTA provides that, in order to qualify as a CFC, a non-resident company should be controlled by United Kingdom shareholders who hold at least a 25% interest in the foreign company. Section 749(5) of the ICTA provides that persons who are deemed to have an interest in a CFC include shareholders with the capacity directly or indirectly to ensure that the company's assets are dealt with for their benefit and any other person who, alone or with others, has control of the company.

In determining the meaning of "control", it should be noted that previously this term carried the meaning of "control" for close companies as set out in section 416 of the ITCA. These rules provided broadly that "control" of a company was obtained through the ability to secure general control of the company itself, or half of its shares, income or assets. However, an amendment was introduced by the FA 2000 Schedule 31 that tightened the definition of "control" and also introduced a definition of "control" peculiar to CFCs. Thus, in terms of section 755D(1) of the ICTA, a person is said to have control of a company if he has the power to ensure that its affairs are conducted according to his wishes and that power may be exercised in relation to either the company under review or another company. This includes the possibility of a company being treated as a CFC, notwithstanding the fact that one or two persons who exercise control are not actually resident in the United Kingdom. For example, if one of the persons, who exercises control is from the United Kingdom and the other is a non-resident, but they each hold 40% of the interests by which they control the company, the company will be a CFC. However, the company will not be considered a CFC where the non-resident holds more than 55% of those interests.¹³ Thus, in addition to defining "control" in a manner which largely follows the previous position, the new test targets international joint venture companies where, typically, neither of the two main parties to the venture has

12 Brown at 646,023; J Tiley *Revenue Law* 5 ed (2005) at 1140; CCH *International Tax Planning Manual – Corporations* vol 2 (2005) at 92,104.

13 See ss 747(IA) and 755D(3) of ICTA 1988.

outright control.¹⁴ Under the previous rules, a United Kingdom company shareholder in a non-resident joint venture company of this kind would escape a CFC charge at the “control” stage.¹⁵

Once it has been determined that a company is resident outside the United Kingdom and that it is controlled by United Kingdom residents, the next step is to ascertain whether it is benefiting from a “lower level of taxation”. In terms of section 750(1) of the ICTA, “a lower level of taxation” means an amount of tax paid under the law of the foreign territory in respect of the profits of the company (the local tax) which is less than 75% of the corresponding United Kingdom tax on those profits. There were, however, cases where some well-known tax havens did not invariably qualify as “low-tax territories” for the purposes of the CFC legislation.¹⁶ This was arranged by enabling companies to pay just the right amount of tax to satisfy the requirement that the CFC is paying at least 75% of the equivalent United Kingdom tax. Such schemes resulted in the avoidance of a CFC charge on a United Kingdom company shareholder as these arrangements allowed companies to effectively choose their rate of tax.¹⁷ In October 1999, the Inland Revenue came up with the so-called “designer rate tax provisions” to bring these schemes within the CFC legislation even if they are taxed at 75% or more of the United Kingdom rate. Section 750A of the ICTA inserted by FA 2000, sets aside the normal requirement that a company is only within the CFC rules if it has paid tax at a level of less than 75% of that which it would have paid if it had been resident in the United Kingdom. Thus if a company is resident outside the United Kingdom and is taxed at a rate of 75% or more of the United Kingdom equivalent tax on its profits, it will be subject to a lower level of taxation for CFC purposes in the accounting period concerned.

14 Brown at 646,303; CCH International at 92,104; see also A Flint *Tolley's Tax Planning* (2003-2004) at 220; G Antczak & K Walton *Tolley's Corporation Tax* (2005-2006) at 345; Hugh J Ault and Brian J Arnold *Comparative Income Taxation: A Structural Analysis* 2 ed (2003) at 383; R Chidell & S Laing *Tax Planning: Business* (2005-2006) at 736-737; S Brandon *Taxation of Non-United Kingdom Resident Companies and their Shareholders* (2002) at 152; J Dixon & M Finney *International Corporate Tax Planning* (2002) at 1-15; S Whiting *Corporate Tax* (2005-2006) in par 7.9.1.

15 Brown at 646, 402.

16 For example, Guernsey bodies with international tax status, Jersey international business companies, Isle of Man international companies, Gibraltar income tax qualifying companies, and Irish companies. See CCH International in par 1.020; see also Flint at 222-223; Antczak & Walton at 347-348; Tilley at 1143.

For the accounting periods of non-resident companies which began after December 2004, further anti-avoidance measures were introduced in order to prevent companies artificially inflating their local tax by either loading local profits with income which would not be taxable in the United Kingdom, but is taxable in the non-resident territory, or taking advantage of regimes which allow tax repayments to be made to companies other than those entitled to the repayment.¹⁸ For such cases, in terms of section 705(1B) of the ICTA, the amount of local tax is treated as reduced where

- income and expenditure is taken into account in determining tax paid locally and that income and expenditure would not have been included in arriving at United Kingdom chargeable profits; in this case, the local tax is reduced to the amount it would have been had that income or expenditure not been included;
- a repayment is made (including a payment in respect of a credit for tax) to a person other than the company and that payment relates to the company's payment of tax. In that case the local tax is reduced by the amount of the repayment or credit made to the other person.

In essence, the effect of the above provision is that for accounting periods beginning after 1 December 2004, where any income or expenditure is taken into account in computing taxable profits in the foreign country, but would not have been taken into account when computing profits chargeable to United Kingdom corporation tax, the foreign tax paid for the purposes of this test is deemed to be that which would have been payable had the income or expenditure not been taken into account in the foreign country.

5.1.3 EXCLUSION FROM CFC LEGISLATION

The United Kingdom has a list of countries which are excluded from the application of the CFC legislation.¹⁹ These regulations are used as an anti-

17 Lang *et al* at 616; Chidell & Laing at 739; Dixon & Finney at 1-16.

18 Whiting in par 7.9.2.

19 Controlled Foreign Companies (Excluded Countries) Regulations 1998 (SI 1998/3081). These regulations replaced the former statutory white list. The regulations consist of two lists; one of territories where all companies are excluded and one of territories where

avoidance measure whereby certain countries are identified and “black listed” as tax havens. A company resident in one of the listed territories will only be excluded if it is carrying on business in that territory and at least 90% of its income or profits are locally generated.²⁰

5.1.4 EXEMPTIONS FROM THE CFC CHARGE

There are five exemptions from the CFC rules as set out in section 748 of the ICTA.

The acceptable distribution policy exemption

In terms of paragraph 2 of Schedule 25 of the ICTA, an exemption is granted where a CFC distributes at least 90% of its net chargeable profits for the accounting period to its United Kingdom shareholders if the dividends are taxable in their hands. The acceptable distribution test will, however, not be met if the dividends are paid out of specific profits. This is to prevent a CFC meeting the distribution test by specifying that dividends are paid out of profits which have been subjected to a high rate of foreign tax, thereby qualifying for double tax relief in the United Kingdom yet leaving untaxed or low taxed profits abroad. Dividends must generally be paid within 18 months of the end of the accounting period. A dividend paid to a dual resident company (and hence not accessible to

companies are excluded save for certain specific exemptions. If a company is resident in an excluded territory it does not qualify for exemption if its non-local source income exceeds 50 000 pounds or (if greater) 10% of its commercial quantified income; see also B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at UK/23; see also Ault & Arnold at 383. See also P Cussons “Finance Act Notes: Controlled Foreign Companies – ss 89 and 90” (2002) *British Tax Review* at 318; Chidell & Laing at 739.

20 CCH International at 92,104; Flint at 224; Tilley at 1152; Dixon & Finney at 1-17.

United Kingdom tax) does not satisfy the distribution test. Furthermore, the exemption does not apply if it is used as part of a tax avoidance scheme.²¹

The exempt activities test

To satisfy this test, a company must fulfil three conditions:

(i) Throughout the accounting period in question, the CFC is required to have a business establishment in the territory in which it is resident. This condition presupposes that the company genuinely operates where it is resident.²²

(ii) Throughout the accounting period in question, its business affairs in that territory should be effectively managed there. This ensures that bona fide foreign trading companies are kept outside the ambit of the CFC legislation.²³

(ii) One of the following should apply:

- The CFC's main business does not consist of investment business, or dealing in goods for delivery to or from the United Kingdom or connected or associated persons; and, in the case of a company mainly engaged in wholesale, distributive or financial business, less than 50% of its gross trading receipts come from connected or associated persons.²⁴
- The CFC should be a "local holding company" that derives at least 90% of its gross income during that period from non-holding companies which are resident in the same territory and engaged in exempt activities.²⁵
- The CFC should be a "non-local holding company" that derives at least 90% of its gross income during that period from local holding companies or non-holding companies engaged in exempt activities.²⁶

21 CCH International at 92,122; Tiley at 1148; Spitz & Clarke at UK23; see also Ault & Arnold at 383; Chidell & Laing at 741; Dixon & Finney at 1-21; Whiting in par 7.9.4(A).

22 According to par 7 of schedule 25, the term "business establishment" means the same as when applied in double tax treaties. There must be premises; these can be a mine, or long-term building site, a shop, office, or factory. The premises must be reasonably permanent and the company's business in the territory must be conducted from them.

23 According to par 8, schedule 25, a company is effectively managed in a territory if it employs sufficient personnel there to conduct its business and if services performed for residents outside the territory are not in fact performed in the United Kingdom.

24 Par 6(2) and 12 of Sch. 25.

25 Par 6(3) and 12 of Sch. 25.

26 Pars 6(4) and 12 of Sch. 25.

- The CFC should be a “superior holding company” that derives at least 90% of its gross income during that period from companies which it controls, each of which is engaged in exempt activities or is itself a superior holding company.²⁷

The public quotation test

In terms of the ICTA, paragraph 13-15 of Schedule 25, an exemption applies if the CFC is listed on a recognised stock exchange in the country in which it is resident. At least 35% of the voting share capital must be held by the public.

The motive test

Section 748(3) and paragraphs 16-19 of Schedule 25 to the ICTA provide that an exemption will be granted if the reduction of United Kingdom tax by diverting profits from the United Kingdom was not one of the main purposes of the company’s existence. A company resident in a country on the “excluded countries list” automatically passes this test.²⁸

The low profit exemption test

In terms of section 748(1)(d) of the ICTA, a CFC charge does not arise if the chargeable profits of the CFC are below £50 000 in any accounting period (the *de minimis* rule).²⁹ The purpose of the *de minimis* rule is to ensure that rules will not apply unless a certain threshold of profits has been exceeded. Such a provision alleviates the administrative burden on tax authorities so that resources are allocated to investigating CFCs with larger profit bases.³⁰

To enhance the effectiveness of the United Kingdom CFC legislation, section 748A of the ICTA was introduced by section 89 of FA 2002. This section has the

27 Par 12A(1) of Sch 25. See also CHH International at 92,122; Flint at 226-227; Antczak & Walton at 363-367; Tiley at 1150-1151.

28 See also Ault & Arnold at 383; Chidell & Laing at 756; Brandon at 156; Whiting in par 7.9.4(F).

29 S 748(1) (d) ITCA 1988.

30 G Clarke *Offshore Tax Planning* 9 ed (2002) at 391.

effect of removing the application of the exempt activities and also all the other exceptions, if the CFC is incorporated in or liable to tax in a territory designated by the Treasury.³¹ The purpose of section 748A is to give United Kingdom tax authorities a weapon against offshore tax avoidance that is in line with the OECD fight against harmful tax competition. The OECD policy is that if a tax haven is uncooperative, OECD members should make use of fiscal and other countermeasures.³² Section 748A enables the Treasury to tighten the CFC regime in respect to CFCs incorporated in a non-compliant territory. The designation of such a territory is, however, subject by statutory instrument to affirmative resolution procedures.³³

5.1.5 RELIEF IN RESPECT OF IMPUTED PROFITS

Where a United Kingdom company is chargeable on profits imputed from a CFC because the CFC fails to satisfy any of the above exemptions, relief is available to the United Kingdom company in terms of Schedule 26 of the ICTA. Such relief may take the following forms:

- The imputed profits may be reduced by loss relief, non-trading deficits on loan relationships, charges on income, management expenses, capital allowances or group reliefs to which the United Kingdom company is entitled.
- If the company disposes of shares in a CFC in respect of which it has paid tax following a CFC charge, the tax so paid may be deducted in computing the United Kingdom company's chargeable gain.
- Double tax relief is granted if the CFC pays a dividend in the same period in which a charge applies, but imputed profits are not relievable under the terms of any double tax treaty which would apply to income of the type received by the CFC had it been received in that form by the United Kingdom company, rather than being imputed. Thus the charge loses the character of the original income in the CFC.³⁴

31 G Clark *Offshore Tax Planning* 9 ed (2002) at 391-392.

32 OECD *Harmful Tax Competition - An emerging Global Issue* (April 1998) par 5

33 S 748A(5) ICTA 1988.

The result of all the above is that if in any accounting period a company is a CFC and none of the exemptions described above applies, then the apportionment is made among United Kingdom residents who have interests in the CFC. Where chargeable profits are apportioned to a United Kingdom resident company, in terms of section 747(4) of the ICTA, an amount equal to corporation tax on the apportioned profits is charged on the company. And in terms of section 747(4A), if the CFC's profits are computed in a foreign currency, the amount apportioned is converted to sterling at the prevailing rate at the end of the CFC's accounting period. The tax charged is the corporate tax at the principal rate. The tax so charged is regarded as tax for the accounting period of the United Kingdom company in which the CFC's accounting period ends and is reduced by so much of the CFC's creditable tax as is apportioned to the United Kingdom company concerned. No CFC charge is, however, charged on a United Kingdom company if less than 25% of the CFC's profits are apportioned to it and to connected or associated companies.

5.1.6 SELF-ASSESSMENT PROVISIONS

In 1998, sections 112-113 and Schedule 17 of the ICTA were introduced to bring CFC provisions into line with the United Kingdom corporation tax self-assessment regime, which became effective from 1 July 1999. Consequently, any company which has an interest in a CFC must complete a supplementary page to the self-assessment return unless the CFC falls within the "Excluded Countries Regulations" or the interest of the United Kingdom company and persons connected or associated with it is less than 25%.³⁵ Prior to the self-assessment rules, there was no obligation on a United Kingdom company to include details of its interest in a CFC in its tax return but now the onus rests on the United Kingdom resident to disclose the details of its interests in foreign subsidiaries and associated companies.³⁶ For instance, United Kingdom

34 Brown at 646,103.

35 D Whitecross & J Pearse "Controlled Foreign Companies and Self Assessment" (1998) *British Tax Review* at 9-10; Whiting in par 7.9.3.

36 With the self assessment regime the need for a discretion from the Board before the provisions apply is removed and the provisions apply automatically if the necessary conditions are met. This approach as opposed to a "policing" approach by the Inland Revenue is progressive and effective as the CFC rules apply automatically. This is unlike

residents have to sign a return whereby they identify a particular exemption and then certify that to the best of their knowledge and belief each of their overseas subsidiaries satisfies the particular exemption claimed. Penalties are not imposed where a United Kingdom resident demonstrates that it has made reasonable efforts to self-assess its CFC's liabilities.

5.1.7 OTHER UNITED KINGDOM ANTI-INCOME TAX DEFERRAL PROVISIONS

Provisions relating to the transfer of income to persons abroad

Leaving the CFC legislation aside, it is worth briefly noting that since 1936 the United Kingdom has also made use of the provisions of section 739, now embodied in the ICTA, to prevent United Kingdom residents from transferring assets abroad where income becomes payable to a non-United Kingdom resident, which results in the avoidance of taxes. Many transactions liable to tax under the CFC rules will also fall within the ambit of section 739. It should be noted, however, that section 739 results in income tax at a top rate of 40% compared with the CFC's corporation tax at the top rate of 30%.³⁷ The main target of the CFC legislation is CFCs that are widely owned by United Kingdom persons (not just companies), which fall outside the ambit of section 739 that covers only limited individual ownership.³⁸ Thus section 739 takes care of transactions that would fall outside the CFC rules. For instance, in cases where all the shares of a foreign company are owned by individuals, the foreign company will not be a CFC, but its profits can be assessed in the hands of the individuals under section 739. Since section 739 relates in general to the taxation of assets that are transferred abroad, it applies as much to companies as to trusts. The section will be discussed in detail in chapter 8 of this work in relation to offshore trusts. It will therefore not be discussed any further in this chapter.³⁹

the previous situation where an assessment triggered a liability which could only occur at a latter stage. See Clarke at 395; Whiting in par 7.9.3.

37 CCH International at 92.123; Antczak & Walton at 372.

38 Tiley at 1140.

39 Suffice it to note that, in relation to companies s 739 applies where assets are transferred,

Provisions relating to capital gains accruing to non-resident companies

Apart from the CFC legislation and section 739 of the ICTA, the United Kingdom also has provisions designed to curb the avoidance of tax that occurs when capital gains accrue to non-resident companies. In brief, section 13 of the Taxation of Chargeable Gains Act (“TCGA”) 1992 taxes United Kingdom residents on capital gains accruing to non-United Kingdom companies that would be classified as close companies if they were United Kingdom resident, subject to certain exceptions.⁴⁰ Where foreign capital gains are paid in relation to the capital gain, a credit is allowed against United Kingdom capital gains tax due under section 13.

5.1.8 THE COMPATIBILITY OF THE UNITED KINGDOM CFC LEGISLATION AND ITS TAX TREATIES

In chapter 4, it was pointed out that the applicability of CFC legislation may be challenged for being in conflict with a countries tax treaties. It is indeed contended that the United Kingdom CFC legislation constitutes a breach of its

or rights are created, and as a result, a United Kingdom ordinary resident individual (and/or his or her spouse) has the power to enjoy the income of a non-United Kingdom resident (including a company). A United Kingdom ordinary resident individual has the “power to enjoy” the income of a non-United Kingdom company, if he/she is a shareholder of a United Kingdom company which owns shares in the non-United Kingdom company, if he/she is a beneficiary of a trust which directly or indirectly owns shares in the non-United Kingdom company, or if he/she settles shares in the non-United Kingdom company in a discretionary trust. When the section applies, its effect is that the individual is taxable on his or her pro rata share of the income accruing to the non-resident, irrespective of whether he/she receives a distribution out of the income. Credit is given for foreign taxes arising on the income. The section does not apply where avoiding liability for United Kingdom taxes was not one of the main motives of the transfer of assets. See CCH International at 92,123.

40

The exceptions to this provision are:

- where the amount apportioned to the United Kingdom resident and connected persons is 10% and less of the gain.
- where the gains arise from the disposal of a tangible asset used for the foreign company’s business.
- where the gain arises on the disposal of foreign currency or a debt representing money used for the non-United Kingdom company’s business.
- where the gain arises as a result of a disposal of assets to a member of the foreign company’s own foreign group, in which case the 75% ownership rules apply.
- where Revenue agrees that a tax treaty can prevent it from taxing a gain that would normally fall within the section.

double tax treaties, but there has been only one United Kingdom case that has challenged this state of affairs.

In *Bricom Holdings Ltd v IRC*⁴¹ (which is briefly discussed in chapter 4, but now discussed in greater detail for purposes of clarifying the United Kingdom position), the taxpayer, Bricom Holdings Ltd, was resident in the United Kingdom and was the sole shareholder of Spinneys International BV (“Spinneys”), a company incorporated and resident in the Netherlands. Bricom Holdings Ltd borrowed substantial sums of money from Spinneys and paid interest on this money. For the taxation years in issue, the interest represented a substantial portion of Spinneys’ profits. In 1994, all the United Kingdom companies were assessed under the CFC regime. There was no dispute about the fact that Spinneys was a CFC, nor was it disputed that Bricom Holdings, as the sole shareholder of Spinneys, was potentially under the CFC regime.

Bricom Holdings appealed the assessments on the basis that the assessments included amounts that were excluded from tax in the United Kingdom under the 1980 United Kingdom-Netherlands Double Taxation Convention.⁴² Article 11(1) of the Convention provides that interest arising in one of the states which is derived and beneficially owned by a resident of the other state shall be taxable only in that other state. Bricom Holdings argued that by virtue of this article, the amounts were exempt from tax in the United Kingdom.

Inland Revenue contended that while the tax under section 747(6)(a) was a tax, it was not corporation tax, but a sum “equal to” corporation tax to be assessed on the United Kingdom resident company “as if” it were an amount of corporation tax chargeable on that company. It was therefore not a tax within the meaning of article 2(1) of the Netherlands/United Kingdom treaty (that set out the taxes covered by the treaty). Since section 747(6)(a) did not impose a corporation tax, the nature of the CFC charge was thus a *sui generis* charge on a notional sum

41 [1996] STC (SCD) 228.

42 Incorporated into United Kingdom domestic law by SI 1980/1961.

equal to corporation tax.⁴³

The court held that the taxpayer could not rely on article 11 of the treaty, as the “chargeable profits” as defined by section 747(6)(a) of ICTA are a purely notional sum that do not represent any profits of Spinneys on which United Kingdom tax is chargeable, nor do they represent any actual payments or receipts of Spinneys, whether of interest or of anything else. They were merely the product of a mathematical calculation made on a hypothetical basis. The “chargeable profits” which are defined by section 747(6)(a), exist only as a measure of imputation. Thus what is apportioned to the taxpayer company and subject to tax was not Spinneys’ actual profits, but a notional sum which was the product of an artificial calculation.⁴⁴ Finding in favour of Inland Revenue, the House of Lords held that the CFC regime was not a corporation tax or substantially similar tax and so it did not qualify for relief under the treaty.⁴⁵

It is worth pointing out that contrary to the court’s conclusions in the *Bricom Holdings* case, it has been contended by some commentators on the case that “chargeable profits” are not a “purely notional sum”. The purpose and effect of the United Kingdom CFC legislation is that the “chargeable profits” of a CFC are, in fact, the profits of the CFC (excluding chargeable gains) calculated in accordance with United Kingdom tax laws. This amount is no more a notional amount than the profits of a United Kingdom corporation computed in accordance with the provisions of the ICTA. The only difference would be the person or persons subject to tax in respect to the CFC’s profits.⁴⁶

Lang and his co-authors⁴⁷ also point out that it is difficult to reconcile the idea that the chargeable profits are on the one hand a manufactured or purely notional sum, and yet on the other hand have the same distinctive meaning for

43 M Clayson “The Impact of European Law and Treaty Relief on the United Kingdom Controlled Foreign Company Rules” (1998) 26 *Intertax* at 326.

44 [1997] STC 1179, at p 1194; Lang *et al* at 619-620 note that the chargeable profits are purely a notional sum and no part of those profits can be identified as constituting a particular source of income.

45 [1997] STC at 1195.

46 D Sandler “Case Notes: Tax Treaties and Controlled Foreign Company Legislation” *British Tax Review* No 1 (1998) at 207.

47 Lang *et al* at 620.

corporation tax purposes. Clayson⁴⁸ also argues that the court's conclusion is not entirely convincing as it is arguable that the tax imposed by the CFC charging provisions is corporation tax. Although section 747(4)(a) of the United Kingdom's ICTA 1988 uses the expression "equal to" and "as if", it merely calculates the amount of corporation tax payable in addition to any other sums payable by the company being assessed.

As the court in the *Bricom Holdings* case held that the treaty did not apply, because the interest in issue had lost its character as interest, and that what was actually taxed was a notional amount, this implied that the CFC legislation did not contravene the double taxation agreement. It is however argued that, notwithstanding this decision, the United Kingdom CFC legislation contravenes its double taxation agreements. However, the court in the *Bricom Holdings* case did not discuss the relevant treaty provisions at length, but instead based its decision on the supremacy of United Kingdom domestic law (ie a treaty can only have effect to the extent that it is enabled by domestic law).⁴⁹ This may have precluded the court from considering broader issues that are relevant to tax treaties.

United Kingdom double taxation agreements are based on the OECD Model Convention on Income and on Capital,⁵⁰ which upholds the principle that each corporation is treated as a separate entity distinct from its shareholders. When countries sign a double tax agreement, a company is generally regarded as resident for tax purposes in its country of incorporation, and its profits in one treaty country in which it is resident are not subject to tax in the other treaty country. The profits of a foreign corporation can only be taxed in the hands of its shareholders when dividends are distributed. However, CFC legislation ignores the notion that the foreign non-resident company is a different legal person separate from its parent company, as resident shareholders of a CFC are subject to tax on their pro rata share of the income of the CFC when it arises

48 Clayson at 327.

49 Lang *et al* at 629.

50 OECD *Model Tax Convention on Income and on Capital* (2005 Condensed version). See also Lang *et al* at 629; Sandler at 2.

rather than when it is distributed.⁵¹ This consolidation approach that is entailed in the CFC legislation, does in effect, contradict the basic structure of tax treaties.⁵²

Article 7 of the OECD Model Tax Convention further provides in part that the profits of an enterprise of a contracting state shall be taxed only in that state, unless the enterprise carries on business in the other contracting state through a permanent establishment situated there. A number of commentators have questioned the validity of CFC legislation in certain jurisdictions, as far as this legislation is in conflict with tax treaties entered into by the country concerned. Where, in accordance with article 7 of the OECD Model Tax Convention, a tax treaty between a shareholder's country of residence and the CFC's country of residence gives the latter the exclusive jurisdiction to tax the CFC's income, or to limit the jurisdiction of the former to tax such income, this may result in conflicts between the CFC legislation and the tax treaty. In the *Bricom Holdings* case, had the taxpayer relied on article 7 rather than on article 11 of the United Kingdom-Netherlands Double Taxation Convention, it could be argued that the profits of Spinneys could only be taxable in the Netherlands, unless Spinneys carries on business in the United Kingdom through a permanent establishment.⁵³

Lang and his co-authors⁵⁴ also point out that the court in the *Bricom Holdings* case did not consider the potential relevance of the Vienna Convention to the Law of Treaties 1969. Article 26 thereof provides that every treaty in force is binding upon the parties to it and must be performed by them in good faith. And article 31 states that a treaty must be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. The effect of these provisions should have been the focus of the United Kingdom courts on the significance of the treaty agreed between the two States. Otherwise, the application of CFC legislation could result in unilateral modification of the treaty without the other party's

51 T Rosembuj "Controlled Foreign Corporations – Critical Aspects" (1998) 26 *Intertax* at 335.

52 Sandler at 2.

53 Sandler at 206.

54 Lang *et al* at 629.

abandoning their right or competence on identical matters.⁵⁵

It has however been argued that the manner in which a domestic court will resolve the conflict between CFC legislation and a tax treaty depends on whether it is the CFC legislation, or the tax treaty that takes precedence.⁵⁶ Thus where a country's treaties are considered paramount to domestic legislation in the event of a conflict, the domestic law cannot override the treaty, in the absence of specific treaty-override provisions.⁵⁷ The CFC legislation may also not be applied, if the respective tax treaty does not contain a safeguarding clause that expressly and explicitly authorises that the CFC legislation may be applied.⁵⁸

In the United Kingdom, section 788(3) of the ICTA provides that the arrangements specified in the treaty shall "notwithstanding anything in any enactment" have effect in relation to income tax and corporation tax in so far as they provide relief from income tax in respect of income or chargeable gains. Upon entry into force in the United Kingdom, the provisions of the treaty are recognised as having the authority of statute law. Where there is a conflict between existing law and the treaty provisions, the treaty will prevail,⁵⁹ but where there is a conflict between the treaty as adopted in United Kingdom law and a subsequent legislative enactment, the subsequent enactment prevails. However, the use of the phrase "notwithstanding anything in any enactment" in section 788(3) suggests that treaty provisions would supersede subsequent domestic legislation.⁶⁰

Notwithstanding the above provisions, the United Kingdom maintains the view that its CFC legislation is compatible with the provisions of any double tax treaty.⁶¹ This is based on the premise that the United Kingdom CFC legislation calculates the notional corporate tax payable by the CFC as if the CFC were

55 Rosembuj at 333.

56 Sandler at 54 and at 99.

57 See International Fiscal Association (IFA), proceedings of a seminar held in Toronto, Canada, in 1994 during the 48th Congress of the IFA *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions* (1995) at 24; Sandler at 54.

58 Sandler at 99.

59 *Ostime v Australian Mutual Provident Society* (1995) 38 TC 492 at 514.

60 Sandler at 51; see also Lang *et al* at 625.

61 Tolley's *International Tax Planning* (1999) at 2-17.

resident in the United Kingdom; the tax would then be apportioned among all the company's shareholders and collected from the United Kingdom resident corporate shareholders, who hold 10 per cent or more of the shares of the CFC. In effect, the legislation employs the attribution-of-tax approach rather than the attribution-of-income approach, which it is reasoned is not in breach of existing bilateral tax treaties. The attribution-of-income approach would result in a breach of article 7, because the tax would then be calculated as if the foreign company were resident in the United Kingdom, and then merely allocated pro rata to its shareholders and collected from United Kingdom corporate shareholders. Despite this reasoning, it is still arguable that United Kingdom CFC legislation breaches its tax treaties as long as the treaties do not contain specific treaty-override provisions.⁶² The compatibility of CFC legislation and tax treaties has also been challenged in other jurisdictions.⁶³

62 Sandler at 158-160.

63 In France certain French companies that had created subsidiaries in Switzerland challenged the compatibility of s 209B of the French Tax Code (which is similar to the CFC legislation) with the 1996 France-Switzerland tax treaty. The first case to be decided in 1995 was *Schneider SDA v DVNI and TA Strasbourg* Decision of 21 November 1995, Lower Administrative Court of Paris, No. 207093/1 (as read from Sandler at 213). The case concerned a French corporation, Paramer. Paramer had paid 0.02 per cent of its profits in Swiss tax in 1981 and 22 per cent in 1992 to its French subsidiary, Schneider, which was assessed under s 209. The court found that the Swiss corporation benefited from a privileged tax regime since the amount of tax it had paid was substantially lower than the rate applied in France. Furthermore, it was not carrying on an industrial or commercial activity in Switzerland apart from its foreign financial investment activities. Accordingly, all the preconditions for the operation of s 209B existed. The taxpayer argued that the application of the CFC regime was contrary to art 9 of the 1996 France-Switzerland Tax treaty. The court held that art 9 was not applicable. See E Milhac & J Saiaac "French Courts Render Conflicting Decisions on CFC Rules" (1997) 14 *Tax Notes International* at 739; see also Rosembuj at 352.

In another French case which also concerned a French corporation, the courts reached a different decision. In *Strafor Facom SA v DG*, Decision of 12 December 1996, Lower Administrative Court of Strasbourg, No. 9158, Strafor Facom SA had created a wholly owned subsidiary in Switzerland. The subsidiary was subject to a privileged tax regime so the French tax administration taxed Strafor Facom SA on the income of its Swiss subsidiary under s 209. Strafor claimed that art 7 of the France-Switzerland tax treaty prohibits taxation in France of its Swiss subsidiary. Art 7 of the treaty provides that the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting states through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state, but only so much of them as are attributable to the permanent establishment. The court held that s 209B was contrary to art 7, because this article excluded from tax in France the profits of a corporation that had its head office in Switzerland, if the corporation did not have a permanent establishment in France. In effect, the court acknowledged that s 209B was a tax on profits of the Swiss corporation that was not permitted under the treaty. See Sandler at 214.

The *Schneider* case referred to above went on appeal to the Administrative Court in Paris

It is also worth noting that as a result of *Bricom Holdings* case, there is now an anomalous situation in United Kingdom domestic law. Where a particular provision makes a “direct” attribution of profits to a United Kingdom resident, it appears that treaty relief is available, but where a provision like a CFC charge makes an attribution of a “fictional sum”, treaty relief is unavailable.⁶⁴ Lang⁶⁵ points out that the distinction between the differing treatments of direct and indirect attributions is very difficult to support and can lead to arbitrary results.

5.1.9 CHALLENGES E-COMMERCE POSES TO THE UNITED KINGDOM CFC LEGISLATION

As explained above, CFC legislation prevents United Kingdom residents from avoiding taxes by diverting profits to CFCs. Gringras⁶⁶ points out that the United Kingdom CFC provisions that apply where a non-resident company, controlled by United Kingdom residents is subject to a lower level of taxation (ie less than 75% of the corresponding United Kingdom tax), can be easily manipulated by e-commerce to avoid taxes. Unlike companies that conduct business in the traditional way, companies trading over the Internet are considerably more mobile and so centres of activity can be easily relocated to any convenient

and the court decided in 2001 that the treaty did override the CFC rules. The court ruled that s 209B of the French tax code was not compatible with the provisions of the treaty signed between France and Switzerland. In conclusion, the position in France appears to confirm that a treaty overrides the CFC rules except in cases where a specific treaty provides otherwise. Subsequent to this decision, the French tax authorities have insisted on including a clause allowing for the application of CFC legislation in all new treaties negotiated. See L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 392; MN Mbwa-Mboma “France-Switzerland Treaty Overrides CFC Regime, French Tax Court Rules” (2002) 27 *Tax Notes International* at 143.

It is however worth pointing out that in 2002, the Supreme Court of Finland reached a decision similar to that in the *Bricom* case where it held that Finland’s CFC regulations could be applied if the wholly owned subsidiary of a Finish company was resident in Belgium. See *A Oyj Abp*, KHO:2002:26, (2002) 4 *International Tax Law Reports* at 1009. In reaching its conclusion, the court found that the large majority of OECD countries regard CFC regulations as compatible with tax treaties. It is however argued that this is not necessarily correct, as in most OECD countries this issue is far from settled. He further argues that the mere fact that the contracting states knew of the existence of CFC regulations before the countries entered into a treaty does not imply that the regulations will apply despite the existence of the treaty. The very essence of entering into a treaty is that its provisions will affect national legislation. See M Lang “CFC Regulations and Double Taxation Treaties” (2003) *International Bureau of Fiscal Documentation* at 56.

64 Lang *et al* at 629.

65 Lang *et al* at 630.

66 C Gringras *The Laws of the Internet* 2 ed (2003) at 409.

jurisdiction. A CFC may conveniently be located in a jurisdiction where tax is charged at a lower rate than in the United Kingdom. If the amount of the tax paid in that territory is at least 75 per cent of the amount of tax that would be paid in the United Kingdom, then the CFC provisions do not apply.⁶⁷

The exemptions to the United Kingdom CFC provisions can also be manipulated by e-commerce to avoid taxes. In terms of the “exempt-activities-test”,⁶⁸ an exemption applies where the CFC has a business establishment in the territory in which it is resident.⁶⁹ Its business affairs in that territory should be effectively managed there.⁷⁰ It was discussed in chapter 4 that e-commerce poses challenges to the “business establishment” concept, in that it can be manipulated to avoid taxes.⁷¹ These challenges also apply in the case of the United Kingdom. Inland Revenue is however of the view that in certain circumstances, it may be difficult for e-commerce to satisfy the “business establishment” exemption to the CFC rules. For example, where a CFC in a low-tax territory sells goods or services via the Internet, a taxpayer may not be able to claim this exemption, if the CFC does not maintain stock or locally employed staff in the low-tax territory to sufficiently manage the business.⁷² Thus, CFCs which are little more than a brass-plate company may not gain this exemption to the CFC Legislation. In these circumstances, the CFC rules may be applied to prevent United Kingdom companies from avoiding taxes when trade is conducted electronically.⁷³

Inland Revenue however acknowledges that CFC legislation was introduced in

67 S 750 of the ICTA.

68 See par 5.1.4 above under the heading “exempt activities test”.

69 Par 7 of schedule 25 to the ICTA.

70 Par 8 of schedule 25 to the ICTA.

71 The “business establishment” concept as used in the United Kingdom legislation carries the same meaning as set out in art 5 of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version). The challenges that e-commerce poses to the “business establishment” concept were pointed out by the OECD. See OECD Committee on Fiscal Affairs “Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on art 5” (22 December 2000). Available at ><http://www.oecd.org/dataoecd/46/32/1923380.pdf><, last accessed 26 June 2007. These challenges were discussed in chapter 4 par 4.8. See also H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) at 261-263.

72 Suddards at 269.

73 Inland Revenue “Electronic Commerce: The UK’s Taxation Agenda” (1999) at 54. Available at ><http://www.irwa.org.uk/e-commerce/resource/ecom.pdf><, last accessed on 16 July 2007

1984 and largely reflects the world before e-commerce. This legislation may not be adequate to deal with new technological developments. The increasing possibility for electronic goods and services to be offered to the international community from a company in a tax-haven country contrasts with the use of tax havens for intra-group arrangements, for which CFC rules were largely written.⁷⁴ It is possible therefore that other exemptions to the CFC rules could be manipulated for tax avoidance purposes and that the CFC exemptions may need to be changed at some point in order to ensure that the United Kingdom tax base continues to be adequately protected.⁷⁵

Inland Revenue also noted that it is not only the scope of the CFC legislation that faces e-commerce challenges but also its administration. Inland Revenue pointed out that for any tax system to work; there are a number of requirements that have to be fulfilled. These requirements are however challenged by e-commerce as discussed below.

Tax administrators should be able to identify who is doing business, whether a taxable transaction has taken place, who are the parties to the transaction, and their location. However, e-commerce has the potential to make it more difficult to satisfy this requirement, since it allows taxpayers to exploit the anonymity afforded by the internet to conceal their identify, location and/or particular transactions, income or gains.

To ensure tax compliance, the records of taxpayer's business transactions should be available to auditors. Encryption of records of financial transactions and electronic documents is legitimate and proper for reasons of commercial confidentiality.⁷⁶ However, encryption of software could be deliberately exploited by taxpayers to make it difficult for tax authorities to access their accounting

74 Inland Revenue 1999 at 54.

75 Inland Revenue 1999 at 54.

76 Inland Revenue 1999 at 52. The term "encryption" refers to the coding of a text message by a transmitting unit so as to prevent unauthorised eavesdropping along the transmission

records.⁷⁷ The global nature of the Internet may also encourage taxpayers to store their accounting records and documents on computers located offshore where they cannot be easily accessed by tax administrators. Where accounting records are available, the data ought to be verified as to its integrity, source, competence and accuracy. The integrity and authenticity of electronic data provides a challenge for tax administrators. They have traditionally relied on audit trails based on paper. Data held in electronic format can be corrupted and manipulate before presentation.⁷⁸

Inland Revenue also pointed out that knowledge of the taxable sector is important in coming up with compliance strategies. E-commerce is essentially a new means of trading. It may be used to take advantage of preferential tax regimes and thus increase harmful tax competition. The transient nature of the Internet together with the low start-up costs may encourage businesses to trade for some time without notifying tax authorities. The technology of smartcards as a means of electronic payment (e-cash) is continuously evolving and it ensures anonymity of cash and may result in unaccounted cash with out physical restrictions.⁷⁹

The United Kingdom government monitors the developments of e-commerce.⁸⁰ Although the government recognises that e-commerce poses risks to tax administration and compliance, it is committed to ensure that taxation is not a barrier to the growth of e-commerce.⁸¹ In 1998,⁸² the government set out its policy on the taxation of e-commerce, in which it pointed out that tax rules and tax compliance should be neutral between e-commerce and more traditional forms of commerce. Furthermore, that the taxation principles of neutrality, certainty and transparency, effectiveness and efficiency should also apply to the taxation of e-commerce. The government took the view that at that stage, it was

line. See R Buys & F Conje *Cyber law: The Law of the Internet in South Africa* (2004) at 131.

77 RA *Westin International Taxation of Electronic Commerce* (2000) at 4.

78 Inland Revenue 1999 at 52.

79 Inland Revenue 1999 at 53.

80 Inland Revenue 1999 at 54.

81 Inland Revenue 1999 at 8.

82 Inland Revenue "Electronic Commerce: UK Taxation Policy" (6 October 1998). Available at ><http://www.inlandrevnue.gov.uk><, last accessed on 16 July 2007.

not necessary to make any major changes to existing tax legislation and regulations, or to introduce new taxes in regard to e-commerce. But as technology developed, changes may become necessary to existing domestic rules in order to ensure that they continue to work efficiently.⁸³

The government also acknowledged that e-commerce would increase international trading transactions to an unprecedented level. International cooperation and the exchange of information between tax administrations is thus essential to detect those that are intent on avoiding taxes.⁸⁴ The United Kingdom government has been working hand in hand with the OECD and the European Union in developing internationally acceptable guidelines for the taxation of e-commerce.⁸⁵ In 1999,⁸⁶ the governments of the United Kingdom and the United States committed themselves to co-operate on a wide range of issues to support the development of global e-commerce. They agreed that in principle any taxation of e-commerce should be clear, consistent, neutral and non-discriminatory. They also agreed to actively participate within the OECD in developing a framework for the taxation of e-commerce that would ensure effective tax administration and prevent tax evasion and avoidance.⁸⁷

5.1.10 HOW THE COMPLEXITY OF THE UNITED KINGDOM'S CFC LEGISLATION AFFECTS ITS EFFECTIVENESS

Commenting generally on the United Kingdom's tax system, the 2006 Report of the Tax Reform Commission⁸⁸ noted that the last decade has seen an increase in United Kingdom tax complexity, and instability which has had the effect of damaging the United Kingdom's economic growth and international competitiveness.

83 Inland Revenue 1999 at 23.

84 Inland Revenue 1999 at 55.

85 Inland Revenue 1999 at 11 and at 55.

86 The Information Warfare Site "US-UK Joint Statement on Electronic Commerce" (30 January 1999). Available at ><http://www.iwar.org.uk/e-commerce/resources/usukecommerce.htm><, last accessed on 16 July 2007.

87 The Information Warfare Site at 2.

The Commission noted that the United Kingdom's CFC legislation has been complicated by repeated amendments.⁸⁹ As each amendment to the CFC legislation is introduced, tax advisers seek to exploit loopholes created unintentionally by the new amendment, then tax authorities respond with more amendments (often at short notice need to "iron out many of the problems that arise in practice") thus creating more unforeseen loopholes. The Commission noted that this cycle can be hard to break, and it in turn makes planning harder, and investment less attractive. The complexity of the legislation also increases administrative burdens and adds to the cost of tax.⁹⁰

The United Kingdom Law Society has noted that, the "United Kingdom's CFC regime is one of the most restrictive of any major foreign jurisdictions as it fails to reflect modern commercial realities and results in a significant compliance burdens".⁹¹ In order to improve the United Kingdom's international competitiveness, and also improve on the simplicity of this legislation, it was recommended that "participation exemptions" should be introduced for all income from qualifying foreign shareholdings.⁹² A participation exemption implies that a holder of a qualifying shareholding in a non-resident company does not pay tax on dividends received on the shares. It is suggested that, with the introduction of participation exemptions, a big part of the United Kingdom's CFC legislation could be substantially simplified.⁹³ This is because, with a participation exemption, there would be no incentive for companies to keep profits offshore and therefore outside the United Kingdom's tax net. It is argued that this would encourage offshore earnings to be repatriated to the United Kingdom. It is also reasoned that the introduction of participation exemptions would remove most of the complexities in the CFC legislation, as most of the complicated rules for calculating underlying tax credits would become redundant. The result would be to enhance greatly the attractiveness of the United Kingdom as a location for

88 United Kingdom Tax Reform Commission "Tax Matters: Reforming the Tax System" (October 2006) at 7. Available at ><http://www.taxreformcommission.com/report.php><, last accessed 10 September 2007).

89 UK Tax Reform Commission Report at 53.

90 UK Tax Reform Commission Report at 22.

91 UK Tax Reform Commission Report at 82.

92 UK Tax Reform Commission Report at 82.

93 UK Tax Reform Commission Report at 82.

controlling international business.⁹⁴

The Tax Reform Commission recommended that, the United Kingdom should follow the example of some countries that have simplified their CFC legislation, as they have come to realise that simpler tax systems are less distorting to the economy, fairer, cheaper to manage, and easier understand.⁹⁵

5.1.11 CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN OFFSHORE PARTNERSHIP/CORPORATE HYBRID ENTITIES: THE UNITED KINGDOM

In the United Kingdom partnerships are governed in terms of the Partnership Act 1890. In terms of this Act, partners in a firm are jointly and severally liable for all the debts and obligations of the partnership. The problem with partnerships is that an individual partner's personal assets are at risk from claims arising out of actions of partners which may exceed not only the firm's insurance cover, but also the ability of the firm to meet the quantum of the claim from its own resources.⁹⁶ To counteract the disadvantages of partnerships, the "limited liability partnership" (LLP) structure was created. The United Kingdom LLP comes into existence upon incorporation.⁹⁷ In terms of section 1(2) of the Limited Liability

94 UK Tax Reform Commission Report at 82-83.

95 The Tax Reform Commission Report quoted the example of the Australian Government which in its 2003-2004 Budget speech introduced a package of reforms to its international tax laws. Among the reforms was the reduction of the costs of complying with CFC rules. This would be achieved by simplifying the application of the CFC rules for Australian companies operating in countries where tax arrangements are comparable to those in Australia and easing these rules for certain services provided in international markets. The Australian government was of the view that such reforms would encourage the establishment in Australia of regional headquarters for foreign groups, and improve Australia's attractiveness as a continuing base for multinational companies. See Australian Government "Budget 2003-04 Paper 1". Available at ><http://www.budget.gov.au/2003-04/bp1/html/bstl-03.htm><, last accessed on 10 September 2007).

96 D Armour *Tolley's Limited Liability Partnerships: The New Legislation* (2001) at 2.

97 J Freedman "Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?" in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives* (2004) at 304.

Partnerships Act 2000 (LLPA), the LLP is a body corporate with legal personality separate from that of its members. The LLP combines the organisation flexibility and taxation treatment of a partnership but with limited liability for its members.⁹⁸ The United Kingdom LLP is thus seen as a “hybrid creature” that is based substantially on the corporate model.⁹⁹

In general, the United Kingdom partnership law does not apply to a limited liability partnership, but the arrangements between the partners may closely follow a traditional partnership agreement.¹⁰⁰ For example, LLPs are run like general partnerships and they have a similar degree of management flexibility.¹⁰¹ However, the LLP’s existence as a corporate entity means that the effect of the general law is different in comparison with a partnership. Members of an LLP benefit from the limited liability and so their own personal assets will be protected whilst those of the LLP will be at risk, as is the case with a limited company.¹⁰² But unlike a limited company, in an LLP there is no distinction between the owners of the company (its shareholders) and its managers (directors).¹⁰³ The participators in an LLP are referred to as members,¹⁰⁴ who are free to regulate their internal affairs as they see fit.¹⁰⁵

For purposes of taxation, the LLP is not treated as a corporation but as a partnership. Sections 10 of the LLPA 2000 inserts section 118ZA to 118ZD in the Income and Corporations Act 1988 (ICTA) and sections 59A and 156A in the Taxation of Capital Gains Act 1992 (TCGA). The effect of these provisions is to

98 Armour at 295.

99 G Morse “Limited Liability Partnerships Law Reform in the United Kingdom” in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives* (2004) 317 at 325.

100 Lawywer.com “Limited Liability Partnerships”. Available at ><http://www.lawyers.com/>< last accessed 29 February 2007; G Morse “Limited Liability Partnerships Law Reform in the United Kingdom” in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives* (2004) 317 at 323.

101 Lawywer.com “Limited Liability Partnerships”. Available at ><http://www.lawyers.com/>< last accessed 29 February 2007.

102 A Jones “Characterisation of other States’ Partnerships” (2000) 56 *Bulletin for International Fiscal Documentation* at 292.

103 Armour at 2.

104 Freedman at 304.

105 Armour at 2.

treat an LLP as if it were a partnership for purposes of these two Acts.¹⁰⁶ Thus, unlike corporate bodies, the profits or gains made by an LLP are not subject to corporations tax assessed on the LLP. Since the LLP is transparent for tax purposes, each member is assessed on his shares of the income or gain of the LLP in accordance with section 111 of the Income and Corporations Taxes Act 1988 (ICTA 1988), and corporate members of the LLP (such as clubs and societies)¹⁰⁷ are liable to corporations tax in accordance with section 114 of ICTA 1988. The tax treatment of the LLP creates opportunities for tax avoidance.

In United Kingdom, a partnership is not regarded as a resident for treaty purposes as it is not liable to tax in the UK.¹⁰⁸ It is however worth noting that in the approach in the United Kingdom to partnerships and double taxation conventions changed as a result of the decision in *Padmore v IRC*.¹⁰⁹ In that case a United Kingdom resident partner of a partnership managed and controlled in Jersey sought exemption from his share of the partnership profits under the terms of the 1952 double taxation treaty between the United Kingdom and Jersey. The High Court held that a partnership was a “body of persons” so as to be capable of satisfying the definition of “resident” and benefit from the treaty. The court however pointed out that the phrase “body of persons” did not have the above meaning for purposes of the Taxes Act.¹¹⁰ It was held that the partnership

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- 106 S 118ZA of the ICTA 1988 provides that for purposes of the Tax Acts, a trade, [profession or business carried on by a limited Liability partnership with a view to profit shall be treated as carried on in partnership by its members (and not by the Limited Liability partnership as such); and, accordingly, the property of the limited liability partnership shall be treated for those purposes as partnership property. Then s 59A of the TCGA 1992 provides that where a limited liability partnership carries on a trade or business with a view to profit –
 (a) assets held by the limited liability partnership shall be treated for purposes of tax in respect of chargeable gains as held by its members as partners, and
 (b) any dealings by the limited liability partnership shall be treated for those purposes as dealings by its members in partnership (and not by the limited Liability partnership as such),
 any tax in respect of chargeable gains accruing to the members of the limited liability partnership on the disposal of any of its assets shall be assessed and chargeable on them separately.
- 107 Freedman at 304.
- 108 P Baker “The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities”. Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.
- 109 [1987] STC 36.
- 110 S 526(5) ICTA 1970, now s 832(1) ICTA 1988, indicates that “body of persons” does not include a partnership.

income was exempt under the treaty and that the profits were similarly exempt in the hands of the individual partners. This decision was upheld on appeal.¹¹¹ The decision in *Padmore* has now been reversed by section 112(4) and (5) ICTA 1988.¹¹² Those sub-sections provide that, where a partnership resident outside the United Kingdom is relieved from United Kingdom tax on income or capital gains by virtue of a double taxation convention, a resident partner shall be taxed without regard to such convention. Thus these sub-sections reverse the specific impact of the *Padmore* decision without overruling the general holding that a partnership may be a body of persons.

As a result of the *Padmore* case, the United Kingdom has begun to include specific references to partnerships in the treaties it has recently negotiated.¹¹³ Where neither state regards a partnership as a taxable entity separate from its partners, partnerships are excluded from the definition of a person.¹¹⁴ Where, however, the other treaty state recognises a partnership as a separate entity, such a partnership is regarded as a person but a specific provision similar to the following is included:¹¹⁵

111 [1989] STC 493.

112 Similar legislation was also enacted in Canada to ensure that the *Padmore* result could not arise in Canada. For details see P Baker "The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities". Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007

113 See art 3(1)(h) of the 1974 Convention with Cyprus, art 3(1)(e) of the 1987 Convention with Bulgaria which expressly exclude partnerships from the scope of the treaty. Article 3(1)(c) of the 1975 Convention with the United States includes partnerships. Article 2(1)(g) of the 1973 Convention with Malaysia originally excluded partnerships; this was amended by Protocol in 1987. For details see P Baker "The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities". Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.

114 For example, art 3(1)(e) of the 1993 convention with Ghana Convention provides: "the term 'person' comprises an individual, a company and any other body of persons, but does not include a partnership". For details see P Baker "The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities". Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.

115 See art 25(1) of the 1993 Convention with India. See also art 24 of the 1993 Convnetion

Where, under any provision of this Convention, a partnership is entitled, as a resident of ..., to exemption from tax in the United Kingdom on any income or capital gains, that provision shall not be construed as restricting the right of the United Kingdom to tax any member of the partnership who is a resident of the United Kingdom on his share of the income and capital gains of the partnership; but any such income or gains shall be treated for the purposes of the article ... of this Convention as income or gains from sources in ...

An attempt to use a hybrid entity structure to avoid United Kingdom taxes can be illustrated by the case *Memec PLC v IRC*.¹¹⁶ This case dealt with “silent partnerships” which are generally arrangements that are contractual in nature. Silent partnerships are not recognised in the United Kingdom but they are recognised in some countries, for example Germany.¹¹⁷ In terms of these arrangements, the silent partners contribute assets to a managing partner in consideration for a share of the profits from the business. Silent partnerships are not treated as entities. The managing partner owns the assets transferred by the silent partners. The payments made to the silent partners are usually deductible when computing the income of the managing partner, although they may be subject to withholding tax. If the country in which the silent partner is resident treats the silent partnership as a partnership and if it taxes business income on a territorial basis, then there will be no tax, except possibly withholding tax, in either country.¹¹⁸

In *Memec PLC v IRC*,¹¹⁹ Memec, a United Kingdom company, owned shares in a Germany company, which in turn owned shares in two Germany operating companies. The operating companies paid German trade taxes that were not creditable against United Kingdom tax when Memec received dividends from its two-tier German subsidiary. Therefore, Memec entered into a silent partnership with the German corporation and then claimed that it had received dividends as a partner directly from the operating companies and that it was entitled to a credit

with Ukraine. For details see P Baker “The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities”. Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.

116 [1998] STC 754.

117 Arnold & Mclyntre at 146.

118 Arnold & Mclyntre at 146.

119 [1998] STC 754.

for the taxes payable.¹²⁰ The United Kingdom Court of Appeal held that the German silent partnership was not a partnership under United Kingdom law and that the source of the income was the contractual agreements. Therefore, the taxes were not creditable.

5.1.12 CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN CONDUIT COMPANY STRUCTURES: THE UNITED KINGDOM

Generally the United Kingdom does not have a general statutory anti-avoidance rule in respect to treaty shopping.¹²¹ It also prefers not to insert general anti-abuse provisions in its double taxation treaties.¹²² The concern of the United Kingdom is the uncertainty such provisions generate especially with respect to distinguishing between abusive and non abusive cases.¹²³ The United Kingdom has instead included specific anti-abuse clauses in its treaties.

In line with the OECD recommendations, the United Kingdom uses the “beneficial ownership” provision in its tax treaties to curb conduit company treaty shopping. However, the United Kingdom does not have a meaning of the term “beneficial ownership” in a treaty context.¹²⁴ In the domestic context, the term beneficial ownership has a different meaning for Common Law and Equity.¹²⁵ The common-law position is that ownership is indivisible and consequently this law only recognises legal ownership. Equity on the other hand, allows divided ownership, with legal title being in one person and beneficial ownership in another. In *J Sainsbury plc v O’Conner (Inspector of Taxes)*¹²⁶ it was held that the term “beneficial ownership” means ownership for your own benefit as opposed to ownership as trustee for another. Further that, beneficial ownership exists where there is no division of legal and beneficial ownership or where legal

120 For a detailed discussion on “silent partnerships” see J Dixon & M Finney *Tolley’s International Corporate Tax Planning* (2002) par 4.4 - 4.9

121 Rohatgi at 371.

122 Tomsett at 107.

123 H J Ault & B J Arnold *Comparative Income Taxation: A Structural Analysis* 2nd edition (2003) at 433.

124 Olivier & Honiball at 349.

125 Oliver et al at 41.

ownership is vested in one person and the beneficial ownership in another.¹²⁷ In *Wood Preservation Ltd v Prior (Inspector of Taxes)*¹²⁸ the court considered the meaning of “beneficial ownership” in the context of shares. The court pointed out that “beneficial ownership” has nothing to do with control of a company and that the beneficial enjoyment of dividends is an important feature of the beneficial ownership of shares. It was held that the term “beneficial ownership” means ownership which is not merely legal ownership by the mere fact of being on the company register, but it is the right to deal with property as your own.

Perhaps one case that provides some guidance in regard to the interpretation of the term in a treaty context, is *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch*.¹²⁹ In this case the Court of Appeal expanded on the United Kingdom's traditionally narrow interpretation of “beneficial ownership”. A key point is that this was not a tax case, but it was litigation on the basis of a contract between Indofood International Finance Ltd (“Indofood”) and the bank “JPMorgan” in its capacity as trustee for some public bondholders. The facts of the case were that PT Indofood Sukses Makmur TBK was a company incorporated in Indonesia, wished to raise capital by issuing loan notes on the international market. Under Indonesian law, it would have been obliged to withhold tax at 20% on interest payments to the note holders. To circumvent this, a wholly-owned subsidiary was incorporated in Mauritius to take advantage of the tax treaty between Mauritius and Indonesia, which provided a reduced withholding tax of 10% on interest payments. The terms of the loan notes allowed early redemption of the loan loans if a change in Indonesian law increased the withholding tax to more than 10%. However, the loan notes also provided that before such redemption can take place, reasonable steps should be taken to remedy the situation.

In 2004, Indonesia gave notice to Mauritius of the termination of the tax treaty. As a result, the 20% withholding tax in terms of Indonesian law would apply. The parent company, Indofood, gave notice to the trustee (JP Morgan) of the early

126 [1999] STC 318, CA at 330.

127 For further comments on this case, see Olivier & Honiball at 349.

128 (1968) 45 TC 112, CA, at 133.

redemption of the loan notes. However, the trustee refused to proceed with the redemption of the loan notes on the basis that Indofood had not pursued all avenues to avoid the increased liability for withholding tax. JP Morgan's argument was that Indofood was able to take reasonable measures to mitigate the increased withholding tax by setting up a conduit company in the Netherlands. As the loan notes were subject to United Kingdom law, it fell to the United Kingdom courts to consider the dispute.

The High Court ruled in favour of JP Morgan, on the basis that the increased withholding tax could have been avoided by the insertion of the Netherlands conduit company. On appeal, one of the issues was whether the Netherlands conduit company would be the beneficial owner of the interest payable by Indofood within the meaning of article 11 of the Netherlands/Indonesia treaty. The Chancellor in the Court of Appeal, referred to the Commentary to OECD Model Convention which provides that a conduit company cannot be regarded as a beneficial owner if, through the formal owner, it has as a practical matter, very narrow powers which render it in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties. In respect to the facts of the case, the Chancellor pointed out that in order for the conduit company to be a beneficial owner, it would need to directly benefit from the income. The facts showed that since the Netherlands conduit company was bound to pay on what it received from Indofood, it was impossible to see how this company "could derive any 'direct benefit' from the interest payable". Its role was therefore equated to that of an "administrator of the income" that could not be regarded as the beneficial owner of the interest.¹³⁰

The Chancellor ruled that in the context of tax treaties, the term "beneficial ownership" should be accorded an international fiscal meaning, taking into

129 [2006] EWCA CV 158

130 See also H Smith "UK: HMRC Publishes Draft Guidance on Indofood". Available at <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=23172&SID=66...<> last accessed 7 March 2007; M Oliver & I Toth "A Review of *Indoffo International Finance Ltd V JP Morgan Chase Bank NA London Branch* [2006]STC 1195 and Draft Guidelines Issued by HM Revenue & Customs". Available at [http://www.birdandbird.com/English/publications/articles/Review_Indofood_HMRC_...>,"](http://www.birdandbird.com/English/publications/articles/Review_Indofood_HMRC_...>,) last accessed 7March 2007.

account the OECD literature and that the meaning should not be restricted to the domestic law of the contracting states. Some commentators have however argued the court's ruling that advocates for an expanded international meaning "is undoubtedly a new departure" that has expanded the United Kingdom's traditionally narrow interpretation of beneficial ownership.¹³¹ It is however arguable that in a treaty context, the term has had such a meaning all along.

The decision in this case, while clearly influenced by the underlying facts, should serve as a reminder that the use of "conduit" companies in tax-planning structures, requires very careful planning.¹³²

5.2 CURBING TAX AVOIDANCE THAT RESULTS FROM INVESTING IN OFFSHORE COMPANIES: THE UNITED STATES

The United States was the first country to enact legislation that prevents deferral of taxation by its residents when foreign companies are established in tax-haven jurisdictions.¹³³ The first means devised by taxpayers to achieve deferral was the establishment of so-called "foreign personal holding companies". An individual would transfer income-producing assets to a wholly-owned corporation in a low-tax foreign jurisdiction, so they would attract no current income tax. The government responded by adopting the "foreign personal holding companies" ("FPHC")¹³⁴ provisions in 1937, which were codified in sections 551-558 of the Internal Revenue Code ("the Code") of 1954.¹³⁵ These rules aimed rather narrowly at what has been called "incorporated pocket books", which are foreign

131 M T McGowan "Indofood court Expands Interpretation of Beneficial Ownership" 42 *Tax Notes International* (June 2006) at 1091.

132 Ernest & Young Tax Services "Dutch Conduits not on Indofood Menu" *Tax Newsletter Issue 3* (June 2006). Available at >http://www.tecbrand.com/taxwatch3-dublin/case_further_03.html<, last accessed 28 March 2007.

133 Westin at 181; Sandler at 24; see also BJ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 130; see also C Doggart "Tax Havens and Their Uses" *The Economist Publication* (1990) Special Report No 1191 at 92; 40th Congress of the International Fiscal Association, *Taxation of Domestic Shareholders on Undistributed Income of Foreign Affiliates: Objectives, Techniques and Consequence* (1986) at 7; WH Diamond & DB Diamond *Tax Havens of the World* (Release No 108 Jan 2002) Vol 1 at INTRO.1; E Tomsett *Tax Planning for Multinational Companies* (1989) at 90; see also A Ogley *The Principle of International Taxation* (1993) at 15.

134 OECD Issues in International Taxation No 1 *International Tax Avoidance and Evasion* (1987) at 20; Doggart note 23 at 92.

135 J Isenbergh "Perspectives on the Deferral of United States Taxation of the Earnings of Foreign Corporations" (1988) 66 *Taxes* at 1063; OECD Issues in International Taxation No 1 at 20; Doggart at 92.

investment entities owned and controlled by a small number of individuals.¹³⁶ As a result of these rules, a United States shareholder in a “foreign personal holding company” was taxed directly on the undistributed income of the company.¹³⁷ The FPHC provisions only affected closely held foreign corporations that are controlled by five or fewer United States shareholders. There was thus a need to enact provisions that would deal with widely held foreign corporations or widely held parent companies with foreign subsidiaries that have investment income.¹³⁸

In 1962, new provisions that are referred to as “subpart F provisions” were enacted to deal with CFCs.¹³⁹ The subpart F provisions were the first comprehensive provisions to deal with CFCs. These provisions went beyond the FPHC provisions by eliminating the deferral of United States tax not only for passive income earned by a CFC, but also for certain foreign source business income.¹⁴⁰ As the FPHC provisions overlapped with the subpart F provisions, Congress repealed the FPHC provisions in 2004.¹⁴¹

In 1961, before the subpart F legislation was adopted, the Kennedy Administration proposed doing away with deferral for all foreign corporations controlled by United States residents by requiring immediate taxation of all foreign business income.¹⁴² The reason for this proposal was that deferral created a bias in favour of overseas investment against domestic investment.

136 Sandler at 24; Arnold at 130.

137 A company qualified as a FPHC when it was incorporated outside the United States and more than 50% of the total voting power or the value of the outstanding stock was directly or indirectly owned by five or fewer United States citizens or United States residents. FPHC income was generally passive income such as dividends, interest, annuities, royalties, rents and gains on the sale of or exchange of securities, which must make up 60% or more of the foreign corporation’s gross annual income for it to be considered a FPHC. Duggart at 92; Spitz & Clarke at US/32; JE Bischel, R Feinschreiber *Fundamentals of International Taxation* 2 ed (1985) at 106.

138 Bischel & Feinschreiber at 105.

139 Rotterdam Institute for Fiscal Studies *International Tax Avoidance* Vol A (1979) at 272.

140 Arnold at 130; ET Laity “The United States’ Response to Tax Havens: The Foreign Base Company Service Income of Controlled Foreign Corporations” (1997) 18 *North Western Journal of International Law and Business* at 3.

141 This was in terms of s 413 of the American Jobs Creation Act of 2004.

142 PR McDaniel, HJ Ault & JR Repetti *Introduction to United States International Taxation* 5 ed (2005) at 113. Note that the appropriateness of the deferral of United States tax has been seriously questioned since 1962. Legislation was proposed at that time which would have eliminated deferral for all United States controlled foreign corporations and taxed the foreign profits directly to the United States shareholders on a current basis. After lengthy and complex legislative process, general elimination of deferral was rejected.

The Kennedy Administration's view was that current United States taxation of controlled foreign corporations across the board would restore a measure of neutrality to investment decisions across national boundaries.¹⁴³ However, the United States business community rejected this proposal, arguing that it would devastate the competitiveness of United States businesses abroad if they were taxed more heavily than their competitors from other countries.¹⁴⁴ Although the arguments of the United States business community were not entirely convincing,¹⁴⁵ eventually, instead of imposing current taxation on various types of tax-haven operations (eg on income attributed to intangible property used overseas, and on foreign profits used to create new overseas ventures), the United States has since then employed the strategy of eliminating deferral mainly on certain passive and highly mobile foreign earnings, while deferral is generally continued for income from active business operations.¹⁴⁶

5.2.1 THE OPERATION OF THE UNITED STATES SUBPART F PROVISIONS

A foreign corporation is defined under United States tax law as a corporation created under the laws of a foreign country. Thus it is not subject to United States income tax on its income, unless it is engaged in trade or business in the United States, or if it generates income from sources within the United States.¹⁴⁷ Its earnings will, however, be subject to United States tax when dividends are distributed to United States shareholders who are subject to worldwide taxation.¹⁴⁸ The effect of this is that the United States tax on foreign-source income earned by a foreign corporation is deferred until the foreign corporation distributes dividends to its shareholders.¹⁴⁹

A CFC is defined as a foreign corporation, if more than 50% of the total

143 JD Kuntz & RJ Peroni *US International Taxation* Vol 1 (2005) in par B3.01 at B3-10.

144 Isenbergh at 1064; Av-Yohan' Comment on Peroni *et al* at 536.

145 Isenbergh at 1064.

146 Isenbergh at 1064; CM Boise "Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty". Available at >http://ssrn.com/sol3/papers.cfm?abstract_id=929587> last accessed 26 October 2006.

147 Ss 881 and 882 of the Code.

148 S 243(b) (1) and (5) of the Code.

149 DA Kleinfeld & EJ Smith *Langer on Practical International Tax Planning* 4 ed (2001) vol 1 in par 85.1; WF O'Conner *An Inquiry into the Foreign Tax Burdens of United States*

combined voting power of all classes of voting stock is owned by United States shareholders on any day during the taxable year of the CFC.¹⁵⁰ The definition of a “United States shareholder” refers to any citizen, resident, partnership, corporation, estate or trust.¹⁵¹ A United States shareholder who owns 10% or more of the total combined voting power of all classes of voting stock of a CFC must include in his income in each year his pro rata share of the CFC’s undistributed income.¹⁵² In terms of section 958 (a)(1)(A) and (B) of the Code, “stock owned” can be stock owned directly or indirectly by or for the foreign corporation, foreign partnership, foreign trust or foreign estate as owned proportionately by the entire entity’s shareholders, partners or beneficiaries. Thus this section acts as a “look through” provision into these foreign entities.¹⁵³

To prevent double taxation of subpart F income, there is no further taxation in the United States when the income is actually distributed by the CFC that earned the income.¹⁵⁴ If the foreign corporation pays tax abroad, the United States shareholder that is a domestic corporation receives a foreign tax credit that can offset the current United States tax on the undistributed income.¹⁵⁵

Subpart F income as defined in section 952(a)(1) and (2) of the Code consists of two principle categories of income. These are insurance income and foreign base company income.¹⁵⁶ Even if income falls into one of the two categories, it does not constitute subpart F income, if it is effectively connected with the conduct of a United States trade or business of the CFC (unless by treaty the income is exempt from tax or is taxed at a reduced rate).¹⁵⁷

(1) Insurance income

Based Multinational Corporations (1980) at 13.

150 Ownership is determined on the basis of stock held directly or indirectly through foreign entities or owned by reason of broad attribution rules. See s 957(b) and s 957(a) of the Code, Treas Reg s 1.951-1(g), 1.957-1.

151 S 951, 957(d), Treas Reg s 1.957-4.

152 S 951(b) and 957(a) of the Code, Treas Reg s 1.951-1(g), 1.957-1.

153 Kuntz & Peroni in par B3.02[2][e] at B3-27.

154 S 961 of the Code.

155 S 951 (a)(1)(2) of the Code and Treas Reg s 1.951-1(b).

156 Note however that subpart F income also includes: “Certain other income to the extent that the CFC has an ‘international boycott factor, certain illegal payments to government officials and certain income from ‘blacklisted’ countries”. S 952(a)(3), (4), and (5) of the Code.

157 McDaniel *et al* at 117.

When Congress adopted subpart F in 1962, insurance income was one of the prime targets. A number of companies were avoiding tax by reinsuring their policies abroad, or by placing initial policies with foreign subsidiaries of a United States corporation.¹⁵⁸ A CFC's insurance income is taxed in the hands of its United States shareholders on a current basis. Section 953(a) defines "insurance income" as including any income that is attributed to the insuring or reinsuring of any insurance or annuity contract that would be taxed under subchapter L (which deals with rules for insurance companies), if the CFC were a domestic insurance company and does not constitute exempt insurance income.¹⁵⁹

Insurance income will be exempt from the provisions' if it is income of a "qualifying insurance company". A "qualifying insurance company" is one that has a "real business nexus" with a foreign country. It should be subject to regulation as an insurance company by its home country, it derives 50% of its total net written premiums from insurance or reinsurance by such CFC, and it should be engaged in insurance business that would be subject to tax under subpart L if it were a United States domestic corporation.¹⁶⁰ However, section 954(i)(1) of the Code provides exclusions for certain qualified insurance income. For instance, the qualified income may be income that is received from a person other than a related person and that is derived from the investments made by a qualifying insurance company.¹⁶¹

(2) Foreign base company income

Section 952(a)(3) of the Code sets out "foreign base company income" (FBCI) as one of the key elements of subpart F income.¹⁶² Section 954 defines this income as including:

- (a) foreign personal holding company income;
- (b) foreign base company sales income;

158 Kuntz & Peroni at B3-202.

159 See also BI Bittker & L Lokken *Federal Taxation of Income, Estates and Gifts* 3 ed (2005) at 69-12.

160 S 953(e)(3)(A)-(C) of the Code.

161 Bittker & Lokken at 69-12.

- (c) foreign base company service income;
- (d) foreign base company oil-related income.¹⁶³

In terms of section 954(b)(3)(A) of the Code, a corporation with a relatively small amount of FBCI may be treated as having no FBCI. This section acts as a *de minimis* rule.

In terms of section 954(b)(3)(B) of the Code, a corporation with a relatively large amount of FBCI may have all its income treated as FBCI under a full inclusion rule. There are also certain provisions that exclude FBCI that would generally be included. For instance, in terms of section 954(b)(4) of the Code, if a CFC earns income that is subject to an effective rate of foreign tax greater than 90% of the highest United States rate, a taxpayer can be excluded from FBCI. Furthermore, United States income that is excluded from subpart F income under section 952(b) of the Code is excluded from FBCI.¹⁶⁴ Section 952(b) of the Code excludes from subpart F income United States source income that is effectively connected with the conduct of a business in the United States, provided that the income is not exempt or subject to a reduced tax rate under a United States tax treaty.

(a) Foreign personal holding company income

In terms of section 954(a)(1) of the Code, foreign personal holding company income (FPHCI) is one of the major components of FBCI. FPHCI generally includes:

- dividends, interest, rents and annuities;
- net gains from certain property transactions;
- net gains from certain commodity transactions;
- certain foreign currency gains;
- income equivalent to interest;
- income from notional principle contracts;

162 Treas Reg s 1.952-1(a)(2).

163 Foreign base company shipping income was previously part of “foreign base company income” but it was repealed in 2004. This income was covered under former s 954(a)(4) of the Code but repealed by s 415(a)(1) of the American Jobs Creation Act of 2004. Note that “foreign base company oil-related” is not discussed in this thesis.

- certain payments in lieu of dividends;
- amounts received under certain personal service contracts.¹⁶⁵

Not all these categories of FPHCI income are discussed in this thesis. Only the categories which are relevant, to comparative study of the CFC legislation of the other countries dealt with in this thesis are discussed.¹⁶⁶

(i) Dividends: Section 954(c)(c)(1) of the Code provides that dividends received by a CFC are FPHCI. Certain dividends are, however, excluded. For instance, under section 959(b) of the Code, if a CFC has a subsidiary that also has a CFC and the lower-tier CFC has income or earnings that result in income to a United States shareholder, if the lower-tier CFC pays a dividend from the earnings and profits, that dividend does not trigger a second tax for the United States shareholder.¹⁶⁷

FPHCI does not include dividends received from a “related person”, that is a corporation that was created or organised under the laws of the same foreign country under which the CFC was created and that has a substantial part of its assets used in its trade or business located in the same foreign country.¹⁶⁸ The legislators saw no reason for taxing the United States shareholders on dividends received by a CFC from a related party where the United States shareholder would not have been taxed, if he had owned the stock of the related party directly.¹⁶⁹ However, a dividend from earnings accumulated before the CFC acquired the stock does not qualify for the same country exception. In other words, the exception cannot apply to the extent that a dividend comes from earnings and profits accumulated while the stock on which the dividend is distributed was not owned by the CFC receiving the dividend, either directly or indirectly through a chain of corporations that all met the conditions of the same country exclusion.¹⁷⁰

164 Treas Reg s 1.954-1(a)(2).

165 S 954(c)(1)(A) – (G) of the Code.

166 See chapter 9 where the CFC legislation of the relevant countries is compared.

167 Kuntz & Peroni at B3-78.

168 S 954(c)(3)(A)(i) of the Code; Treas Reg s 1.954-2(b)(1)(i).

169 Bittker & Lokken at 69-22.

170 S 954(c)(3)(C) of the Code.

(ii) Interest: Section 954(c)(c)(1)(A) of the Code provides that a portion of the gross income of a CFC that consists of interest is generally FPHCI. FPHCI does not, however, include interest that is derived in the conduct of a banking business and “export financing interest”.¹⁷¹ Furthermore, FPHCI does not include interest received from a related person, that is a corporation created or organised under the laws of the same foreign country under whose laws the CFC was created or organised and that has a substantial part of its assets used in its trade or business located in the same foreign country.¹⁷²

(iii) Royalties: In terms of section 954(c)(c)(1)(A) of the Code, a portion of the gross income of a CFC that consist of royalties is generally FPHCI. Exceptions exist for certain royalties derived in an active business and for certain royalties received from related persons.¹⁷³

(iv) Banking or financial income: When adopting section 954(c), Congress recognised the need to allow United States businesses to compete in foreign countries on an equal footing with other businesses in those countries, but deferral of United States taxes on passive income from portfolio investments was not allowed. This is the main target of section 954(c). There are, however, certain exclusions from the definition of FPHCI. For example, section 954(h)(1) of the Code excludes from FPHCI the “qualified banking or financing income” of an eligible CFC. An eligible CFC means a CFC that is predominantly engaged in the active conduct of banking, financing, or similar business and conducts substantial activity with respect to that business.¹⁷⁴ A corporation is predominantly engaged in the active conduct of banking, financing or similar business, if it meets the following conditions:

- Over 70% of the gross income of the corporation is derived directly from active and regular conduct of a “lending or financing business” from transactions with customers that are not related persons.
- It is engaged in the active conduct of a banking business and, is an institution licensed to do business as a bank in the United States.

171 S 954(c)(2)(B) of the Code.

172 Treas Reg s 1.954-2(b)(4).

173 Treas Reg s 1.954-2(b)(1)(iii).

174 S 954(h)(2)(A)(i) and (ii) of the Code.

- It is engaged in active conduct of a securities business and it is registered under the provisions of the United States securities law.¹⁷⁵

Section 954(h)(1) of the Code excludes income from being FPHCI only if it is “qualified banking or financing income”. To qualify, firstly, the income must be derived from the active conduct of a banking or financing business by the eligible CFC itself or by a qualified business unit of the eligible CFC. Secondly, the income must be derived from transactions with customers located in a country other than the United States and substantially all the activities must be conducted, or deemed to be conducted, in its home country. Further, the corporation must treat the income earned as taxable in the corporation’s home country.

There are also several anti-abuse rules with respect to the exclusion of qualified banking or financial income.

- Firstly, there is the disregard of any item of income, gain or loss, or deduction with respect to any transaction that has a principal purpose of qualifying income or gain for the exclusion.¹⁷⁶
- Secondly, there is the disregard of any item of income, gain, loss or deduction of any entity that is not engaged in regular and continuous transactions with customers that are not related persons.¹⁷⁷
- Thirdly, there is the disregard of any item of income, gain, loss or deduction with respect to any transaction using, or doing business with, an entity to meet any home country requirement for a special purpose entity or arrangement, if one of the principal purposes of the transaction is qualifying income or gain for the exclusion under section 954(h) of the Code.¹⁷⁸
- Fourthly, a customer is not treated as a related person, officer, director or employee of a CFC, if a principal purpose of such person’s transactions is to meet any requirement of section 954(h) of the

175 Bittker & Lokken at 69-35.

176 S 954(h)(7)(A) of the Code.

177 S 954(h)(7)(B) of the Code.

178 S 954(h)(7)(C) of the Code.

Code.¹⁷⁹

(b) Foreign base company sales income (FBCSI)

In terms of section 954(d)(1) of the Code, this income includes profits, commissions and fees. It may also involve a CFC that either buys and sells for its own account or acts as the agent for a related person. Foreign base company sales income always involves the purchase or sale of personal property.¹⁸⁰ The property involved in each transaction must be made and used outside the country in which the CFC is incorporated. FBCSI may not result, however, if a corporation sells property that it has used in its business.¹⁸¹ A sales transaction generates FBCSI only if a related person is involved as a seller or buyer. In terms of section 954(d)(3) of the Code, a related person is an individual or entity that controls the CFC, an entity controlled by the CFC, or an entity that is controlled by the person or persons that control the CFC. "Control" is ownership of more than 50% by either voting power or value, of the corporation's stock. A CFC has FBCSI, if it participates in four basic transactions, namely:

- The CFC buys personal property from related persons and sells it to anyone.
- A CFC may have FBCSI as a result of buying personal property from anyone and selling that property to a related person.
- A CFC may have FBCSI as a result of buying personal property from anyone on behalf of a related person.
- A CFC may have FBCSI as a result of selling personal property to anyone on behalf of a related person.¹⁸²

Income from a sale is excluded from FBCSI, if the goods are manufactured, produced, grown or extracted in the country in which the CFC is organised.¹⁸³ A

179 S IRC 954(h)(7)(D) of the Code.

180 B Spitz *International Tax Havens Guide: Offshore Strategies* (2002) at 299; Kuntz & Peroni at B3-123.

181 Treas Reg s 1.954-3(a)(1)(i).

182 S 954(d)(1) of the Code.

183 Kuntz & Peroni at B3-124 to B3-125. For example, a CFC incorporated in country X purchases grapefruit grown in country X and resells them to its parent corporation for distribution in the United States. This may be evidence that the country of incorporation for the CFC was selected for business, not for tax avoidance reasons. But this exclusion may

branch engaged in selling or purchasing goods is treated as a separate corporation in applying the definition of FBCSI, if it is located outside the country in which the CFC is incorporated, and the effective rate at which the CFC is taxed on the branch's income falls below a threshold rate, which is the lesser of 90% of the rate at which the country of incorporation would tax the income, or a rate of 5% below the rate of the country of incorporation.¹⁸⁴

FBCSI is basically an anti-avoidance measure that targets avoidance schemes involving the sale of goods between related parties.

(c) Foreign base company service income

In terms of section 954(e)(1) of the Code, "foreign base company service income" is generally income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services. For the income to be considered foreign base company service income, two conditions have to be met. Firstly, the CFC must perform services for or on behalf of a related person.¹⁸⁵ Secondly, the CFC must perform the services outside the country under the laws of which that corporation was created or organised.¹⁸⁶

Services are considered to be performed for or on behalf of a related person, if the related person pays the CFC for the services, the related person is or was obliged to perform the services performed by the CFC, the performance of the services by the CFC was a material term of a sale of property by a related person or if the related person contributed "substantial assistance" in the performance of the services by the CFC.¹⁸⁷

There are, however, exceptions to "foreign base company service income". For instance, it does not result when a CFC derives income for services that relate

be lost if the goods are sold through a branch that is physically separate from the manufacturing facility and the manufacturing and sales operations are in different countries. See Bittker & Lokken at 69.

184 Treas Reg s 1.954-3(b)(1)(i).

185 S 954(e)(1)(A) of the Code.

186 S 954 (e)(1)(B) of the Code.

187 Treas Reg ss 1.954-4(b)(1)(i) to (iv).

directly to the sale or exchange by the corporation of property manufactured, produced, grown or extracted by the corporation. Nor does it result when a CFC derives income for services that relate directly to an offer to sell or exchange property manufactured, produced, grown or extracted by the corporation.¹⁸⁸ There are also exceptions to in respect to income from insurance, banking, securities commodities and financing transactions.¹⁸⁹

5.2.2 OTHER UNITED STATES ANTI-INCOME TAX DEFERRAL PROVISIONS

Passive foreign investment company (PFIC) rules

Since the introduction of CFC legislation, the United States has also enacted other anti-tax-haven measures related to the CFC provisions. In 1986, special provisions were enacted to deal with domestic portfolio investments in foreign investment companies. These rules are referred to as “passive foreign investment company” (PFIC) rules.¹⁹⁰ They were aimed at the deferral of United States tax on passive income earned abroad through an investment fund that is organised outside the United States and that does not distribute its income annually. Persons owning shares in such investment funds are subject to PFIC rules. These rules also apply to United States persons that indirectly own PFIC shares through one or more intermediate entities. Under the PFIC rules, an interest charge is imposed on foreign earnings which are accumulated and then subsequently distributed to United States shareholders. The distribution is treated as having been received rateably over the period for which the United States shareholder has held the stock, and an interest charge is imposed on the taxes which would have been due on the hypothetical distributions. A foreign corporation is classified as a passive foreign investment company, if 75% or more of its income is passive or if 50% or more of the fair market value or adjusted bases of its assets generate passive income.¹⁹¹

188 S 954(e)(2)(A) and (B) of the Code.

189 S 954(e)(2) of the Code.

190 Sandler at 24; Doggart at 92; T Viherkentta *Tax Incentives in Developing Countries and International Taxation* (1991) at 77; Bishel & Feinschreiber at 84.

191 Ault & Arnold at 387; Kleinfeld & Smith in par 85.1.

In effect, these rules improve on one aspect of the subpart F rules, in that they reach all United States shareholders of foreign corporations that comply with the definition of an PFIC. Thus, unlike in the subpart F rules, there is no threshold percentage ownership requirement before current taxation is imposed. A second difference from the subpart F rules is that there is no minimum shareholding Requirement and no required overall level of United States investment.¹⁹² However, by virtue of its definition of a “passive foreign investment company”, the PFIC regime follows the pattern of subpart F legislation in leaving deferral intact for active foreign business income of foreign subsidiaries.

Provisions relating to the disposition of stock in a CFC

The subpart F provisions prevent the deferral of United States tax on foreign base company income.¹⁹³ However, these provisions do not apply to non-base company income. This opened up several avenues for United States shareholders to avoid income tax on their foreign earnings. For instance, a shareholder could sell the stock of a foreign corporation and realise an increase in the value of the stock at capital gains rates. He could also liquidate the corporation and convert the foreign earnings into a capital gain.¹⁹⁴ To prevent such schemes, section 1248 of the Code was enacted to complement the subpart F provisions. In terms of this section, if any gain or disposition of stock is made in a CFC, it will be treated as a capital gain and must be reported as ordinary income to the extent of the foreign corporation’s earnings and profits accumulated after 1962.¹⁹⁵

Section 1248 applies to any sales or exchange of stock by a United States person in a CFC and to any corporate distribution to such person for which capital gains treatment is provided. The foreign corporation must be a CFC as defined in the subpart F provisions, and the United States person selling or exchanging the stock must own at least a 10% interest in the voting stock of the

192 Ault & Arnold at 387; Kleinfeld & Smith in par 85.1.

193 S 954 of the Code.

194 Rotterdam Institute for Fiscal Studies *International Tax Avoidance* Vol B (1979) at 272.

corporation. For section 1248 to apply, the corporation need not be a CFC at the time the sale or other disposition is made, as long as it was a CFC at any time during the 5-year period preceding the sale.¹⁹⁶ The effect of this legislation is that the accumulated earnings of a CFC that are realised by United States shareholders through the liquidation or sale or exchange of stock will eventually bear the full United States corporate tax at the same rate as if the earnings had been distributed as dividends.¹⁹⁷

5.2.3 REPORTING REQUIREMENTS

In terms of Internal Revenue Code Regulations section 1.883-1, United States shareholders who own 10% or more of the total combined voting power of all classes of voting stock of a CFC, must complete a copy of Form 5471 entitled “Information Return of US persons with Respect to Certain Controlled Foreign Corporations” when submitting their tax returns. In terms of this provision, they are expected to disclose:

- Their name, street address and the taxpayer identification number.
- Their proportionate share of subpart F income.
- The percentage value of the shares of the CFC that they own.

5.2.4 HOW EFFECTIVE HAVE THE UNITED STATES PROVISIONS BEEN IN CURBING OFFSHORE TAX AVOIDANCE?

On the face of it, the subpart F provisions appear to be an effective measure for preventing United States shareholders from deferring United States taxation of CFC earnings. However, there are a host of issues that dramatically limit the effectiveness of the subpart F provisions. Firstly, subpart F is limited to certain kinds of passive, highly mobile income earned by the CFC. Subpart F income does not in general include a CFC’s earnings from most active business operations. Accordingly, United States shareholders of a foreign corporation, which even by virtue of its ownership could be considered a CFC, will not be

195 O’Conner at 19.

196 Rotterdam Institute for Fiscal Studies Vol B at 272.

197 O’Conner at 19.

subject to current taxation under subpart F on the corporation's foreign earnings from an active business.¹⁹⁸

Even if all of a foreign corporation's income is passive, subpart F may still not have the effect of imposing current taxation on that income. Under subpart F, a foreign corporation is a CFC only if more than 50% of (1) the total combined voting power of all classes of stock entitled to vote; or (2) the total value of the stock of such corporation is owned by United States shareholders. This implies that the characterisation of a foreign subsidiary as a CFC may be avoided by ensuring that at least 50% of the foreign subsidiary's stock is owned by foreign persons. In such circumstances, United States persons owning stock of the foreign subsidiary will enjoy deferral of United States taxation even on the subsidiary's passive foreign earnings.¹⁹⁹

The other limitation lies in the fact that the term "United States shareholders" includes only those United States persons who own actually or by statutory attribution 10% or more of the total combined voting power of all classes of the CFC's stock that are entitled to vote. Thus, a United States corporation may still achieve deferral of United States tax on even the passive foreign earnings of a foreign subsidiary by simply owning less than 10% of the foreign subsidiary's voting stock.

In general, even though the subpart F provisions are intended to eliminate deferral with respect to passive income earned by foreign corporations controlled by United States shareholders, subpart F does even this limited duty rather poorly, because it does not end deferral for all foreign corporations with passive income, nor does it impose current taxation on all United States persons that are shareholders of foreign corporations. More importantly, subpart F leaves deferral intact for most of the active foreign business income earned by CFCs.²⁰⁰

Even with the presence of the subpart F provisions, United States taxpayers

198 CM Boise "Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty" (2007) *George Manson Law Review* at 3. Available at >http://ssrn.com/sol3/papers.cfm?abstract_id=929587>, last accessed 26 November 2006.

199 Boise at 4.

have found ways of circumventing these provisions. It is estimated that nearly \$650 billion in foreign earnings are held offshore by foreign subsidiaries of United States corporations, out of reach of United States taxation. And it is further estimated that \$68 billion in tax revenue will be lost between 2007 and 2011, as a result of the deferral problem.²⁰¹

The American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 contained a provision that gave United States corporations a one-year window period during which to repatriate earnings from their foreign subsidiaries at a tax rate that was a fraction of the marginal corporate rate normally applicable to dividends paid to United States shareholders by foreign corporations. The rationale behind the enactment of the Act was that United States worldwide taxation discouraged United States shareholders of CFCs from repatriating foreign earnings of CFCs. Section 965(a)(1) of this Act permitted a corporate United States shareholder of a CFC to deduct from income 85% of the amount of the cash dividends it received from the CFC. The effect of the provision was to dramatically reduce the effective rate of tax on dividends paid by the CFC to its United States shareholders. Such a substantial reduction in the effective tax rate on dividends was expected to create a substantial incentive for CFCs to voluntarily end deferral and repatriate foreign earnings to their United States shareholders.

However, the section afforded the greatest benefits to the multinational industries with substantial offshore assets and operations. This is particularly so in the case of the pharmaceuticals and technology industries, which have the largest concentrations of intangible assets, making it easier for them to shift income abroad.²⁰² The provision was therefore strongly supported by these industries, as they potentially had the most to gain from a reduced rate of taxation on

200 Boise at 6.

201 Boise at 4.

202 For example, from 1994 to 2003, the share of pharmaceutical companies' profits derived from foreign jurisdictions increased dramatically from 37.6% in 1994 to over 65% in 2003.

repatriated earnings. The section damaged the public perception of the fairness of the tax system by cloaking its provisions in the garb of job creation, but ultimately benefiting even those corporations that used repatriated earnings to cut American jobs. It was viewed by most taxpayers as a corporate give-away²⁰³

5.2.5 NEW IDEAS IN THE UNITED STATES TO CURB OFFSHORE TAX AVOIDANCE

It has been suggested that ending deferral would be the most effective way of curbing offshore tax avoidance in the United States. To end deferral altogether, each United States person owning stock in the foreign corporation would be required to currently include a pro rata share of such income or expenses in computing his, her or its own United States tax liability. This would end deferral with regard to the United States shareholders' full shares of all the foreign corporations' income, not merely certain categories of income earned by CFCs as described in the subpart F rules. In addition, each United States person owning stock in a foreign corporation would be apportioned his, her or its share of the foreign taxes paid by the corporation during the year, and could claim a direct credit for those taxes, to the extent that they are creditable taxes.²⁰⁴ By granting a foreign tax credit when the United States citizens or corporations derive income from other countries, capital export neutrality is achieved, so that a United States taxpayer's decisions on whether to invest in the United States or abroad are not based solely on economic considerations.²⁰⁵ Currently, United States tax on the foreign earnings is only imposed when the earnings are repatriated to the United States and then a credit is given for the foreign taxes paid. When United States tax is deferred through the use of a foreign subsidiary until the profits are repatriated, the tax deferral essentially works out as a subsidy granted by the United States government for foreign investment.²⁰⁶

See MA Sullivan & JA Almond "Economic Analysis: Drug Companies Park Increasing Share of Profits in Low-Tax Countries" 104 *Tax Notes* (2004) at 1336.

203 Boise at 6.

204 Peroni *et al* at 509.

205 See United States Treasury Department Policy Study at 63, where it is pointed out that capital export neutrality was the preferable policy whether viewed from a global or national export perspective.

206 McDaniel at 127; see also Peroni *et al* at 498.

One of the biggest arguments in favour of deferral has been that if United States multinationals are subject to current taxation on the foreign source earnings of their subsidiaries, they will be unable to compete in host countries against foreign multinationals that are based in countries that grant deferral or exemption of foreign source income.²⁰⁷ This argument is, however, defeated by the recommendations of the OECD report on curbing harmful tax competition, which encouraged countries that do not have CFC rules to consider adopting them and countries that have such rules to ensure they are apply in order to curb “harmful tax competition”, which the OECD report defines as including measures designed to attract foreign investors (such as targeted tax holidays).²⁰⁸

Ending deferral is also said to be the most efficient way of promoting equity among taxpayers as it ensures that all taxpayers do not limit taxation of foreign income by incorporating foreign corporations. At the same time, the abolition of deferral would also ensure economic efficiency and welfare, because it would largely eliminate taxpayers’ consideration of decisions regarding the location of investment. Although it has been argued that the repeal of deferral could result in a major loss of revenue,²⁰⁹ Avi-Yonah²¹⁰ contends that this may not be necessarily so. He gives an example of the consequences of the check-the-box regulations that encouraged taxpayers to choose whether or not to defer income from foreign investments. The elective deferral that these regulations encouraged had the opposite effect that lead to loss of revenue. He argues that this will not necessarily be the case, where deferral is ended altogether, as each taxpayer owning investments in a foreign corporation would be required to currently include a pro rata share of any income or expenses in computing the United States tax liability.

5.2.6 THE COMPATIBILITY OF UNITED STATES CFC LEGISLATION AND

207 RS Avi-Yonah “Comment on Peroni, Fleming and Shay, ‘Getting Serious About Curtailing Deferral of US Tax on Foreign Source Income” *SMU Law Review* 52 (1999) at 536; Avi-Yonah at 222.

208 OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) at 40-41.

209 H Ault “The International Tax Policy Challenges Facing President-Elect Clinton” (1992) Nov 16 *Tax Notes Int’l* at 1021; PW Oosterhuis “The Cost of Deferral’s Repeal: If Done Properly, It Loses Billions” (1993) *Tax Notes* at 765.

210 Avi-Yonah at 223.

ITS TAX TREATIES

It has been discussed above that the applicability of CFC legislation may be challenged in some countries for being in conflict with its double taxation treaties. This however depends on whether it is the country's CFC legislation or its tax treaties that take precedence.²¹¹ Thus where a country's treaties are considered paramount to domestic legislation in the event of a conflict, the domestic law cannot override the treaty in the absence of specific treaty-override provisions.²¹² The CFC legislation may also not be applied, if the respective tax treaty does not contain a safeguarding clause that expressly and explicitly authorises that the CFC legislation may be applied.²¹³

When a treaty has been signed between the United States and a treaty partner, the President submits the treaty to the Senate for its advice and consent by a two-thirds majority. Approval by the House of Representatives is not required.²¹⁴ Some treaties become operative as domestic legislation in the United States only upon enactment of enabling legislation. Such treaties require majority approval in both the Senate and the House of Representatives. However, other treaties, including tax treaties, are "self executing" in that they do not require separate enabling legislation in order to become operative as domestic law. These treaties become operative upon approval by the Senate and the subsequent exchange of the instruments of ratification of the two governments.²¹⁵

The legal status and relationship of domestic legislation and tax treaties is governed by the Constitution of the United States of America.²¹⁶ Article VI(2) of

211 Sandler at 54 and at 99.

212 See International Fiscal Association (IFA), proceedings of a seminar held in Toronto, Canada, in 1994 during the 48th Congress of the IFA *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions* (1995) at 24; Sandler at 54.

213 Sandler at 99.

214 Sandler at 52.

215 Sandler at 52.

216 The Constitution of the United States is the oldest Federal constitution in existence and was framed by a convention of delegates from twelve of the thirteen original states in Philadelphia in May 1787, Rhode Island failing to send a delegate. The Constitution is the landmark legal document of the United States. The Constitution comprises the primary law of the U.S. Federal Government. It also describes the three chief branches of the Federal Government and their jurisdictions. In addition, it lays out the basic rights of citizens of the United States.

the Constitution provides that federal legislation and treaties to which the United States is a party, as well as the Constitution are the supreme law of the land. Thus statutes and treaties have equal status under the Constitution.²¹⁷ This implies that treaties and domestic legislation have to be interpreted in the same manner as two federal statutes. If there is a conflict between the two, a rule of statutory construction that is applied is that a latter statute will be construed as repealing an earlier one, but only to the extent of the repugnancy. Thus, a federal statute is binding on the courts even if it conflicts with a previous treaty, while a statute will give way to a subsequent self-executing treaty.²¹⁸

There are a number of provisions in the Internal Revenue Code and in tax treaties to which the United States is a party that operate to limit conflicts between treaties and the Internal Revenue Code. The United States has in its domestic legislation the doctrine of “treaty override” that authorises the revenue authorities to disregard the terms of a double taxation agreement where tax avoidance is anticipated.²¹⁹ Section 7852(d) of the 1954 Internal Revenue Code provides that no provision of the Code would apply in any case in which its application would be contrary to any treaty obligation of the United States in effect on the date of the enactment of the Code. The Revenue Act 1962, which contained the subpart F of the Code (that was introduced in 1962), provided that section 7852(d) was not applicable in respect to any amendment made by that Act. There was a concern that the subpart F provisions and other legislation then introduced construed a breach of certain tax treaties entered into by the United States. This obviously represents a change from the provision in the 1954 Internal Revenue Code, which suggested that treaties were considered paramount.²²⁰

The United States also has other provisions that limit conflicts between treaties and the Internal Revenue Code. The United States maintains the position that its double tax treaties exist for the benefit of non-resident aliens only, not residents

217 Sandler at 52.

218 *Cook v US*, 288 US 102 (1933), p.120 as read from Sandler at 52.

219 R Rohatgi *Basic International Taxation* (2002) at 372; M Hampton *Offshore Interface: Tax Havens in the Global Economy* (1996) at 12.

220 Sandler at 53.

or (citizens) of the United States.²²¹ The United States has a “Model Income Tax Convention” on which its double taxation agreements are based.²²² The “savings clause” found in virtually all tax treaties concluded by the United States, subject to certain exceptions (such as the foreign tax credit that deals with the relief of double taxation) provides that the United States may tax its citizens and residents as though the treaty had not come into effect.²²³ This is intended to limit the impact of the treaty provisions on domestic law to non-resident aliens (those that are resident in the other contracting state).²²⁴

5.2.7 CHALLENGES E-COMMERCE POSES TO THE UNITED STATES CFC LEGISLATION

The United States treasury observed in its 1996 report on e-commerce²²⁵ that if CFCs can engage in extensive commerce, information and services through websites or computer networks located in a tax haven, it may become increasingly difficult to enforce subpart F legislation, because e-commerce makes it difficult to verify the identity of the taxpayer to whom foreign base company sales income accrues, and the amount of such income. Treasury noted that it may be necessary to revise subpart F and the regulations under it, in order to take these new types of transaction into account.

221 IFA proceedings of a seminar held in Toronto at 24; Sandler at 54.

222 United States Model Income Tax Convention (15 November 2006). Available at ><http://www.ustreas.gov/press/release/reports/hp16801.pdf><, last accessed 13 July 2007. L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 7.

223 For example article 1(4) of the United States/South Africa treaty provides *inter alia* that notwithstanding any provision of the Convention, the United States may tax its residents and citizens as if the Convention had not come into effect. See *Government Gazette* No 18553 of 15 December 1997.

224 Sandler at 54.

225 United States Treasury Department (Office of Tax policy) “Selected Tax Policy Implications of Global Electronic Commerce” (1996) in par 7.3.5. Available at ><http://jya.com/taxpolicy.htm><, last accessed 8 November 2007.

The treasury report also noted that, apart from the enforcement challenges, e-commerce has implications for the content and scope of the subpart F rules. These rules were enacted in the 1960s, when the foreign business paradigm was a manufacturing plant and jurisdiction to tax was based on where transactions or activities took place. With e-commerce, new forms of offering services, such as Internet access, video conferencing and remote order processing, have emerged. These make it difficult to assign a place of performance, a factor that is relevant with respect to CFC rules. Similarly, it may be difficult to ascertain a place of use, consumption or disposition for the sale of digitised products, such as images and computer software that are delivered electronically.²²⁶ These new technologies increase opportunities for CFCs to be incorporated in low-tax or no-tax jurisdictions, as they increase the ease with which employees of a CFC can be located outside the CFC's jurisdiction of incorporation, and they also increase the ease with which certain products and services can be provided to a CFC.²²⁷ The new technologies also allow CFCs to provide services to customers located outside their jurisdiction of incorporation with relative ease. E-commerce also poses challenges in respect of the classification or identification of the nature of income arising from transactions. Subpart F provisions have different rules for different types of income. In certain circumstances, it may be unclear whether payments for digitised products are treated as payments for a good, a right or a service.²²⁸

Doernberg and his co-authors²²⁹ note that for a country like the United States, which applies its CFC legislation on "tainted income" (ie passive income or base company income) in relation to related parties,²³⁰ it may be difficult to determine what tainted income is, in the e-commerce era. If a CFC purchases software from a related party and sells it to customers in another country, the CFC would

226 United States Treasury Report (1996) in par 7.3.5.

227 AR Myerson "Ideas and Trends: Virtual Migrants; Need Programmers? Surf Abroad" (1998) 18 January *New York Times* at 4; JS Hiller & R Cohen *Internet Law and Policy* (2002) at 265.

228 United States Treasury Report (1996) in par 7.3.5.

229 RL Doernberg, L Hinnekens, W Hellerstein & J Li *Electronic Commerce and Multijurisdictional Taxation* (2001) at 333.

230 Bittker & Lokken at 69-12.

generate tainted income and the CFC rules may be applied. But where the employees of a CFC develop software which is then sold to customers in another country, the income may not be treated as tainted income under the CFC rules, since the CFC is not itself purchasing the software from a related party but rather is developing the software.²³¹

In terms of section 954(d) of the Code, selling goods to a CFC in a low-tax jurisdiction, for resale to a high-tax jurisdiction, creates “foreign base company sales income” that is subject to the CFC rules. However, if the goods are completely transformed, this provision may not apply. Consider a CFC in a tax-haven jurisdiction that acquires software programmes from its parent company in the United States, which it copies and provides to its customers, delivering the final software product abroad by encoding the programme on a compact ROM disc, or delivering the programme by downloading it to the customer’s computer. It becomes difficult to determine whether the CFC merely resold the programme or if it manufactured a new product.²³² Well advised tax payers may use similar scenarios and add value to their projects in order to escape the CFC provisions. Despite the above, the United States noted in the “Framework for Global Electronic Commerce”,²³³ that e-commerce is still in the early stages of its development, so it should not be unnecessarily regulated, as this would distort its development. Government attempts to regulate e-commerce are likely to be outmoded by the time enactments made; especially to the extent such regulations are technology specific. It was thus recommended that governments should refrain from imposing new and unnecessary regulations, bureaucratic procedures, or taxes and tariffs on commercial activities that take place via the Internet.²³⁴ “In addition, the United States believes that no new taxes should be imposed on Internet commerce and that its taxation should be consistent with the

231 S 954(d) of the Code; see also Doernberg *et al* at 333; A Maguire & L Anolik “Subpart F and Source of Income Issues in E-Commerce” (23 October 2000) *Tax Notes International* at 1935; A Tillinghast “Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven” (1999) 4 *Florida Tax Review* at 339.

232 Westin at 474; Doernberg *et al* at 333.

233 The White House “A Framework for Global Electronic Commerce” (1 July 1997). Available at ><http://www.technology.gov/digeconomy/frameworkr.htm><, last accessed on 4 June 2007. See also Hiller & Cohen at 256.

234 The White House at 3.

established principles of international taxation, should avoid inconsistent national tax jurisdictions and double taxation, and should be simple to administer and easy to understand.”²³⁵ In this respect, it was stated that any taxation of internet sales should follow these principles:

It should neither distort nor hinder commerce. No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions

The system should be simple and transparent. It should be capable of capturing the overwhelming majority of appropriate revenues, be easy to implement, and minimize burdensome record keeping and costs for all taxpayers

The system should be able to accommodate tax systems used by the United States and our international partners today. Wherever feasible, we should look to existing taxation concepts and principles to achieve these goals.²³⁶

From the above, the challenge for countries is to adapt their tax legislation to accommodate the new technological developments.

5.2.8 HOW THE COMPLEXITY OF THE UNITED STATES' CFC LEGISLATION AFFECTS ITS EFFECTIVENESS

A task force set up in 2006 to report on the efficacy of the United States

235 The White House at 4.

236 In response to these challenges that are international in nature, in 1997, the OECD held a conference in Turku, Finland, and called on countries to co-operate and begin formulating a policy on the taxation of e-commerce. See OECD “Dismantling the Barriers to Global Electronic Commerce” (November 1997). Available at >http://www.oecd.org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00.html<, last accessed on 4 June 2007. As a follow up, another conference was held in Ottawa in 1998, where it was suggested that e-commerce should not be subjected to a new form of taxation, but that existing tax rules should be amended to cater for the taxation of e-commerce. See OECD Ministerial Conference on Electronic Commerce: Ottawa Canada “A Borderless World” (October 1998). Available at ><http://www.ottawaoecdconference.org/English/conference-program/agenda.pdf><, last accessed on 4 June 2007. It was agreed that the taxation principles which are applied for conventional commerce (neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and the flexibility of taxation) should also apply to the taxation of e-commerce. Further, that in taxing e-commerce transactions, the fiscal sovereignty of countries should be maintained, so that each country is able to protect its tax base and at the same time be able to avoid double taxation and unintentional non-taxation of e-commerce transactions. In 2001, the OECD Global Forum noted that e-commerce is a global phenomenon affecting a large percentage of world trade and therefore it required a global solution. It was suggested that there was need for dialogue between governments and businesses to build up international consensus on the taxation of e-commerce, where e-commerce flourishes and also where national sovereignty and neutrality of taxation is maintained. See OECD 6th Global Forum “Taxation Aspects of E-commerce: Addressing the Challenges and Opportunities” (September 2001). Available at ><http://www.oecd.org/dataoecd/38/42/2349701.pps#279,1,6th Annual Global Forum><, last

international tax laws stated that the workings of the components of subpart F income are very complicated.²³⁷ Each type of income is complicated with exclusions that are not so easy to understand. This is further complicated by certain exceptions to the exclusions that make the legislation difficult to interpret in practice. Apart from the exclusions complicated by exceptions, there are also numerous elections that increase complexity and compliance burdens for taxpayers. The task force noted that simplification will not be achieved in the absence of policy changes that restrict the degree of electivity in these rules.²³⁸

The task force recommended the most effective way to reduce the burden of complexity is to reduce the number of elections that could in some cases be the driving force behind numerous tax planning schemes.²³⁹ An example of some of the elective rules that complicates the United States CFC legislation, and opens a door for tax avoidance, is the Check-the-Box Regulations that were discussed above.²⁴⁰ The United States legislators have amended and added to the legislation several times, slowly decreasing the ability of residents to defer income earned offshore.²⁴¹ However, it has been noted that most of the amendments to the legislation over the past years have been stop-gap responses to perceived abuses without significant consideration of underlying policies.²⁴² An example is the American Jobs Creation Act of 2004, which as discussed above,²⁴³ afforded the greatest benefits to multinational industries that have substantial offshore assets and operations.²⁴⁴

It has been noted that, although numerous revisions have been made to the United States international tax system, these have only made the system more complex without significantly eliminating the problems caused by the deferral of

accessed on 4 June 2007.

237 Report of the Task Force on International Tax Reform 59 *Tax Lawyer* (2006) at 662. Available at ><http://www.abanet.org/tax/pubs/taskforceintltxreform.pdf><, last accessed on 15 August 2007.

238 Report of the Task Force on International Tax Reform at 662.

239 Report of the Task Force on International Tax Reform at 662.

240 See the discussion in par 5.2.4 above under the heading "Hybrid Entity Techniques".

241 RM Bird "Shaping a New International Tax Order" 42 *Bulletin for International Fiscal Documentation* (1988) at 296).

242 Report of the Task Force on International Tax Reform at 662.

243 See par 5.2.4 above under the heading "The American Jobs Creation Act of 2004".

244 Peroni *et al* at 508.

taxes.²⁴⁵ The end product of this legislative process has been ineffectiveness, since deferral has been left largely intact, thus encouraging United States taxpayers to shift their operations abroad to low-tax foreign jurisdictions, but requiring that a taxpayer navigate through a number of anti-deferral hurdles to attain that result. Moreover, the current rules make deferral elective for the well-advised United States taxpayers, thus undermining taxpayer confidence in the fairness and efficiency of the tax system. It is thus contended that the whole system is more complicated, susceptible of tax abuse, and economically inefficient.²⁴⁶

Commentators on this state of affairs are of the view that the complexity in the United States anti-deferral legislation can be resolved by amending the legislation to end deferral on all kinds of income, instead of the legislation ending deferral mainly for passive income and base company income.²⁴⁷ This would imply that each United States person owning stock in a foreign corporation, would be required to currently include a pro rata share of such income or expenses, in computing United States tax liability. Then, a foreign tax credit would be granted for income derived from other countries.²⁴⁸ It is argued that an approach that ends deferral for all types of income would significantly simplify the legislation, as all taxpayers would be subject to a foreign tax credit and taxed currently.²⁴⁹

As pointed out above, apart from the CFC rules, the United States also has other anti-deferral provisions, such as the “passive foreign investment company” rules, and section 1248 of the Code, that were discussed above.²⁵⁰ The problem with this proliferation of anti-deferral regimes is that they often overlap, and taxpayers have to go through each of them for its potential application. Each regime is complicated by exceptions that require many hours of study. Avi-Yonah²⁵¹ suggests that significant simplification would be achieved, if deferral was

245 Peroni *et al* at 508.

246 Peroni *et al* at 508; see also Sweitzer at 7.

247 Boise at 6; Peroni *et al* at 498.

248 Boise at 5; McDaniel *et al* at 127; Peroni *et al* at 498.

249 McDaniel *et al* at 127.

250 See par 5.2.2 above.

251 Avi-Yonah at 223.

abandoned and a unified regime adopted that would subject all United States shareholders to current taxation on their holdings.

5.2.9 PARTNERSHIPS/CORPORATE HYBRID ENTITIES: THE UNITED STATES

United States income tax laws generally recognise only two types of business entities: corporations and partnerships.²⁵² Subpart F rules are largely premised on the assumption that for non-tax reasons, business will be carried on in a corporate form. This makes it possible to avoid these provisions by using planning techniques that exploit their corporate focus.²⁵³ Planning techniques have been encouraged by measures such as the United States “Check-the-Box Regulations” that were introduced in 1996. These regulations have allowed United States multinational enterprises to significantly reduce the effective rates of tax on their non-United States income, thus facilitating tax avoidance techniques that generally involve the use of hybrid entities.²⁵⁴ Hybrid entities are entities that are recognised as corporations under foreign tax laws, but are partnerships or disregarded entities for United States tax purposes.²⁵⁵ By exploiting the differences in the United States tax treatment of corporations and disregarded entities, as well as differences in entity classification among different countries, a United States person is able to deflect operating income from a high-tax jurisdiction to a low-tax jurisdiction while avoiding the application of subpart F

252 L Lokken “What Happened to Subpart F? US CFC Legislation after the Check-The-Box Regulation” (2005) 7 *Florida Tax Review* at 194.

253 United States Treasury Department Policy Study “The Deferral Of Income Earned Through US Controlled Foreign Corporations” *Tax Analyst* 2001 TNT 1-1 at 63, Doc 2001-492 (Dec 29, 2000). Also accessible on > [http:// www.treasury.gov/offices/tax-policy/library/subpartf.pdf](http://www.treasury.gov/offices/tax-policy/library/subpartf.pdf)> accessed 10 Sep 2006.

254 TD 8697, 61 Fed Reg 66,584 (Dec. 18, 1996); RJ Peroni, C Fleming & SE Shay “Getting Serious About Curtailing Deferral of United States Tax on Foreign Source Income” (2005) 52 *SMU Law Review* at 515-516; R Altshuler & H Gruber “The Three Parties in The Race to the Bottom: Host Government, Home Governments and Multinational Companies” *Florida Tax Review* (2005) 7 at 158 state that the Check-the-Box regulations gave companies the freedom to either identify an entity as a separate corporation or to “disregard” it as an unincorporated branch of another corporation by simply checking the box on a tax form. See also Lokken at 195; US Treasury Department Policy Study at 6; see also Bittker & Lokken in par 69.13.1 at 69-88.

255 Bittker & Lokken in par 65.3.6 at 65-55; also in par 69.13.1; RS Avi-Yonah “To End Deferral As We Know It: Simplification Potential Of Check-The-Box” (1997) 74 *Tax Notes* at 219; Kleinfeld & Smith par 86:2.4; CR Sweitzer “Analysing Subpart F in Light of Check-The- Box” (2005) 20 *Akron Tax Journal* at 7-8 .

rules.²⁵⁶ The United States Treasury Department²⁵⁷ uses this example to explain this situation: A United States person wholly owns a CFC in Country A, a high tax jurisdiction. To deflect operating income from Country A to country B, a low tax jurisdiction, the United States person could cause the CFC to establish an entity in country B that would be treated as a corporation in Country A but would be disregarded for United States tax purposes. The United States person would then cause the hybrid entity to make a loan to the CFC. Because Country A treats the hybrid entity as a corporation, the interest payments from the CFC to the hybrid would be deductible in Country A and therefore, would reduce the amount of CFC operating income that would have been subject to high tax in country A. Because Country B is a low tax jurisdiction, the interest payments received by the hybrid from the CFC would be subject to little tax or to no tax in Country B. Since the United States would treat the hybrid as a disregarded entity for United States tax purposes, the taxpayer would take the position that the interest payment between the CFC and the hybrid should be disregarded for United States tax purposes and thus not be part of subpart F income.²⁵⁸

The check-the-box regulations have facilitated these arrangements, because they often allow a foreign entity to be treated, at the taxpayer's election, as a corporation, or as a branch or a partnership. For example, taxpayers can elect to treat entities organised under foreign equivalents of the United States limited liability company laws as branches or partnerships for United States tax purposes, even if they are taxed as separate corporate entities under foreign laws.²⁵⁹ These regulations are inconsistent with the policies and rules which are intended to prevent the shifting of passive income to lower tax jurisdictions for tax avoidance purposes.²⁶⁰

The United States is one of the few countries which has adopted a provision in its Model tax treaty and domestic legislation dealing with the application of double

256 US Treasury Department Policy Study (2000) at 63.

257 US Treasury Department Policy Study (2000) at 63; See other examples described by Lokken at 198-199 and also by Bittker & Lokken at 69-87.

258 US Treasury Department Policy Study (2000) at 63.

259 Bittker & Lokken in par 69.13.1 at 69-87.

260 Bittker & Lokken in par 69.13.1 at 69-88.

tax conventions to hybrid entities.²⁶¹ Broadly, this adopts a “flow-through” approach.²⁶² Article 4(1)(d) of the 1996 United States Model Convention states that:²⁶³

An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

5.2.10 CURBING CONDUIT COMPANY TREATY SHOPPING: THE UNITED STATES

The United States makes use of its domestic anti-avoidance provisions such as the “substance over form” doctrine²⁶⁴ and the requirement of “business purpose” in order to disregard treaty shopping schemes. The United States also has specific anti-conduit provisions in its domestic law that are designed to curb treaty shopping. Under section 7701(1) of the Internal Revenue Code (IRC), the Internal Revenue Service (IRS) has authority to re-characterise certain conduit arrangements to determine their true nature.²⁶⁵ For instance certain, conduit financing arrangements, such as back-to-back loans,²⁶⁶ that are utilised in stepping-stone conduits,²⁶⁷ can be disregarded and re-characterised as direct

261 See the Regulations under the Internal Revenue Code s.894(c).

262 See P Baker “The Application of the Convention to Partnerships, Trusts and Other, Non-corporate Entities”. Available at >http://www.taxbar.com/documents/application_convention_pb_000.pdf<, last accessed 21 April 2007.

263 See also article 1(8) of the UK/US Double Taxation Convention of 24th July 2001.

264 J Ware & P Roper P *Offshore Insight* (2001) at 77, the “substance over form” permits the tax authorities to ignore the legal form of a tax arrangement and look at the actual substance of the relevant transaction.

265 RA Westin *International Taxation of Electronic Commerce* (2000) at 403.

266 See WH Diamond & DB Diamond *Tax Havens of the World* (Release No. 108 Jan 2002) vol. 1 2 at glossary 1, where the term “back-to-back loans”, is used to describe a situation where funds are deposited by a subsidiary incorporated in a tax haven as collateral for a loan to another foreign subsidiary. Interest earned on the time deposit accumulates free of tax while in many locations the interest expense of the borrower qualifies as a tax deduction.

267 After setting up a conduit company structure, “stepping stone” strategies can be applied to shift income from the contracting countries. These strategies involve changing the nature of the income to appear as tax deductible expenses such as commission of service fees. An example is the use of “back-to-back” loans. See FJ Wurm *Treaty Shopping in the 1992 OECD Model Convention Intertax* (1992) at 658; SM Haug “The

loans.²⁶⁸ In the case of *Aiken industries, Inc v Commissioner* 56 TC 925 (1971)²⁶⁹ this result was achieved by interpreting the treaty by reference to its intentions which did not include exploitation of conduit entities. The facts of the case were that an intermediary company resident in Honduras that received interest from a related United States borrower and paid over a matching amount of interest to a parent company organised in a non-treaty country that could not claim the benefit of the treaty between United States and Honduras. Virtually all of the intermediary's assets consisted of loans to the parent's other subsidiaries and the intermediary paid over virtually all its income back to the third country. Because of the intermediary's offsetting obligation to its parent, the United States tax court concluded that the intermediary never had dominion and control over the interest it received from the United States borrower and was nothing more than a mere collection agent.²⁷⁰

Apart from the above, section 894(c) of the IRC disallows treaty withholding tax reductions where the ultimate beneficiary is not resident in either of the contracting countries.²⁷¹ The United States may also curb treaty shopping by applying the provisions of the Tax Equity and Fiscal Responsibility Act of 1982. Under section 342 thereof, the IRS must establish procedures to limit the advantage of reduced withholding tax rates under income tax treaties to only those entitled to the treaty benefits. A certificate of residence has to be filled, in which the holder has to state under oath that he is entitled to the reduced rate of withholding tax.²⁷² Taxpayers claiming tax benefits under a United States tax treaty must file a tax return with the IRS disclosing the "treaty-based return position". This implies that the taxpayer must compare the tax liability to be

United States Policy of Stringent Anti-treaty shopping Provisions: A Comparative Analysis" (1996) 29 *Vanderbilt Journal of Trans-national law* at 196; E Tomsett *Tax planning for Multinational companies* (1989) at 149; BJ Arnold & MJ McIntyre *International Tax Premier* (2002) at 114-115.

268 R Rohatgi *Basic International Taxation* (2002) at 371; see also International Fiscal Association *The OECD Model Convention - 1998 and Beyond; The Concept of Beneficial Ownership in Tax Treaties* (2000) at 29.

269 As quoted by Westin at 400.

270 International Fiscal Association's 2000 Report on The OECD Concept of Beneficial Ownership in Tax Treaties at 28.

271 MWE Glautier & FW Bassinger *A Reference Guide to International Taxation: Profiting from Your International Operations* (1987) at 228.

272 C Daggart "Tax Havens and Their Uses" (1990) Special Report No 1191 *The Economist Publication* at 95; Rohatgi at 371.

reported on the taxpayer's return and the tax liability that would be reported if the relevant treaty position did not exist. The difference is the reportable "treaty-based return position" and a reporting must be made.²⁷³

In its tax treaties, the United States insists on using the "limitation of benefits" (LOB) provision to curb conduit company treaty shopping. As discussed above, the LOB is one of the provisions recommended by the OECD for curbing conduit company treaty shopping. The purpose of the LOB provision is to lay down objective factors to determine whether a conduit entity was incorporated in one of the contracting states solely to obtain treaty benefits or whether sound commercial reasons exist for its incorporation. In essence, minimum requirements are laid down with which an entity must comply before it is entitled to treaty benefits.²⁷⁴ For example, the LOB clause in the double taxation treaty between South African and the United States makes it difficult, if not impossible, to use South Africa as a conduit to avoid United States withholding taxes on dividends.²⁷⁵

The United States has been known to employ very strict measures where its treaties are used to encourage treaty shopping. For instance, the United States terminated its treaty with Malta due to its concern over domestic law changes in Malta which could result in persons which are not residents of either of the contracting states claiming treaty benefits.²⁷⁶

5.2.11 CONCLUSION

Internationally, CFC legislation is largely prophylactic, which is why there are very few cases relating to the legislation. Taxpayers generally plan their affairs to avoid the application of the provisions, rather than risk a case questioning whether their particular activities fall within the scope of the provisions, let alone a case questioning the validity of the provisions themselves.²⁷⁷

273 Diamond & Diamond at INTRO-12.

274 Olivier & Honiball at 424.

275 Olivier & Honiball at 267.

276 P Kallaa "A Study of Article XXIX A of the Canada-US Tax Treaty: The Limitation of Benefits Article" 2002 *Canadian Tax Journal* 2219 at 2221.

277 Sandler at xix.

In order to determine the effectiveness of any country's CFC legislation, it is necessary to evaluate it against the fundamental criteria of a good tax policy. These include: meeting revenue needs in an equitable manner, promoting economic welfare, minimising compliance and administrative burdens, and conforming to international norms as far as possible.²⁷⁸

The core objective of any tax system is to raise revenue to fund government functions and services. A perception of unfairness can undermine the willingness of taxpayers to comply voluntarily with a tax system.²⁷⁹ For a tax system to raise revenue effectively, taxpayers must believe that the tax burden is being equitably distributed.²⁸⁰ This requires that some form of anti-deferral regime is necessary to prevent taxpayers from using tax avoidance techniques involving foreign corporations to reduce the tax on their income from foreign investment.

The rationale for CFC legislation is to reduce the potential inequity by limiting the ability of taxpayers to reduce or eliminate taxes on income from foreign investment. In order to promote the goal of equity, income from domestic and foreign investment should be taxed at a similar rate, in order to promote efficiency and economic welfare. This is achieved by reducing the disparities in tax rates between income earned from investments in foreign countries and income earned from investments in the home country.²⁸¹ The principle of "capital export neutrality" discussed in chapter 4 requires structuring taxes, so that they are neutral and do not cause investors to favour domestic or foreign investment. This is the best policy for promoting economic welfare. Where the deferral of foreign income does not result in the same tax treatment or tax rate for both foreign and domestic investment, the result is economic inefficacy.

As mentioned in chapter 4,²⁸² a good tax policy should also be simple and easy

278 United States Treasury Department Policy Study at 82.

279 United States Treasury Department Policy Study at 82.

280 PA Harris *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* (1996) at 10.

281 United States Treasury Department Policy Study at 84; Harris at 7.

282 See chapter 4 par 4.9.

to administer.²⁸³ In almost all jurisdictions, CFC legislation is complex and difficult to administer. The challenge is to explore avenues for simplifying this legislation, so as to facilitate compliance and minimise administrative costs for taxpayers and government respectively. However, care should be taken that legislation is not over-simplified to the extent that it is easily taken advantage of by sophisticated taxpayers.

A good tax policy should be in harmony with international norms so as to preclude double taxation or non-taxation of income.²⁸⁴ Limiting deferral through CFC rules is consistent with international norms, but care should be taken that a country's CFC rules do not conflict with its tax treaties.

With respect to curbing tax avoidance that results from investing in offshore partnership/corporate hybride entities, the discussion above has shown that both the United Kingdom and the United States have come up with specific provisions in their tax treaties that deal with the application of the relevant treaties to partnership/corporate hybrid entities.

With respect to conduit company treaty shopping, the discussion above has shown that the United Kingdom applies the "beneficial ownership" provision to curb the ensuing tax avoidance. It was held in *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch*,²⁸⁵ that the term "beneficial ownership" should be accorded an international fiscal meaning, taking into account the OECD literature and that the meaning should not be restricted to the domestic law of the contracting states. The discussion above has also shown that United States applies various statutory provisions to curb treaty shopping. In its tax treaties, the United States insists on using the "limitation of benefits" provision to curb conduit company treaty shopping.

283 United States Treasury Department Policy Study at 84.

284 United States Treasury Department Policy Study at 85.

285 [2006] EWCA CV 158

CHAPTER 6

THE “TRUST” CONCEPT: WHY TRUSTS ARE IDEAL FOR OFFSHORE
TAX AVOIDANCE

6.1 INTRODUCTION

In 2000, it was estimated that about 60% of the world’s transactions took place offshore.¹ It is further estimated that more than 40% of these transactions are done via trusts. This implies that more than 24% of the world’s wealth is held in offshore trusts.² In other words, a quarter of the world’s funds are housed in offshore trusts.³ The formation of offshore trusts is becoming increasingly popular with South African residents, and there are a significant number of South Africans who have set up trusts offshore in which the majority of beneficiaries are resident in South Africa.⁴

There are various reasons for setting up such trusts: for instance, non-resident trusts could be used for estate planning purposes, to protect assets from creditors, to avoid exchange control regulations, as a hedge against the devaluation of the currency and political uncertainty, to build up funds to finance children’s education, as a vehicle for overseas retirement funds, and also to make it easier to engage in international transactions.⁵ When a trust is set up in a low-tax jurisdiction, this often results in some tax advantages that the founder’s

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- 1 PEW Roper “Investing in the Offshore Market Place” (June 2000) *Insurance and Tax Journal* at 7 (“Roper 2000”).
 - 2 R King & B Victor *Law and Estates Planning Easiguide* (2006/2007) in par 16; J Christensen “Tackling Dirty Money: Illicit Capital flight and Tax Evasion” (World Social Forum - Bamako, Mali. 19-23 January 2006) at 5. Available at >http://www.taxjustice.net/cms/upload/pdf/World_Social_Forum_at_Bamako_-_JEC_-_Jan_2006.pdf<, last accessed 3 July 2007.
 - 3 J Ware & PEW Roper “The World of Offshore Sham Trusts” (1999) *Insurance and Tax Journal* in par 1 (“Ware & Roper 1999”) see also PEW Roper “Getting to Grips with Offshore Trusts” (December 1998) *Insurance and Tax Journal* at 5 (“Roper 1998”).
 - 4 T Mhlongo “The Efficacy of Trusts in the Current Legislative Climate” (2002) *Insurance and Tax Journal* 9.
 - 5 RP Van der Westhuisen & MM Pace *Wills and Trusts* (2005) at 1; A Kaplan *Trusts in Prime Jurisdictions* (2000) at 27; A Duncan “Hidden Assets” (2004) *De Rebus* 30; RB Whitfield “A Guide to Offshore Trusts and International Financial Planning” *The Accountant*. Available at >http://www.eagletraders.com/books/guide_offshore_trusts.htm<, last accessed on 24 May 2007.

country of residence may curtail.⁶ The focus of this research is the tax savings that can be achieved by investing in offshore/non-resident trusts.

As will be discussed in more detail further on in this chapter, in South Africa, a trust is a taxable entity.⁷ However, if a trust is formed in an offshore jurisdiction, South Africa cannot tax its income, unless it is distributed to resident beneficiaries. But if an offshore trust is effectively managed in South Africa, in that the trustees carry out the day-to-day management of the trust in the Republic, South Africa may apply the residence basis of taxation to tax the worldwide income of that trust.⁸ A discussion on the effective taxation of offshore trusts in South Africa requires an understanding of the trust concept from a South African perspective. It is also necessary to describe the various types of trusts, in order to determine which types are prevalent for offshore tax avoidance. Effective taxation of offshore trusts also requires an understanding of the general features of trusts that encourage tax avoidance. In addition to these features, offshore trusts have other unique features that encourage country residents to avoid taxes by investing in offshore trusts. These aspects are discussed below.

6.2 THE ORIGIN OF THE TRUST CONCEPT AND ITS INCORPORATION INTO SOUTH AFRICAN LAW

The concept of a trust appears to have originated in feudal times in England, but now it is recognised and employed in most legal systems in the world.⁹ Trusts were created in order to protect the interests of landowners during their prolonged absence on the military crusades that were undertaken out of mediaeval England between the 11th and 13th centuries.¹⁰ In order to finance these military crusades, the king had to prescribe a military tax and make other

6 PH Pettit *Equity and the Law of Trusts* 10 ed (2006) at 16; Duncan at 30; Roper (2000) at 4. See also M Ramjohn *Cases and Materials on Trusts* 3 ed (2004) at 18.

7 See the discussion in par 6.8 below.

8 See the discussion in par 6.8 below.

9 E Cameron, M De Waal, B Wunsh and P Solomon *Honore's South African Law of Trusts* 5 ed (2002) at 2-3.

10 Pettit at 12; J Duddington *Essentials of Equity and Trust Law* (2006) at 64; AW Scott, WF Fratcher, ML Ascher *Scott and Ascher on Trusts* 5 ed (2006) at 5; JE Penner *The Law of Trusts* (2006) at 9 and at 12; F Du Toit *South African Trust Law: Principles and Practice* (2002) 16-17; MM Corbett "Trust Law in the 90's: Challenges and Change" (1993) *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* at 262-263.

demands on landowners in return for land grants, thus making land an important bargaining commodity worthy of protection. If a crusader did not return, the King would dispossess his family of the land. In order to protect property (such as land) against the sovereign king, a practice developed of placing fixed property in a trust under the name and care of a trusted friend (*feoffee* - trustee), to be held for the benefit of another. This enabled the landowner to evade some of the feudal dues which fell on the person seized of the land.¹¹ From an early stage of their development these trusts, known as “uses”, became a means of reducing exposure to the tax liability imposed by the king.¹² Although the English common law courts did not at first recognise “uses”,¹³ the Court of Chancery (which was headed by the Chancellor and dispensed a system of justice based on equity) could often be relied on to declare an “equitable interest” in the property on petition by the beneficial owners.¹⁴

The formation of trusts gained ground after the arrival of the Franciscan monks in England. These monks used trusts as a vehicle to enable them to hold and enjoy property donated to them, while vesting the beneficial interests in the local community - on the grounds that their religious vows prevented them from owning land in their own names. By the 16th century, “uses” were commonplace and large areas of land in England were held in use by religious interests. Because the king was losing so much revenue in the form of feudal dues through the device of the “use”, in 1535 the Statute of Uses was passed to limit this practice. This Statute outlawed “uses” for land ownership and as a result, the church was dispossessed of its trusteeship of substantial amounts of land in England.¹⁵ However, in the 17th and 18th centuries, the trust again emerged as a method of custodianship and distribution of assets upon the death of the settlor.¹⁶

11 Pettit at 13; Ramjohn at 2.

12 G Watt *Trusts* 2 ed (2006) at 6-7; N Stockwell & R Edwards *Trusts and Equity* 7 ed (2005) at 14-15; Pettit at 12; Penner at 12.

13 Ramjohn at 3.

14 Pettit at 13; Penner at 1; Stockwell & Edwards at 6; Watt at 7; Duddington at 65; R Pearce & J Stevens *The Law of Trusts and Equitable Obligations* 4 ed (2006) at 4; MJ De Waal “The Core Elements of the Trust: Aspects of English, Scottish and South African Trusts Compared” (2000) *South African Law Journal* at 552-554 (“De Waal 2000 SALJ”); King & Victor in par 16.1.1; Du Toit at 16-17; L Theron *Die Besighelstrust* (1990) at 11 (“Theron 1990”) at 14.

15 Duddington at 66; Pettit at 13; Watt at 7; Stockwell & Edwards at 7; Du Toit at 16-17; De Waal 2000 SALJ at 552-554.

16 Watt at 6-7; Du Toit at 16-17; Corbett at 262-263; De Waal 2000 SALJ at 552-554.

The concept of a trust was unknown in Roman-Dutch law (ie the South African common law). The trust concept was imported into South African law by common usage after the British occupation of the Cape in 1806.¹⁷ However, the South African courts had difficulty explaining the trust concept from Roman-Dutch law principles. For instance, in *Estate Kemp v Mc Donald's Trustees*,¹⁸ the first South African case in which the validity of a trust had to be determined, it was held that the English law of trusts formed no part of our law.¹⁹ It was, however, acknowledged that the concept of placing assets under a trustee's custodianship for the benefit of others (whereby the trustee has no beneficial interest in the property) was so firmly rooted in practice that it needed to be given legal recognition, as there was nothing in Roman-Dutch law which was inconsistent with the workings of trusts. The trust concept is now part of South African law. The courts have devised distinctive South African rules and principles applicable to trusts, and new rules are constantly being created. These rules are a mixture of English, Roman-Dutch and indigenous South African rules.²⁰

6.3 THE DEFINITION OF A TRUST AND THE PARTIES TO A TRUST

A trust has been defined as a contract whereby a donor (also referred to as the settlor, founder or creator, henceforth referred to as the founder) transfers property to a trustee or trustees in terms of a trust deed or trust instrument, whereby the trustees are bound to hold and apply the property for the benefit of other persons (beneficiaries) or for the accomplishment of some special purpose.

21

17 Cameron *et al* at 2-3; RP Pace *Wills and Administration of Estates* (last updated September 2006) in par B2; W Abrie, C Graham, D Liebenberg *Trusts, Wills and Taxation in Estate Planning* (1997) at 37 ("Abrie *et al* 1997"); JP Coetzee 'n *Kritiese Ondersoek na die Aard en Inhoud van Trustbgeunstigdes se Regte ingevolge die Suid-Afrikaanse Reg*, LLD Thesis Unisa (2006) at 3; K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 593; Theron (1990) at 15.

18 1915 AD 494.

19 See also *CIR v Estate Crewe* 1943 AD 656; *CIR v Smollan's Estate* 1955 (3) SA 266(A) at 269F; *Crookes and Another v Watson and Another* 1956 (1) SA 277(A) at 280F.

20 Cameron *et al* at 82; Coetzee at 16; De Waal 2000 at 557; King & Victor in par 16.2; Du Toit at 1; MJ De Waal "In Search of a Model for the Introduction of the Trust into a Civilian Context" (2001) *Stellenbosch Law Review* at 63 ("De Waal 2001").

21 In *Deedat v The Master* 1995 (2) SA 377 (A) at 383E-F, it was held that a trust exists when the creator or founder of the trust has handed over or is bound to hand over to

In terms of article 2 of the Hague Convention on the Law Applicable to Trusts and their Recognition,²² a trust refers to the legal relationship created *inter vivos* or upon death by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary, or for a specific purpose. Although South Africa is not party to the Hague Convention, the provisions of this Convention are internationally accepted, such that the features of the trust concept as it has developed in our law conform to the definition of a trust in this Convention.²³

In terms of section 1 of the Trust Property Control Act,²⁴ the term “trust” means

the arrangement through which the ownership of property of one person is by virtue of a trust instrument made over or bequeathed -

(a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or

(b) to the beneficiary designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the objective stated in the trust instrument, but does not include the case where the property of another is to be administered by another person as executor, tutor or curator or in terms of the provisions of the Administration of Estates Act 1965.

From the above, it can be deduced that the parties to a trust are the founder, the trustees and the beneficiaries. It is necessary to set out the legal position and responsibilities of these parties so as to appreciate how the legal position and responsibilities of these parties can be manipulated in an attempt to avoid taxes. The founder is the person who establishes the trust, and he/she is usually the original owner of the property being placed in the trust. The founder appoints the

another the control of property which, or the proceeds of which, is to be administered or disposed of by the other (the trustee or administrator) for the benefit of some person other than the trustee as beneficiary, or for some impersonal object. See also Editorial “Estate and Tax Planning: The Use of Trusts” (1994) 43 *The Taxpayer* at 43, where a trust instrument is defined as a written agreement or testamentary writing or court order according to which a trust was created. See also Cameron *et al* at 4; Editorial “The Trust Property Control Act” (1989) 38 *The Taxpayer* at 182.

22 Hague Convention on the Law Applicable to Trusts and their Recognition, which was concluded 1 July 1985 and entered into force on 1 January 1992. Available at <http://www.legallanguage.com/hague/haguex30e.html>, last accessed 6 June 2007; see also Ramjohn at 11-12.

23 Cameron *et al* at 5; see also Editorial on “The Use of Trusts” at 42.

trustees by way of a trust deed and also specifies the beneficiaries to the trust property.²⁵ The founder of a trust could also be a beneficiary or even the sole beneficiary of the trust.²⁶

The trustees are the “management” of the trust.²⁷ They are also the legal owners of the trust property, but they have no beneficial interest in the property (except where the trustee in his private capacity happens to be a beneficiary as well).²⁸ Common law requires that the trustees hold the property in a fiduciary capacity.²⁹ As a result, they are not taxed on trust income in their personal capacity.³⁰ Section 9 of the Trust Property Control Act³¹ requires that the trustees exercise care, diligence and skill in managing the affairs of the beneficiaries. Under South African law, a founder cannot set up a trust by transferring assets to himself as the sole trustee, as he would not have divested himself/herself of the trust property.³² However, there would be a divestment where the founder transfers the property to a number of trustees, among whom the owner himself/herself is a co-trustee.³³ Even where the founder is a co-trustee, any control exercised over

24 Act 57 of 1988.

25 Pace in par B6.1; Du Toit at 5; see also King & Victor in par 16.2.1/

26 S 12 of the Trust Property Control Act; art 2 of the Hague Convention; W Abrie, CR Graham & PW Van der Spuy *Estates: Planning and Administration* 4 ed (2000) at 40; see also J Harris *The Hague Trusts Convention: Scope, Application and Preliminary Issues* (2002) at 110; *Goodricke v Registrar of Deeds, Natal* 1974 (1) SA 404 (N) at 408. See also Huxham & Haupt at 597.

27 Pace in par B6.2.1; Du Toit at 6; PC Soars *Trusts and Tax Planning* 3 ed (1987) at 7.

28 *Estate Kemp v MacDonald's Trustees* 1915 AD 491 at 503-4; see also Coetzee at 354-355; JG Riddall *The Law of Trusts* 6 ed (2002) at 2; P Todd & S Wilson *Textbook on Trust* (2003) 6 edition at 50; Harris at 108; EM Stack, M Cronjé and EH Hamel *The Taxation of Individuals and Companies* 15 ed (2001) at 549.

29 This implies that the fiduciary (trustee) has a duty to act impartially in the interests of principle - a trustee must not have a personal interest in exercising his discretion in a particular way. Thus a trustee must be motivated to benefit the trust and not himself. See Cameron *et al* at 11; Du Toit at 6; De Waal 2000 *SALJ* at 559; Todd & Wilson at 368-369; Riddall at 274-275; *The Trident Practical Guide to Offshore Trusts: A Chancellor Publication* (1995) at 55 in par 4.4.5.7; MJ De Waal “The Liability of Co-trustees for Breach of Trust” (1999) *Stellenbosch Law Review* at 78 (“De Waal 1999”); MJ De Waal “Authorisation of Trustees in Terms of the Trust Property Control Act” (2000) *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* at 472 (“De Waal 2000”); Coetzee at 350-351.

30 Abrie *et al* 1997 at 83; L Theron “Enkele Gedagtes Oor Die Regsaard van 'n Trust en die Aanspreeklikheid van 'n Trustee vir Trustskulde” (1991) *De Jure* at 319 and at 325; Theron 1990 at 21; King & Victor in par 16.2.1. See also art 2 of the Hague Convention.

31 Act 57 of 1988.

32 Editorial on “The Use of Trusts” at 43.

33 *Ex parte Leandy* 1977 (4) SA 363 (N) 368E-H; RP Pace & MW Van der Westhuisen *Wills and Trusts* (1995) at 14; L Olivier “Trusts: Traps and Pitfalls” (2001) *South African Law Journal* 226 (“Olivier 2001”); Editorial on “The Use of Trusts” at 43.

the property in this capacity should not be to further his own interests.³⁴

The beneficiaries are the equitable or beneficial owners of the trust property and all conduct by the trustees and the founder should in principle be for their benefit.³⁵ A trustee may also be a beneficiary of the trust, but unlike the founder, a trustee may not be the sole beneficiary of a trust.³⁶

It appears from the above discussion that it is possible that a trust can be set up where the founder is also the beneficiary of the trust or a co-trustee of the trust. This may create a situation where the trust can be manipulated by the founder to avoid taxes. It is thus the necessity to look into the requirements for a valid trust.

In South African law, there are five basic *essentialia* for a valid trust.³⁷ Firstly, the founder must intend to create a trust. He must not merely use the trustees as contracting parties and yet retain too much power and control over the way in which the trust is managed.³⁸ Secondly, the founder must express his intention to create a trust in a manner that places a legal obligation on the trustees to manage the trust object. This could be done through a will or a contract. In South African law, a unilateral declaration of intent to create a trust is insufficient.³⁹ Thirdly, the subject matter of the trust must be defined with reasonable certainty. A trust does not come into existence without an asset donated by the founder to the trustees.⁴⁰ Fourthly, the objective of the trust must be defined with

34 *Estate Kemp v MacDonald's Trustee* 1915 AD 491 at 503-4.

35 Pace in par B6.3; Riddal at 2.

36 S 12 of the Trust Property Control Act; art 2 of the Hague Convention; see also Harris at 110; *Goodricke v Registrar of Deeds, Natal* 1974 (1) SA 404 (N) 408; Huxham & Haupt at 597.

37 *Administrators, Estate Richards v Nichol* 1996 (4) SA 253 (C) at 258E-F; *Cameron et al* at 117; Du Toit at 27; Coetzee at 135-136; Theron 1990 at 31-32.

38 *Cameron et al* at 118; Pace in par B8.1.

39 *Cameron et al* at 137-138; Pace in par B8.2; King & Victor in par 16.4.1.2. *Cameron et al* at 117 notes that in terms of the South African law of trusts, a trust cannot be created unintentionally. Thus the English law mechanisms of resulting and constructive trusts have not been received in South African law. A "constructive trust" usually arises where a trust is imposed by the courts irrespective of the intention of the owner. In a "resulting trust", although the legal title is vested in a trustee, the founder and the beneficiary are actually the same person. This usually happens where the founder has failed to divest himself of the equitable interest in the property or where the property has been divested from him but has for some reason later reverted to him. See Riddal at 238; Todd & Wilson at 69; DJ Hayton *The Law of Trusts* 4 ed (2003) at 17; Stockwell & Edwards at 14-15; Duddington at 169; Pearce & Stevens at 234.

40 *Cameron et al* at 146; Pace in par B8.3; King & Victor in par 16.4.1.3.

reasonable certainty. For instance, it might be specified in the trust deed that the trust funds will be used for the benefit of named or ascertainable beneficiaries, or that the funds will be donated to charity. Where the trustees have the discretion to choose the beneficiaries, a valid trust would not be created. If a class of beneficiaries is mentioned, that class must be defined with reasonable certainty.⁴¹ And lastly, the trust object must not be illegal.⁴² Where a trust does not comply with the above requirements, it is deemed to be invalid.⁴³ Section 4 of the Trust Property Control Act further requires that the trust should be registered with the Master of the High Court. A trust that is registered with the Master is deemed to be resident in South Africa, which means that in terms of section 1 of the Income Tax Act, its worldwide income is liable to tax in South Africa.

6.4 CLASSIFICATION OF TRUSTS: WHICH KIND IS IDEAL FOR TAX AVOIDANCE PURPOSES?

Trusts can be classified and distinguished from each other by considering the way in which they were created, or from the viewpoint of the beneficiaries' rights to the ownership of the trust assets.⁴⁴ When a trust is classified from the viewpoint of how it was created, then it could fall into one of two categories, namely the testamentary trust, or the *inter vivos* trust.⁴⁵ When trusts are classified from the viewpoint of beneficiaries' rights to the ownership of the trust assets, then the trusts would fall into three main categories, namely "bewind" trusts, vested trusts and discretionary trusts.⁴⁶ These classifications are analysed below so as to determine which type is most frequently used for tax avoidance purposes.

6.4.1 TESTAMENTARY TRUSTS AND *INTER VIVOS* TRUSTS

Testamentary trusts

41 *Ex parte Estate Kemp* 1940 WLD 26; Pace in par B8.4.

42 Cameron *et al* at 11; Pace in par B8.5; L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 230; DM Davis, C Beneke & RD Jooste *Estate Planning* (September 2004) Service Issue 17 in par 5.4; Stack *et al* at 548.

43 S 4 of the Trust Property Control Act.

44 Du Toit at 3; Pace in par B3; King & Victor in par 16.3.1- 16.3.2.

45 See Pace in par B3.

A “testamentary trust” is a trust created in terms of a will, whereby a deceased person leaves his estate to a trustee, who administers the estate assets on behalf of the beneficiaries.⁴⁷ A testamentary trust exists from the date of the testator’s death, and actual transfer of the property is not essential for the trust to come into existence.⁴⁸ Testamentary trusts are seldom used for tax avoidance purposes, as the founder who would be liable for income tax and thus interested in its avoidance, is the deceased.

Inter vivos trusts

An *inter vivos* trust is a trust created by a living person, who transfers some of his assets to a trustee or trustees, who then deal with the assets on behalf of the beneficiaries.⁴⁹ An *inter vivos* trust is created by means of a contract⁵⁰ between the founder and the trustee(s), in terms of which contract the founder donates and transfers property to the trustees for the benefit of the beneficiaries.⁵¹ *Inter vivos* trusts are the ones that are mainly used for tax avoidance purposes, as the contract between the founder and the trustees often involves the control of private wealth while the founder is still alive and liable for taxation.

Irrespective of whether a trust was created as a testamentary or an *inter vivos* trust, the rights of the beneficiaries to the ownership of the income or capital of the trust could be bebind, vested or discretionary (hence the classification of trusts as bebind trusts, vested trusts or discretionary trusts). These different trusts are now discussed as instruments used for tax avoidance purposes.

46 Du Toit at 3.

47 Du Toit at 21; Coetzee at 121; Huxham & Haupt at 594; Stack *et al* at 548; DJM Clegg *Income Tax in South Africa* (Nov 2004) in par 17.3 and 17.3.1; AP de Koker *Silke on South African Income Tax* (Nov 2006) in par 24.126; King & Victor in Par 16.3.1; P McLoughlin & C Rendell *Law of Trusts* (1992) at 69; Harris at 43.

48 Davis *et al* in par 5.5.

49 Clegg in par 17.3; De Koker in par 24.126; Theron 1990 at 28; Coetzee at 98; King & Victor in par 16.3.1. See also McLoughlin & Rendell at 63; Todd & Wilson at 47; PricewaterhouseCoopers at 138.

50 *Crooks NO v Watson* 1956 (1) SA 22(A). When the beneficiaries of an *inter vivos* trust accept the rights conferred on them by the contract, they acquire a personal right against the trustee. See also King & Victor in par 16.1.2.2.

51 Clegg in par 17.3.2; Coetzee at 370.

6.4.2 BEWIND, VESTED AND DISCRETIONARY TRUSTS

Bewind trusts

A bewind trust is one where the real rights of ownership of the trust vest in the trust beneficiaries, but the administration/management and control over these assets vest in the trustee.⁵² If the beneficiary dies, ownership is included in his estate for estate duty purposes, and the asset itself is transferable to his heirs, either conditionally or unconditionally, depending on the terms of the trust deed.⁵³ Since the role of a trustee in a bewind trust corresponds to the appointment of an administrator in Roman-Dutch law,⁵⁴ it was at one stage disputed whether a bewind trust is to be classified as a trust in the strict sense, as the gap between the English trustee - who is the legal owner of the trust property - and the South African common law administrator - who is not - was unbridgeable.⁵⁵ Cameron and others⁵⁶ are, however, of the view that since control by the trustee/administrator rather than ownership is the essential feature of a trust, a bewind trust, under which the administrator holds an office, is a trust. Cameron and others also contend that this is in line with section 1 of the Trust Property Control Act⁵⁷ - which in effect defines a trust as an arrangement under which the ownership of the trust assets may be vested in the trustee/administrator or in the beneficiary, depending on the trust instrument.⁵⁸

Since the ownership of the trust property in a bewind trust vests in the beneficiary, and only the administration and control over the trust assets vests in the trustees, bewind trusts do not make ideal tax avoidance trusts, as the founder cannot easily manipulate the trust to gain income tax advantages. However, it may be possible to manipulate the trust and gain some tax advantages, if the founder can devise a mechanism to prevent the beneficiary

52 Cameron *et al* at 6; Pace in par B6.3.2; Coetzee at 120.

53 See King & Victor in par 16.3.2.

54 Cameron *et al* at 6; Du Toit at 4.

55 Cameron *et al* at 6; PA Olivier *Trust Law and Practice* (1990) at 3; NJ Van der Merwe & CJ Rowland *Die Suid-Afrikaanse Erfreg* 6 ed (1990) at 334.

56 Pace in par B6.3.2; Cameron *et al* at 7.

57 Act 57 of 1988.

58 Cameron *et al* at 7; see also Du Toit at 4; Pace in par B6.3.2.

from alienating the trust property without the consent of the trustees.⁵⁹

Vested trusts

A vested trust is one where ownership and control/administration of the trust assets vests in the trustee in his representative capacity, and the beneficiaries have only personal rights to claim their trust benefits from the trustees upon the happening of a certain event (such as the attainment of a certain age or upon marriage) as specified in the trust deed. The right that such a beneficiary has in the income or capital of the trust is termed a “vested right”. In *ITC 76*,⁶⁰ the Special Court defined a vested right as “something substantial; something which could be measured in money; something which had a present value and could be attached.” Furthermore, in the context of income tax, a vested right is an accrued right. This implies that, upon the happening of the relevant specified event, the income or capital of the trust must be paid to that particular beneficiary and the trustees are merely administering the income or the capital for the beneficiary.⁶¹

Vested trusts are not usually used for tax avoidance purposes, as the event that has to take place ensures that income accrues to, and is taxed, in the hands of a particular beneficiary. The trustees merely administer the trust property and they have no right to deal with it according to their own discretion.

Discretionary trusts

A discretionary trust is a trust where discretion is conferred by the founder on the trustees to decide (or vary) which member or members of a class of beneficiaries should be entitled to the income or capital of the trust.⁶² The beneficiaries are only beneficiaries in name, and what they have is just a “contingent right” to the income or capital of the trust. The meaning of the term “contingent right” was

59 Cameron *et al* at 578.

60 (1927), 3 SATC 68 at 69.

61 Pace in par B6.3.1; D Meyerowitz *Meyerowitz on Income Tax* (2006-2007) in par 16.136; Huxham & Haupt at 594; Olivier & Honiball at 233; BA van der Merwe “Meaning and Relevance of the Phrase: ‘Vested Right’ for Income Tax Law” (2000) 3 *SA Mercantile Law Journal* at 319.

62 Cameron *et al* at 20; Davis *et al* in par 5.11; Coetzee at 166; A Ginsberg *International Tax*

described by Watermeyer CJ in *Durban City Council v Association of Building Societies*⁶³ as being “the conditional nature of someone’s title to the right”.⁶⁴ Thus, although the beneficiaries may be eligible to the income or capital of the trust, they are not entitled thereto, unless the trustees in their sole and absolute discretion decide to pay over the benefits.⁶⁵ This implies that there is a possibility that a beneficiary may never receive any portion of the income or capital in the trust.⁶⁶ It is worth noting however that in *ITC 76*⁶⁷ the Special Court defined the term “contingent right” as a mere *spes* - an expectation which might never be realised. This definition has been criticised by Davis⁶⁸ and Jooste,⁶⁹ who submit that the interest of a discretionary beneficiary is a “contingent right”. Cameron and others⁷⁰ explain that “if a trustee has a discretion not merely how, but also whether to pay income or distribute capital to the beneficiary, then the latter’s right is merely contingent”.

Owing to the fact that the beneficiaries of discretionary trusts do not have vested rights in the income and/or capital of the trust, these trusts have been found to be ideal vehicles for income tax avoidance.⁷¹ This is because the beneficiaries in a discretionary trust are not considered to own taxable interests in the income and/or capital of the trust until the time when there is a receipt or accrual in favour of the beneficiaries. The advantage of this is that, as the trustees are given wide discretion over the vesting of the trust income or capital, this gives them flexibility and control to vest income and capital assets in beneficiaries at ideal moments, with tax avoidance in mind.⁷² The trustees could, for instance,

63 *Havens* 2 ed (1997) at 28; Riddall at 283; Watt at 80; Todd & Wilson at 70; Soares at 12. 1942 AD 27 at 33.

64 See also *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163 at 175; Meyerowitz in par 16.135. Davis *et al* in par 6.3.1; M Grundy *Grundy’s Tax Havens: Offshore Business Centres - A World Survey* 6 ed (1993) at 78; see also G Clarke *Offshore Tax Planning* 9 ed (2002) at 12.

65 Cameron *et al* at 473; Du Toit at 75; Abrie *et al* 1997 at 56-57; King & Victor in par 16.3.4. See also *Jewish Colonial Trust v Estate Nathan* 1940 AD 163 at 175; *Pentz v Gross* 1996 (2) SA 518 (C) at 523.

66 Meyerowitz in par 16.135; Huxham & Haupt at 594; Olivier & Honiball at 233; Van der Merwe at 319; Stack *et al* at 551.

67 (1927), 3 SATC 68 at 70.

68 Davis *et al* in par 6.3.1.

69 Jooste at 203.

70 Cameron *et al* at 557.

71 M Grundy *Grundy’s Tax Havens: Offshore Business Centres:- A World Survey* 6 ed (1993) at 78; see also G Clarke *Offshore Tax Planning* 9 ed (2002) at 12.

72 Mhlongo at 4; Ginsberg at 43; WH Diamond & DB Diamond *Tax Havens of the World*

vest the income or capital in a large number of beneficiaries, so that it is spread among them. This creates room for reducing the tax payable, as the quantum of taxable income in the hands of each of the beneficiaries is reduced.⁷³

Instead of distributing the income or capital to beneficiaries and thus subjecting it to tax in the hands of the beneficiaries, a founder could avoid such taxation by accumulating the income or capital in the trust. This is usually achieved by distributing benefits to the beneficiaries (normally the founder's children) only when they attain a specific age, or marry, with a provision that they should be maintained out of the income of the trust, but that any surplus income should be accumulated in the trust.⁷⁴ In the absence of anti-avoidance measures to prevent such schemes, capital gains tax can be deferred, especially if the trust is set up in a low-tax jurisdiction, where it will be liable to nil or minimal taxation.⁷⁵ It is worth pointing out, however, that there may be income tax liability when the accumulated income/capital is repatriated to the founder's country of residence.⁷⁶

The general conclusion reached regarding the classification of trusts is that it is mainly trusts created *inter vivos* which are discretionary trusts that are used for tax avoidance. Further discussion of the use of "trusts" for offshore tax avoidance may therefore be taken to refer primarily to this type of trust.

6.5 GENERAL FEATURES OF TRUSTS THAT ENCOURAGE OFFSHORE TAX AVOIDANCE

In chapter 3 of this thesis, the features of companies that make them ideal vehicles for offshore tax avoidance were discussed. In this chapter, it has been pointed out that taxpayers frequently make use of trusts instead of companies as a vehicle for offshore tax avoidance. It has actually been noted that trusts are the

(Publication 722, Release 108, Jan 2002) at Glossary-4.

73 Editorial "Estate and Tax Planning -The Trust, the Taxation Aspects" (1994) 43 *Taxpayer* 85

74 McLoughlin & Rendell at 118; Todd & Wilson at 191-192; Soares at 203.

75 International Trident Trust Group *The Trident Practical Guide to Offshore Trusts* 2 ed (1995) at 62 in par 4.6.

76 M Hampton *Offshore Interface: Tax Havens in Global Economy* (1996) at 28; see also Gundy at 77; N Boldman "International Tax Avoidance" (1981) 35 *Bulletin for International Fiscal Documentation* 443.

most effective tools for holding assets outside of a taxpayer's country of residence.⁷⁷ This is based on the assertion that a trust is one of the most reliable means that can be used to deal with unforeseen political and economic circumstances that often result in increased taxation and thus the need to avoid such taxation. This is because, even though the founder of the trust may not be able to foresee these circumstances and spell them out in a will or deed of trust, by giving his trustees discretionary powers to be exercised within the guidelines laid down in the trust deed, the founder can ensure that such unforeseen circumstances are taken care of.⁷⁸ The characteristics of trusts that make this possible include the autonomy of trusts, the principle of separation of management, ownership and enjoyment of trust property, and the flexibility of trusts.

The autonomy of trusts

Unlike a company, which owes its existence to a statute, and has defined and restricted functions that are set out in its memorandum and articles of association,⁷⁹ a trust owes its existence to the particular rules of a given trust, as set out in a will or trust deed.⁸⁰ A trust deed, unlike a company share register, is a private document, and it ensures the anonymity of the beneficiaries of the trust.⁸¹ Even access to the trust deed may not reveal the trust beneficiaries, especially in the case of most discretionary offshore trusts, which often stipulate the widest possible class of beneficiaries.⁸² The autonomy of the trust makes it an all-purpose instrument that can be put to a wider range of uses than a company can.⁸³ The autonomy of trusts is enhanced by the fact that in South Africa there is no specific legislation which regulates the law of trusts, such as the Companies Act which regulates companies.⁸⁴ The Trust Property Control Act of 1988 is limited to aspects governing the powers and duties of trustees and

77 Roper 2000 at 7.

78 Editorial on "The Trust, the Taxation Aspects" at 181.

79 Soars at 10.

80 Soars at 10; Editorial on "The Trust, the Taxation Aspects" at 181.

81 O Stanley & G Clarke *Offshore Tax Planning* (1986) at 73.

82 Stanley & Clarke at 73.

83 Cameron *et al* at 14; Hayton at 47; Soars at 1; PricewaterhouseCoopers at 185.

some supervisory matters. Although this Act contains provisions relating to the supervisory jurisdiction over trusts by the courts and the Master,⁸⁵ it does not contain detailed provisions for the control of the operations of trustees and the way the trust should be administered.⁸⁶ Often the law of contract, as well as case law have to be taken into account.⁸⁷

The autonomy of trusts is one of the factors that encourage the location of trusts in tax-haven jurisdictions for tax avoidance purposes.⁸⁸ This autonomy is augmented by the confidentiality laws in the tax-haven jurisdictions that prevent the disclosure of the founder and the beneficiaries to authorities of other jurisdictions, and the trusts incorporated in the tax-haven jurisdictions are, as far as possible, "insulated" against claims that might arise from other jurisdictions.⁸⁹

Separation of management, ownership and enjoyment

Unlike a company that is recognised as a separate juristic person, in South Africa, a trust is not generally recognised as a separate juristic person,⁹⁰ but in terms of section 1 of the Income Tax Act 58 of 1962, a trust is treated as a separate juristic person for income tax purposes.⁹¹ A trust is treated as separate and distinct from the founder and the beneficiaries.⁹² Because of this unique feature, a trust can be used as a means of separating assets from the control and ownership of their original owner and the beneficiaries' enjoyment of the trust

84 Abrie *et al* 1997 at 35-36.

85 Ss 2 and 4 of the Trust Property Control Act provide that the trust deed must be lodged with the Master. S 6(1) of the same Act provides that a trustee should not carry out any action in relation to the trust unless authorised to do so by the Master. See also Abrie *et al* at 35-36.

86 Cameron *et al* at 20.

87 Abrie *et al* 1997 at 35-36.

88 Harris at 65.

89 See Harris at 67; see also International Trident Trust Group in par 4.3.5.

90 South African Courts have on numerous occasions held that the trust, as indeed a deceased estate is not to be regarded as a legal person. See *CIR v MacNeillie's Estate* 1961 (3) SA 833 (A) at 840F-G; *Kohlberg v Burnett* 1986 (3) SA 12 (A) at 25G; *Mariola v Kaye-Eddie* 1995 (2) SA 728 (W) 731; *Rosner v Lydia Swanepoel Trust* 1988 (2) SA 126 (W) at 127A; *Jourbert v Van Rensburg* 2001 (1) SA 753 (W) at 768F-G

91 Soars at 2; P Stephan "Trusts: When is a Person Not a Person for Tax Purposes?" (1998) *Insurance and Tax Journal* in par 1. Note that a trust is also considered a separate juristic person for purposes of the Estate Duty Act 45 of 1955 and the Transfer Duty Act 40 of 1949 and the Value Added Tax Act 89 of 1999. See Du Toit at 10.

92 S 12 of the Trust Property and Control Act; Du Toit at 9; Clarke at 11.

property.⁹³ This allows the founder to “put the trust property outside his or her competence to dispose of yet retain an effective voice in its administration”.⁹⁴ The separation of ownership from the control and enjoyment of the owner is, however, not peculiar to the law of trusts. It is also a feature of usufructs of property, where the *dominus* remains a bare owner of the property, but the usufructuary manages the property and enjoys the income during his or her lifetime.⁹⁵ The difference between the legal position of the usufructuary and the separation of ownership/management and enjoyment in trust law lies in the fact that under trust law, the trustee may not necessarily be a present or prospective beneficiary, whereas in the case of a usufruct, the usufructuary has a present right to the enjoyment of the property, while the bare owner merely has a prospective right to enjoy the property.⁹⁶ Because in trust law this separation breaks the chain of legal ownership of the trust property between the founder of the trust and his wealth,⁹⁷ it encourages the use of trusts as a vehicle for investing and accumulating income in low-tax jurisdictions, where it will be subject to low or minimum tax, and its ownership cannot be easily associated with the founder so as to be subjected to tax in his country of residence.⁹⁸

The flexibility of trusts

Another factor that makes a trust ideal for tax planning is its flexibility.⁹⁹ The way a trust deed explains how a trust is to be administered often allows the trust deed

93 Hampton at 28; Cameron *et al* at 17; B J Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 124; see also R Helsby, J McMahon & B McCarthy *Trouble with the Tax Man? Offshore Survival* 2 ed (1990) at 10; J Ware & P Roper *Offshore Insight* (2001) at 179; also B Spitz & G Clarke *Offshore Service* (March 2002) 66 at OFT/1.

94 Cameron *et al* at 20. Effective control may however have detrimental estate duty implications – see s 3(5) of the Estate Duty Act 45 of 1955.

95 *Geldenhuis v CIR* 1947 (3) SA 256 (C) at 258F. A person who has “usufructuary interest” in an asset does not own the asset, but is only allowed to use it. A person who has a “bare dominium” in an asset, owns the asset, but is not allowed to use it. See also Cameron *et al* at 17; MM Corbett, G Hofmeyr & E Kahn *The Law of Succession in South Africa* (2001) 409-410; Du Toit at 28; Meyerowitz in par 6.8.

96 Cameron *et al* at 17.

97 Olivier & Honiball at 235.

98 Grundy at 147.

99 MJ De Waal “Anomalieë in die Suid-Afrikaanse Trustreg” (1993) 56 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* at 8 observes that the flexibility and adaptability of the trust derive in part from ambivalences in its legal character. See also Hayton at 47; Soars at 1; Davis *et al* in par 14.1 at 14-4.

to be varied to suit the intention of the founder.¹⁰⁰ South African law accepts that, in view of the contractual nature of an *inter vivos* trust, a founder (with the consent of the trustees) may vary or revoke the trust, if he has reserved the right to do so in the trust deed and as long as the beneficiaries have not accepted the benefits. This principle was established in *CIR v Estate Crewe*¹⁰¹ and confirmed in *Crookes NO v Watson*,¹⁰² where Centlivres CJ reasoned that:

a trust deed executed by a settlor and a trustee for the benefit of certain other persons is a contract between the settlor and the trustee for the benefit of a third person ... and the settlor and the trustee can cancel the contract entered into between them before the third party has accepted the benefits conferred on him under the settlement.¹⁰³

The result, as Hayton¹⁰⁴ notes, is that

... in trust law a settlor may ... have the power to add or subtract beneficiaries, may have powers of appointing income and capital amongst the beneficiaries ... may have power to revoke his trust, whilst the trustees may have power to accumulate income within the trust and to invest in non-income-producing assets. A trust is like a sponge capable of soaking up liquid funds and retaining them without undue leakage, yet capable of being squeezed lightly or harshly or of being totally squashed so as to yield its contents into the required hands; it can even be split up into smaller pieces having the same qualities as a whole.

The ability of the founder to vary a trust can be manipulated for tax avoidance purposes. In his book on trusts, Watt¹⁰⁵ notes that “tax laws change every year, if the terms and structures of trusts were not varied by the founder, trusts would be ‘sitting ducks’ for the guns of the inland revenue”.¹⁰⁶

The courts also have jurisdiction to sanction the variation of trusts, where the variation would be to the benefit of the beneficiaries, or where the public interest would be jeopardised.¹⁰⁷ Section 13 of the Trust Property Control Act¹⁰⁸ confers upon the court the power to vary any provisions of a trust instrument if certain conditions are present, namely where the provisions bring about consequences which, in the opinion of the court, the founder of the trust did not contemplate or

100 Cameron *et al* at 19; Pace in par B18.2.2; Soars at 1; Watt at 198.

101 1943 AD 656.

102 1956 (1) SA 277 (A).

103 1956 (1) SA 277 (A) at 285; See also *Hofer v Kevitt NO* 1998 (1) SA 382 (A) at 385F; *Davis et al* in par 5.9.2; Editorial on “The Use of Trusts” at 45; King & Victor in par 16.5.

104 Hayton at 47.

105 Watt at 197.

106 Watt at 197.

107 See also *Bydowell v Chapman* 1953 (3) SA 514 (A) at 517F; see also *Ex parte Naude* 1945 OPD 1; *Robertson’s v Robertson’s Executors* 1914 AD 503; Pace in par B18.2.5; Editorial on “The Use of Trusts” at 45.

108 Act 57 of 1988.

foresee and which provisions hamper the achievements of the objects of the founder, prejudice the interests of the beneficiaries or are in conflict with public interest. Courts have also sanctioned the variation of the trust even where tax avoidance was an issue.¹⁰⁹

6.6 SPECIAL FEATURES OF OFFSHORE TRUSTS THAT ENCOURAGE TAX AVOIDANCE

In the discussion above, a description has been made the general features of trusts that make them ideal vehicles for offshore tax avoidance. In addition to these features, offshore trusts have other special features that encourage offshore tax avoidance.¹¹⁰ For South African residents wishing to invest in non-resident trusts, these features could appear to make it easier to manipulate non-resident trusts to gain tax advantages than it is when a trust is resident in the Republic. The legality of these features and the possibility of using them to gain tax advantages is discussed below.

The letter of wishes

109 For instance in one English case, *Re Windeatt*, [1969] 1 WLR 692, the founder sought to vary the trust for tax planning purposes, and this involved the moving of the trust from England to Jersey. The court approved this variation on the grounds that the family of the founder had been in Jersey for nineteen years and the children had been born there and they would not be disadvantaged by the variation of the trust. However, in the earlier case of *Re Weston's Settlements*, [1968] 1 ALL ER 338, where the founder sought to transfer property settled by him on his sons from England, where they resided, to Jersey, the court denied the variation, as the arrangement was simply to avoid tax and not for the benefit of the children.

In the Jersey case of *In the matter of Moody Jersey's settlement* 1990 JLR 264 contained in G Clarke & B Spitz *Offshore Service Cases* Vol 1 (1999) at 518, the trustees of a settlement applied to rectify a deed of trust, because the parties to the settlement had intended it to avoid tax in the United Kingdom, but a mistake had been made, as a result of which the wife of the founder was included as one of the beneficiaries, and this had the effect of defeating the intention of the parties. The court held that even though the rectification of the deed of settlement would result in the avoidance of United Kingdom tax, the court had the discretion to rectify a trust document where it was satisfied that the document did not carry out the intention of the parties, since they are entitled to arrange their affairs to avoid the payment of tax, if they can legitimately do so. In another Jersey case, *Re The Peter Hynd's Settlement* 3 ITEL 701, discussed in Clarke & Spitz *Offshore Service Cases* at 412, the founder of a Jersey trust applied for a variation of the trust to provide a more flexible form of trust that would enable the trustees to plan how best legitimately to avoid United Kingdom taxation. The court consented to the variation, as the arrangement was for the benefit of the persons concerned. See also Duddington at 295; Pearce & Stevens at 464; Watt at 212; Stockwell & Edwards at 166.

110 Davis *et al* in par 17.2.

The establishment of offshore trusts is usually accompanied by a so-called letter of wishes.¹¹¹ A “letter of wishes” has been defined as “an instrument outside of the trust deed wherein the founder indicates to the trustees how they should exercise some of their powers”.¹¹² It is a private letter between the founder and the trustee, and it is a very useful guide to the trustees of non-resident trusts, who often know very little about the beneficiaries concerned and have to use the letter of wishes as a basis for their decisions.¹¹³ Since the letter sets out the manner in which the founder wishes the trustees to exercise their powers and discretion, a founder may request the trustees to carry out certain activities that may be contrary to the trust deed, and this could entail carrying out certain directions in regard to the trust property that could result in the avoidance of taxes.

However, according to the English law of equity,¹¹⁴ a letter of wishes is considered not to be binding on the trustees,¹¹⁵ and it does not form part of the trust deed. This implies that a beneficiary named in a letter of wishes would not be a connected person in relation to the trust.¹¹⁶ In the South African Income Tax Act, the term “connected person” in relation to trusts refers to any beneficiary of such trust and any connected person in relation to such beneficiary.¹¹⁷ For the purpose of the connected person definition, the term “beneficiary” means any person who has been named in the founder’s will or the trust deed as a beneficiary, or as a person upon whom the trustee has the power to confirm a benefit from the trust. It is worth noting, however, that this definition differs from the one provided by the South African Revenue Service (SARS) in Practice Note 7, where the term “beneficiary” is defined as including any person named in a will, trust deed or letter of wishes, upon whom the trustee or the trust has a power to confer a benefit from the trust.¹¹⁸ SARS takes the view that a letter of

111 Davis *et al* in par 17.2; L Lacob “The Offshore Trust World” (2000) 8 *Juta’s Business Law* (2000) at 82.

112 Editorial “Tax Briefs” *Taxgram* (July 1999) at 14.

113 Davis in par 5.16; Rothschild “Trust Financial Planning: Letter of Wishes”. Available at >http://www.rothschildtrust.com/strategies/default.asp?doc=articles/ltrs_wishes<, last visited 24 May 2007.

114 Editorial “Tax Briefs” at 14.

115 Editorial “Tax Briefs” at 14.

116 Editorial “Tax Briefs” at 14.

117 S 1 of the Income Tax Act 58 of 1962.

118 SARS Practice Note: No 7 of 6 August 1999 section 31 of the Income Tax Act 1962 (the

wishes forms part of the trust deed for the purposes of the connected person definition, and by implication, a person named in a letter of wishes would be a beneficiary in relation to a trust. As a letter of wishes does not *per se* form part of the trust deed, it is doubtful whether SARS' views can be relied upon in South Africa to deem a person named in a letter of wishes to be a beneficiary. SARS Practice Notes are not law, so they are not binding on either SARS or the taxpayers.¹¹⁹ Paragraph 3.1 of Practice Note 7 states that this Practice Note was drafted as a practical guide and is not intended to be prescriptive or exhaustive. Although a letter of wishes may provide suggestions to trustees as to how they should exercise the power and discretion accorded to them in the trust deed, letters of wishes do not replace the trustees' exercise of their powers and discretion as conferred by the trust deed.¹²⁰ Where the trustees follow a letter of wishes slavishly, there is the danger of the trust being set aside as a scam and the assets being regarded as still vested in the founder.¹²¹

The mere existence of the letter of wishes does not, however, necessarily imply that the trust is a sham.¹²² The facts of each case have to be analysed to determine whether the founder remained in control of the trust in substance, although in form, the assets were transferred from the founder.¹²³ For example, in the Jersey case of *Abdel Rahman v Chase Bank Trust Company (CI) Ltd and Five others*,¹²⁴ the court found that Rahman, the founder, exercised control over the trustees in the management and administration of the settlement. He made distributions of the capital to himself and to others as gifts or loans, and he disposed of the investments, treating the assets as his own and the trustees as

Act): *Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* in par 1.1.4.1 (i); see also PEW Roper "South African Transfer Pricing Explored" (2000) *Insurance and Tax Journal* in par 5.

119 SARS Discussion Paper "Proposed System for Advance Tax Rulings" (2003) at 4. Available at ><http://sars.gov.za/legislation/Discussion20%Papers/Discussion%20proposed%20sytem20%Advance20%Tax20%Rulings.pdf><, last accessed 7 November 2007.

120 Davis *et al* in par 5.16; Olivier & Honiball at 238.

121 Lacob at 82; Davis *et al* in par 5.16; Olivier 2001 at 224. If the letter of wishes does not accord with the trust deed, it may also constitute breach of faith.

122 Olivier & Honiball at 238.

123 Olivier & Honiball at 238.

124 1991 JLR 103. Available at ><http://www.jerseylegalinfo.je/Judgments/JerseyLawReports/display.aspx?cases/JLR1991/JLR910103.htm><, last accessed on 21 July 2007; See also Ware & Roper "The World of Offshore Sham Trusts" (1999) at 17; see also Lacob at 5; see also Davis *et al* in par 17.4;

his agents or nominees. The court found that there was no valid or effective delivery of assets to the trustees other than as nominees, as Rahman had reserved the rights of disposition over the trust assets so that he could get them back for himself.¹²⁵ It was held that the trust was a sham.

South African case law supports the view adopted by the Jersey court in the *Rahman* case. For instance, in *Jordann v Jordann*,¹²⁶ the husband had transferred some assets from the matrimonial estate to a number of trusts, but he continued to use the assets as his own. The court held that the trusts were sham trusts. Although this case revolved around divorce matters, it provides a clear indication that our courts will not uphold a trust where the founder never intended to give up control of the assets transferred. The *Rahman* and *Jordann* judgments serve as a warning to prospective founders of trusts not to create non-resident trusts based on the expectation that the trustees will merely rubber-stamp the instructions of the founder.¹²⁷

Notwithstanding the judgments in the *Rahman* and *Jordann* cases, a trust will not automatically be a sham trust, simply because the founder is able to exercise some control over issues like the amendment of the trust deed, the appointment of trustees or investment decisions. With a proper understanding of the powers of the trustees, a founder can still structure a trust and gain tax advantages in a way that will not render the trust a sham trust.

The office of the protector

Most offshore trusts make provision for the appointment of a “protector”.¹²⁸ Different jurisdictions have differing definitions of a “protector”, but generally, the protector is a person with certain powers over the trustees or the trust fund. The

125 Ginsberg at 428; Olivier & Honiball at 238.
1991 JLR 103. Available at
><http://www.jerseylegalinfo.je/Judgments/JerseyLawReports/display.aspx?cases/JLR1991/JLR910103.htm><, last accessed on 21 July 2007.

126 2001 (3) SA 288 (KPA) at 289.

127 Ware & Roper 1999 at 18.

128 King & Victor in par 19.9.6; Roper 1998 at 168.

protector may have the power to appoint or remove trustees, and in some cases, the consent of the protector is required before capital distributions are made.¹²⁹ The protector could be a trusted friend or a family member who will ensure that the trustees are aware of and desirous of fulfilling the founder's wishes. It is usually through the "letter of wishes" that the founder states why the protector has been granted his powers, and under what circumstances the founder would like the protector to use them.¹³⁰ A protector is expected to act in a fiduciary capacity, such that he is not entitled to benefit.¹³¹

The question which arises is whether a valid trust is created under South African law where a trust deed provides for the appointment of a protector. Olivier¹³² notes that if it can be argued that it is not a requirement for the validity of a trust (in South Africa) that the trustees act independently, then it can be said that the existence of the protector does not invalidate the trust. If, however, the independence of the trustees is a requirement for the continuation of the trust, then the existence of a protector may result in the invalidity of the trust.¹³³ This issue is not very clear in South African law.¹³⁴ Olivier¹³⁵ is of the view, however, that the fact that another person has the right to appoint a trustee does not necessarily imply that the founder never intended to create a valid trust. Each case should be analysed to determine whether the protector is a mere puppet of the founder, or whether he/she is acting in an advisory capacity in the best interests of the beneficiaries.¹³⁶

6.7 EXAMPLES OF OFFSHORE TRUSTS

Blind trusts

129 Roper 1998 in par 2.2; Davis in par 17.2; Olivier & Honiball at 236-237.

130 Ware & Roper 1999 at 17-18; Roper 1998 in par 2.2.

131 Davis *et al* in par 17.2.

132 Davis *et al* in par 17.2.

133 Olivier & Honiball at 234-235

134 Olivier & Honiball at 234-235.

135 Olivier & Honiball at 234-235.

136 Olivier & Honiball at 234-235; In the English case *IRC v Schroder* 57 TC 94 the settlor was one of the members of a protection committee. The trust was held to be valid as on the facts the settlor did not have control of the protection committee.

Blind trusts are trusts that are set up with no clear purpose. In a blind trust, the identity of the beneficiaries cannot be established from the provisions of the trust deed.¹³⁷ Blind trusts are often established in tax-haven jurisdictions by a founder who donates a substantial sum to a trustee and appoints a charity as a beneficiary. However, the charity is never informed of its appointment and it never receives any material benefit from the appointment.¹³⁸ Although a blind trust may be regarded as valid in tax-haven jurisdictions, under South African law, a blind trust would probably be regarded as a sham or an invalid trust, as the object of the trust and the trust beneficiaries are not clearly indicated.¹³⁹

Asset protection trusts

Offshore trusts can be set up for asset protection purposes. These are often set up in tax havens because of their strict confidentiality laws and their history of stability during times of war and unrest.¹⁴⁰ Asset protection trusts could for instance be set up to protect assets from home country risks such as political or economic risks, liquidation risks and malpractice suits from practicing professionals such as lawyers and accountants. An example of a tax haven that encourages the setting up of asset protection trusts is Barbados, which in terms of its 1995 International Trusts (Amendment) Act, introduced certain features to its asset protection provisions. In terms of these amendments,

- Barbados law becomes the proper law of a valid Barbados trust, thus enabling an offshore settler to escape his own country's unfavourable forced heirship, matrimonial or bankruptcy legislation;
- The settler is able to protect his or her assets against attack by future litigation.¹⁴¹

An "asset protection trust" may sometimes contain a so-called "Cuba clause", which permits the transfer of the legal asset and proper law of the trust in

¹³⁷ Ware & Roper 1999 at 63; Kaplan at 27; Pettit at 16.

¹³⁸ Olivier & Honiball at 240.

¹³⁹ See par 6.3 above where the requirements for a valid trust in South Africa are set out. See also Cameron *et al* at 96-97; De Waal & Schoeman at 120; Du Toit at 27.

¹⁴⁰ Olivier & Honiball at 466.

¹⁴¹ Olivier & Honiball at 467.

circumstance where it may be necessary to do so, such as in a war situation.¹⁴² Where the main purpose of setting up an offshore trust in a tax haven was for asset protection purposes, the fact that the trust deed contains a Cuba clause could provide evidence that asset protection was the motivation for investing in such a trust as opposed to a tax-avoidance motivation.¹⁴³ Generally, "asset protection trusts" are tax neutral and are normally not established for tax reasons. However, it is now possible to combine the benefits of tax deferral and asset protection in one and the same offshore trust.¹⁴⁴

Accumulation trusts

These are trusts created for purposes of accumulating income for beneficiaries who are children of the settlor of the trust or for other persons. Accumulation trusts are often set up in the Bahamas and usually consist of American, Canadian and European growth securities. Income accumulated in a Bahamian trust is for instance not liable to the United States tax when it is derived from foreign assets if there are no United States beneficiaries of the trust.¹⁴⁵

An example of an accumulation trust is the Isle of Man "Manx" trust. A Manx trust is permitted to accumulate income without any form of restriction. The Manx trust is ideal for individuals who do not need to make use of their assets invested in a trust. These trusts offer total anonymity as no registration of either settlor or beneficially are required. Manx trusts are often used by United Kingdom residents to avoid tax on their accumulated income. For United Kingdom residents abroad, no tax is levied unless someone resident in the United Kingdom benefits. No stamp duties or taxes are levied upon formation of a Manx trust and no tax is payable upon the either accumulation or payment of income by the trust.

With a portfolio of investments in a Manx trust, a taxpayer can avoid the tax levied in the United Kingdom on any capital gains when an investment is

142 Ginsberg at 45 and at 229.

143 Olivier & Honiball at 467.

144 Ginsberg at 31.

switched. An expatriate who wishes to return to the United Kingdom can set up a trust in the Isle of Man before leaving the country in which he is residing. In this manner he can eliminate the investments in the trust from his United Kingdom estate when he returns to the United Kingdom. In this way, he is able to defer capital gains tax until the benefits are realised by the beneficiaries of the trust.¹⁴⁶

Purpose Trusts

These are trusts designed for a specific, reasonable and plausible purpose without naming any individual as a predetermined beneficiary. For example, in Bermuda “purpose trusts” can be created in terms of the Trusts (Special provisions) Act of 1989.¹⁴⁷ The laws of most jurisdictions classify the beneficiary of a trust as an owner of the trust assets. A company or individual taking advantage of the Bermuda purpose trust may undertake a commercial activity or hold assets in a purpose trust and avoid classification as the owner of the commercial activity or trust assets. There are also other commercial and regulatory benefits in using a purpose trust.¹⁴⁸ For example, a purpose trust can be used to remove voting control of stock from the hands of a company or an individual. Several regulatory authorities and taxation statutes impose restrictions upon activities and regulatory consequences based on the concept of voting control. When voting control is removed by transferring the common shares of a company to a purpose trust, the transfer may be free of certain restrictions and the tax consequences to which it would otherwise be subject.¹⁴⁹

Pension trusts

Multinational companies have been taking advantage of Bermuda for the creation of pension trusts, particularly for the benefit of their employees who transfer from one country to another. An offshore pension trust in Bermuda provides:

- Low administration costs;

145 Diamond & Diamond at Bahamas-11.

146 Ginsberg at 402.

147 Ginsberg at 163; Diamond & Diamond at Bermuda-21.

148 Diamond & Diamond at Bermuda-21.

149 Diamond & Diamond at Bermuda-22.

- Flexibility in making investments with trust assets;
- Simplicity in designing a benefit plan which can cover a particular employee as he moves from country to country;
- Less restrictive trust laws; and
- The option of obtaining an undertaking from the Government granting a tax holiday from new applicable tax legislation until 2016.¹⁵⁰ In Bermuda, no trust may be set aside by reason only that the laws of a foreign jurisdiction do not recognise the concept of a trust where the trust defeats forced heirship rights. No taxes, stamp duties or other imposts are payable.¹⁵¹

Life insurance trusts

In many jurisdictions, insurance is only included in an estate for the purposes of taxation when the descendant possesses the “incidences of ownership”. A life insurance trust, as a planning vehicle, is designed to shift the incidence of ownership of the insurance policy on to others. Liquidity will be available to avoid estate shrinkage due to expenses, taxes and fees without having additional death taxes on the same money at the same time.¹⁵²

The British Virgin Island “VISTA” trusts

In 2003, the British Virgin Islands (BVI) enacted the Virgin Islands Special Trusts Act (VISTA) (effective from 1 March 2004). This trust permits a settler to form a trust to hold his or her company shares and remove the trustee from management responsibility. VISTA trusts are useful in family-held business succession planning, where retention of the shares is more important than maximising the values of the assets in the trust.¹⁵³ These trusts remove the rule of governing trustees, which has traditionally made trusts less useful in the family business scenario. In terms of this Act, the trustee cannot be a director of the company. Beneficiaries of VISTA trusts are not permitted to seek modification or

150 Diamond & Diamond at Bermuda-23.

151 Ginsberg at 165.

152 Ginsberg at 112.

termination of the trust. The trust instrument may permit trustee intervention under specified circumstances. The shares in a VISTA trust must be BVI companies, other assets in a VISTA trust must be owned by the BVI company. The trustee must be licensed by BVI Financial Services Commission and must act as the sole trustee.¹⁵⁴

The Cayman Islands “STAR” trust

Under the laws of Cayman Islands, a special type of highly flexible trust can be created called the STAR trust, which is an acronym for the name of the legislation under which it is created, namely The Special Trust Alternative regime of the Trust Law (2001 Revision). This legislation sets out the unique nature of this type of trust, which has trustees but does not need to have beneficiaries. The trust however has an “enforcer” whose role is to enforce the provisions of the trust deed. The enforcer could be the settler, the intended beneficiary or some other person, including a corporate entity.¹⁵⁵ Unlike ordinary trusts, a STAR trust can be created for the growth and development of a business venture. The enforcer has the power to insert a beneficiary in the trust deed at a future date. It could then be argued that a person inserted in this manner, would not be deemed to have a “contingent right”¹⁵⁶ during the past period when the STAR trust received income or a capital gain, with the result that from a South African perspective, provisions of section 25B(2A) of the Income Tax Act and paragraph 80(3) of the Eighth Schedule to this Act (discussed in chapter 7) would not apply. However, it could be argued that the ordinary meaning of “contingent right” is wide enough to cover this situation. Where the enforcer is the settler or someone acting as an agent for the settler, he would not have given up control of the trust assets. Where the enforcer is the settler or the agent of the settler, and the enforcer is legally able to insert himself as a beneficiary of the trust, such a person is considered to have an “interest “in the trust and should make such disclosure in his annual return for South African income tax purposes.¹⁵⁷

153 Diamond & Diamond at British Virgin Islands-12.

154 Diamond & Diamond at British Virgin Islands-12.

155 Olivier & Honiball at 240.

156 See discussion with respect to this term in chapter 6.

157 Olivier & Honiball at 240.

Unit trusts (mutual funds) or protected cell trusts

Offshore unit trusts or mutual funds are also some times referred to as “collective investment schemes”. However, “offshore collective investment schemes” have different structures. Some of them operate under a corporate structure, where as others operate under a trust structure. Under the trust structure, in South Africa they are referred to as “unit trusts”. Where a “unit trust” is set up in a tax haven, investors' funds, securities and other assets bought with those funds, are held in a trust. The fund or scheme appoints a trustee to look after the assets in the trust. The money pooled in these investments is divided into equal portions called units.

In terms of South African exchange controls, a natural person is allowed to take a maximum of R2 million out of the country. A number of South Africans, use this allowance to invest in offshore unit trusts. Investments in unit trusts ensure that investments are properly diversified across different countries, currencies, economic sectors, industries and companies. It also helps as a hedge against the devaluation of the South African currency. Offshore funds are also useful for those South African that have liabilities in a foreign country (for example where they have to send their children to study abroad.¹⁵⁸ Although a unit trust set up in an a tax haven may be liable to nil or minimum taxes, a South Africa resident that invests in an offshore unit trust must declare any income and/or foreign dividends earned, and/or capital gains realised from an investment in the offshore unit trust.

Examples of tax havens that have legislation that caters for offshore unit trusts or mutual funds include: Jersey, Guernsey, the Isle of Man, Luxembourg, Bermuda, Cyprus, the Cayman Islands, the British Virgin Islands and Mauritius. Unit trusts find it advantageous to set up in the Bahamas where the infrastructure and background of banking and trust management expertise are well developed.¹⁵⁹

158 Personal Finance FNB “Offshore Investments”. Available at <http://www.persfin.co.za/index.php?fSectionId=589&fArticleId=2178398>> last accessed 20 March 2007.

159 Ginsberg at 112. Cyprus is a prominent location for the activities of International Collective Investment Schemes. In May 1999, Cyprus assed legislation passed that provides for the

In Mauritius, unit trusts or mutual funds are sometimes referred to as “protected cell trusts”.¹⁶⁰ Mauritius is a platform for open-ended mutual funds, with a large number of these funds being listed in Mauritius and/or on major international stock exchanges such as London, New York and Hong Kong. The bulk of these investments are directed towards India, China and South Africa. Mauritius seeks to consolidate and develop its mutual funds/collective investment schemes client base by emerging as an alternative to the comparatively costlier international financial centres in the Caribbean-Pacific region.¹⁶¹ The Mauritius National Mutual Fund Ltd (NMF) was established in 1990.¹⁶²

6.8 SOUTH AFRICAN RESIDENTS AND OFFSHORE TRUSTS

The ability of South Africans to invest offshore has been enhanced by the continuous relaxation of the Exchange Control Regulations since 1 July 1997.¹⁶³ Currently, the Exchange Control Regulations permit South African residents to make direct offshore investments of up to R2 million.¹⁶⁴ The offshore allowance is not available to trusts,¹⁶⁵ but there is nothing that prevents an individual from transferring offshore investments made out of R 2 million into an offshore trust.¹⁶⁶

South African residents have been known to transfer assets to offshore trusts in

establishment and regulation of International Collective Investment Schemes. See Aspen Trust group “The Cyprus International Collective Investment Scheme”. Available at >http://www.aamil.com/en/services-collective_investment-schemes.aspx< last accessed 20 March 2007.

160 Worldwide Business centre Limited, Mauritius “Mauritius Offshore Company Incorporation” Available at > <http://www.mauritiusoffshorecompanies.com>< last accessed on 20 March 2007.

161 Aamil Global Financial Services “Mauritius Offshore, A Major IFC”. Available at >http://www.Mondaq.com/article.as?article_id=52152-33k< last accessed 20 March 2007.

162 National Mutual Fund “National Mutual Fund, Mauritius”. Available at ><http://www.nmf.mu/>< last accessed 20 March 2007,

163 Roper 2000 in par 1; Davis *et al* in par 17.1; Ginsberg at 29 and at 581; J Ware & P Roper “The Impact of Residence-based Tax on Offshore Trusts” (2001) 16 *Insurance and Tax Journal* at 21 (“Ware & Roper 2001”).

164 South African Reserve Bank “Exchange Control Manual” in par 6.1.1. Available at ><http://www.reservebank.co.za/><, last accessed on 16 May 2007.

165 Previously the offshore allowance was R750 000, on this note see J Gordon “The R750 000 offshore allowance: Loans and ‘Loop backs’ Between Trusts and Beneficiaries” (2000) *Insurance and Tax Journal* in par 1.

166 South African Reserve Bank “Exchange Control Manual” in par 6.1.1; Davis *et al* in par 8.3.6.

two ways. Firstly, assets can be transferred by means of a donation. This is usually done by parents who are resident in South Africa and who desire their children who are resident in other countries to be able to inherit their wealth.¹⁶⁷ Secondly, assets can be sold to non-resident trusts for cash or on loan account, which may or may not bear interest, depending on the circumstances of the case.¹⁶⁸ Ware and Roper¹⁶⁹ note that, as a general rule, South Africans tend to sell assets to non-resident trusts on an interest-free basis.

South African residents frequently make use of interest-free loans to transfer the amount permitted by the Exchange Control authorities to non-resident trusts.¹⁷⁰ For example, an individual who has obtained permission to export a certain amount of money out of the country could transfer the amount into an offshore trust set up for the purpose of owning the individual's offshore assets. The trust deed is constructed in such a way that the trust owes the individual the amount transferred to the trust and interest is not charged on the outstanding capital. Usually care is taken to ensure that the loan is denominated in Rand, so that the amount outstanding is not owed to the individual in a foreign currency employed by the trust.¹⁷¹ This is necessary so that the individual does not end up owing a higher amount due to high exchange rates.

South African beneficiaries of non-resident trusts, who may not be able to utilise their offshore investment allowance, because they do not have enough funds in South Africa, have also been known to get involved in schemes that enable them to take advantage of this allowance to place investments offshore.¹⁷² If the non-resident trust is entitled in terms of the trust deed to make loans to the beneficiaries, they can borrow funds from the non-resident trust and use those funds to purportedly make use of their offshore investment allowance to transfer and invest the funds offshore. After a short period of time, the beneficiary pays the loan from the offshore trust by ceding the relevant investment to the trust for a certain period of time. This type of scheme has been used as a means for

167 Ginsberg at 586; Olivier & Honiball at 240.

168 Ware & Roper 2001 at 21; see also Davis *et al* in par 17.9.

169 Ware & Roper 2001 at 21.

170 Davis *et al* in par 17.9.

171 Davis *et al* in par 17.9.

South African residents to own offshore assets.¹⁷³ In the absence of anti-avoidance measures, such schemes can result in the deferral of capital gains tax.

6.9 JURISDICTION TO TAX INCOME FROM OFFSHORE TRUSTS IN SOUTH AFRICA

As pointed out earlier, a trust is not recognised by the South African courts as a legal person. However, in section 1 of the Income Tax Act, a trust is included in the definition of a “person” for income tax purposes,¹⁷⁴ where it is defined as “any trust fund consisting of cash or other assets, which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust, or by agreement, or under the will of a deceased person”.¹⁷⁵

Persons who are resident in the Republic are taxable in the Republic on their worldwide income.¹⁷⁶ The definition of “resident” in section 1 of the Income Tax Act distinguishes between natural persons and persons other than natural persons. A trust is not a natural person. It thus falls into the category of a person other than a natural person. In terms of section 1 of the Income Tax Act, a person other than a natural person is deemed to be a resident of the Republic, if it is incorporated, established or formed in the Republic, or if it has its place of effective management in the Republic. The Act does not, however, provide a definition of the terms “incorporated”, “established or formed”. Where a statute is silent on the meaning of any given term, recourse is normally had to the ordinary

172 Gordon in par 1.

173 Gordon in par 1.

174 The definition of “person” in s 1 of the Income Tax Act. The income tax treatment of trusts was prompted by the Appellate Division of the Supreme Court (as it then was) decision in *Friedman and Others NNO v CIR: In Re Phillip Frame Will Trust v CIR* 1991 (2) SA 340(W) which ruled that income retained in a trust was not taxable as a trust was not a legal person and the trustees were not considered to be its representative taxpayers in respect of its undistributed income. The *Friedman* decision prompted the legislator to amend the definition of “person” in the Income Tax Act to include a trust. See also PricewaterhouseCoopers at 186; Meyerowitz at 16-44; Cameron *et al* at 8; MJ De Waal & L Theron “Die Aard van die Suid-Afrikaans Reg-Skikking na Aanleiding van Behoefte?” (1991) Tydskrif vir Suid Afrikaanse Reg at 449; L Theron “Regulering van die Besigheidstrust” (1991) *South African Law Journal* at 283; L Theron *Die Besigheidstrust* (1990) at 21.

175 S 1 of the Income Tax Act 58 of 1962 (as amended).

meaning of the term.¹⁷⁷ Ordinarily, as a trust is not required to be incorporated (as is the case with a company),¹⁷⁸ it can only be deemed a resident of the Republic if it is established or formed, or if it has a place of effective management, in the Republic.¹⁷⁹

In order to determine where a trust was established or formed, an inquiry has to be made into how the trust was created. As a testamentary trust is created by the will of a testator, by implication such a trust can be deemed a South African resident, if the will under which the trust was created was drawn up in South Africa. Section 4 of the Trust Property Control Act also requires that a trust be registered with the Master of the High Court. As an *inter vivos* trust is a contract,¹⁸⁰ it may be argued that such a trust will be resident in South Africa, if the contract bringing about its existence was concluded in South Africa.¹⁸¹ According to the South African law of contract, a contract is generally deemed to be concluded at the location where the offeror is informed of the acceptance of his or her offer.¹⁸² By implication, for a trust to be an offshore trust, it must have been formed or established outside the Republic.

Determining the place of effective management of a trust is not an easy task. This is because there is no statutory definition of the concept “place of effective management” in the South African Income Tax Act, nor is there any case law that provides guidance on the interpretation of the term. However, as was discussed in Chapter 3, the concept “place of effective management” is commonly used in double taxation agreements as a so-called “tie-breaker” criterion that is used to determine the residence of an entity, for tax purposes, when it is dual resident.¹⁸³ In terms of article 4(3) of the OECD Model Tax

176 The definition of “gross income” in s 1 of the Income Tax Act; De Koker in par 24.126.

177 De Koker in par 27.7.

178 S 32 of the Companies Act 61 of 1973.

179 De Koker in par 5.21; Huxham & Haupt in par 27.3.10; see also K Mitchell & L Mitchell *Offshore Transactions and the World-wide Basis of Taxation* (2004 seminar notes) at 85.

180 *Crookes NO and Another v Watson and Others* 1956 (1) SA 277 (A) at 258F; see also *Hofer v Kevitt NO* 1998 (1) SA 382 (SCA) at 384F.

181 Olivier & Honiball at 247.

182 RH Christie *The Law of Contract in South Africa* 5 ed (2006) at 32; AJ Kerr *The Principles of the Law of Contract* 6 ed (2002) at 97; S Van der Merwe *Contract: General Principles* 2 ed (2003) at 43.

183 See art 4(1) of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version). See also the discussion in Chapter 3 par 3.6, under the heading “How to Determine the Place of Effective Management of a Company”.

Convention,¹⁸⁴ a dual resident entity is deemed to be a resident only of the state in which its place of effective management is situated. For purposes of the discussion on trusts, this implies that if a trust is for instance resident in an offshore jurisdiction, because it was formed there, but it is also resident in South Africa, because it is effectively managed in South Africa, that trust will be considered a resident of South Africa, and South Africa will have the jurisdiction to tax its world-wide income.

Although South Africa does not have a legal meaning for the term “place of effective management, in terms of SARS Interpretation Note 6,¹⁸⁵ the term “place of effective management” refers to the place where a company is managed on a regular day-to-day basis by its directors or senior managers. That is the place where the policies and strategic decisions made by the board of directors are executed and implemented, irrespective of where the overriding control of the trust is exercised, or where the board of directors meets.¹⁸⁶ Although the term “place of effective management” is used in Interpretation Note 6 in respect of companies, this Interpretation Note can be relied on to determine the meaning of “place of effective management” in respect of trusts. As the trustees are the ones who have the power and duty to manage a trust, Olivier¹⁸⁷ argues that the place of effective management of a trust is the place where the substantial or day-to-day management decisions are taken and implemented. Silke¹⁸⁸ also points out that the place of effective management of the trust can be determined by considering the country of residence of the trustees, the country from which the trust fund is administered, or the country where trustees meet to attend to the affairs of the trust. In *Nathan Estates v CIR*,¹⁸⁹ the court held a trust to be resident in Natal, because the trustees were resident in that province, and the trust fund was administered from that province.

Silke¹⁹⁰ further points out that, in determining the place of effective management of a trust, each case has to be decided on its own merits, but the place where the assets of the trust are effectively managed will be crucial. It would thus be

184 OECD Model Tax Convention on Income and on Capital (2005 Condensed Version).

185 Issued on 26 March 2002.

186 Issued on 26 March 2002.

187 Olivier & Honiball at 247.

188 De Koker in par 5.21.

189 1948 (3) SA 866 (N).

necessary to understand the business activities of the trust and the activities of the trustees. In the case of active business operations carried on by the trust, it may be easy to determine its place of effective management, as the day-to-day business operations of the trust will normally be located where the active business of the trust takes place.¹⁹¹ In the case of a passive investment holding trust, the activities of the trustees would be limited to trustees' meetings to manage the investments of the trust on an infrequent basis.¹⁹² In such a case, determining the place of effective management of the trust may be difficult, as it would require knowing the place where the decisions concerning the trust are made and where they are actually carried out. Where the place of effective management is not clear, in that the duties of the trustees are not centralised in one specific country (which can be a means of avoiding taxes, as the relevant country does not have jurisdiction to tax a trust that is not resident - effectively managed, in that country), then the residence status of the trustees may have to be considered to decide the tax residence of the trust.¹⁹³ It may also be necessary to consider evidence regarding the trustees' visits to specific countries for the purposes of taking and implementing decisions relating to the trust. The passports of the trustees could then be produced as evidence.¹⁹⁴ A founder could ensure that the trust is not deemed resident onshore by seeing to it that all or a majority of the trustees are not resident in the country concerned, and that the general administration of the trust is carried on outside that country.¹⁹⁵

From the above, it can be concluded that if a trust is deemed to be a resident of the Republic, because its place of effective management is here, then it will be taxable on its worldwide income. Although SARS Interpretation Note provides valuable guidance to the interpretation of the term "place of effective management", the taxation of a trust on the basis of its place of effective management being in South Africa may be challenged in a court of law. The reason being that, South Africa does not have a legal meaning for the term "place effective management", and SARS interpretation notes are not law.¹⁹⁶ As

190 De Koker in par 5.2l.

191 Olivier & Honiball at 247.

192 Olivier & Honiball at 247.

193 Olivier & Honiball at 247.

194 Olivier & Honiball at 247.

195 Diamond & Diamond at INTRO-94.4.

196 *ITC 1675* (1998), 62 SATC 219. See also the discussion in chapter 3 par 3.6, under the heading "How to Determine the Place of Effective Management of a Company".

was recommended in chapter 3, it is reiterated that SARS's interpretation of the term should be given the force of law by refining and incorporating it in the Income Tax Act.

6.9 CONCLUSION

From the above description of the trust concept and the appealing features of trusts, especially those set up in tax-haven jurisdictions, it is not surprising that a country's residents may find the trust to be an ideal offshore tax-planning vehicle. Although South Africa may apply the residence basis of taxation to tax the worldwide income of the trust beneficiaries, and the income of an offshore trust if it is effectively managed in South Africa, in absence of specific anti-avoidance measures, donors and trust beneficiaries can still avoid taxes when they engage in certain tax avoidance schemes. In the next chapter the legislation that South Africa has in place to curb certain anti-avoidance schemes is discussed in some detail.

CHAPTER 7

CURBING OFFSHORE TRUSTS' TAX AVOIDANCE: SOUTH AFRICA

7.1 GENERAL INFORMATION ABOUT THE TAXATION OF TRUST INCOME

In respect of the general taxation of trusts, section 25B of the Income Tax Act¹ provides that income received by, or accrued to, or in favour of, any person in his capacity as the trustee of a trust shall, subject to the provisions of section 7, to the extent to which such income has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to be income which has accrued to the beneficiary, and to the extent to which such income is not so derived, be deemed to be income of the trust.

In summary, section 25B read with section 7 sets out three possibilities as regards the incidence of tax on income that is the subject of a trust:

- Income may be taxed in the hands of the founder of the trust (donor) where certain circumstances as set out in section 7 come into play.
- Income that accrues to ascertained beneficiaries who have a vested right to the income is taxed in the hands of those beneficiaries.
- If income is retained in a trust, it is taxed in the trust.

These three possibilities are discussed below in relation to the way they are applied to curb tax avoidance that could result from investing in non-resident trusts. Note that although the order of income tax liability for a trust, in the Income Tax Act, is as set out in the above, for purposes creating a clear flow of the discussion, the order of discussing the above possibilities is changed.

7.2 LIABILITY OF THE TRUST

In terms of section 25B(1), if trust income is not distributed to beneficiaries, but retained in the trust, the trust is liable for tax since it is deemed to be a "person",

1 Act 58 of 1962 (as amended).

and thus a taxpayer, for income tax purposes.² Currently trusts (excluding “special trusts”) are taxed at a flat rate of 40% on all retained income.³ This encourages trustees to apportion the trust income to the beneficiaries, rather than retain it in the trust.⁴

If a trust is not resident in South Africa, in other words it was not formed or established in the Republic, nor is it effectively managed in the Republic, then potentially the trust income and capital could be accumulated in the non-resident trust without being liable for tax in the Republic, as the Republic has no jurisdiction to tax the income of non-residents, if that income does not have its source in the Republic.

7.3 LIABILITY OF THE BENEFICIARIES

Section 25B(1) also provides that the income of a trust may be taxed in the hands of an ascertained beneficiary with a vested right to such income, if such income is derived for his immediate or future benefit. This implies that when the income or capital of a non-resident trust vests in a resident beneficiary, any receipt or accrual in his favour that is derived for his immediate or future benefit will be taxable in the hands of the relevant beneficiary.

In order to avoid taxation when income from an offshore trust is distributed to resident beneficiaries, the income could be accumulated in an offshore trust for a period exceeding a year, with the intention that when it is distributed, it will be regarded as capital in nature and therefore not taxable in the hands of the beneficiary.⁵ To prevent the ensuing tax avoidance, section 25B(2A) was enacted to override any possible argument that when the accumulated income vests in the beneficiary, it is of a capital nature and therefore not taxable.⁶

2 See the definition of “trust” in s 1 of the Income Tax Act. In terms of s 1 of the Income Tax Act, the trustee is the representative taxpayer of the trust.

3 S 5 of the Income Tax Act.

4 R King & B Victor *Law and Estates Planning Easiguide* (2006/2007) in par 16.8.6.

5 K Mitchell & L Mitchell *Offshore Transactions and the World-wide Basis of Taxation* (2004 seminar notes) at 88; DM Davis, C Beneke & RD Jooste *Estate Planning* (September 2004) Service Issue 17 in par 6.3.1.

6 S 25B(2A) came into effect on 1 January 2001. See also D Meyerowitz *Meyerowitz on Income Tax* (2006-2007) par 16.142A; RP Pace *Wills and Administration of Estates* (last updated September 2006) in par B21.3.3.

Section 25B(2A)⁷ provides as follows:

Where during any year of assessment any resident acquires any vested right to any amount representing capital of any trust which is not a resident, that amount must be included in the income of that resident in that year, if -

- (a) that capital arose from any receipt and accruals of such trust which would have constituted income if such trust had been a resident, in any previous year of assessment during which that resident had a contingent right to that income; and
- (b) that amount has not been subject to tax in the Republic in terms of this Act.

In terms of section 25B(2A)(a), capital should have arisen from receipts and accruals of the offshore trust which would have constituted income, if the trust had been a resident. This implies that, if the funds are invested as “roll-up” funds and “wrap bonds”⁸ which confer no right to income, section 25B(2A) cannot apply.

Initially the term “income” appeared in section 25B(2A), and it could be argued that the section could not be applied to income from a foreign source. In terms of the definition of “gross income” in section 1 of the Income Tax Act, a non-resident is liable for tax in South Africa only on receipts and accruals of income derived from a source within or deemed to be within the Republic. To counter reliance on such arguments, this section was amended in 2001,⁹ resulting in the amendment of the wording of section 25B(2A)(a) to “receipts or accrual ... which would have constituted income if such trust had been a resident”. This made it clear that the section did apply to income from a foreign source.¹⁰ The Revenue Laws Amendment Act 32 of 2004 further amended this provision, and now the section generally refers to “amount” rather than “income”. The Explanatory Memorandum on the Revenue Laws Amendment Bill 2004 explains that the term

7 As amended by s 27 of the Revenue Laws Amendment Act 32 of 2004.

8 RD Jooste “Offshore Trusts and Foreign Income - The Specific Anti-avoidance Provisions” (2002) *Acta Juridica* 201. “Roll-up” funds and “wrap-bonds” are investment structures that allow an investor to roll up income and gains generated by underlying assets without ongoing tax liabilities. No income or capital gains need to be accounted for in the investor’s tax return until benefits are actually taken from the plan. When benefits are taken, both investments create a capital gain which is subject to income tax rather than capital gains tax. See Davis *et al* in par 6.3.1. See also Offshore Investments Specialists “Offshore Bond: UK Tax Breaks Investing in Offshore Funds through an Offshore Bond”. Available at ><http://www.offshore.com/investing-offshore-4.htm><, last accessed 9 July 2007.

9 S 14(1)(b) of the Revenue Laws Amendment Act 19 of 2001.

10 At the time the definition of “gross income” did not distinguish between residents and non-residents. Receipts or accruals had to be from a South African source or deemed to be from a South African source in order to be taxed in the Republic. See DM Davis, C Beneke and RD Jooste *Estate Planning* (September 2004) Service Issue 17 in par 6.3.1; see also Jooste at 201.

“amount” as used in the section makes it clear that a term which has a broader scope than the word “income” is intended.¹¹

Section 25B(2A) limits the application of this provision to receipts or accruals that would have constituted income, if the trust had been resident in any previous year of assessment at the time of the receipt or accrual. This implies firstly that section 25B(2A) cannot apply to receipts or accruals before 1 January 2001 (when the residence basis of taxation was introduced), as those receipts or accruals then had a non-South African source and so they would not have constituted “income” at that time.¹² Secondly, if the trust has received income that is exempt from tax under South African law, section 25(2A) cannot be applied.¹³

Section 25B(2A)(b) makes it clear that where the income or the receipts and accruals have been subjected to tax in the Republic, the section cannot be applied.¹⁴ Thus, if the accumulated income has been subject to tax in South Africa, for example in terms of section 7(5) or section 7(8),¹⁵ it cannot be taxed again in terms of section 25B(2A). This is intended to prevent double taxation of the income. It can thus be argued that if SARS fails to apply section 7(5) or section 7(8) to tax the income in the year of its accrual to the trust, in circumstances where these sections were applicable, then SARS cannot apply section 25B(2A) to the accumulated income in a subsequent year when the income is distributed as capital. This is because the income was “subject to tax” as required by section 25B(2A) in the year of its accrual to the trust, and SARS cannot choose to apply section 7(5), or section 7(8), in the year of accrual of income to the trust, or section 25B(2A) in the year of distribution of the accumulated income.¹⁶

In order to apply section 25B(2A), a resident beneficiary who acquires a vested right to any amount representing the capital of a non-resident trust, should have had a contingent right to that amount in a previous year of assessment. The

11 Clause 27 of the Revenue Laws Amendment Bill 24 of 2004.

12 Davis *et al* in par 6.3.1; see also Jooste at 201.

13 L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 245.

14 Olivier & Honiball at 245; Jooste at 201; Davis *et al* in par 6.3.1 at 6-9; De Koker in par 12.25A.

15 The operational scope of these sections is discussed in more detail below.

16 Davis *et al* in par 6.3.1 at 6-9.

meaning of the term “contingent right” was described by Watermeyer CJ in *Durban City Council v Association of Building Societies*¹⁷ as being “the conditional nature of someone’s title to the right”.¹⁸ There have been arguments that section 25B(2A) could fail in its application to non-resident discretionary trusts, as the interest of a discretionary beneficiary can best be described as a *spes* or a mere hope and not as a “contingent right”.¹⁹ Davis²⁰ and Jooste,²¹ however, submit that the interest of a discretionary beneficiary is a “contingent right” within the meaning of section 25B(2A). These submissions are based on Cameron’s²² statement that “if a trustee has a discretion not merely how, but also whether to pay income, or distribute capital to the beneficiary, then the latter’s right is merely contingent”. On the authority of Cameron’s statement above, it is submitted that the interest of a discretionary beneficiary is a contingent right within the meaning of section 25(2A), and that therefore this provision can be applied to non-resident discretionary trusts.

Where a resident beneficiary that had a contingent right to the income of a non-resident trust, acquires a vested right to any amount representing capital of a non-resident in a subsequent year, that amount must be included in the income of that beneficiary in that year. Therefore, if the amount representing capital of the trust is received by, or accrues to, a trust beneficiary subsequent to the year in which the income accrued to the trust, section 25B(2A) cannot be applied.²³ Olivier et al²⁴ also argue that if a beneficiary is only a capital beneficiary and not an income beneficiary, the section cannot be applied, as a capital beneficiary would not have had a contingent right to the income in a previous year. This may necessitate an examination of the trust deed and the trust accounts to establish whether the section applies.²⁵

Tax liability in terms of section 25B(2A) arises from the fact that the beneficiary was a resident in the year that he/she acquired a vested right to the capital of the

17 1942 AD 27 at 33.

18 See also *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163 at 175; Meyerowitz in par 16.135. Davis *et al* in par 6.3.1; M Grundy *Grundy’s Tax Havens: Offshore Business Centres - A World Survey* 6 ed (1993) at 78; see also G Clarke *Offshore Tax Planning* 9 ed (2002) at 12.

19 DJM Clegg *Income Tax in South Africa* (last updated November 2006) in par 17.3.8.

20 Davis *et al* in par 6.3.1.

21 Jooste at 203.

22 E Cameron, M de Waal, B Wunsh & P Solomon *Honore’s South African Law of Trusts* 5 ed (2002) at 557.

23 Davis *et al* in par 6.3.1 at 6-9; De Koker in par 12.25A.

24 Olivier & Honiball at 246.

trust. Thus, if a person has had a contingent right to an amount in a non-resident trust for a number of years during which income is accumulated in the trust and he/she acquires a vested right to any amount representing the capital of a non-resident trust in the year he/she is a resident of the Republic, he/she will be liable in that year for tax on the accumulated income accruing to him/her. It is immaterial whether the taxpayer has always been a resident. The date on which he/she became a resident is also immaterial.²⁶ Conversely, if the beneficiary is a non-resident in the year that he/she acquires the vested right to any amount representing the capital of a non-resident trust, even though he/she may have been a resident during the period when he/she had a contingent right to the income of the trust, he/she is not liable for tax on the amount that is distributed by the trust.²⁷

There is, however, no certainty that the section could be applied, if a beneficiary had only a contingent right to the income of the trust for part of the year of assessment. It could be argued that, where the beneficiary does not have a contingent right to the income at the end of the year of assessment, the section is not applicable.²⁸ On the other hand, it could be argued that, as tax is an annual event, the holding of a contingent right to the income for only part of the year of assessment does not render the section inapplicable.²⁹ It is submitted that the latter argument is correct.

It might be possible to avoid the application of section 25B(2A) by providing in the trust deed that no income may be awarded by the trust to a resident beneficiary in the year in which it accrues to the trust. Then it could be argued that when capitalised income is distributed to the beneficiary, section 25B(2A) is not applicable, because in the year that the income accrued to the trust the beneficiary did not have a contingent right to the income.³⁰ Davis³¹ submits that “on the current wording of section 25B(2A), it may be difficult to apply the provision and that legislative amendment may be necessary to close this loop-

25 Olivier & Honiball at 246.

26 Meyerowitz in par 16.142A; De Koker in par 12.15A.

27 Meyerowitz in par 16.142A.

28 Olivier & Honiball at 245.

29 Olivier & Honiball at 245.

30 Davis *et al* in par 6.3.1 at 6-10(1); Jooste at 204.

31 Davis *et al* in par 6.3.1 at 6-10 - 6-10(1).

hole”.³² Although this discussion is not centered on general anti-avoidance provisions, it is worth pointing out that such a scheme could be caught by the general anti-avoidance provisions in sections 80A-80L of the Income Tax Act, which subject to tax any scheme which has the purpose and effect of avoiding tax. In brief, a successful application of sections 80A-80L would *inter alia* require the courts to look into the surrounding circumstances of the case to prove that the scheme has created a right or obligation which would not normally be created between persons dealing at arm’s length.³³ In this case, as the resident beneficiary can only be awarded the income once it has been capitalised, this requirement would have been satisfied. But if the liberal approach adopted by the Supreme Court of Appeal in *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd)*³⁴ is applied, SARS may not be successful. In that case, it was ruled that a taxpayer who sets out to achieve a *bona fide* commercial objective, can do so through a structure specifically aimed at the avoidance of tax even if the contracts in such a structure create abnormal rights and obligations. The abnormality requirement in the anti-avoidance provisions also require that the provisions be viewed “having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out”,³⁵ and that the special relationship between the parties be taken into account. These requirements limit what constitutes abnormality in the particular circumstances and make SARS’s task more difficult.³⁶

By the use of the words “arose from”, section 25B(2A) makes it clear that capital must have arisen from income received by or accrued to the trust. This presupposes a direct causal link between the income that accrues to the beneficiary and the capital of the trust. The link may be clearly apparent from an arithmetical calculation, or it may be clear through designation by a body or persons making the capital distribution in which the source of the capital being

32 Davis *et al* in par 6.3.1 at 6-10 - 6-10(1).

33 *Hicklin v SIR* 1980 (1) SA 481 (A) at 485A, 1980 *Taxpayer* 49, 41 SATC 179; see also Meyerowitz in par 29.7.

34 1999 (4) SA 1149 (SCA) at 1151E, 1999 *Taxpayer* 173.

35 *Hicklin v SIR* 1980 (1) SA 481 (A) at 484B, 1980 *Taxpayer* 49. Note that the previous anti-avoidance provision under s 103(1) of the Income Tax Act was replaced by ss 80A-80L in terms of s 36 of the Revenue Laws Amendment Act 20 of 2006. Although the new anti-avoidance provisions are not yet supported by case law, there are a number of similarities between the old and the new provisions thus, certain principles established in the cases with reference to s 103(1), are still relevant. See K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 360.

36 Davis *et al* at 6-10.

distributed is named.³⁷ In practice, however, it is difficult to establish a link, for the simple reason that, although capital grows on an annual basis as a result of income received in the course of a year and not distributed, the capital also decreases as a result of distributions made from the capital. The result is that there is usually no clear link between a distribution made from capital and the various income items that have been aggregated over the years to form the capital.³⁸ Where there is no causal link between a distribution made from capital and the various income items that have aggregated over the years to form the capital, the section cannot be applied.³⁹

The use of the words “arose from” in section 25B(2A) also implies that, if the distribution is made up of capital from certain sources, such as capital with which the trust was set up, or a capital gain made from the disposal of a capital asset, the section will not be applied.⁴⁰ Thus, if an award is made to a beneficiary out of “genuine” capital as opposed to capitalised income, section 25B(2A) cannot be applied.⁴¹ This may require the trustees to identify the “genuine” capital, so as to prevent any disputes that could arise as to the source of the award.⁴²

If section 25B(2A) is to be applicable, the income at issue must accrue to a non-resident trust. In terms of section 1 of the Act, a non-resident trust is one which was not formed or established in South Africa and does not have a place of effective management in South Africa. Taxpayers could set up non-resident trusts that may be deemed invalid in South Africa, because they do not comply with the requirements of a trust (discussed above) as set out in our law. Since such a trust would be invalid under South African law, section 25B(2A) cannot be applied to it. Some examples are the so-called “non-charitable purpose trusts”, which are recognised in jurisdictions such as the Isle of Man, the British Virgin Islands, Jersey, the Cayman Islands and Mauritius.⁴³ The “non-charitable purpose trust” is a trust set up without ascertainable beneficiaries, and the

37 Olivier & Honiball at 245.

38 Olivier & Honiball at 245.

39 Olivier & Honiball at 245.

40 Olivier & Honiball at 245.

41 Davis *et al* in par 6.3.1 at 6-9.

42 Davis *et al* in par 6.3.1 at 6-9.

43 Jooste at 205.

purpose of the trust is usually not clearly stated.⁴⁴ Once again, although this discussion is not about general anti-avoidance provisions, it is worth briefly pointing out that, where SARS cannot apply the specific anti-avoidance provision under section 25B(2A), it may be possible to prevent tax avoidance by attacking the integrity of a “non charitable purpose trust” and impugning it as a sham trust under Common Law. The reason would be that the founder of the trust had no real intention to pass ownership and control of his or her assets to the trustees of the trust. The “trust” income would then be deemed to accrue to the founder, as if no “trust” had been created.⁴⁵ The fact that such a trust could be considered a sham in the Republic does not necessarily imply that it is a sham in the jurisdiction in which it was formed. This is especially so if the trust has been set up in a tax-haven jurisdiction where secrecy laws help to disguise offshore investments. The formation of sham trusts is, however, coming under attack in at least certain offshore jurisdictions, as is evidenced by the judgment by the Royal Court of Jersey in the case of *Rahman v Chase Bank Trust Company (CI) Ltd and Others*⁴⁶ (which was discussed above).

7.4 LIABILITY OF THE DONOR

In terms of section 25B of the Income Tax Act, income retained in a trust is taxable in the trust, and beneficiaries with vested rights to the income of the trust are liable to tax on any receipt or accrual in their favour. This section is, however, subject to section 7 of the Income Tax Act, which is an anti-avoidance measure that provides that in certain circumstances, income from the trust will be taxable in the hands of the donor. Section 7(5) and section 7(6) are generally applied to curb tax avoidance in respect of domestic discretionary trusts, but to some extent they can also be applied to non-resident discretionary trusts.⁴⁷ Section 7(8) specifically targets non-resident trusts. These provisions are analysed below.

Trusts subject to a condition

Taxpayers often take advantage of the fact that the beneficiaries of a discretionary trust have no vested interest in the assets of the trust and thus,

44 Davis *et al* in par 6.3.1; A Kaplan *Trusts in Prime Jurisdictions* (2000) at 26.

45 Davis *et al* in par 6.3.9.

46 1991 JLR 103.

47 It is submitted that s 7(7) does not apply to this discussion, as it applies where a donor cedes investment income to someone else, but retains the underlying property.

they cannot be subjected to tax, until there has been a receipt or accrual in their favour. Taxes could be deferred by the donor if he inserts a condition in a trust deed, whereby the beneficiaries are denied the benefits, until the relevant condition is met. The accumulated funds could then be used to make further investments. Section 7(5) is an anti-avoidance provision that can be applied to counter the tax advantages that could result from such schemes. This work does not, however, entail a detailed discussion of this section since its application to offshore trusts is limited as explained below.

In terms of section 7(5),

If any person has made any donation, settlement or other similar disposition which is subject to a stipulation or condition, whether made or imposed by that person or anyone else, to the effect that the beneficiaries or some of them shall not receive the income or some portion of the income thereunder until the happening of an event, fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation settlement or other disposition, be received by or accrued to or in favour of the beneficiaries, shall until the happening of the event or the death of that person, which ever takes place first, be deemed to be the income of that person.⁴⁸

The general aim of this section is to prevent tax avoidance where and so long as the donor does not permit the beneficiary to enjoy the income derived from the trust, by deeming the income in issue to be that of the donor.⁴⁹ There are three factors that have to be in place for this section to apply, namely:

- there must be a deed of donation, settlement or other disposition,
- it must contain a stipulation to the effect that the beneficiaries, or some of them, shall not receive the income, or some portion of it, until the happening of some event, whether fixed or contingent,
- but for that stipulation income would have been received by or accrued to the beneficiary,⁵⁰

If an affirmative answer is given to each of these questions, then “the income” must be deemed to be the income of the person who made the stipulation.

48 It important to note that s 7(5) applies irrespective of whether the stipulation or condition withholding income from the beneficiaries was made by the person making the donation, or by some other person. See De Koker in par 12.20; Clegg in par 17.3.5.

49 Meyerowitz in par 16.144; De Koker in par 12.20; Clegg in par 17.3; D Kruger & W Scholtz *Broomberg on Tax Strategy* 4 ed (2003) at 14.

50 In *ITC 673* (1948), 16 SATC 230 at 233 it was held that: “An analysis of the subsection shows that it first of all contemplates a hypothesis, viz. the existence of a stipulation that the beneficiary shall not receive the income under the deed till the happening of an event. Secondly, the subsection provides what is to be deemed to be a devolution of the income until the event takes place. That devolution is back to the donor if apart from the stipulation it would be received by or accrue to the beneficiary concerned”. See also *ITC 1033* (1959), 26 SATC 73 at 75; Clegg in par 17.3.5; Davis *et al* in par 6.3.4 at 6-13;

The words “donation” and “settlement” were defined in *Ovenstone v SIR*⁵¹ to imply a disposal of property for no consideration, ie a wholly gratuitous disposal, made out of the liberality or generosity of the donor, and that the term “other disposition” excludes any disposition of property that is a wholly commercial or business one.⁵² The phrase “donation, settlement or other disposition” is used in other subsections of section 7 that are discussed in this thesis. Wherever it occurs in the remainder of this thesis, the phrase will be considered to bear the above meaning.

The facts in *Estate Dempers v SIR*,⁵³ were that the trust deed settled monies upon trustees and directed that until the donor’s death, the annual income could be used by the trustees in their discretion for the benefit of the donor’s grandson and/or his issue, or for making charitable donations. After the donor’s death, the annual income was to be used in the trustees’ discretion for the benefit of the grandson, and the balance of the income was to accumulate in the trust. One third of the total fund was to be paid to the grandson when he attained the age of twenty-five, fifty per cent of the remainder when he attained the age of thirty, and the balance when he attained the age of thirty-five. If he were to die before reaching any one of these ages, other beneficiaries were substituted for him. In determining whether the former section 9(5) (ie the section equivalent to 7(5)) was applicable to this case, Corbett JA ruled that it was necessary to determine whether the stipulation in the deed of trust provided for an “event”, until the happening of which the beneficiaries of the trust would not receive the income

Huxham & Haupt at 352.

51 1980 (2) SA 721 (A) at 735 where it is explained that a “settlement” is usually of the same genus as a donation as it is also generally made gratuitously out of liberality or generosity. It is probably separately mentioned in the critical phrase because in form, substance, or effect it may sometimes not be regarded as a true donation. For example, where the recipients of the property are trustees who are not themselves enriched by the settlement”.

52 Although it seems that this does not specifically expand on the words “other disposition”, in terms of the *ejusdem generis* rule, which provides that words following particular and specific words must be restricted to things of the same nature as those specified, the words “other disposition” can be interpreted as having the same meaning as a donation and a settlement. These words could also be interpreted by using the *noscitur a sociis* maxim, which provides that “when two words which are susceptible of analogous meaning are coupled together [*noscitur*] *a sociis* they are understood to be used in their cognate sense. They take, as it were, their colour from each other, that is, the more general is restricted to a sense analogous to the less general. See De Koker in par 25.12; see also Clegg in par 17.3.5.

53 1977 (3) SA 410 (A); 1977 *Taxpayer* 150.

thereof.⁵⁴ An “event” for the purposes of section 7(5) could be the attainment of the stipulated ages by the beneficiary, the death of the beneficiary, or the marriage of the beneficiary.⁵⁵ It was held that a stipulation in the trust deed, to the effect that the beneficiary should not receive the accumulated income until the happening of an event (viz the termination of the trust by the attainment by the donee of the ages stated in the trust deed, or the predecease of the donee, causing a devolution upon his issue), satisfied the requirements of the subsection.⁵⁶

It has been argued, in some cases, that for a devolution to take place, the beneficiaries ought to have vested rights to the income of the trust, which would imply that section 7(5) - which refers to discretionary trusts - is inapplicable. For example, counsel for the appellant in the *Estate Dempers* case submitted that it could not be said that, but for the stipulation, the income withheld in terms of the stipulation would have been received by or have accrued to or in favour of the donee, as the devolution can only apply where the beneficiaries have vested rights to the accumulated income and they did not have such rights in the *Estate Dempers* case.⁵⁷ This argument was also relied on in *ITC 775*.⁵⁸ This case, however, went off on its particular facts, and it cannot be relied on as providing authority on this matter.⁵⁹ In *Estate Dempers* Corbett JA ruled that, in the application of the subsection, a vested right to the accumulated income is not a *sine qua non*.⁶⁰ If the beneficiaries have vested rights, then this would be a strong, possibly decisive, factor leading to the conclusion that, but for the

54 *Estate Dempers v SIR* 1977 (3) SA 410 (A) at 421G.

55 There have been controversies as to whether the exercise of discretion by the trustees is an “event” as contemplated by s 7(5). In *Hullet v CIR* 1944 NPD 263 the court was of the view that the exercise of a trustee’s discretion may in certain circumstances be an “event”. This interpretation was followed in *ITC 775* (1953), 19 SATC 314(C) and *ITC 1033* (1959), 26 SATC 73. However, the respondent counsel in *CIR v Berold* 1962 (3) SA 748 (A) at 750H, and the appellant’s counsel in *Estate Dempers v SIR* at 422E reasoned that the exercise of trustees’ discretion was not an event. The same reasoning was also upheld by appellant’s counsel in *ITC 1328* (1980), 43 SATC 56. In all three cases, the courts did not make a decision on this matter. It is recommended that the courts should decide on this matter to resolve the present controversies. For details see Editorial “Estate and Tax Planning: Inter Vivos Trusts: Income Tax and Donations Tax” *The Taxpayer* vol 43 No 6 (June 1994) at 111; Jooste at 198; EM Stack, M Cronjé & EH Hamel *The Taxation of Individuals and Companies* 15 ed (2001) at 557; Clegg in par 17.3.5; Davis *et al* in par 6.3.4 at 6-17; De Koker in par 12.20.

56 *Estate Dempers* at 424.

57 *Estate Dempers* at 425.

58 *ITC 755* (1954), 19 SATC 314.

59 *Estate Dempers* at 425.

60 *Estate Dempers* at 425.

stipulation withholding the income, it would have been received by them. The judge ruled, however, that the subsection is not confined in its application to instances where the beneficiary has a vested right to the income which is to be withheld. The use of the words “fixed and contingent”⁶¹ in denoting the event, until the happening of which a beneficiary is not to receive the income, indicates that the subsection can also apply to discretionary trusts.

As stated above, section 7(5) generally applies to curb tax avoidance that results from investments in discretionary trusts; its application to offshore discretionary trusts is limited. The reason is that this provision can only apply, if there is evidence in the trust deed that shows that the distribution of the trust benefits is subject to a condition. If an offshore trust is effectively managed in South Africa, in that the trustees carry on the day-to-day management of the trust here, it may be possible to get access to the trust deed, prove the presence of a condition and then apply section 7(5) to tax the resident donor. If however the trust was formed offshore and if the trust deed is kept offshore, the applicable laws may contain secrecy provisions that could prevent access to the relevant trust deed. It should also be noted that, if the income is retained in the non-resident trust, section 7(5) cannot apply to such a trust, if it receives income only from a non-South African source.⁶²

Liability of the donor: Retaining the power to revoke the right to income

The flexibility of discretionary trusts can be used to avoid taxes where the trust deed contains a stipulation that the donor can revoke a beneficiary’s right to receive the trust income and confer that right on another person. With the ability to vary the beneficiaries to the trust income, the donor can decide on an annual basis which of the beneficiaries has the lowest marginal rate of tax, and then direct that the income accruing to the trust should be paid to that particular beneficiary.⁶³ This work does not, however, entail a detailed discussion of this section since, like section 7(5); its application to offshore trusts is limited as

61 A “contingent event” as an event which may or may not happen. A “fixed event” is an event which will certainly and inevitably happen. See *Estate Dempers* at 425; see also *Jewish Colonial Trust v Estate Nathan* 1940 AD 163 at 175-176; *Durban City Council v Association of Building Societies* 1942 AD 27 at 33-34. For the difference between a “vested right” and a “contingent right” see the discussion in chapter 6 par 6.4.2.

62 Clegg in par 17.3.5; Huxham & Haupt in par 27.3.10.

63 Clegg in par 17.3.5; Davis *et al* in par 6.3.5 at 6-17; Huxham & Haupt in par 27.3.7.

explained below.

Section 7(6) provides that

If any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred, may, under the powers retained by the person by whom the right is conferred, be revoked or conferred upon another, so much of any income as in consequence of the disposition, settlement or other disposition is received by or accrues to or in favour of the person on whom the right is conferred, shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers.

In *ITC 543*,⁶⁴ the taxpayers were two brothers who carried on a business in which a third brother had been employed. Desiring to provide their brother with a pension in consideration of his services, the taxpayers (two brothers) formed a trust fund, whereby the third brother was to receive a portion of the income from the trust fund during his lifetime. On his death, the trusts had the discretion of paying the income to his widow, or to the donors, or their legal representatives. The taxpayers' brother died, and in the exercise of their discretion, the trustees paid the income to his widow. The Commissioner invoked section 9(6) (as it was then) and taxed the donors on the trust income. The court held that the section was applicable, as the trustees were not bound to pay the trust income to the widow. In terms of the trust deed, the balance not paid to her was to be divided between the two donors.

It appears that section 7(6) is not limited to an express provision in the deed, which empowers the donor to revoke a beneficiaries' right to income and confer it upon another, it can also be applied where the exercise of this power is implied.⁶⁵ Thus, where the donor has the power to require that income be lent to him, this could amount to a right to revoke the income, since the trustee would have been deprived of the power to distribute it.⁶⁶ It is argued that section 7(6) could also be

64 *ITC 543* (1942), 13 SATC 118.

65 Meyerowitz in par 16.151.

66 Cameron *et al* at 282. In *ITC 673* (1948), 16 SATC 230, the trust deed provided that the donor had the right to exercise voting powers in respect of the shares donated, to require the trustees to lend him the income of the trust without security and with or without interest, to revoke the appointment of any trustee, and to fill any vacancy. In addition, the trustees were permitted to abandon any claim or debts due to the trust. It was contended by the Commissioner that all these provisions amounted to an implied power to revoke the right to receive income. The court rejected this contention, and held that s 7(6) only contemplates an express provision in the deed, which reserves the right to the donor to revoke the right to any accruing income and to confer it upon another. However, Meyerowitz in par 16.151 and Cameron *et al* at 282 are of the view that s 7(6) should have been applied as the circumstance of the case show that donor had retained the power to

applied where the donor retains the right to cancel the trust as he would have retained the right to confer or revoke the rights under the trust deed. However, if the trust deed provides for the automatic termination of the trust at the end of a fixed period, even if, on expiry of that period, the income and capital of the trust will revert to the donor, he does not retain the power to revoke or confer upon another the right to receive the income of the trust as contemplated in section 7(6).⁶⁷

It appears that section 7(6) can only be invoked where the beneficiary has a vested right to receive the income that is subject to revocation through the exercise of powers retained by the donor.⁶⁸ Thus, where a donation confers a discretion on trustees to decide whether to distribute the income to a beneficiary, who only has a contingent right to that income, section 7(6) cannot be applied until the trustees exercise their discretion. Section 7(5) would be applicable in such a case.⁶⁹

As mentioned above, although section 7(6) can be used to curb tax avoidance in regard to discretionary trusts generally, it has limited application to offshore discretionary trusts. This provision can only apply, if there is evidence in the trust deed that shows that a donor has retained power to revoke the rights under the trust deed. It is retaliated that, as in the case with section 7(5), If an offshore trust is effectively managed in South Africa, it may be possible to get access to the trust deed from resident trustees and tax the resident donor. But where the trust was formed in a tax-haven jurisdiction, the applicable laws that contain secrecy provisions could prevent access to the trust deed.

Liability of the donor: Donations made to offshore trusts

Apart from the section 7(5) and section 7(6), which apply generally to discretionary trusts, the Income Tax Act does contain provisions, which can be used to directly target offshore trusts. One such provision is section 7(8) (as amended by the Revenue Laws Amendment Act 32 of 2004). This section provides the following:

Where by reason of or in consequence of any donation, settlement or other disposition

revoke the right to income.

67 Davis *et al* in par 6.3.5 at 6-19; De Koker in par 12.21.

68 De Koker in par 12.21.

69 De Koker in par 12.21.

(other than a donation, settlement or other disposition to a foreign entity, as defined in section 9D, of a public character) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign entity as defined in section 9D in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of such resident so much of that amount as is attributable to such donation, settlement or other disposition.⁷⁰

In summary, this section deems any amount received by, or accruing to, a non-resident (which would have constituted “income” as defined in the Income Tax Act had that person been a resident) and arising from a donation by a resident donor to be that of the donor.⁷¹

Before analysing the working of this provision, it is worth pointing out that previously, non-resident trusts (offshore trusts) were included in the definition of “controlled foreign entity”, whereby an amount received by the “controlled foreign entity”, which is attributed to a donation, settlement or other disposition, would be imputed to the donor, in terms of section 9D (2) of the Income Tax Act. Non-resident trusts have now been removed from the definition of “controlled foreign entity”, which is now referred to as a “controlled foreign company”.⁷² A non-resident is only liable to tax in the Republic for income that accrues from a source within the Republic. This implies that, if a non-resident trust does not make distributions to beneficiaries resident in the Republic (who would be subject to tax in terms of section 25B(1)), then in the absence of a provision, such as section 7(8) which “imputes” to the South African donor the income of

70 See s 5(1) of the Revenue Laws Amendment Act 32 of 2004.

71 De Koker in par 12.25A; Huxham & Haupt in par 27.3.10; A Duncan “Hidden Assets” (July 2004) *De Rebus* 32.

72 S 9D(2) was amended by s 22(1)(c) of the Revenue Laws Amendment Act 45 of 2003.

the non-resident trust,⁷³ residents could easily avoid taxes by shifting income-producing assets to non-resident trusts.⁷⁴

Before the amendment of section 7(8) in 2004,⁷⁵ the section referred to “income” accruing to or being received by a non-resident. The use of the word “income” implied that section 7(8), as it read then, would not be applicable to non-resident trusts, as the word “income” is defined in section 1 of the Act as meaning “gross income” less “exempt income”. In terms of the definition of “gross income” in section 1 of the Income Tax Act, a non-resident is liable to tax in South Africa only on receipts and accruals of income derived from a source within, or deemed to be within, the Republic. This prompted the argument that section 7(8) (before its amendment) could not apply to foreign-source income accruing to the non-resident trust.⁷⁶

To remedy this anomaly, it was argued⁷⁷ that the above interpretation that results in the exemption from taxation, could not have been the intention of the legislature when enacting section 7(8).⁷⁸ Jooste⁷⁹ and Olivier⁸⁰ contended that the word “income” as used in the section should be given its wider meaning, implying “profits” irrespective of their source. Support for this interpretation was based on the decision in *CIR v Simpson*,⁸¹ where the court held that the word “income”, as used in the equivalent section 7(2), had to be construed as meaning the profits and gains, and not “income” in the sense of gross income less exemptions, as the term is defined in section 1 of the Income Tax Act. The court in the *Simpson* case arrived at this interpretation by referring to a rule of law which provides that, “if a defined expression is used in a context which the

73 King & Victor in par 16.8.6; B Goodall *Tax and Investments Easiguide* (2005/2006) in par 1.17.2.

74 Jooste at 186.

75 Amended by s 5 of the Revenue Laws Amendment Act 32 of 2004.

76 Olivier & Honiball at 246; Jooste at 189; Davis *et al* in par 6.3.6A; Clegg in par 17.3.8; De Koker in par 4.67B.

77 De Koker in par 4.67B.

78 De Koker in par 4.67B.

79 Jooste at 189.

80 Olivier & Honiball at 246.

81 1949 (4) SA 678 (AD), 16 SATC 268; it was also held in *Cape Brandy Syndicate v IRC* (1921) 1 KB 64 at 71 and also in *Canadian Eagle Oil Company Ltd v The King* (1946) AC 199 at 140 that “in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.”

definition will not fit, it may be interpreted according to its ordinary meaning".⁸² This is in line with the principle canon of interpretation of statutes, namely, that if the meaning of a word used in a statute is not clear, the literal meaning of the word must be applied.⁸³ Reference could also be made to contextualisation, another rule of interpretation of statutes, which requires that the purpose of the legislation can be used to determine the intention of the legislature, where a word is ambiguous and does not have the effect the legislature intended.⁸⁴ The decision in the *Simpson* case is evidence that the South African courts tend not to "slavishly" follow the strict meaning of words, or the very letter of a statutory provision. Instead, they have sought to solve problems of interpretation by endeavouring to determine what the legislature intended, taking into account not only the language of the legislature, but factors such as its object, intention and manifest purpose.⁸⁵

In 2004, an amendment was made to section 7(8), whereby instead of referring to the word "income", the section now refers to "any amount" that is received by, or accrued to, a non-resident, "which would have constituted income had the person been a resident". This amendment, which was initiated by SARS, is most welcome, as it dispels any argument that section 7(8) does not apply to donations resulting in income from a foreign source.

In order for section 7(8) to apply, an amount must have been received by, or accrued to, a non-resident person (for example a non-resident trust). Thus, if trust funds are invested in instruments which confer no right to income, such as "roll-up" funds and "wrap bonds",⁸⁶ section 7(8) cannot apply.

For section 7(8) to apply, income must have been received by, or accrued to, a non-resident by "reason of or in consequence" of a donation, settlement, or other disposition made by a resident. The phrase "donation, settlement or other disposition" bears the same meaning of a gratuitous disposition, as was discussed previously in relation to section 7(5). The words "by reason of or in

82 A rule laid down in the SHG Halsbury *Halsbury's Laws of England* 4 ed (1984) at 1108. See also De Koker in par 4.67B.

83 Meyerowitz in par 3.6-3.8.

84 De Koker in par 4.67B.

85 De Koker in par 4.67B.

86 Jooste at 188; see also Davis *et al* in par 6.3.6A. For the meaning of "Roll-up funds" and "wrap bonds" see fn 8 above.

consequence of” denote that there must be a certain nexus between the income received by the non-resident and the donation, settlement, or other disposition made by the resident.⁸⁷ It is worth noting that other anti-avoidance provisions in section 7⁸⁸ use either the phrase “by reason of”, or “in consequence of”, but section 7(8) uses both phrases. Jooste⁸⁹ notes that the combination of both phrases indicates that a very liberal interpretation of the nexus required by section 7(8) may be called for, and that the legislature intended the ambit of section 7(8) to be even wider in this regard than in the other anti-avoidance provisions in section 7.⁹⁰

The phrase by “reason of”, as used in determining the nexus required by the equivalent of the anti-avoidance provision section 7(3), was held by Centlivres CJ in *CIR v Widan*⁹¹ to imply some causal relation between the donation and the income in question, and that in ascertaining whether such causal relation exists, one must look not necessarily to the cause which is proximate in time, but to the real effective cause of the income being received.⁹² In addition, the court held that the donor’s motive was an important factor in ascertaining whether the necessary connection is present. In *Joss v SIR*,⁹³ the taxpayer sold assets to a company on an interest-free loan. The taxpayer’s minor daughter was a shareholder in the company and received a dividend. SARS deemed the dividend to be the taxpayer’s. The court found that the portion of the dividend that accrued to the minor, was attributable to the parent, as it was “by reason of” the interest-free loan made by the parent.⁹⁴

There appears to be no difference between the meaning of the words “by reason of”, and “in consequence of”, as used in this section.⁹⁵ The *ejusdem generis* rule, which was discussed previously, would also be applicable here. Its effect would be that words following particular and specific words must be restricted to things of the same nature as those specified.⁹⁶ Further, in terms of the “*noscitur a*

87 Jooste at 191.

88 See ss 7(2)(a), 7(3), 7(5), 7(6) and 7(7).

89 Jooste at 191.

90 Jooste at 191.

91 1955 (1) SA 226 (A) at 233.

92 *CIR v Widan* 1955 (1) SA 266 (A) at 234.

93 1980 (1) SA 674(T); 1980 *Taxpayer* 192.

94 *Joss v SIR* 1980 (1) SA 674 (T) at 683.

95 De Koker in par 4.67B; Davis *et al* in par 6.3.6A at 6-24.

96 De Koker in par 25.12; see also Clegg in par 17.3.5.

sociis” maxim which was discussed earlier, when two words with an analogous meaning are coupled together, they are understood as being used in their cognate sense.⁹⁷ Therefore, just as the phrase “donation, settlement or other disposition” is understood in a cognate sense, the phrase “in consequence” carries the same meaning as “by reason of”.

In light of the above, it appears that section 7(8) has sufficient scope to be applicable in a wide range of circumstances. The Explanatory Memorandum on the Revenue Laws Amendment Bill 2004 gives two examples of such circumstances in regard to section 7(8). The first example is where a South African resident donates R750 000 to a foreign discretionary trust, which is owned by a foreign trustee with oversight from a foreign protector. The foreign trustee has the power to vest the trust assets in a wide range of parties, but an attached letter containing the donor’s wishes requests that the funds be ultimately vested back in the South African resident, or a connected family member. The foreign trust places the full R750 000 in a foreign bank account, thereby generating R60 000. In terms of section 7(8), the amount of R60 000 generated by the foreign trust from the foreign bank account is included as income of the South African resident, because this amount would have been income for the South African resident, had this amount been received by, or accrued directly, to the South African resident.

The other example is where the foreign trust transfers an amount of R800 000 of accumulated funds to a foreign collective investment scheme, and the scheme generates R40 000 of foreign dividends, that are paid to the foreign trust. In terms of section 7(8), the full R40 000 would be included as income of the South African resident. It is immaterial that the foreign collective investment scheme assets stem from the foreign bank account, because the full amount is initially attributable to the donation made by the South African resident.

Section 7(8) could also apply, where a resident grants an interest-free loan to a non-resident trust. As mentioned previously, South Africans tend to make use of interest-free loans to transfer the amount permitted by the Exchange Control Regulations to offshore trusts.⁹⁸ To explain how section 7(8) could be applied in

97 De Koker in par 25.15.

98 J Ware & P Roper “The Impact of Residence-based Tax on Offshore Trusts” (June 2001)

this regard, consider the following hypothetical case: a South African resident donor forms an offshore trust. The offshore trust then forms an offshore company, in which the offshore trust holds all the equity shares. If the South African resident donates an interest-free loan to the offshore trust, which in turn donates the interest-free loan to the offshore company, and the company utilises the interest-free loan to generate foreign income, would that income be taxable in the Republic? ⁹⁹

To establish whether section 7(8) is applicable to the above scenario, it has to be determined whether the interest-free loan amounts to a donation, settlement, or other disposition. Secondly, it has to be determined whether the foreign company's income arose "by reason of or in consequence of" the interest-free loan.

The question whether an interest-free loan is gratuitous in nature and therefore a "donation, settlement or other disposition", was discussed in *CIR v Berold*.¹⁰⁰ The facts of the case were that the taxpayer did not charge interest on the purchase price of the assets, which he sold to Luzen Holdings (Proprietary) Limited, a company that the taxpayer had incorporated. The taxpayer then created certain trusts (for the benefit of his minor children), to which he donated the shares in Luzen Holdings. No interest was charged to the trusts for the donation. The result was that the interest-free loan and the dividend income ended up being for the benefit of the taxpayer's children. The court held that the donation of shares in the company (on an interest-free basis) to the trusts allowed the trusts to obtain the benefit of a continuing donation in the form of the enhanced dividends received on the shares.¹⁰¹ As long as the taxpayer refrained from compelling the company to pay the loan, there was a continuing loan by him of the interest on the loan, which made it subject to tax in terms of section 7(8).¹⁰² Section 7(9) also specifically states that a disposition for less than market value (which is what an interest-free loan basically entails) is considered to be a donation to the extent

16 *Insurance and Tax Journal* at 21; *Davis et al* in par 17.9.

99 *Davis et al* in par 6.3.6A at 6-24; *Olivier & Honiball* at 246; *Jooste* at 192; *Stack et al* at 560.

100 1962 (3) SA 748 (A).

101 *CIR v Berold* 1962 (3) SA 748 at 753.

102 *Stack et al* at 561; *Huxham & Haupt* at 610-611 also point out that an interest-free loan is a gratuitous disposition that should be subject to s 7(8) if all the requirements of the section are fulfilled.

that the market value exceeds the consideration received.¹⁰³

In the above scenario, an interest-free loan donated by a South African resident to an offshore trust, which is in turn donated to an offshore company, could be taxed under section 7(8). Jooste¹⁰⁴ notes that for section 7(8) to operate, the income in question does not have to accrue to the person to whom the interest-free loan is made, so it does not matter that the income accrues to the company and not the trust. The issue here is simply whether the income accruing to the company is “by reason of, or in consequence of”, the interest-free loan made by the donor to the trust.¹⁰⁵

In *CIR v Widan*,¹⁰⁶ the facts were that in terms of a deed of trust, a father had donated all the shares in a company to his four children. The company declared a dividend of £21 000, which the trustees distributed to the father in his capacity as guardian of the four children (the beneficiaries). The money was then used to subscribe for shares in another company, and it was the income from the second company which was at issue. It was held that the income from the second company was by reason of the donation, because the original donation was intended to produce income, which would be used to acquire the shares in the second company. The whole arrangement was in fact a scheme for donating income-producing assets to the taxpayer’s children.

On the authority of the *Widan* case, it is submitted that, where there is an agreement between a resident and an offshore trust, whereby the resident makes a loan to the trust on condition that the funds lent are on-lent by the trust to a company, such an agreement would clearly support the conclusion that the income accruing to the company was “by reason of, or in consequence of”, the interest-free loan made by the resident, and so section 7(8) would be applicable. Writing on this issue, Davis¹⁰⁷ notes that “if the court is satisfied that it was the donor’s “all embracing design”¹⁰⁸ that his interest-free loan to the trust should be on-lent interest-free to the company, in order to generate income in the

103 The need for this subsection is however questionable as a sale at less than market value is a “similar disposition” in any event. See also Ware & Roper “The impact of residence-based tax on offshore trusts” in par 2; Stack *et al* at 559; De Koker in par 4.67B.

104 Jooste at 192.

105 Jooste at 192.

106 1955 (1) SA at 226 (A) at 234.

107 Davis *et al* in par 6.3.6A.

company's hands, it is unlikely that the court would find that this consequence "is too remote for the law to treat as a consequence". Neither is it likely that the on-lending by the trust to the company will be viewed as a *novus actus interveniens*, which severs the connection between the loan to the trust and the income accruing to the company.¹⁰⁹

It is also important to note the approach adopted in the (former) Appellate Division case, Erf 3183/1 *Ladysmith and Another v CIR*,¹¹⁰ where there was an unwritten agreement between the parties which the court used to infer that the resident made the interest-free loan to the trust, on condition that the funds lent were on-lent by the trust to the company. The court held that such an agreement would clearly support the conclusion that the income accruing to the company was "by reason of, or in consequence of", the interest-free loan made by the resident.

Based on the decisions in the above cases, it can be concluded that section 7(8) can be applied to curb tax avoidance, where income arises as a result of an interest-free loan to a non-resident trust.

Apart from the use of interest-free loans, section 7(8) can also be applied where income accrues to a non-resident through a so-called "income on income" situation (income accrues from the re-investment of the income from the donation).¹¹¹ An example would be a situation where a resident makes a donation to an offshore trust, and by reason thereof, foreign investment income accrues to the trust and is then reinvested to generate further foreign investment income.¹¹²

In *CIR v Widan*, it was held that section 7(8) may be applied to "income on income" situations, so as to tax the original investment income and the further investment income in the donor's hands in terms of section 7(8).¹¹³ A different

108 *CIR v Widan* 1955 (1) SA 226 (A) at 234.

109 Davis in par 6.3.6A.

110 1996 (3) 942 (A) 942; 21 SATC 379.

111 Huxham & Haupt at 612; Jooste at 195.

112 Davis *et al* at 6.3.6A.

113 1955 (1) SA at 226 (A) at 234.

decision was, however, arrived at in *Kohler v CIR*.¹¹⁴ In this case, income was received by the taxpayer's daughter from a re-investment of the income which accrued from a donation made by the father. Briefly, the facts were that a father donated a certain amount of money to each of his daughters. Each daughter purchased shares using the income which accrued to her from the investment of the money. The Commissioner taxed the father on the income which accrued from the shares in terms of section 9(3) (now section 7(3)). Finding in favour of the father, it was held that:

Once income has (actually or by deeming) accrued to or been received by the minor, and has been capitalized, its subsequent earning or product is attributed not to the source from which the original income was derived but to the advantageous employment of the minor's new capital. In this respect the "income upon income" now in issue stands, as I see it, on the same footing as income derived by the minor from the employment of other capital of his, borrowed, earned or bequeathed.

The circumstances in the *Kohler* case can, however, be distinguished from those in the *Widan* case. In the *Widan* case, it was ruled that, in cases of this nature, there were no hard and fast rules, and each case would have to be judged on its merits. In this context Centlivres CJ held:

There must be some causal relation between the donation and the income in question. Difficult cases may conceivably arise. Where, for instance, a father donates a sum of money to a minor child and the child buys a business to which he contributes his skill and labour and from which he earns an income that may be regarded as being attributable to two cases, viz, the donation and the skill and labour of the child. In such a case it may be impossible to say which part of the income was the result of the donation and which part the result of his skill and labour and it may be that the Commissioner would not be able to apply s 9(3) (now (section 7(3))).¹¹⁵

With regard to the scenario above, it can be concluded that the decision in *CIR v Widan* provides authority that section 7(8) may be applied where a South African resident donates money to an offshore trust, which in turn donates the money to an offshore company, so as to generate further income.¹¹⁶

Apart from the use of interest-free loans and the "income on income" situations discussed above, taxpayers could engage in other more complex schemes to circumvent section 7(8). For example, instead of donating a loan to an offshore trust, a South African resident might subscribe for redeemable preference shares in an offshore company, which might then lend the proceeds from the redeemable preference shares to an offshore trust, which it uses to generate

114 1949 (4) SA 1022.

115 *CIR v Widan* 1955(1) SA 226 (A) at 234.

116 *Davis et al* in par 6.3.6A.

foreign income.¹¹⁷ On the authority of the *Widan* case above, it is submitted that section 7(8) is applicable to such situations, as there is a causal relation between the subscription for the shares in the company and the foreign income generated by the offshore trust. But before it can be concluded that section 7(8) would be applicable, it would have to be determined whether the subscription for redeemable preference shares amounts to a “donation, settlement or other disposition”. Jooste¹¹⁸ and Davis¹¹⁹ argue, that where the company is simply an empty shell that is interposed between the resident and the offshore trust to serve no other purpose than tax avoidance (since it is unable to pay any dividend), then it can be concluded that the subscription for redeemable preference shares has an element of “gratuitousness and generosity”, that could constitute a “disposition” within the meaning of “donation, settlement or other disposition”.¹²⁰ In essence, this would effectively be the same as the resident’s making an interest-free loan to the trust.

In general, the reading of section 7(8) makes it clear that the section can only be applied, if the “donation, settlement or other disposition” is made by a resident. It thus appears that, if a person makes a donation prior to becoming a South African resident, any income arising on the donated asset will not fall within the ambit of the section after he becomes a resident.¹²¹ Jooste¹²² argues that, if section 7(8) is given such a narrow interpretation, it would be simple for an immigrant to South Africa to avoid the application of section 7(8) by donating his or her foreign income-purchasing assets to a discretionary offshore trust prior to becoming a resident.¹²³ In this regard, Jooste¹²⁴ submits that section 7(8) is ambiguous and could be manipulated for tax avoidance purposes. Since the provision is designed to prevent tax avoidance, it should be given a wider meaning. In *Glen Anil Development Corp Ltd v SIR*,¹²⁵ Botha JA held that the *contra fiscum* rule¹²⁶ of interpretation does not apply to tax avoidance provisions,

117 Jooste at 193.

118 Jooste at 193.

119 Davis *et al* in par 6.3.6A at 6-25.

120 Jooste at 193-194; Davis *et al* in par 6.3.6A at 6-25.

121 Clegg in par 17.3.7.

122 Jooste at 197.

123 Jooste at 197. In terms of s 54 of the income Tax Act, donations tax is not payable on donations by non-residents.

124 Jooste at 197.

125 1975 (4) SA 715 (A).

126 The *contra fiscum* rule provides that in the case of any legislation imposing a burden upon a subject, the interpretation less cumbersome to the subject must be endorsed as the true

and that they should therefore be interpreted in a manner that will advance the remedy provided by the section, which is to suppress the mischief against which the section is directed.

Where a person donates an interest-free loan to an offshore trust and then immigrates to South Africa, would section 7(8) apply, if the loan were still outstanding when he or she became a resident? Davis¹²⁷ argues that the loan is deemed to be a "continuing donation"¹²⁸ and that section 7(8) becomes applicable once the person becomes a resident. What is not clear is whether the section would apply, if the donor were a resident when the disposition was made and then ceased to be a resident. It is clear that the section cannot operate in respect of foreign income. But in respect of South African income, the wording in section 7(8) to the effect that "there shall be included in the income of such resident" seems to imply that the donor must be a resident at the time when the income is included in his/her gross income.¹²⁹ The courts still have to clarify this matter.

In *CSARS v Woulidge*,¹³⁰ the respondents' father had created two *inter vivos* trusts in terms of which the respondent's son and daughter were the income and capital beneficiaries. During 1982 the respondent sold shares in four companies to the trusts. It was agreed that the purchase price would be paid in such amounts and at such times as may be mutually agreed upon. Further that, the respondent would be entitled to charge interest, not exceeding the prevailing bank rate, on the balance of the purchase price. The trust then sold a percentage of the shares to another company and then paid outstanding loans to the respondent. Relying on the provisions of section 7(3) and 7(5) of the Income Tax Act, the Commissioner taxed the respondent for the years 1990 and 1991 on the basis that notional interest was due to him in respect of the unpaid purchase price of the shares sold by him to the trusts.

intention of the legislature. See also *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 727-728.

127 Davis *et al* in par 6.3.6A.

128 *CIR V Berold* 1962 (3) SA 748 at 753.

129 Davis *et al* at 6.3.6A at 6-26(3); Jooste at 198-199.

130 2002 (1) SA 68 (SCA).

The respondent unsuccessfully objected to the assessments and then appealed to the Cape Special Court for Hearing Income Tax Appeals where it was held that the respondent should be taxed on the forsaken interest in respect of the unpaid price of the shares sold to the trusts. But that such interest would not exceed an amount equal to the price of the shares. This limitation on interest was said to flow from the operation in the *in duplum* rule.¹³¹ On appeal, the High Court in *CSARS v Woulidge*¹³² upheld the finding of the court *a quo*. On further appeal to the Supreme Court of Appeal, it was held that there was indeed an appreciable degree of gratuitousness as far as the forbearance of interest was concerned (in the form of annual donations of the interest not charged), however, there was no donation with respect to the sale itself. The market-related purchase price, the terms of the deed of sale and the subsequent payment of that purchase price constituted due consideration in respect of the sale itself. With respect to the *in duplum* rule, the Supreme Court of Appeal held that this rule could only be applied in the real world of commerce and economic activity where it served as public policy to protect borrowers against exploitation by lenders. The rule cannot be applied in this case as there was no lender or borrower in the facts. The facts showed that there was a gratuitous disposition to which the *in duplum* rule cannot apply. The Supreme Court of Appeal directed the Commissioner to revise the assessments for the tax years 1990 and 1991 that were based on the *in duplum* rule. It should however be noted that the Supreme Court of Appeal agreed that the forbearance of interest (in the form of annual donations of the interest not charged) was a gratuitousness disposal to which section 7(3) could apply.

It is worth noting that also in *CSAR v Brummeria Renaissance (PTY) Ltd and others*¹³³ (a case that did not specifically deal with trusts), it was held that the right to retain and use borrowed funds without paying interest had a monetary value which had to be included in the taxpayer's gross income for the year of assessment in which the rights accrued to the taxpayer. Although this case does not specifically deal with trusts, its judgement is wide enough to cover trusts.

131 The *in duplum* rule provides that interest stops running when the unpaid interest equals the outstanding capital. This rule aids debtor in financial difficulties. For a detailed discussion of this rule, see WG Schulze "The *In Duplum* Rule: A Short List of Some Unresolved Issues" (2006) 18 *SA Mercantile Law Journal* at 487.

132 2000 (1) SA 600 (C).

Commenting on this case, a 2007 article in “Tax Gram”¹³⁴ stated that South Africa is “littered” with property trusts that have been funded by way of interest-free loans from donors. The author of the above mentioned article¹³⁵ reasons that the judgement in this case can be applied where interest-free loans are received, by trusts, and no consideration is provided in return for the use of the capital on the loan account.

The concern that arises from this judgement, however, is whether SARS can reissue previous assessments, and impute interest on the donor. This case makes it clear that where a taxable benefit arises from an interest-free loan, the borrower (donor in case of a trust) is taxed on the basis that he was deriving a non-monetary benefit, namely a contractual right to have use of money without paying interest and it is the value of that interest that is taxable.¹³⁶

In the past, taxpayers used to circumvent section 7(8) by hiding their interest in offshore trusts from tax authorities. This was because offshore disclosure was only effected by the income tax return. Section 7(10) has now shifted the onus of disclosure onto the taxpayer.¹³⁷ The section requires that, when submitting a tax return, taxpayers should disclose to the Commissioner in writing any donation, settlement or disposition. Failure to disclose the obligation in section 7(10) can lead to criminal sanctions.¹³⁸ It could also result in the taxpayer being subjected to additional assessment under section 79 of the Income Tax Act. Section 7(10) thus prevents taxpayers from pleading ignorance in mitigation where penalties are imposed when they have failed to disclose section 7(8) income, and their non-disclosure is discovered.¹³⁹

In terms of section 78 of the Income Tax Act, where the Commissioner has

133 69 SATC 205.

134 Editorial “Shock SCA decision on Interest-free Loans” (Nov/Dec 2007) *Tax Gram*. Also available at <http://bibinf.unisa.ac.za/nxt/gateway.dll/7b/nf/zmlxa/lfg5a/mfg5a>, last accessed 1 April 2008.

135 Editorial “Shock SCA decision on Interest-free Loans” (Nov/Dec 2007) *Tax Gram*. Also available at <http://bibinf.unisa.ac.za/nxt/gateway.dll/7b/nf/zmlxa/lfg5a/mfg5a>, last accessed 1 April 2008.

136 Editorial “Shock SCA decision on Interest-free Loans” (Nov/Dec 2007) *Tax Gram*.

137 Jooste at 199; Ware & Roper “The Impact of Residence-based Tax on Offshore Trusts” in par 2; De Koker in par 4.67B; Duncun at 33.

138 S 75 and 104 of the Income Tax Act.

139 Jooste at 200; Stack *et al* at 559.

reason to believe that a resident has not declared, or accounted for, any funds or assets owned outside the Republic, or where the income or capital gains from any funds or assets outside the Republic could be attributed to that resident in terms of any of the subsections of section 7, or Part X of the Eighth Schedule, the Commissioner must estimate the amount of foreign currency of such funds, or the market value of those assets, and include the estimated amount in the taxable income of that person. The estimation could be based on information such as: any funds or assets transferred by that resident from the Republic any amount received by, or accrued to, that resident from any source outside the Republic, or the period that has elapsed since those funds or assets were transferred outside the Republic.

7.5 CAPITAL GAINS TAX (CGT) PROVISIONS THAT RELATE TO OFFSHORE TRUSTS

Before discussing the CGT provisions that can be applied to curb tax avoidance when investments are made in non-resident trusts, it is necessary to provide some background information on how CGT works.

The Income Tax Act provides for the levying of CGT.¹⁴⁰ In order to determine the CGT liability of a taxpayer, his/her capital gains and losses must be determined in respect of all “disposals” of “assets” that take place on or after 1 October 2001 (the valuation date). A capital gain in respect of an asset disposed of during a year of assessment is determined by deducting the “base cost” of that asset from the “proceeds” of that disposal. A capital loss results if the asset’s base cost exceeds the proceeds. For the purposes of this discussion on tax avoidance, only capital gains will be referred to.

For CGT purposes, an asset is defined in paragraph 1 of the Eighth Schedule to the Income Tax Act (any references to paragraphs hereafter are references to paragraphs in the Schedule) as including property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coins made mainly from gold or platinum, and any right or interest of whatever nature to or in such property. A vested right in a trust asset qualifies

140 S 26A read with the Eighth Schedule of the Income Tax Act 58 of 1962.

as an asset for CGT purposes.¹⁴¹ In terms of paragraph 2 of the Eighth Schedule to the Act, a South African resident is subject to CGT on the disposal of any asset (as defined), whether situated in or outside the Republic. In contrast, a non-resident is subject to CGT on the disposal of any immovable property situated in the Republic, or any interest or right in immovable property situated in the Republic, as well as any asset of a permanent establishment of the non-resident in the Republic. As this discussion is centred on curbing tax avoidance when residents invest in offshore trusts, only the CGT implications of the disposal of assets by residents will be considered.

In terms of paragraph 11(1), a “disposal” is defined as any event, act, forbearance or operation of law, which results in the creation, variation, transfer, or extinction of an asset. This would include a sale or a donation of an asset.¹⁴² In terms of paragraph 11(1)(d), the vesting of an interest in an asset of a trust in a beneficiary constitutes a disposal, as it, in effect, involves the creation for the beneficiary of a right to that asset, or a portion of it.¹⁴³ This implies that the exercise of a trustee’s discretionary powers to vest a benefit in a beneficiary, or the occurrence of an event (such as marriage or death) that results in the benefit vesting in a beneficiary, qualifies as a disposal of an asset.¹⁴⁴ It is worth noting, however, that in terms of paragraph 11(2)(e), there is no disposal of an asset by a trustee in respect of the distribution of an asset of the trust to a beneficiary to the extent that the beneficiary already has a vested interest in that asset. This is because a subsequent transfer of ownership to the beneficiary entitled to that asset (on distribution) would involve a second disposal by the trust.¹⁴⁵ This is in line with the time of disposal rules in paragraph 13(1)(d), which provide that the time of disposal of an asset in consequence of the vesting of an interest in an asset of a trust in a beneficiary is the date on which that interest vests.

The time of disposal of an asset, if it is by means of a donation, is the date of compliance with all the legal requirements for a valid donation. In the case of a discretionary trust, this would be the date on which the contract (deed of trust)

141 G Swart “The Taxation of Trusts - Superimposing New Rules on Old Principles” (2002) *Acta Juridica* 123-124; see also RC Williams *Capital Gains Tax - A Practitioner’s Manual* 2^{ed} (2005) in par 10.2.

142 Swart at 123.

143 King & Victor in par 7.19.1; De Koker in par 24.127.

144 Swart at 124.

145 Swart at 125 and at 129; see also De Koker in par 24.127.

between the donor and the trustee is signed. In terms of paragraph 35, the proceeds from the disposal of an asset are deemed to be equal to the amount received by, or accrued to, or in favour of, a person in respect of that disposal. In term of paragraph 38, where a person donates an asset, or disposes of it to a connected person (other than a spouse), such as his child, at a non-arm's length price,¹⁴⁶ the donation is treated as a disposal of the asset by the donor and an acquisition of that asset by the donee at market value.

In order to curb tax avoidance, a capital gain may in certain circumstances be attributed to, and taxed in the hands of a person other than the one in whose hands it arises. The circumstances that could cause the CGT attribution rules to apply in regard to offshore trusts are generally similar to the way in which income is deemed to accrue to a donor in terms of section 7 of the Income Tax Act (discussed above). Paragraphs 70 and 71 apply generally to domestic trusts, but are to some extent also applicable to non-resident trusts. Paragraphs 72 and 80(3) specifically target offshore trusts. These provisions are discussed below.

Conditional vesting in a discretionary trust

In terms of paragraph 70 of the Eighth Schedule to the Income Tax Act, when a person has made a donation, settlement, or other disposition, that is subject to a stipulation or condition imposed by any person, which is to the effect that a capital gain or portion of it will not vest in the beneficiaries until the happening of some fixed or contingent event, the capital gain is taken into account in determining the aggregate capital gain or loss of the person who made the donation, settlement or other similar disposition.¹⁴⁷ The working of this provision is similar to that of section 7(5) of the Income Tax Act discussed above.

For this paragraph to apply, there must be a stipulation or condition to the effect that the capital gain does not vest in the beneficiary, until some fixed or

146 A non-arm's length price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction. South African Revenue Service ('SARS') *Practice Note No 7 Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing (s 31 of the Income Tax Act No. 58 of 1962)* 6 August 1999 in par 7.1; art 9 of the OECD Model Tax Convention on Income and on Capital (2005 condensed version).

147 Meyerowitz in par 39.16, Huxham & Haupt in par 30.16.1.

contingent event has occurred. The capital gain is then deemed to devolve back to the donor, if it would have vested in the relevant beneficiary, had it not been for the stipulation or condition. It is worth noting that CGT will be payable by the individual who made the donation and not necessarily by the founder of the trust. Thus, if a grandfather makes a gratuitous disposition to a trust and the gain attributable to it does not vest in a beneficiary in the year concerned, the gain will be taxable in the grandfather's hands. If more than one person has supplied such funding, then the gain must be proportionately attributed.¹⁴⁸

Paragraph 70 applies only if the person to whom the gain is attributed has been resident in South Africa throughout the tax year in which the gain arises. If the person has not been resident throughout the year, then the gain will be taxable in the hands of the trust.¹⁴⁹

For paragraph 70 to apply, it is immaterial whether the trust is resident or non-resident. In the case of a non-resident trust, however, the provision can only apply, if the asset is immovable property situated in the Republic, or if it is an asset of a permanent establishment of the non-resident in the Republic.¹⁵⁰

Paragraph 70 deals only with capital gains attributable to a donation, settlement, or other disposition, and is not concerned with capital losses of any kind. Such capital losses remain with the trust, or are attributed to the relevant person, depending on the terms of the trust deed.¹⁵¹

Revocable vesting

Paragraph 71 of the Eighth Schedule is similar to section 7(6) of the Income Tax Act. This paragraph is intended to curb tax avoidance in a situation where a trust deed confers on a resident beneficiary a right to receive a capital gain, but the person conferring the right has the power to revoke it, or confer it upon another person. In that case, if a person has made a donation to a trust, then, if in a particular year a capital gain attributable to such a donation vests in the aforesaid beneficiary, the capital gain will be deemed to be that of the person who

148 Clegg in par 5A.7.3.2.

149 Clegg in par 5A.7.3.2.

150 Par 2 of the Eighth Schedule.

151 De Koker in par 24.131.

conferred the right and not that of the beneficiary.¹⁵²

For paragraph 71 to operate, the donor must have retained the power to revoke or vary the terms of the trust throughout the year in which the capital gain vests in the beneficiary. It appears that for the purposes of paragraph 71, the donor must be a resident in order for the provision to apply.

It also appears that it is not essential for the application of this paragraph that the person should actually exercise the right of revocation reserved by him/her. All that is required is that the person should be vested with the power and that his/her exercise of the power would result in the diversion of the capital gain to someone else or in the capital gain being accumulated in the hands of the trustees.¹⁵³

Paragraph 71 only deals with capital gains attributable to a donation, settlement or other disposition. It does not deal with capital losses. This implies that the capital losses remain with the trust or are attributed to the relevant person, depending on the terms of the trust.¹⁵⁴

Vesting in a non-resident

Generally, non-resident trusts are not liable to CGT (except in the case of South African immovable property, or where a non-resident trust has a permanent establishment in South Africa). There is no CGT liability where the non-resident trust disposes of assets anywhere in the world. However, distributions of capital made to a resident beneficiary, which represent earlier capital gains in the trust are subject to CGT in the beneficiary's hands. As an anti-avoidance measure, where the non-resident trust has been funded by a gratuitous disposition from a resident, paragraph 72 applies to attribute CGT to the resident donor. The purpose of this provision is to prevent the possibility of capital gains escaping the CGT net by virtue of their vesting in non-residents who are not subject to tax in

152 See also Clegg in par 5A.7.3.2; Huxham & Haupt in par 30.16.2.

153 De Koker in par 24.131.

154 De Koker in par 24.131.

South Africa.¹⁵⁵ This provision works like section 7(8) of the Income Tax Act (described above).

Paragraph 72 provides that, if a resident has made a donation, settlement, or other similar disposition to a non-resident during a year of assessment, (other than a public benefit organisation as contemplated in section 30), and the capital gain attributable to the donation settlement or other similar disposition vested in any non-resident (including a non-resident trust), then the capital gain must be taken into account when determining the aggregate capital gain or loss of the resident donor, who will then have to pay tax on the capital gain.

Example: A, a South African resident disposes of an asset. The disposal results in a capital gain of R100 000, which A decides to vest in a Cayman Islands trust (which is non-resident for South African tax purposes). In terms of paragraph 72, the capital gain will be attributed to A, and the CGT liability for the gain will fall on A.¹⁵⁶

With this example in mind, even where an asset of the trust has been acquired with funds from a donation or low-interest loan, the attribution under paragraph 72 would apply. In the case of a low-interest loan, the attribution must, however, be limited to the interest foregone by the resident on the loan concerned and also by any attribution which takes place in respect of the same loan for income tax purposes.¹⁵⁷ It has to be noted, that since the trust is non-resident, only gains on South African fixed property, or permanent establishment assets can be attributed.¹⁵⁸

A scrutiny of paragraph 72 shows that the paragraph can only apply, if the person making the disposal is a resident. Thus, if a person made a disposition at a time when he or she was not resident, paragraph 72 would not apply, even if that person subsequently became resident.¹⁵⁹

155 T Mhlongo "The Efficacy of Trusts in the Current Legislative Climate" (Dec 2002) *Insurance and Tax Journal* 9 in par 4.4.1. Also see generally E Mazansky, G Thornton & K Feinstein "Capital Gains Tax and Estate Planning" (Nov 2001) *Taxgram* at 11-15.

156 Example adopted from Mhlongo in par 4.4.1; see also Meyerowitz in par 39.16.3; Huxham & Haupt in par 30.15.2; De Koker in par 24.131; Clegg at 5A.7.3.2.

157 Clegg at 5A.7.3.6.

158 Clegg at 5A.7.3.6.

Paragraph 72 deals only with capital gains arising from a deed of donation, settlement, or other disposition and is not concerned with any capital losses. Such a capital loss will remain with the trust, or be attributed to the relevant person, depending on the terms of the deed of donation, settlement, or other disposition.¹⁶⁰

Interests in non-resident trusts

Over the years, South African residents have set up trusts offshore, in which the majority of beneficiaries are residents of South Africa. Although the residence basis of taxation does make residents liable for tax on their world-wide income (which also includes capital gains), the Eighth Schedule to the Income Tax Act also provides that there will be a liability for CGT in the event of a vesting taking place in favour of a resident beneficiary.

In terms of paragraph 80(3), when a resident acquires a vested right to an amount representing capital of any non-resident trust and that capital arose from a capital gain of the trust determined in any previous year of assessment, during which the resident had a contingent right to the capital, or any amount which would have constituted a capital gain of the trust, if the trust had been a resident; and the capital gain has not been subject to tax in the Republic, that amount must be taken into account for the purposes of calculating the aggregate capital gain or loss of the resident in the year of assessment in which he acquires the vested right. This provision is similar to section 25B(2A) of the Act,¹⁶¹ in that it prevents tax avoidance, where capital is accumulated in a non-resident discretionary trust and is only distributed to the beneficiaries in subsequent years.¹⁶²

This provision could apply in the following example: Trust X, which is located in Australia, disposes of an asset. In the process, a capital gain of 100 000 Australian dollars is realised. The trustees then decide to vest this gain in Z, a beneficiary of the trust, who is a South African resident. In terms of this provision,

159 Clegg at 5A.7.3.6 ; De Koker in par 24.134A.

160 De Koker in par 24.131.

161 Discussed in par 7.3 above.

162 Meyerowitz in par 39.16.9; see also Huxham & Haupt in par 30.15.3; Mitchell & Mitchell at 92.

Z will be liable for CGT on the Rand equivalent of the capital gain.¹⁶³

In order for paragraph 80(3) to apply, the gain must be determined as though the trust was a resident. This implies that non-South African gains are included.¹⁶⁴ To prevent any double taxation that would arise, the paragraph provides that, if the capital gain had been subject to tax in the Republic (say under paragraph 70 or paragraph 72), then the provision would not apply. For example, if the non-resident trust owned fixed property situated in the Republic and then realised the property, any resultant capital gain would have been included in the taxable income of the trust and subjected to normal tax. Should the resident beneficiary in a subsequent year of assessment acquire a vested right to the capital gain included in the capital of the trust, the amount has to be disregarded for purposes of CGT.¹⁶⁵

Paragraph 80(3) makes it clear that it applies only where the resident acquires a vested right to an amount representing the capital of the trust, and where that capital arose in any previous year of assessment, during which the resident had a contingent right to the capital. As discussed above in regard to section 25B(2A), it may be argued that a discretionary beneficiary of a non-resident trust has only a *spes* (ie a mere hope) of benefiting, and that this does not constitute a right. It is, however, submitted that a discretionary beneficiary is still covered by the provision. As was also discussed with regard to section 25B(2A), another way of avoiding paragraph 80(3) would be to provide in the trust deed that the beneficiary has no right (vested or contingent) to any capital gain in the year that it accrues to the trust, but that it may be vested in the beneficiary in a later year. However, general anti-avoidance provisions under sections 80A-80L of the Income Tax Act may be applied, where CGT has been avoided, reduced, or postponed through the use of the offshore trust. Another possibility is that the trust could be deemed to be a sham trust, and its capital gains could be treated as those of the founder of the trust.¹⁶⁶

For paragraph 80(3) to apply, the capital must have arisen from the capital gain of the trust. This implies that it may be necessary for individuals receiving

163 Example adopted from Mhlongo in par 4.4.2.

164 Clegg in par 5A.7.3.6; Mhlongo in par 4.4.3.

165 De Koker in par 24.134A; Mhlongo in par 4.4.3.

166 Davis *et al* in par 2A-12.

distributions from such trusts to establish the origins of amounts representing the capital of the trust from the trustees. The onus is on the taxpayer to prove the nature of an amount, and if satisfactory evidence is not produced, SARS can make an assessment based on any terms.¹⁶⁷

Where a non-resident trust distributes an asset directly to a resident, there is no deemed disposal by the trust (unless the asset is South African immovable property, or a permanent establishment asset of the non-resident trust). Such an event therefore has no CGT repercussions, unless it represents capitalised capital gains from prior years.¹⁶⁸

In order to prevent over-taxation in a situation where a capital gain is attributed to a resident and also where income is attributed to a resident in terms of the section 7 anti-avoidance provisions, paragraph 73 states that, when both an amount of income and a capital gain are derived by reason of, or are attributable to, a donation, settlement, or other similar disposition, the total amount of that income, that is required to be included in the income of the resident under section 7, and the amount of the capital gain, that is to be attributed to the resident, may not exceed the amount of the benefit derived from the donation, settlement, or other similar disposition. Paragraph 73(2) provides that, for the purposes of paragraph 73, the benefit derived from a donation, settlement, or other similar disposition, means the amount by which the person to whom it was made, has benefited from the fact that it was made for no consideration, or for an inadequate consideration.

CGT consequences of interest-free loans made to trusts

Traditionally South African residents have been known to transfer assets to trusts in circumstances where no money changes hands but the trust remains indebted to the seller for the assets disposed of. In many cases interest is not charged on the loan that arises between the seller of the assets and the trust being the purchaser thereof.¹⁶⁹ In effect, the settler is deemed to have donated the asset to

167 Clegg in par 5A.7.3.6.

168 Clegg in par 5A.7.3.6.

169 Edward Nathan Friedland "Estates and Trusts: Interest free loans made available to trusts - the fiscal consequences" (October, 2003). Available at <http://www>.

the trust.

Normally, when assets are donated to a trust, whether it is located in South Africa or offshore, the donor pays donations tax at a rate of 20% of the value of the donation.¹⁷⁰ Individual taxpayers (natural persons) are currently entitled to an exemption of R100 000 a year from donations tax.¹⁷¹ In other words, when a donation is made to a trust, the 20% tax only becomes payable on any amount over R100 000. In order to take advantage of the donations tax exemption, schemes are devised whereby the donor gradually reduces the loan by writing off R100 000 a year as a tax-free donation to the trust.¹⁷²

Generally countries' tax authorities deal with such schemes by imputing interest on the donor where an interest-free loan is made to a trust. In other words, the donor who gave the loan is taxed on the amount of interest he or she is deemed to have received each year.

In terms of paragraph 12(5) of the Eighth Schedule to the Income Tax Act, this donation is regarded as a capital gain in the hands of the trust that is subject to capital gains tax. An example of a case in which this provision was applied is *ITC 1793*.¹⁷³ The brief facts of the case are that the testatrix had sold shares to a family trust (the taxpayer in this case). And the taxpayer owed the testatrix money on loan account in respect thereof. The testatrix had bequeathed the debt to the taxpayer in her last will and testament. On her death, the commissioner was of the view that the bequest in issue was a discharge of a debt for no consideration and thus a capital gain had been created in the hands of the trust. The taxpayer's executor sought a ruling that the provisions of paragraph 12(5) of

saica.co/integritax/1128_interest_free_loans_made_available_to_trusts_the_fiscal_consequences.htm> last accessed 20 March 2007.

170 S 64 of the Income Tax Act. In terms of this section, the 20% donations tax rate applies to property donated on or after 1 October 2001.

171 S 56(2)(b) of the Income Tax Act. In terms of this section, this exemption does not apply to casual gifts, but to all property donated by a natural person.

172 Kwazulu-Natal Law Society "Words and Deeds" Current News in the Field of Property Law (5 September 2006). Available at > www.lawlibrary.co.za/notice/wordsanddeeds/2006/2006_09_05.htm - 105k -< last accessed 1 March 2007.

the Eighth Schedule did not apply to the bequest. It was held that the provisions in the testatrix's will that discharged the taxpayer's debt, constituted a deemed disposal in terms of paragraph 12(5) of the Eighth Schedule. Consequently CGT was payable by the taxpayer on the amount of the discharged debt.

7.6 SECTION 31(1): TRANSFER PRICING AND NON-RESIDENT TRUSTS

In chapter 1 of this thesis it was mentioned that "transfer pricing" (described below) is one of the mechanisms used by taxpayers to avoid taxes in their country of residence. Since "transfer pricing" is a substantial topic in its own right, a comprehensive discussion thereof is beyond the scope of this work.

For purposes of this discussion, it is however worth noting that the transfer of funds to non-resident trusts on an interest-free basis could also be caught by the transfer pricing provisions under section 31(2) of the Income Tax Act. The term "transfer pricing" describes the process by which related entities set prices at which they transfer goods or services between each other.¹⁷⁴ Transfer pricing is also described as the systematic manipulation of prices, in order to reduce or increase profits artificially, or cause losses and avoid taxes in a specific country.¹⁷⁵ A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons¹⁷⁶ where each party strives to get the utmost possible benefit from the transaction.¹⁷⁷ Transfer prices

173 (2005) 67 SATC 256 (G).

174 South African Revenue Service (SARS) *Practice Note No. 7*: Section 31 of the Income Tax Act 1962 (the Act): *Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (6 August 1999) in par 2.1.

175 The Second Interim Report of the Commission of Inquiry into Certain Tax Structures of South Africa *Thin Capitalisation Rules* (1995) in par 1.3b; see also B Arnold & MJ McIntyre *International Tax Primer* (2002) at 53; see also N Boldman "International Tax Avoidance" (1981) 35 *Bulletin for International Fiscal Documentation* 443; A Stoud & C Masters *Transfer Pricing* (1991) at 10; J Ware & P Roper *Offshore Insight* (2001) at 178; AW Oguttu "Resolving Transfer-pricing Disputes: Are 'Advance Pricing Agreements' the Way Forward for South Africa?" (2006) 18 *SA Mercantile Law Journal* at 462.

176 Arnold & McIntyre at 55.

177 SARS *Practice Note No 7* at 7.1; art 9 of the OECD *Model Tax Convention on Income and on Capital* (2003 condensed version). See also D Hay, F Horner & J Owens "Past and Present Work in the OECD on Transfer Pricing and Selected Issues" (1994) 10 *Intertax* 424; OECD Report of the Committee on Fiscal Affairs *Issues in International Taxation No*

are usually not negotiated in a free, open market and so they may deviate from prices agreed upon by non related trading partners in comparable transactions under the same circumstances.¹⁷⁸

Transfer pricing may occur when South African residents sell assets to non-resident trusts on an interest-free loan basis.¹⁷⁹ The ensuing tax avoidance can be prevented by section 31(2) of the Income Tax Act, which provides that

where any goods or services are supplied or acquired in terms of an international agreement and the acquirer is a connected person in relation to the supplier; whereby goods or services are supplied or acquired at a price which is either less than the price which such goods or services might have been expected to fetch if the parties to the transactions had been independent persons dealing at arm's length (such price being the arm's length price); or greater than the arms length price, then for purposes of this act in relation to either the acquirer or supplier, the commissioner may, in the determination of the taxable income of either the acquirer or suppliers, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.

In brief, the section provides that the Commissioner of the South African Revenue Service can adjust the consideration for goods or services supplied in terms of an international agreement, if the actual price paid is either less or greater than the price that would have been paid, if the supply of the goods or services had been between independent parties dealing on an arm's length basis. In other words, the adjustment that is made on the consideration in determining the taxable income of the connected parties is based on the conditions which would have existed between unconnected persons under comparable circumstances.

The following is noted in the South African Revenue Service (SARS) Practice Note 7, under the heading "Interest-free loans to non-residents"

Residents of the Republic making loans to non-resident individuals, trusts or companies often charge no interest on the loans and no repayment conditions are agreed upon. In exercising his discretion in terms of section 31(2) to adjust the consideration in respect of the granting of the financial assistance, the Commissioner will take into account the amount of income of the non-resident which is taxed in the Republic in terms of the provisions of section 9D, the impact of the transaction on the tax base of any of the taxes imposed under any of the Acts administered by the Commissioner, the business activities

2 Thin Capitalisation: Taxation of Entertainers, Artists and Sportsmen (1987) at 17; VH Miesel, HH Higinbotham & CW Yi "International Transfer Pricing: Practical Solutions for Inter-Company Pricing - Part 11" (2003) 29 *International Tax Journal* 1. OECD Report of the Committee on Fiscal Affairs 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators' (1994) 172 *Intertax* 318 in par 12.

178 M van Blerck "Transfer Pricing and Thin Capitalisation: The Basics" (1995) 8 *SA Tax Review* 44; AW Oguttu "Transfer Pricing and Tax Avoidance: Is the Arm's-length Principle Still Relevant in the E-commerce Era?" (2006) 18 *SA Mercantile Law Journal* at 142-143.

179 Ware & Roper "The Impact of Residence-based Tax on Offshore Trusts" at 21.

of the non-resident and the ruling interest rates in the Republic as well as the country of residence of the non-resident who/which borrowed the funds.¹⁸⁰

The Commissioner determines an arm's length price by using one of the methods set out in Practice Note 7.¹⁸¹ Although, South African Revenue Service (SARS) Practice Notes, or Interpretation Notes, are not law,¹⁸² Practice Note 7 sets out the methods which have been developed in international practice for determining and appraising a taxpayer's transfer prices.¹⁸³ These methods are the comparable uncontrolled price method (CUP), the resale price method (RP), the cost price method (CP), the transactional net margin method (TNMM), and the profit split method.¹⁸⁴ Generally, all the methods are based on measuring a multinational's pricing strategies against a benchmark of the pricing strategies of independent entities in uncontrolled transactions.¹⁸⁵

For the purposes of the applicability of section 31(2) to non-resident trusts, it is necessary to define some of the terms used in the section.

180 SARS *Practice Note 7* in par 11.8.

181 SARS *Practice Note 7* in par 9.1.2 to 9.1.3; See also De Koker in par 17.59.

182 *ITC 1675* (1998), 62 SATC 219 at 229A.

183 These methods are recognised by the Report of the OECD Committee on Fiscal Affairs "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators" (1994) *Intertax* pars 92-115.

184 The "comparable uncontrolled price" (CUP) method is the primary pricing method. This method requires a direct comparison to be drawn between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction in comparable circumstances. See OECD Transfer Pricing Guidelines in par 92. Then there is the "resale price" method. This method is based on the price at which a product which has been purchased from a connected enterprise is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller's operating costs, so as to provide an appropriate profit having taken into consideration the functions performed, assets used and risks assumed by the reseller. The balance is then regarded as the arm's length price. See OECD Transfer Pricing Guidelines in par 65. The other method is the "cost plus" method. This method requires an estimation of an arm's length consideration by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark up should provide for an appropriate profit to the supplier, in light of the functions performed, assets used and risks assumed. See OECD Transfer Pricing Guidelines in par 115. Then there is the "transactional net margin method" (TNMM). This method examines the net profit margin that a taxpayer realizes from a controlled transaction, relative to an appropriate base of for example costs, sales or assets. The profit level indicator of the tested party is compared to the profit level indicators of comparable independent parties. See SARS *Practice Note No 7* in par 9.7.1. Lastly there is the "profit split" method. Under this method the combined profit is identified and split between the connected parties in a controlled transaction. The profit is split by economically approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length. See SARS *Practice Note No 7* in par 9.8.1; OECD Transfer Pricing Guidelines in par 131.

185 SARS *Practice Note 7* in par 9.2.1-9.2.3.

The term “connected person”, as used in section 31(2), is defined in section 1 of the Act, in relation to a trust, to imply any beneficiary of such trust and any connected person in relation to such beneficiary. A connected person in relation to a trust (other than a collective investment scheme) includes any other person, who is a connected person in relation to such trust. In defining the term “connected person” in relation to a natural person, section 1 of the Act also provides that any trust, of which such natural person or such relative is a beneficiary, is a connected person. This implies that a non-resident trust is a connected person in relation to a South African resident, if such person or his or her relatives are a beneficiary of the trust.¹⁸⁶ So if a South African resident, who is a connected person in relation to a trust, enters into a transaction with the trustees of an offshore trust and the transaction is not concluded at arm’s length, then section 31(2) may come into play.¹⁸⁷ What is not clear, however, is whether section 31(1) would apply where the provider or acquirer of a loan is not a beneficiary, or a relative.

The term “service”, as used in section 31(1), is defined in the section to include the granting of financial assistance, including the making of a loan, advance or debt, and the provision of any security or guarantee.¹⁸⁸

The term “international agreement” is defined in section 31(1) to include a transaction, operation, or scheme entered into between a resident and a non-resident for the supply of goods or services to or from the Republic.

If a South African resident grants an interest-free loan to a non-resident trust, SARS could consider the South African resident not to have received a market-related rate of interest on the loan, as an interest-free loan is not a market-based interest rate (not an arm’s length transaction), in terms of section 31(2).¹⁸⁹ The provision of the loan in terms of the trust deed can be deemed an international

186 See also Meyerowitz in par 12.23; “Tax Briefs” *Taxgram* (July 1999) at 14.

187 Ware & Roper “The Impact of Residence-based Tax on Offshore Trusts” at 22; see also SARS *Practice Note 7* in par 2.7; see also SC Borkowski “Transfer Pricing Documentation and Penalties: How Much is Enough?” (2003) 26 *International Tax Journal* 3; Blerck 45.

188 Meyerowitz in par 9.112.

189 Ware & Roper “The Impact of Residence-based Tax on Offshore Trusts” at 22; Mitchell and Mitchell at 93; *Tax Briefs* at 14; Olivier & Honiball at 248.

agreement, the lending is a service, and the parties are connected persons.¹⁹⁰ Thus, the granting of an interest-free loan to an “offshore trust” could lead to the invocation of the transfer pricing rules, since the interest-free loan is not an arm’s length transaction, in terms of section 31(2).

It must be noted that the above transfer pricing provisions do not apply only to trusts, but can also be applied to companies. Again, a detailed discussion of transfer pricing in this regard is beyond the scope of this thesis.

7.7 CONCLUSION

With all the above provisions in place, one could conclude that the tax net seems to have closed in on opportunities by South African residents to avoid taxes by investing in offshore trusts. However, it is presumptuous to suggest that the trust has outlived its usefulness as a tax avoidance tool on the basis of the above legislative provisions.

Writing on the efficiency of trusts as a tax avoidance tool in the current legislative climate, Mhlongo¹⁹¹ suggests that this has “simply altered the terrain and landscape” in which taxpayers use trusts for tax avoidance. Inevitably, the current legislation places an even greater responsibility on taxpayers to constantly keep abreast of legislative and other developments pertaining to trusts, so as to fully appreciate their implications. In so doing, they will be equipping themselves to make optimum use of the trust as a unique planning instrument. Ware and Roper¹⁹² note that a correctly structured offshore trust will continue to be a versatile tax avoidance tool.

190 Huxham & Haupt at 348.

191 Mhlongo in par 5.

192 J Ware & P Roper “The World of Offshore Sham Trusts” (Dec 1999) *Insurance and Tax Journal* at 19.

CHAPTER 8

CURBING TAX AVOIDANCE BY OFFSHORE TRUSTS: THE UNITED KINGDOM AND THE UNITED STATES

In this chapter, a study is made of the United Kingdom and the United States legislation that curbs income tax avoidance, as a result of investments in offshore trusts by residents. It is trite that the trust concept is a creation of Anglo-Saxon, and specifically English law, and that the concept of the offshore trust is an essential part of the law of numerous tax-haven jurisdictions that have a historical connection with the United Kingdom.¹ The use of the English trust, which is respected worldwide, encourages the setting-up of offshore trusts in those jurisdictions.² The United Kingdom has historically had to curtail the offshore trust tax-avoidance schemes that its residents get involved in. In respect to the United States, it is notable that this nation is historically known for being very unforgiving in its treatment of offshore tax avoidance. A look at the anti-avoidance legislation of these two countries, in regard to offshore trusts, is likely to suggest various measures for reforming South Africa's law in areas where there are shortcomings.

8.1 UNITED KINGDOM: TAXATION OF OFFSHORE TRUSTS

Regarding investments made in offshore trusts by country residents, Lord Walker recently observed in *Schmidt v Rosewood Trust Ltd*³ that:

It has become common for wealthy individuals in many parts of the world (including countries which have no indigenous law of trusts) to place funds at their disposition into trusts (often with a network of underlying companies) regulated by the law, of, and managed by trustees resident in, territories with which the settler (who may be also a beneficiary) has no substantial connection. These territories (sometimes called tax havens) are chosen not for their geographical convenience ... but because they are supposed to offer special advantages in terms of confidentiality and protection from fiscal

1 JE Penner *The Law of Trusts* (2006) at 12; AW Scott, WF Fratcher, ML Ascher *Scott and Ascher on Trusts* 5 ed (2006) at 5; DJ Hayton *The Law of Trusts* 4 ed (2003) at 1; see DM Davis, C Beneke & RD Jooste *Estate Planning* (2004) Service Issue 17 in par 17.2, 17-7. MJ De Waal, RRM Paisley, R Zimmermann, D Visser & K Reid *Mixed Legal Systems in Comparative Perspective: Property and Obligations in Scotland and South Africa* (2004) at 819; see the discussion in Chapter 6 par 6.2.

2 RH Blum *Offshore Haven Banks, Trusts and Companies: The Business of Crime in the Euromarket* (1984) at 8.

3 [2003] 3 All ER 76 at 1.

demands (and, sometimes, from problems under the insolvency laws, or laws restricting freedom of testamentary disposition, in the country of the settlor's domicile). The trusts and powers contained in a settlement established in such circumstances may give no reliable indication of who will in the event benefit the settlement. Typically it will contain very wide discretions exercisable by the trustees ... in favour of a widely-defined class of beneficiaries. The exercise of those discretions may depend on the settlor's wishes as confidentially imparted to the trustees ... As a further cloak against transparency, the identity of the true settler may be concealed behind some corporate figurehead.

The offshore trust has long been the primary vehicle used by United Kingdom domiciled individuals in offshore tax planning; even now, it is still being used as a tax planning vehicle.⁴ The United Kingdom legislation contains a number of measures to discourage individuals, who are both resident and domiciled in the United Kingdom, from seeking to avoid or defer their tax liabilities through the use of offshore trusts. (This discussion will be limited to the income tax and capital gains tax measures. Inheritance tax implications will not be discussed.) The term "trust" is, however, not comprehensively defined in the statute law of the United Kingdom.⁵ The lack of such definition in the English trust law is also carried over into revenue law. The Income and Corporations Taxes Act 1988 ("ICTA"), which is the main taxing statute for income and corporation tax, uses the term "settlement", instead of the term "trust". A "settlement" is defined in section 660 of the ITCA as including any disposition, trust, covenant, agreement, arrangement, or transfer of assets. This definition applies to both income tax and capital gains tax.⁶

The term "settlor" (which carries the same meaning as "founder" of a trust), is defined in section 660G of the ICTA as meaning any person who makes a settlement. A person is deemed to have made a settlement, if he has made, or entered into, a settlement directly or indirectly, if he has directly or indirectly provided, or undertaken to provide, funds for the purpose of the settlement, or if he has made a reciprocal arrangement with another person for that person to make a settlement.⁷

4 G Clarke *Offshore Tax Planning* 9 ed (2002) at 11.

5 A Kaplan *Trusts in Prime Jurisdictions* (2000) at 51.

6 Kaplan at 52; Clarke at 326.

7 Clarke at 328.

The term “offshore trust” is not defined in any United Kingdom statute, but it generally denotes a trust that is resident outside the United Kingdom.

Under English law, a trust does not have a residence, since it is not considered a separate legal person in its own right.⁸ It is the residence status of the trustees, and not that of the settlor or the beneficiaries, that determines whether a trust is an “onshore” trust, or an “offshore” trust. The residence and domicile status of the settlor and beneficiaries are only relevant in determining how the trust income and gains are taxed.⁹

The ICTA does not provide a single definition of residence that applies to trustees across all taxes. There are separate and different definitions of the residence status of trustees for income tax on the one hand and capital gains tax on the other.

For income tax purposes, there is no specific rule for determining the residence of trustees (except where some trustees are, and some are not, resident in the United Kingdom).¹⁰ This implies that the general rules for determining the residence status for individuals have to be applied to each trustee.¹¹ Where all the trustees are resident in the United Kingdom, the trust will be resident there. Where none of the trustees are United Kingdom residents, the trust will not be resident in the United Kingdom.¹² Where some trustees are resident in the United Kingdom and others are not, then, in terms of section 110 of the 1989 Finance Act (FA), the residence of the trust will depend on the residence and domicile status of the settlor. If the settlor is resident, ordinarily resident, or domiciled in the United Kingdom at one or more key times (such as time of the

8 Kaplan at 55; Hayton at 3.

9 Kaplan at 55.

10 Clarke at 262.

11 Kaplan at 55. The United Kingdom does not have a basic statutory definition of residence in respect of individuals and so each case is decided on its particular facts. In *Levene v CIR* [1928] AC 217 at 222, it was held that the term residence means “to dwell permanently or for a considerable time, to have one’s settled or usual abode, to live in or at a particular place”. In a number of instances, United Kingdom tax legislation also refers to the term “ordinary residence”. In *Shah v Barnet London Borough Council* [1983] 1 ALL ER 309 at 343, the House of Lords indicated that “ordinary residence” refers to “a man’s abode in a place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of long or short duration”.

12 R Fraser & J Wood *Taxation of Offshore Trusts and Funds* (2002) at 17; AR Thornhill & KJ Prosser *Potter and Monroe’s Tax Planning with Precedents* 11 ed (2004) at 1401.

creation of the trust, or when the settlor provides funds directly or indirectly to the trust), then the residence of even one trustee in the United Kingdom will make the trust resident in the United Kingdom.¹³

8.1.1 INCOME TAX MEASURES TO PREVENT THE USE OF OFFSHORE TRUSTS TO AVOID TAXES

According to the law of the United Kingdom, a trust is not liable to tax, since it is considered not to be a legal person. Liability for income tax falls on the trustees, except where a beneficiary is liable for income tax, if he is absolutely entitled to the trust income.¹⁴ Apart from the liability of the trustees and the beneficiaries, there are a number of anti-avoidance provisions which deem the income of the trust to be that of the settlor. These provisions can be divided into two categories. The first category contained in sections 660A-682A in Part XV chapters IA and IB of the ICTA, applies generally to all trusts, whether resident or non-resident.¹⁵ The second category contained in sections 739-746 of the ICTA, is not limited to trusts, but counters all transfers of assets abroad to avoid tax in the United Kingdom, and so these provisions are also relevant to offshore trusts.¹⁶ These two categories are considered below.

The taxation of the income of settlors of non-resident trusts (Part XV of the ICTA)

In terms of section 660 of the ICTA, income arising under a settlement (whether resident or non-resident) is deemed to be that of the settlor, if he retains an interest in the settlement, or if he receives a benefit from the settlement. The settlor is regarded as having retained an interest in the settled property, if it is, or if it becomes payable to him, or applicable for the benefit of the settlor or his spouse in any circumstance.¹⁷ There are certain exceptions, however. Under

13 S McKie & S Anstey *Tolley's Estate Planning* (2005-2006) at 179; Kaplan at 55; M Hutton & I Ferrier *Tolley's UK Taxation of Trusts* (2004) at 190; Fraser & Wood at 18.

14 Kaplan at 58; RM Antoine *Trusts and Related Tax Issues in Offshore Financial Law* (2005) at 295.

15 Clarke at 323.

16 Clarke at 323.

17 B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at UK/32; Kaplan at 75;

section 660A of the ICTA a settlor does not have an interest in the settlement

- if a person can only benefit in the event of the bankruptcy of a beneficiary;
- in the case of an assignment or change by a beneficiary of his interest;
- in the case of a marriage settlement, the death of both parties thereto and any children of the marriage;
- in the case of the death of a beneficiary under the age of 25;
- if a person under the age of 25 is alive, and during that person's life the settlor and his spouse cannot benefit.¹⁸

Under section 660B(1) of the ICTA trust income paid to or for the benefit of a child of the settlor who is under the age of 18, is treated as the income of the settlor. Section 660B(1)(b) was introduced by section 64 of the 1999 Finance Act. It provides that, if income is appropriated to the child without being paid to him in such circumstances that the income is treated as his for tax purposes, the settlor will be taxed. This applies even where income is accumulated and distributed as capital (section 660B(6)(a)). Thus, a capital distribution to a child of the settlor is taxed as the settlor's income, save to the extent that it exceeds retained income in the trust which has not been applied towards expenses or otherwise treated as that of the settlor.

Under section 660G(3) of the ICTA, income arising under a settlement, which is situated inside or outside the United Kingdom, is taxed in the hands of the settlor, if it is either income chargeable to income tax, or income which would have been so chargeable if received by a person resident and domiciled in the United Kingdom. In terms of section 660G(4), income arising under the settlement is excluded, if the income did in fact arise to the settlor, and he is not liable for income tax, because he is not resident or domiciled in the United Kingdom. The effect of this section is that if the settlor is not resident in the United Kingdom, the foreign income of the settlement is not deemed to be his. But the income of the

Antoine at 295; N Eastaway, I Richards & D Garlick *Tolley's Tax Advisers Guide to Trusts* 2 ed (2003) at 279-286.

18 Antoine at 295.

settlement is treated as his, whether the settlement is resident or non-resident.¹⁹

In terms of the United Kingdom legislation, the source income of a resident settlor, who is not domiciled in the United Kingdom, is excluded from taxation, unless it is remitted to the United Kingdom. Section 660G(4) of the ITCA provides that income is deemed to arise under the settlement in the year of remittance, if the settlor would have been chargeable had he been actually entitled to it.

Transfer of assets abroad (ss 739-746 of the ICTA)

Sections 739-746 of the ICTA are the most powerful weapons used to counter offshore tax avoidance in the United Kingdom. The sections relate to the taxation of assets that are transferred abroad so they also apply to transfers of assets to offshore trusts.

Section 739 of the ICTA provides for a charge on the settlor. This section comes into play where, with a view of avoiding income tax, there is a transfer of assets resulting in income being paid to a person resident or domiciled outside the United Kingdom.²⁰ Under section 739(2), a settlor will be liable to a charge where

- he has in some way “power to enjoy” any income of a non-resident or non-domiciled person, or
- where he may receive, or be entitled to, any “capital sum” in any way connected to the transfer or any associated operation.

The phrases “power to enjoy” and “capital sum” need to be explained, in order to make the working of this provision clear. The phrase “power to enjoy” as used in section 739, is explained in section 742(a)-(e). In terms of this section, a settlor (transferor) is deemed to have “power to enjoy” income of a non-resident or a

19 Clarke at 330; Fraser & Wood at 23-24.

20 Spitz & Clarke at UK/42; see also Clarke at 277; Kaplan at 78; Antoine at 296; Eastaway *et al* at 282; Fraser & Wood at 27; Thornhill & Prosser at 1403.

non-domiciled person, if

- the income concerned is dealt with so as to ensure a benefit to the settlor,
- the income concerned is applied in such a way that it increases the value of the assets held by the settlor (or the value of assets held for his benefit),
- the settlor receives a benefit, or is entitled to receive a benefit, and the benefit derives from either the income or monies available because of associated operations that caused the income to arise,²¹
- the settlor becomes entitled to the enjoyment of the income and the events which cause him to become entitled to that income, are exercised by reason of the powers he has to control the application of the income.²²

In terms of section 739(2), liability does not arise, unless the settlor or transferor is ordinarily resident in the United Kingdom in the tax year in which he has “power to enjoy”.

In terms of section 739, if the settlor or his spouse either receives, or is entitled to receive, a “capital sum”, he will be liable to a charge. The term “capital sum” is defined in section 739 as including the making of a loan to the transferor, or the repayment of a loan he has made. It also includes any capital sum not paid for full consideration in money or money’s worth. The payment of the sum must be connected with the transfer or an associated operation, and the settlor must be resident in the United Kingdom at the time of receipt or entitlement.²³

Relief is granted where the taxpayer subsequently receives the income taxed under section 739, for example, where the transferor has been charged to tax on income which has been deemed to be his under section 739, and it is subsequently received by him. The income received is deemed not to form part of his

21 In *CIR V Botnar CA* [1999] STC 711, the taxpayer transferred shares to a trust in Liechtenstein. The Special Commissioner had held that s 739 did not apply as the taxpayer was excluded from the benefit under the trust. On appeal it was held that the section applied as the assets could be transferred to another trust from which the taxpayer and his family might benefit (as read from *Hutton and Ferrier* at 198). See also *Eastaway et al* at 286.

22 Kaplan at 79-80; Clarke at 283; Spitz & Clarke at UK/43; Antoine at 296; *Eastaway et al* at 283; *Hutton & Ferrier* at 198; *McKie & Anstey* at 180.

23 Clarke at 286; Kaplan at 79; *Eastaway et al* at 283; *Fraser & Wood* at 29.

income again for income tax purposes.²⁴

There are, however, limitations to the application of section 739. In practice, the section proved wide in its interpretation, which made it cumbersome to administer. In *Vesty v IRC*,²⁵ the House of Lords decided to restrict its wide interpretation. The imposition of liability under section 739 also has a limitation, as it applies only to the transferor (or his spouse) and not to a beneficiary who is not a transferor.²⁶ In order to cater for these limitations, section 740 was enacted to tax benefits received by non-transferors (beneficiaries).²⁷ The conditions for the application of section 740 as set out in section 740(1)(a) are the following:

- Income must be payable to a person resident or domiciled inside the United Kingdom, by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated persons.
- The income must arise from a person resident or domiciled outside the United Kingdom, or by virtue of the transfer or any associated operation, and the income can directly or indirectly be used for providing a benefit for the taxpayer, or enabling a benefit to be provided for him.
- The taxpayer must be ordinarily resident in the United Kingdom in the year in which he receives the benefit.
- The taxpayer must not be taxable under section 739.²⁸

Where these conditions apply, the amount of the value of the benefit is deemed to be taxable as the income of the recipient (beneficiary).

A benefit that is received by a resident is defined in section 742(9) as including a payment of any kind. In terms of section 740(1), the benefit is taxable, if the recipient is ordinarily resident in the United Kingdom in the year of assessment in which the benefit is received. It is taxed in the year of receipt to the extent that it

24 S 743(4); see also Clarke at 292.

25 [1980] AC 1148; see also Hutton & Ferrier at 198.

26 Kaplan at 81; Eastaway *et al* par 10.29 at 287; A Shipwright & R Baldry *Trusts and UK Taxation* 2 ed (2000) at 252.

27 Finance Act Notes *British Tax Review* (1997) No 4 at 235; Clarke at 297-298; Eastaway *et al* at 288; McKie & Anstey at 180; Hutton & Ferrier at 242; Thornhill & Prosser at 1403-1404.

28 See also Clarke at 297.

equals, or is less than the relevant income of the current or prior years. If it exceeds the relevant income, it is carried forward and taxed as and when there is relevant income in a future tax year.²⁹ Thus, if the recipient is domiciled in the United Kingdom, the benefit is fully taxable, even if it is received and kept abroad. For instance, a benefit is received, if offshore trustees allow a beneficiary the use of a holiday home in a foreign country. Also, if income is accumulated in an offshore trust for the benefit of the settlor's children, and no capital sums are paid out to or for their benefit until they attain a certain age, each child may be charged income tax under section 740, on the income which arose to the trustees (before or after they attained the relevant age) and was accumulated and which could, when it arose, have been (directly or indirectly) used to provide a benefit for them.³⁰

There is, however, an exception to the application of the United Kingdom provisions. Both section 739 and section 740 are subject to the motive defence test, as set out in section 741 of the ICTA. In terms of this provision, the taxpayer has to prove that the transfer and any associated operations were *bona fide* commercial transactions, not designed for purposes of avoiding liability to taxation.³¹ For instance, in *A Beneficiary v IR Commissioners*,³² a Japanese grandfather deposited money in England and then transferred it to a Jersey discretionary trust. The money was intended for the support of his granddaughter and her children and grandchildren resident in the United Kingdom. It was held that tax avoidance was not the motive for the transfer and so section 739 was found not to be applicable.

8.1.2 CAPITAL GAINS TAX MEASURES TO PREVENT THE USE OF OFFSHORE TRUSTS TO AVOID TAXES

In terms of section 2(1) of the Taxation of Capital Gains Act 1992 ("TCGA"), a

29 S 740(2).

30 McKie & Anstey at 180-181.

31 J Kessler "Tax Avoidance Purpose and Section 741 of the Taxes Act 1988" (2004) 4 *British Tax Review* 375; Spitz & Clarke at UK/43; Clarke at 313; Kaplan at 83; Hutton & Ferrier at 198; Antoine at 297; Eastaway *et al* at 289; Fraser & Wood at 29; Thornhill & Prosser at 1404.

32 [1999] STC Section CD 174 as read from Kaplan at 84. See also Eastaway *et al* at 289.

person is chargeable for capital gains tax (CGT) in respect of capital gains accruing to him in a year of assessment during which he is resident or ordinarily resident in the United Kingdom. A person who is resident or ordinarily resident in the United Kingdom, but is not domiciled in the United Kingdom, is not liable to CGT on gains arising from assets situated outside the United Kingdom, except when the amount representing the gains is remitted to the United Kingdom. A person who is not resident or ordinarily resident in the United Kingdom at any time in the tax year, is not liable to CGT, except where the non-resident is carrying on a trade, profession or vocation in the United Kingdom, through a branch or agency, whose assets are situated in the United Kingdom and used in the United Kingdom business, branch or agency at or before the time of disposal.³³

Determining the residence status of a trust for capital gains tax purposes

As noted above, in the United Kingdom a trust is not a taxable entity. The residence status of the trustees is used to determine how a trust's capital gains are taxed.³⁴ For the purposes of capital gains tax, unlike income tax (dealt with above), there are specific statutory rules for determining the residence status of trustees.³⁵ Instead of being viewed as individuals, the trustees are regarded as a single and continuous body of persons that is considered to be resident and ordinarily resident in the United Kingdom, unless:

- the general administration of the trust is ordinarily carried on outside the United Kingdom; and
- either all or the majority of the trustees are either not resident, or not ordinarily resident, in the United Kingdom.³⁶

In terms of section 69(2) of the TCGA, there is an exception in the case of professional trust managers acting as trustees, who are regarded as non-resident where the whole of the trust property is, or derives from, property that was provided by a person who was neither resident, ordinarily resident or

33 S 12(1) TCGA 1992.

34 Kaplan at 55.

35 Antoine at 297.

domiciled in the United Kingdom at the time.

How a CGT charge arises

CGT is charged on any gain arising on a disposal, or deemed disposal, of an asset. A gain is calculated as the difference between the net disposal proceeds of an asset and the cost of acquisition of the asset, including the cost of any enhancement reflected in the state of the asset at the time of disposal. In terms of section 12 of the TCGA, a disposal is defined as including a sale of an asset and also a transfer for no consideration (for instance a gift), as well as the loss or destruction of an asset.

In regard to trusts, when a person becomes absolutely entitled to any trust property, there is a deemed disposal and an immediate re-acquisition of that property by the trustees at its market value. This means that any increase in the value of the property, while held in trust, is deemed to be realised by the trustees, and the beneficiary takes over the property at an acquisition cost equal to its market value. Only gains accruing after 6 April 1965 (when CGT was introduced) are liable to tax.

Events giving rise to a United Kingdom CGT charge in regard to offshore trusts

The five events that give rise to a charge to CGT in regard to offshore trusts are:

- transfers of assets into offshore trusts;
- the disposal of an interest in an offshore trust;
- realisation of a gain by an offshore trust;
- capital payments to beneficiaries resident in the United Kingdom;
- the emigration of a United Kingdom trust.³⁷

These events are discussed below.

36 S 69(1) of TCGA 1992.

The transfer of assets into offshore trusts

In terms of section 2(1) of the TCGA, when a settlor, who is resident or ordinarily resident in the United Kingdom, settles assets in an offshore trust, he makes a disposal and is liable for CGT. The disposal is treated as having been made for a consideration equal to the market value of those assets.³⁸

Disposal of an interest in an offshore trust

In terms of section 12(1) of the TCGA, individuals resident or ordinarily resident, but not domiciled in the United Kingdom, are not liable to CGT on the disposal of assets situated outside the United Kingdom. A CGT charge does, however, arise on any gains accruing when they are received in the United Kingdom.³⁹ The CGT charge is calculated on the actual proceeds, or the market value.⁴⁰

Realisation of capital gains of an offshore trust (attribution to the settlor)

Gains realised by the trustees of an offshore trust (except those associated with a trade in the United Kingdom) are not chargeable to CGT, as the trustees are not resident in the United Kingdom. In the absence of countering measures, non-resident trustees could take advantage of this provision by realising gains completely free of CGT, except where they carry on business in the United Kingdom. (It should be remembered that for CGT purposes, the trustees are regarded as a single continuing body of persons that is regarded as resident, or ordinarily resident, in the United Kingdom, unless the general administration of the trust is carried on outside the United Kingdom, and either all, or the majority

37 Antoine at 298.
38 Kaplan at 101.
39 Antoine at 299.
40 Kaplan at 123.

of the trustees are not resident, or not ordinarily resident, in the United Kingdom.) In order to avoid any opportunity for tax avoidance, there are provisions that attribute the offshore gains to the settlor. These provisions apply where the settlor or an associated person has retained an interest in the trust.⁴¹ In terms of section 86 and Schedule 5 of the TCGA, gains which arise where a settlor has an interest in the settlement, and the settlement is a “qualifying settlement”, will be liable to CGT.⁴²

Section 86(1)(c) of the TCGA provides that the gains of a qualifying settlement can only be attributed to the settlor, if in the year in which the gains arise, the settlor is both resident and domiciled in the United Kingdom. A person is a settlor in relation to a settlement, if the settled property consists of, or includes, property originating from him.⁴³ Property “originates” from the settlor where it has been directly or indirectly provided by him, or is property representing such property.⁴⁴

In terms of section 86 of the TCGA, a settlor is treated as having an interest in the settlement, if the property or income in the settlement is, or will, or may become, applicable for the benefit of a “defined person”, or payable to him in any circumstance, or if the defined person enjoys a direct or indirect benefit from any property or income in the settlement.⁴⁵ The “defined persons”, according to paragraph 2(3) of Schedule 5 of the TCGA, are: the settlor, the settlor’s spouse, any child of the settlor or his spouse, the spouse of any child, the grandchild of the settlor or his spouse, any spouse of such grandchild, or any companies controlled by them. A “defined person” may benefit where:

- there is property originating from the settlor, which is, or may, at any time be included in the trust property and may become payable or applicable for the benefit of that person,
- there is income originating from the settlor, which arises, or may arise under the trust that may become payable or applicable for the benefit of that person, or where

41 McKie & Anstey at 185; Clarke at 333; Kaplan at 103; Hutton & Ferrier at 206; Eastaway *et al* at 301.

42 Qualifying settlements are those potentially caught by the legislation.

43 Schedule 5 par 6; see also Spitz & Clarke at UK/33; Clarke at 333; Kaplan at 106.

44 Kaplan at 107.

- the person already enjoys a benefit directly or indirectly from such property or income.⁴⁶

There are certain exceptions to section 86 of the TCGA, as set out in Schedule 5 to the TCGA. A settlor is not deemed to have an interest in the settlement, if a defined person can only benefit in the following instances:

- The bankruptcy of a beneficiary, the assignment, or change by a beneficiary of his interest.
- In the case of a marriage settlement, the death of both parties thereto and any children of the marriage, or the death of any beneficiary under 25 years of age (paragraph 2(4) of schedule 5 of the TCGA).
- Under paragraphs 4 and 5 of Schedule 5 of the TCGA, gains are not attributed to the settlor, if only one defined person has an interest in the settlement in a year of assessment and that person dies during the year, or if two or more persons have interests and they all die during the year.
- Gains are also not attributed, if the only defined person with an interest in the settlement is the spouse of the settlor, or the spouse of one of his children or grandchildren, and the marriage ends during the year concerned.⁴⁷ These exceptions are perhaps intended to cover those situations where tax avoidance is not the motive.

In terms of section 86(1)(e) of the TCGA, a charge is made of the amount on which the trustees would have been chargeable to CGT for the tax year concerned, if they had been resident in the United Kingdom. The settlor will be taxable on any gains realised by the trustees, unless he is domiciled outside the United Kingdom in the relevant tax year, is neither resident, nor ordinarily resident in the United Kingdom during any part of the year, or if he is dead. The offshore charge arises in the year following the exporting of the settlement.⁴⁸

Realisation of capital gains (attribution to the beneficiaries)

45 Clarke at 334; McKie & Anstey at 186; Kaplan at 106.

46 Kaplan at 107.

47 Clarke at 335.

Where a capital payment is made, or a benefit out of capital is provided to a United Kingdom resident and domiciled beneficiary, CGT arises.⁴⁹ In terms of section 87(3) the TCGA, where in any tax year the trustees of a settlement are resident outside the United Kingdom throughout the year, and a beneficiary who is both resident and domiciled in the United Kingdom receives a capital payment from that settlement, the beneficiary will be chargeable when the gain is deemed to accrue to him. This implies that, until a capital payment is received by a United Kingdom resident and domiciled beneficiary, no capital gains tax will be payable on any disposal by the trustees.⁵⁰ The attribution of gains to beneficiaries should not exceed the amount actually received by them. A charge under this provision does not require the settlor to be a United Kingdom resident, or to be domiciled in the United Kingdom at any time.⁵¹ Basically, the conditions for the application of this section are the following:

- There must be a “beneficiary”, who is both domiciled in the United Kingdom and either resident, or ordinarily resident, in the United Kingdom at some time in the year.
- The trust must be an offshore trust throughout the year, and it must have “trust gains” in that year, and the beneficiary must receive a “capital payment” in that year, or have received a capital payment in the previous year.⁵²

The term “beneficiary”, as defined in section 87 of the TCGA, refers not only to a person named in the trust deed, but also to any person, who has received, or is treated as having received, a capital payment after 18 March 1991. This rule excludes trustees of the trust in question, or trustees of any other trust.⁵³

“Trust gains” are defined in section 87 of the TCGA as gains made by the trustees in any year, in respect of which they would have been charged CGT, if they had been resident, and also any gains made in previous years, which have

48 Mc Kie & Anstey at 159.

49 Antoine at 299.

50 Hutton & Ferrier at 203; McKie & Anstey at 161; A Shipwright & R Baldry *Trusts and UK Taxation* 2 ed (2000) at 272.

51 Kessler at 400; Kaplan at 113.

52 Kaplan at 114.

53 Kaplan at 114.

not yet been attributed to the beneficiaries, or attributed to the settlor in terms of section 86. The “trust gains” also include gains realised by a closely held non-resident company that are apportioned to the offshore trustees as direct or indirect participators.⁵⁴

The term “capital payment”, as used in section 87, is defined in section 97 of the TCGA as meaning any payment, which is not chargeable to income tax on the beneficiary or, if the beneficiary is not resident or ordinarily resident in the United Kingdom, any payment received otherwise than as income, and any transfers of assets, or the conferring of any benefit. In terms of section 87(7), a beneficiary will not be liable for capital gains tax for a capital payment received from an offshore trust, unless he is domiciled in the United Kingdom at some time during that year. A beneficiary is treated as having received a payment from trustees, whether he receives it directly or indirectly; if it is directly or indirectly applied by the trustees for the beneficiary’s benefit, or for the payment of his debts; or if it is received by a third person at the beneficiary’s direction.⁵⁵

Where a settlor returns to the United Kingdom after less than five years of non-residence, and gains have accrued to him in the years of absence, the settlor is deemed to realise those gains in the year of return, and so he is liable to CGT on those gains. If the gains include those attributed to him under section 86 of the TCGA as a settlor of an offshore trust, then only the portion of those gains, that has not already been attributed to beneficiaries under section 87, is chargeable.⁵⁶

Under section 91 of the TCGA, a supplementary charge is imposed on beneficiaries of offshore trusts. This section is intended to prevent the deferral of CGT where offshore trustees do not make capital payments and so indefinitely defer the CGT that would have been paid by United Kingdom-domiciled resident beneficiaries. This charge is made, where a capital payment is matched with a trust gain arising before the year immediately preceding the relevant year of

54 Clarke at 352; Kaplan at 114.

55 Kaplan at 115.

56 Kaplan at 121.

assessment.⁵⁷ In effect, the supplementary charge prevents deferral of CGT when it is accumulated in an offshore trust.

As a further deterrent to the deferral of CGT in the United Kingdom, in terms of the Finance Act (FA) 1991, interest is charged on beneficiaries, who receive capital payments from offshore trusts. Ten per cent per annum is charged on the CGT due under section 87 of the TCGA, on delayed capital payments to beneficiaries and this interest rate can go up to a maximum of 60%.⁵⁸

Curbing tax avoidance: Offshore companies holding the assets of offshore trusts

Where an offshore company holds assets owned by an offshore trust, the United Kingdom has a number of provisions that can be used to curb the ensuing tax avoidance. For instance, section 92 of the TCGA extends the provisions of section 87, by providing that payments received by beneficiaries in terms of section 87 include

- payments from a company controlled by the trustees, either alone or together, with the settlor, and persons connected with the settlor; and
- payments to a non-resident company controlled by beneficiaries.

Further, section 13(10) of the TCGA extends to non-resident trustees the provisions attributing gains made by non-resident close companies to shareholders resident or ordinarily resident (or individuals domiciled) in the United Kingdom. Such gains realised by non-resident trusts are brought within the ambit of section 87. Then section 96 of FA 2000 amended section 96(5) of the TCGA to eliminate the requirement that each of the persons controlling an

57 Shipwright & Baldry at 275; Hutton & Ferrier at 206; McKie & Anstey at 188; Kaplan at 120; Antoine at 299; Eastaway *et al* in par 10.37 at 290.

58 Hutton & Ferrier at 211.

offshore company, to which payments are made by offshore trustees, must be resident, or ordinarily resident, in the United Kingdom. The interposition of non-resident persons in the control of the offshore company had been used to frustrate the operations of section 96 of the TCGA.⁵⁹

In terms of section 94 of FA 2000, section 79B was inserted in the TCGA to prevent the use of double tax treaties to shelter gains realised by offshore companies owned by a trust. Such gains may be attributed to resident or non-resident trustees as participators in those companies.

Emigrating settlements

When a trust that was formerly resident in the United Kingdom emigrates offshore, a CGT charge arises. Emigration takes place where there is an appointment of new non-resident trustees to constitute a majority, or where trustees that were formerly resident in the United Kingdom emigrate and the majority of trustees are now non-resident.⁶⁰ A trust is also deemed to have emigrated, if the general administration of the trust is transferred abroad.⁶¹ Under section 80 of the TCGA, where a United Kingdom resident trustee emigrates, the trustee will be deemed to have disposed of the “defined assets” and acquired them at their current market value immediately before the trust emigrated. The “defined assets” of a trust that emigrates from the United Kingdom, are defined in section 80(4) of the TCGA as including all trust assets other than those which would in any event remain within the United Kingdom tax charge, in terms of section 10 of the TCGA. There is an exception in the case where a double-taxation agreement applies, whereby the taxing rights on the disposal of the asset have been surrendered by the United Kingdom to the jurisdiction to which

59 Hutton & Ferrier at 214.

60 Antoine at 299.

61 Clarke at 211; Kaplan at 121.

the trust emigrates.⁶² There are, however, provisions to prevent a double charge to tax with reference to disposals of interest under trusts. In terms of section 82 of the TCGA, there are limitations to the charge to tax, where there is an inadvertent change in residence resulting from the death of a trustee, or where the former residence status is resumed within six months. Then there are also provisions governing the liability for tax of past trustees, where a United Kingdom trust becomes non-resident and an export charge remains unpaid.

In terms of section 89 of the TCGA, a capital payment made to a beneficiary during a time when the trust was resident in the United Kingdom can be apportioned, if it was made in anticipation of a disposal made by the trustees subsequently, when non-resident.

Related to the emigration of trusts is the situation where funds held in separate trusts are derived from a single settlement and one fund of the settlement is exported offshore, leaving another with trustees resident in the United Kingdom. The trustees in the United Kingdom may bear the capital gains tax liability for gains made by the offshore trustees of the fund that is exported (since in terms of section 69 of the TCGA, the trustees are treated as a single and continuing body of persons resident in the United Kingdom, unless the administration of the settlement is carried on outside the United Kingdom and a majority of the trustees are resident outside the United Kingdom). In *Roome and Denne v Edwards HL*,⁶³ a settlement, which had been divided into two funds was held to constitute a single settlement and the trustees, resident and non-resident, to constitute a single body, so that United Kingdom trustees could be assessed for gains which accrued to Cayman Islands trustees.

8.1.3 OTHER CGT PROVISIONS ENACTED TO CURB CERTAIN TAX AVOIDANCE SCHEMES INVOLVING OFFSHORE TRUSTS

Dual resident trusts were often used to avoid taxes in the United Kingdom. A dual resident trust could arise where the majority of the trustees of a trust are resident in the United Kingdom, but its general administration is carried on elsewhere.

62 Hutton & Ferrier at 206; Kaplan at 121-122; Clarke at 214.

Generally, in terms of section 69 of the TCGA, the trust would be United Kingdom resident, but a double taxation treaty might provide that the trust would be treated as resident, where the general administration was carried on. Use of certain reliefs (like gift reliefs or other roll-over reliefs) would allow assets to be transferred into such trusts, or disposed of without tax under the protection of the double tax treaty.⁶⁴ Section 69 of the TCGA is an anti-avoidance provision that denies the roll-over relief on the transfer.

Section 83 is another anti-avoidance provision that can be used to curb tax avoidance where, by virtue of a double taxation treaty, dual resident trustees use their residence status in another country to avoid a United Kingdom CGT charge. The section applies where the trustees are resident and ordinarily resident in the United Kingdom under United Kingdom domestic law, but become exempt from capital gains tax on the disposal of assets, because of the residence provisions of a double tax treaty. In terms of section 83, the trustees are deemed, immediately before becoming dual resident, to have disposed of the assets and reacquired them at market value. Although the United Kingdom does not have double tax treaties that cover capital gains tax with most tax havens, this provision is necessary in the light of the fact that section 788(3) of the ICTA gives tax treaties primacy over any enactment, including anti-avoidance provisions.⁶⁵

Schedule 26 of the FA 2000 has provisions relating to an offshore tax avoidance scheme known as “flip-flop”, which results in gains being extracted from a trust tax-free, or with minimum taxation, by making use of borrowed money. The way flip-flop works is that the trustees borrow money on the security of assets in the trust and advance the money to another trust, after which the settlor severs his interest in the first trust. In the following tax year, the trustees of the first trust sell the assets and use the proceeds to repay the debt. The effect of this scheme is that it results in capital payments being made to United Kingdom resident beneficiaries from the second trust without charge to tax.⁶⁶ In terms of Schedule 4C to the TCGA, the anti-avoidance provision in Schedule 26 of the FA 2000,

63 1981, 54 TC 359 as read from Hutton & Ferreir at 191.

64 Hutton & Ferrier at 205.

65 Hutton & Ferrier at 207.

that prevents the use of flip-flop schemes, also extends to offshore trusts, in that beneficiaries are charged in respect of gains accruing to offshore trustees by virtue of a transfer of value made to them.

Another scheme that was utilised to avoid taxes in the United Kingdom involves bringing a trust onshore and then exporting it again. The gains on the trust property escape a CGT charge, because they were realised while the trust was onshore, and the beneficiary pays little or no tax on the sale of an interest in the trust, because of the rule providing for its value to be uplifted on the trust's exit from the United Kingdom.⁶⁷ Section 94 of the FA 2000 amended section 85 of the TCGA to block such schemes, with the result that there will be no uplift where the trust is "pregnant" with gains not attributed to beneficiaries, or the trust has gains which are caught under the measures to counter flip-flop schemes in the FA 2000.

The above provisions reflect an endeavour by the United Kingdom to enact specific provisions dealing with certain anti-avoidance schemes as they arise.

8.1.4 REPORTING REQUIREMENTS

United Kingdom law imposes several reporting obligations on trustees, settlors and beneficiaries of offshore trusts. In terms of section 745 of the ICTA, the following applies:

- Where a person transfers property to an offshore trust, he is expected within 12 months to report details of the property transferred, the date of transfer, the consideration (if any), and the identity of the trust.
- Within 12 months of becoming domiciled in the United Kingdom, as an ordinary resident, a settlor of an offshore trust must report his name, address, date of creation of the trust, and the names and addresses of the trustees.
- The trustees of a United Kingdom resident trust that emigrates from the United Kingdom must within 12 months file a return specifying the

date of creation of the trust, the name and address of each person who was a settlor immediately before emigration, and the names and addresses of each trustee before emigration.

- Within three months of creating an offshore trust, the settlor must report his address and the names and addresses of trustees and the date of creation of the trust. This obligation does not extend to non-domiciled settlors, or settlors who, although domiciled in the United Kingdom, are not ordinarily resident.⁶⁸

Apart from the reporting obligations imposed on the trustees, settlors and beneficiaries, section 98 of the TCGA confers on Inland Revenue wide information-gathering powers with regard to sections 87-90 of that Act and also the same powers in terms of section 745 of the ICTA, with regard to sections 739 and 740 of the ICTA.

8.2 UNITED STATES: TAXATION OF OFFSHORE TRUSTS

In the United States, a trust is a separate taxpaying entity, and it is liable for income tax on any income that is received by, or accrues to it.⁶⁹ In United States law, the residence of the trust depends on the legal and fiduciary control over the trust.⁷⁰ A trust that is resident in the United States is referred to as a domestic trust. There are two tests used in the United States to determine whether a trust is a domestic trust. In terms of section 7701(a)(30) of the Internal Revenue Code (“the Code”) of 1954, a trust is classified as a domestic trust for tax purposes, if

- a United States court can exercise primary supervision over the administration of the trust, and
- one or more United States persons have the authority to control all substantial decisions of the trust.

These two tests are referred to as the “court test” and the “control test”. The first

67 Hutton & Ferrier at 214.

68 Kaplan at 124-125.

69 KE Anderson, TR Pope & JL Kramer *Prentice Hall's Federal Taxation: Corporations Partnerships, Estates and Trusts* (2004) at 14-3.

70 Kaplan at 128.

test is satisfied, if the trust instrument is governed by United States laws. The second test is satisfied, if only United States persons make all the substantial decisions in the trust, with no non-United States person having the power to veto any substantial decisions. If either of these tests is not satisfied, the trust is treated as a foreign trust (offshore trust).⁷¹ In the United States, offshore trusts are mainly used for asset protection purposes (so as to shield the assets transferred to the trust from future creditors), but this could result in some tax advantages that revenue may curtail.⁷²

8.2.1 INCOME TAX TREATMENT OF OFFSHORE TRUSTS

The income tax benefits arising from the use of offshore trusts have been significantly curtailed in the United States. One of the schemes that was utilised by United States taxpayers to avoid taxes, was to shift income from high bracket taxpayers to lower bracket taxpayers, without transferring the underlying assets directly to the donee. This is commonly referred to as “tax-bracket shopping”. The implications are that income from the trust assets is not taxed at the rate applicable in the transferor’s tax bracket, but rather at the applicable rate in a lower income tax bracket governing either the trust itself, or its beneficiaries, who are often the taxpayer’s children.⁷³ The tax savings derived from such income-shifting are curtailed in the United States through the application of two measures:

- Firstly, “tax-bracket shopping”, that involves either accumulating income in the trust, or distributing the income to beneficiaries, is curtailed by limiting the tax brackets for trusts, so that all trust income is taxed at the highest marginal rate. So income tax savings, that result from shifting income to the trust, in the hope of earning the tax rate for the trust accumulation of income, become minimal. In addition, in terms of the 1986 Tax Reform Act (“TRA”), provisions were enacted whereby income beyond \$1000 earned by children

71 Kaplan at 129; Antoine at 302-303; PR McDaniel, HJ Hugh & JR Repetti *Introduction to United States International Taxation* 5ed (2005) at 80.

72 EM Nelson “Taxing Offshore Asset Protection Trusts: Icing on the Cake” (1996) 15 *Virginia Tax Review* 404.

73 Nelson at 406.

under 14 years of age is taxed at the parents' highest marginal rate. This curtailed the use of trusts to obtain a lower rate on distribution to trust beneficiaries.⁷⁴

- The second method used in the United States to prevent tax-bracket shopping is the grantor trust rules. The grantor trust rules are used to prevent taxpayers from shifting income to lower tax bracket taxpayers without actually relinquishing control of the trust property.⁷⁵

A “grantor” is defined as including a person who creates a trust, or a person who directly or indirectly makes a gratuitous transfer of property to a trust.⁷⁶ In terms of section 671 of the Code, a grantor trust's assets are treated as assets owned by the grantor for income tax purposes. The implications of this are that any income received by the grantor trust is deemed to have been received by the grantor.⁷⁷

The United States grantor trust rules are also used to prevent foreign trusts from being used to defer taxation of the income of United States persons. This is done by treating most foreign trusts created by United States persons as “grantor trusts” for income tax purposes, and by treating most trusts created by non-resident aliens as non-grantor trusts.⁷⁸ A “non-grantor” trust is a trust that is not treated as the property of the grantor. The income of a non-grantor trust is taxed in the trust itself, if the income is accumulated in the trust, or in the hands of a beneficiary, to whom it is distributed.⁷⁹

8.2.2 GENERAL RULES RELATING TO GRANTOR TRUSTS

Before describing the working of the grantor trusts, it is worth pointing out that

74 Nelson at 407.

75 Nelson at 407.

76 CM Bruce *United States Taxation of Foreign Trusts* (2000) at 99 (“Bruce 2000”); JG Glattmachr & AM Michaelson *Income Taxation of Estates and Trusts* 14 ed (2005) in par 3.1 at 3-2.

77 Kaplan at 130; RJ Morril, HB Cheney, CM Korsel & RG Stewart *Grantor Trusts Demystified* (2006) at 31; see also generally CM Bruce, LD Solomon & LJ Saret “Asset Protection, Privacy and AML Compliance” *Taxes* (September 2004) at 15; Nelson at 408; Anderson *et al* at 14-30.

78 Spitz & Clarke at United States/42.

there have been a number of amendments to these rules since they were introduced in 1954 the reason being that taxpayers soon came up with schemes that escaped the grantor trust rules, while retaining significant benefits from the trust assets. The TRA of 1986 effectively curtailed these schemes. In terms of the 1986 amendments, any powers or interests held by the grantor's spouse were rendered attributable to the grantor.

Further, before the TRA 1986, a grantor could have a reversionary interest in trust assets and not be taxed under the grantor trust rules, as long as the trust term exceeded ten years (Clifford Trusts).⁸⁰ After the coming into effect of the TRA 1986, the ten-year trusts were also deemed to be grantor trusts, with the effect that all reversionary interests in such trusts result in the grantor being liable for tax.⁸¹

The rules that determine when a trust is a "grantor trust", subjecting the grantor to tax liability, are set out in sections 673 to 679 of the Code. These are considered below.

Reversionary interests

Section 673(a) of the Code, as amended by the TRA 1986, provides that a grantor is taxed on income of the trust, if he has a reversionary interest in either the income or the principal worth over 5% of the value of the trust at its inception. Under section 672(e), a grantor is treated as holding any interest held by him or his wife. As an exception to this rule, the grantor rules will not apply, where the value of the reversionary interest does not exceed 5% of the value of the trust.⁸² The rules will also not apply, if the reversion will occur only if the beneficiary dies before reaching the age of 21, and the beneficiary is a linear descendant of the grantor.⁸³ If approval of an adverse party is required before any powers may be exercised by, or for, the grantor, then the grantor is released from the application

79 Anderson *et al* at 14-30; Spitz & Clarke at US/34-40; Kaplan at 131.

80 Anderson *et al* at 14-31; Bruce 2000 at 95; Glattmachr & Michaelson in par 3.1 at 3-3.

81 Nelson at 409.

82 Nelson at 410; Bruce at 106.

83 Bruce 2000 at 106.

of this provision.⁸⁴

Power to control beneficial enjoyment

Grantor trust rules apply where the grantor retains the power to designate the recipients of trust income or principal.⁸⁵ Under section 674 of the Code, a grantor is taxed on income, if (without the consent of an adverse party) he or his spouse has the power to control another's beneficial enjoyment, such as by deciding how much income to distribute.

In terms of the United States legislation, the amounts distributed from a grantor trust are not taxable to a beneficiary, because they are treated as gifts from the grantor. However, the United States legislation gives a wide meaning to the term beneficiary in regard to a United States beneficiary. A trust has a United States beneficiary, even if United States beneficiaries may not receive distributions during the grantor's lifetime. A trust is also considered to have a United States beneficiary, even if the beneficiary cannot receive distributions while resident in the United States and can only receive distributions after terminating his residence status. If a trust, that has no United States beneficiaries, subsequently acquires a United States beneficiary, the grantor will be taxable on all income that accrued to the trust from inception, and thereafter the trust will be treated as a grantor trust.⁸⁶

The section 674 grantor rules do not apply:

- if the power is applied to support a dependant;
- if the power affecting the beneficial enjoyment occurs after an event such that a grantor would not be treated as the owner under section 673 of the Code;
- if the power is a reversionary interest;
- if the power is exercisable by a will, other than the grantor's power or discretion concerning the income of the trust that is exercised

84 Nelson at 410.

85 Nelson at 410.

86 Spitz & Clarke at US/42.

- without the approval of any adverse party;
- if the power is exercised to allocate income among charitable beneficiaries;
 - if the power is exercised to withhold income temporarily, for instance during the disability of a beneficiary.⁸⁷

Administrative powers

Grantor trust rules apply where the grantor enjoys self-serving administrative powers over the trust.⁸⁸ In terms of section 675 of the Code, such powers would include the power to purchase or exchange trust property for less than market value, the power to borrow from the trust without adequate interest or security, and the power to vote stock of a corporation in which the holdings of the grantor and the trust are significant.

Power to revoke

Grantor rules apply, if the trust is revocable.⁸⁹ Section 676 of the Code, entitled “Power to revoke”, provides that the grantor of a revocable trust shall be treated as the owner of any portion of the trust and shall be taxed on income generated by the revocable trust, if he can control assets conveyed to the trust by altering the terms of the trust (including the identify of the beneficiaries) and/or withdrawing assets from the trust. Section 676 of the Code does not, however, apply to a power, which, if exercised, can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event relating to reversionary interests under section 673 of the Code.

Income for the benefit of the grantor

In terms of section 677 of the Code, grantor trust rules apply, if the trust can be used to benefit the grantor. For instance, with respect to income that may be

87 Bruce 2000 at 107-109.

88 Anderson *et al* at 14-32; Nelson at 409; Bruce 2000 at 110.

89 Anderson *et al* at 14-31; Nelson at 409.

distributed to the grantor or his spouse, income held or accumulated for future distribution to the grantor or his spouse, income used to pay premiums on life policies on the life of the grantor or his spouse, or the use of trust income to provide for the support for a child that the grantor is legally obliged to support.⁹⁰ This provision does not in respect to the beneficial enjoyment of the income for a period commencing after the occurrence of an event relating to reversionary interests under section 673 of the Code.

Persons other than the grantor treated as owner of trust assets

The grantor rules generally result in the grantor being treated as the owner of the trust's assets and thus liable to tax. The exception to these provisions is section 678, which provides that an individual other than the trust's grantor will be taxed on the trust income, if he has the power exercisable solely by himself under the trust instrument to vest the trust principal or income in himself.

Foreign trusts having one or more United States beneficiaries

Not all grantor trust rules come into play as a result of retained powers. Under section 679 of the Code, enacted as part of the Tax Reform Act 1976, a United States person transferring property to a foreign trust will be treated as the owner of the trust assets under the grantor rules for any year in which a United States person is a named beneficiary of any portion of the trust.⁹¹ In a nutshell, the section provides that, if a foreign trust is created by a United States person and that trust has, or has the possibility of having a United States beneficiary, then, for tax purposes, the trust will be ignored and the grantor will be treated as the owner of the assets. In terms of section 679(c) of the Code, a trust is treated as having a United States beneficiary, unless;

- (i) no part of the income or corpus may be paid, or accumulated, for

90 Nelson at 409; Bruce 2000 at 112.

91 See generally CM Bruce *New United States Withholding Tax Rules: A Practical Guide* (2002) at 55 ("Bruce 2002"); BI Bittker & L Lokken *Fundamentals Of International Taxation* (2005/2006) par 83.2.1 at 83.4; Antoine at 304; McDaniel *et al* at 141; Glattmachr & Michaelson in par 4.2 at 4.4.

- the benefit of a United States person, and
- (ii) if the trust were terminated, no part of the income or corpus could be paid to, or for the benefit of, a United States person.

This legislation owes its origin to the fact that historically, United States persons were creating foreign trusts, in order to accumulate income in countries that did not impose any taxes on trust income, and thus the accumulated income was subject to neither United States, nor foreign taxes. Section 679 of the Code applies to trusts created in any foreign jurisdiction, not just “tax havens”. For that matter, the section applies even if the settlor of the trust retains no interest or powers over the trust assets.⁹² Thus, even if a grantor can relinquish all practical control over the trust property, he can still be treated as the owner of the property, simply because he is a United States person, the trust is a foreign trust and there is a United States beneficiary.⁹³

Embedded in section 679 of the Code, is a special rule applicable to a foreign grantor who subsequently became a United States person. The provision is to the effect that, if a non-resident alien individual becomes a resident alien (United States taxpayer) within five years after directly or indirectly transferring property to a foreign trust, section 679 will apply, as if the individual made the transfer to the trust immediately upon coming to the United States.⁹⁴ The amount of the transfer is equal to the amount in the trust attributable to the property transferred to him. Undistributed net income for years prior to the time the individual came to the United States is taken into account in determining the amount in the trust attributable to property transferred by him.⁹⁵

Section 679 of the Code also contains a provision to the effect that the grantor will be taxed, if the trust acquires a United States beneficiary at a later date. Thus, if a foreign trust does not have a United States beneficiary, but subsequently acquires such a beneficiary, then the grantor is treated as having an income for the taxable year equal to the undistributed net income of the trust

92 Bittker & Lokken at 85-5; Bruce 2000 at 54; Nelson at 411.

93 Bruce 2000 at 94.

94 McDaniel *et al* at 142; Antoine at 304; Bittker & Lokken at 83-10; Bruce at 163.

at the close of the year immediately preceding the taxable year. A beneficiary, who at the outset of the trust was not a United States resident alien, but then immigrated to the United States, causes the grantor to become taxable on all the income earned in the trust.⁹⁶

Section 679 of the Code does not, however, apply to transfers to the foreign trust by reason of the death of the grantor, sales, or exchanges of property at fair market value, where gain is recognised by the grantor, or to transfers made by foreign transferors prior to becoming United States residents.⁹⁷

A special rule applicable to foreign grantor trusts

When the grantor trust rules were codified in 1976, they applied to both domestic and foreign trusts. The foreign grantor trusts were, however, utilised to avoid United States tax. The reason was that a foreign person, who created a domestic or foreign trust, would not be liable to United States tax, as he was not resident for tax purposes. And the beneficiary, even though a United States citizen or resident, would not pay any tax on distributions.⁹⁸ In order to prevent the avoidance of United States taxation, the TRA 1996 enacted section 672(f) of the Code to prevent the application of the grantor trust rules to foreign grantors, where this would result in the owner of the trust assets being a non-United States citizen or resident, or a domestic corporation not being liable to tax.⁹⁹ By limiting the circumstances in which a non-resident alien would be treated as the owner of the trust's income, the Code limits the ability of United States beneficiaries to receive distributions from trusts that avoid United States income tax.¹⁰⁰

The general rule preventing the application of the grantor trust rules to foreign grantor trusts does not, however, apply to any trust or portion of a trust,

- if the power to revest absolutely in the grantor title of the trust property is exercisable solely by the grantor without the approval or consent of

95 Antoine at 304; Bruce at 163; McDaniel *et al* at 142; Bittker & Lokken at 83-10.

96 Bittker & Lokken at 83-10; Bruce 2000 at 164; Antoine at 304; Mc Daniel *et al* at 142.

97 Nelson at 411; Bittker & Lokken at 83-11.

98 Bruce 2000 at 116; McDaniel *et al* at 82.

99 SK Vetter "Keep Trusts Offshore" (2003) 142 *Trusts and Estates* at 69; Bruce 2000 at 93; Bittker & Lokken par 83.2.2 at 83-13.

100 Anderson *et al* at 14-33.

- another person, or with the consent of a related or subordinate party who is subservient to the grantor,
- if the only amounts distributable from the trust during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

Furthermore, the rule would not apply to any trust distributions that are taxable as compensation for services rendered.¹⁰¹

Apart from the above, the United States has other anti-avoidance provisions that relate to offshore trusts.

8.2.3 GAINS ACCUMULATED AND DISTRIBUTED BY FOREIGN TRUSTS

In order to prevent deferral of taxes, section 643(a)(6) and section 667(a) of the Code provide that gains accumulated and distributed by a foreign trust lose their character as capital gains and are taxed as ordinary income. The capital gains are included in distributable net income.¹⁰² Deferral of tax on income accumulated in a foreign trust is further prevented by a “throw-back” rule (which is a penalty rule), that results in an increased tax rate on the accumulation distribution, by taxing the income passed out to the United States beneficiary at the ordinary income tax rates that would have applied, if the distribution had been made in the year earned.¹⁰³

On top of the additional tax imposed by the “throw-back” rules, in terms of section 668 of the Code, an annual interest charge is imposed to eliminate the benefit of paying the tax later. The interest is charged against the artificially high tax liability created by the throw-back rule, as if this were the tax previously deferred. In addition, the interest charge is compounded and is not deductible in computing net taxable income.¹⁰⁴

101 Bittker & Lokken at 83-14; Bruce 2000 at 117.

102 Bruce 2000 at 156; Bittker & Lokken at 83-5, 83-26.

103 Bruce 2000 at 75.

104 Vetter at 69; Bruce 2000 at 160-162; Bittker & Lokken at 83-5, 83-28; Glattmachr & Michaelson in par 4.3 at 4-7.

Loans from foreign trusts to a United States grantor or beneficiary

Section 643(i) of the Code provides that, if a foreign trust makes a loan of cash or marketable securities, directly or indirectly, to a United States grantor or beneficiary, or to any person, who is related to the grantor or beneficiary, the amount of the loan will be treated as a distribution taxable in the hands of the recipient.

8.2.4 TAX TREATMENT OF CERTAIN UNDERLYING ENTITIES

A foreign trust that is owned by a United States person, can own, or participate in, a number of investments and entities. For example, it can own a corporation or a partnership, it can be a grantor, or a beneficiary of another trust, and it can even own insurance policies.¹⁰⁵ Before considering the income tax implications of such ventures, it is important to point out that a transfer of property by a United States person to a foreign non-grantor trust is taxable as a sale of property for its market value.¹⁰⁶ Further, if a domestic trust migrates outside the United States, all the trust's assets are considered to have been sold on the day on which the domestic trust was converted into a foreign trust, and the gain will be taxable in the domestic trust on that day.¹⁰⁷ However, in terms of section 367 of the Code, the transfer of assets by a trustee of a foreign non-grantor trust to a foreign corporation is not subject to tax, since for tax purposes, the foreign trust is a non-United States person. With foreign ownership of this kind, taxation of United States income can be deferred by United States beneficiaries of the foreign non-grantor trust (who are also shareholders in the foreign corporation), until the income is distributed and repatriated to the United States. An example of a scheme that has been used to defer United States taxation is the formation of a foreign non-grantor trust, where there are no United States beneficiaries but instead a foreign charity is named as the beneficiary. When the income from the

105 Bruce 2000 at 223.

106 In terms of s 684(b) of the Code, the general rule under s 684(a) does not apply to a transfer to a foreign trust by a United States person to the extent that any person is treated as the owner of the foreign trust under s 671. Thus, a United States grantor will not be subject to this provision, if he transfers appreciated property to a foreign grantor trust. See Kaplan at 132.

107 Bruce 2000 at 165.

foreign corporation is distributed, the trustees of the foreign non-grantor trust only make nominal distributions to the foreign charity, using the rest of the income for purposes such as the acquisition of foreign-issued life insurance on the life of a United States person (the insured normally being the settlor, who created the foreign non-grantor trust, or some other United States persons, who only become beneficiaries one year after the death of the settlor and his spouse). The use of a foreign non-grantor trust in such circumstances allows the deferral and avoidance of substantial income taxation, as well as the removal of insurance proceeds from the estate of the United States insured.¹⁰⁸

In order to prevent the avoidance and deferral of taxes, where a foreign non-grantor trust (with United States beneficiaries) transfers assets to a foreign entity, the United States has controlled foreign corporation (CFC) legislation, which provides that a United States shareholder, who owns 10% or more of the total combined voting power of all classes of voting stock of a CFC, must include in his income in each year his pro rata share of the CFC's undistributed income.¹⁰⁹ A United States shareholder, as defined in section 951(b) of the Code, includes a trust that directly or indirectly owns more than 10% of the corporation's voting stock. This covers indirect ownership of the beneficiary through his interest in a foreign trust.

Where an offshore trust that is owned by a United States settlor makes investments in a "passive foreign investment company" (PFIC), so as to defer United States tax on the investment, passive foreign investment legislation (PFIC) may also come into play. A PFIC is any foreign corporation, if at least 75% of its gross income for the tax year is passive, or at least 50% by value of the assets it held during the year produce passive income.¹¹⁰ In terms of section 1291(a)(1) and (2) of the Code, a United States shareholder must pay United States tax, plus interest, based on the value of the tax deferral. All gains and distributions are deemed to be ordinary income, rather than capital gains, and the United States shareholders must report the distributions and dispositions to

108 Kaplan at 132-133.

109 Ss 951(b) and 957(a) of the Code, Treasury Regulations 1.951-1(g), 1.957.1.

110 See also Bruce 2000 at 235.

Revenue.

8.2.5 REPORTING RULES AND PENALTIES

In terms of section 6048(a) of the Code, as amended by the TRA 1996, a person who transfers property to a foreign trust under the grantor rules, or a person who receives a gift or a bequest from a foreign trust, is supposed to comply with certain reporting rules. Section 6048(a)(1) of the Code provides that such a person must within 90 days inform Revenue Services about the foreign trust and transfers of property to the trust. The purpose of the reporting requirements is generally to ensure compliance with the requirements of section 679 of the Code.¹¹¹

Section 6048(b) of the Code requires that any United States person, who is treated as the owner of any portion of the assets of a foreign trust, must ensure that the foreign trust files an annual return setting out information regarding trust activities and operations.

Section 6048(c) requires any United States beneficiary, who receives a distribution from a foreign trust, to file a return, which includes the name of the trust and the aggregate amount of distributions received. If adequate records are not provided to the IRS to determine the proper treatment of the distribution, the entire distribution will be treated as an accumulation distribution that is included in the recipient's gross income.¹¹²

Failure to file a report under section 6048(a)(1) of the Code, is subject to a penalty equal to a certain percentage of the amount transferred to the trust. Section 6677 also prescribes certain penalties that apply where information required by section 6048 has not been filed.¹¹³ In terms of section 671(a) of the Code, interest charges may also apply where an item is not included in

111 JO Allen "Taxation of Investment Income from Offshore Trusts and other Foreign Entities". Available at >http://www.diloffshore.com/lib_taxation.htm<, last accessed 26 May 2007; McDaniel *et al* at 143; Glattmahr & Michaelson in par 4.5 at 4-10.

112 Antoine at 309.

113 McDaniel *et al* at 143; Bruce 2000 at 246.

computing taxable income.

8.2.6 CONCLUSION

The above discussion shows that both the United Kingdom and the United States have been vigilant in enacting legislation to curb specific tax avoidance schemes with respect to offshore trusts. It is however, worth pointing out that, despite these provisions, the offshore trust has not outlived its usefulness as a tax avoidance vehicle. Clarke¹¹⁴ points out that despite rigorous anti-avoidance legislation, significant tax advantages can still be achieved through investing in offshore trusts. Evidence shows that when laws are enacted, taxpayers soon find loopholes.

114 Clarke at 11.

CHAPTER 9

THE ROLE OF EXCHANGE CONTROLS IN LIMITING THE OUT-FLOW OF CAPITAL TO OFFSHORE JURISDICTIONS (SOUTH AFRICA)

9.1 INTRODUCTION

In chapter 1,¹ it was pointed out that this thesis focuses mainly on some of the legislation that is employed to curb offshore income tax avoidance. The previous chapters have analysed the effectiveness of this legislation from a South African perspective, and a comparative study of similar legislation in the United Kingdom and the United States has also been covered. It is however worth noting that a discussion on “offshore tax avoidance” cannot be complete without reference to the exchange control requirements of investing offshore. Exchange controls are implemented by countries to limit and control the outflow and inflow of capital.² Essentially, exchange controls complement the anti-avoidance legislation in preventing the outflow of capital from a country that could lead to the depletion of the tax base. Note that, as the discussion of exchange controls is not the main focus of this thesis, this chapter deals with only the role of South Africa’s exchange control measures in preventing the depletion of the tax base. A discussion of exchange controls with respect to the United Kingdom³ and the United States⁴ is not covered.

In South Africa, the main purposes of exchange control are to –

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- 1 See chapter 1 par 1.6 under the heading “Scope of the Study”.
 - 2 TE Johnson *Export/Import Procedures and Documentation* (2002) at 22.
 - 3 Note that in the UK, exchange controls were abolished in 1979. See MJ Artis & M P Taylor “Abolishing Exchange Control: The UK Experience”. Available at ><http://ideas.respec.org/p/cpr/ceprdp/294.html><, last accessed 8 June 2007; Centre for Economic Policy Research “UK Exchange Controls: Effects of Abolition” Available at ><http://www.cepr.org/bubs/bulletin/dps/dp294.htm><, last accessed 8 June 2007; K Phylaktis “Exchange Controls Cannot be Enforced” (Jan-March 1985) *Economic Affairs* at 12-13.
 - 4 For information on United States Exchange Controls see AC Stockman & DA Hernandez D “Exchange Controls, Capital Controls, and International Financial Markets” (February 1989). National Bureau of Economic Research (NBER) Working Paper No W1755. Available at ><http://ssrn.com/abstract=227403><, last accessed 7 October 2007; A van Campenhout “United States: International Monetary Fund Agreement and Foreign Exchange Control Regulations: *Perutz v Bohemian Discount Bank in Liquidation* (1953) 2 *The American Journal of Comparative Law* 389-392.

- (a) ensure the timeous repatriation into the South African banking system of certain foreign currency acquired by residents of South Africa, whether through transactions of a current or of a capital nature; and
- (b) prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa.⁵

The relationship between capital flows and exchange control regulations has long occupied policy makers in South Africa. Exchange controls were first introduced in South Africa in the form of Emergency Finance Regulations at the outbreak of the Second World War in 1939.⁶ The intention was to protect South Africa's foreign exchange reserves. However, exchange controls on capital transfers were minor from the immediate post-war period until the late 1950s.⁷ During the apartheid era, South Africa had a negative political reputation, the price of gold declined, so exchange controls became increasingly restrictive to protect the Rand from further devaluation. Exchange controls on residents were tightened in response to the large-scale capital outflows experienced in the apartheid era.⁸ Particularly significant was the decision to block the repatriation of the proceeds of sales of South African securities by non-residents during that time.⁹

The change in the political situation in South Africa culminated in the democratic election of a Government of National Unity in April 1994, which duly inherited an economy which was not highly indebted but where residents had little opportunity to diversify their portfolios. The process of re-integration into the world's financial markets provided opportunities for liberalising exchange controls. The re-integration into the global economy, through complying with world norms and standards, has also boosted South Africa's international credibility and recognition. This has in turn encouraged greater confidence from both local and foreign investors thus creating an economic environment for further easing of

5 South African Reserve Bank "Exchange Control Manual" par E. Available at ><http://www.reservebank.co.za>< last accessed on 11 March 2008.

6 Exchange Control Manual par C; B K Spitz *Exchange Control Encyclopedia* (2002 Service Issue 4) at Part at 2-1.

7 R M Gidlow *The South African Reserve Bank Monetary Policies under Dr TW De Jongh: 1967- 1980* (1995) at 180.

8 Olivier & Honiball at 438.

9 Exchange Control Manual par C.

exchange controls. The exchange control system has been gradually liberalised over the past few years, and it is the stated intention of National Treasury that the liberalisation and deregulation of exchange controls will continue.¹⁰

9.2 ADMINISTRATION OF EXCHANGE CONTROLS

In terms of section 9 of the Currency and Exchanges Act 9 of 1933, the President¹¹ is empowered to make regulations in regard to any matter directly or indirectly relating to or affecting currency, banking or exchanges. Exchange Control Regulations were promulgated by Government Notices R1111 and R1112 of 1 December 1961. These regulations have been amended and updated on several occasions since then.¹²

The regulations aim to control capital movements in and out of the Common Monetary Area (CMA). The CMA consists of South Africa, Lesotho, Namibia and Swaziland. There are no exchange control restrictions among the members of the CMA as they form a single exchange control territory. The Monetary agreement between South Africa, Namibia, Swaziland and Lesotho provides for the free flow of funds and access to capital markets between the countries. However, Lesotho, Namibia and Swaziland have their own exchange control authorities as well as their own regulations and rulings. But in terms of the Common Monetary Area Agreement the application of their regulations and rulings must at least be as strict as those of South Africa.¹³ It follows that authorised dealers (defined below) are not permitted to enter into foreign currency transactions with customers of banks in other CMA countries. If such requests are received, customers are referred back to their banks in the CMA country concerned.¹⁴

In South Africa, Exchange Control Regulations are administered by the Minister of Finance in terms of regulation 22E, who delegates his powers, functions and

10 Exchange Control Manual par C.

11 Note that in terms section 9 of this Act, it was formally the Governor-General.

12 Exchange Control Manual par C.

13 Exchange Control Manual par D7.

14 Olivier & Honiball at 437.

obligations to the South African Reserve Bank (SARB). However certain powers, functions and duties have been assigned to and imposed by National Treasury. In terms of the Exchange Control Regulations, the National Treasury in turn, has appointed as "authorised dealers" certain banks (such as selected commercial and merchant banks), to administer certain categories of transactions on its behalf.¹⁵ The authority of the authorised dealers is regulated by Exchange Control Rulings. All applications to the "Exchange Control" (the National Treasury and SARB, acting through it Exchange Control Department) must be made through an authorised dealer. However applications for the approval of certain transactions, have to be made to the Exchange Control and not to the authorised dealers.¹⁶ For instance, applications for the relaxation of any restrictions or for requests which require special consideration in terms of the wide discretion given to the Exchange Control in the various regulations.¹⁷ Each case is considered on its own merits. Where an application is unsuccessful, the Exchange Control is obliged to give reasons therefor in terms of section 33 of the Constitution and section 5 of the Promotion of Administrative Justice Act 3 of 2002.

In *S v De Blom*¹⁸ the validity of the delegation of the minister's powers to the South African Reserve Bank in terms of Rule 2 of the Exchange Control Regulations was challenged. The court held that the delegation of the Minister's powers to the SARB was appropriate and valid. This decision was reinforced in 1987 with the insertion of section 9(2)(c) in the Currency and Exchanges Act, which specifically permits any regulation to authorise any person who is vested with any powers (or who must fulfill any duty), in terms of any regulation to delegate that power or assign that duty to any other person. The Exchange Control has wide discretion that is exercised in accordance with the Exchange Control Regulations and the Exchange Control Rulings in line with the policy guidelines laid down by the Minister of Finance. The discretion is however, not arbitrary but is based on policy guidelines set out in Exchange Control Rulings

15 Exchange Control Manual par D4; Spitz in Part 1 at 3-2.

16 Exchange Control Manual par D4 and D5; Spitz in Part 1 at 3-3.

17 Oliver & Honiball at 438.

18 1977 (3) SA 513 (A). In *S v Seedat* 1977(2) SA 686 (RA), the Appellate Division of Rhodesia held that the delegation of the powers of the Minister of Finance to the Reserve Bank of Rhodesia in terms of s 32 of Rhodesia's Exchange Control regulations, was an appropriate and valid delegation.

and Circulars that are issued by the Minister to the authorised dealers.¹⁹ The Rulings and Circulars have general application to residents and are set out in the Exchange Control Manual E which is updated from time to time.

The purpose of the Exchange Control Manual²⁰ is to give guidance to authorised dealers, their clients, and other interested parties on the operation of the exchange control system in the Republic of South Africa and the CMA. However, the Manual itself has no special legal status.²¹ In terms of Exchange Control Regulation 2, the general policy approach to exchange controls is that

... except with permission granted by the Treasury, and in accordance with such conditions as the Treasury may impose, no person other than an authorised dealer shall buy or borrow any foreign currency or any gold from, or sell or lend any foreign currency or any gold to any person not being an authorised dealer and an authorised dealer shall not buy, borrow or receive or sell, lend or deliver any foreign currency or gold except for such purposes or on such conditions as the Treasury may determine.

From the above, it is clear that the legal framework of exchange control is one of a total prohibition to deal in foreign exchange except with the permission of and on the conditions set by the Treasury. The economic policy underlying exchange control is, however, not totally prohibitive, since such an approach would not be conducive for international trade and investment.²²

9.3 THE MEANING OF THE WORDS “PERSON” AND “RESIDENT”

In terms of regulation 2, the exchange control regulations apply in respect to a “person”. However there is no definition of “person” in the Currency Exchanges Act or in the Regulations. According to the Exchange Control Manual D 8, the term “person” refers to a natural person, body corporate, foundation, a trust or a partnership.²³ Some of the exchange control regulations refer to a “person resident in the Republic”, while some regulations refer to a person who is

19 Exchange Control Manual par D2.

20 Exchange Control Manual par D4.

21 B Wunsh “The Legal Aspects of Exchange Control” (1995) 112 *The South African Law Journal* 407.

22 Exchange Control Manual par E; see also Oliver & Honiabl at 438.

23 Note that In terms of the Income Tax Act, a partnership is not a taxable person.

“resident outside the Republic”. Since this work deals with offshore tax avoidance in relation to residents, only the regulations that deal with persons who are resident in the Republic will be dealt with.

It should be noted that the definition of the term “resident” in the Income Tax Act²⁴ is not necessarily the same for exchange control purposes. The term “resident” is not defined in the Currency Exchanges Act or the Exchange Control Regulations. The Interpretation Act 33 of 1957 also does not contain a definition of the term “resident”.²⁵ However, Exchange Control Manual D 8, states that a “South African resident” is a person, whether of South African or any other nationality, who has taken up residence, is domiciled or registered in the Republic. Since this work deals with curbing tax avoidance as a result of offshore investments in respect to companies and trusts, only these categories of resident persons will be dealt with. Note that for income tax purposes, a person other than a natural person (eg a company or a trust) is resident in South Africa if it is incorporated, established or formed in South Africa, or if it has its place of effective management in South Africa.²⁶ In terms of Exchange Control Manual D 8 a legal person (such as a company) is resident if it has its normal place of registration in South Africa. It is arguable that the phrase “normal place of registration” in this context means either the equivalent of incorporation or it is a factual test. For example, it can be argued that this definition will not include a foreign company merely because it is registered as an “external company” in term of section 322 of the Companies Act,²⁷ as such registration is not its “normal place of registration”, but rather a secondary registration which is required when the foreign company, already registered elsewhere, establishes a place of business in South Africa. Consequently, based on definition of “resident” in the Exchange Control Manual, a branch of a foreign company will not necessarily be an exchange control resident merely because it has been registered as an

24 The definition of the term resident in s 1 of the Income Tax Act distinguishes between natural persons and persons other than natural persons. In terms of this provision, a natural person is resident in South Africa if he is ordinarily resident in South Africa (*CIR v Kuttel* 1992 (3) SA 242 (A)) or if he meets the requirements of the physical presence test.

25 Olivier & Honiball at 440.

26 The definition of the term resident in s 1 of the Income Tax Act.

27 Act 69 of 1984.

external company in South Africa.²⁸

Regulation 17 provides that for exchange control purposes, a branch must be treated as if it is a separate person, even though it forms part of the same legal entity as the foreign head office and is controlled from the same head office. In *Sagit Property Holdings Ltd v Union Bank of Switzerland*,²⁹ the court stated that if the effect of regulation 17 was that the branch was resident in South Africa, then the transaction is to be treated accordingly, even if the actual control of such branch from overseas would otherwise make it non-resident. Nevertheless, although a branch is a person separate from its head office in terms of regulation 17, the Court stated that it was still a question of fact whether the relevant branch was a resident. For instance, it has to be determined whether the branch in issue is registered in terms of section 322 of the Companies Act.³⁰

In practice, the issue about the exchange control residence of a branch is relevant in two instances: firstly, where loans are made to a branch by a South African resident, or by a branch to a South African resident, then no approval from the Exchange Control would be required if the relevant branch was a resident. Secondly, this issue is relevant where shares are issued by a branch in terms of a separate branch register. Such shares may only be taken up by South African exchange control residents if the branch itself is an exchange control resident.³¹ Based on the definition of a resident in the Exchange Control Manual and on the *Sagit Property Holdings* case, merely registering the branch as an external company in terms of section 322 of the companies Act will not make it a resident. The branch will therefore have to take active steps to show that on the facts it is a South African exchange control resident before South African residents may take up shares issued by it.³²

It appears that in circumstances where regulation 17 applies, it is only the branch and not the foreign head office which is the exchange control resident, and that

28 Olivier & Honiball at 443.

29 1977 (3) SA 897(W).

30 Olivier & Honiball at 443.

31 Olivier & Honiball at 443.

32 Olivier & Honiball at 443.

the foreign head office is regarded as non-resident for exchange control purposes. Based on the above, it can be concluded that a company incorporated in South Africa will always be an exchange control resident despite the fact that its place of effective management may be elsewhere.³³ This is similar to the income tax position, where a company incorporated in South Africa is always an income tax resident despite the application of a tax treaty which may give another state taxing rights on the basis of the place of the effective management of the company. Note that for income tax purposes, a branch is not considered a separate legal entity.³⁴ It thus cannot be considered a “resident” for income tax purposes.

With respect to trusts, there is no regulation or statutory provision that determines the residence of a trust for exchange control purposes. In practice the Exchange Control treats a trust as a person. In determining a trust’s residence, the residence status of the trustees is considered. Thus a trust will become non-resident for exchange control purposes if the majority of the trustees become non-resident although the trust remains registered with the Master of the High Court of South Africa.³⁵ It should be noted that for income tax purposes, a trust is a taxable person and it is considered a “resident” if it formed in South Africa or if it has a place of effective management in South Africa.³⁶ This implies that even if the majority of the trustees become non-resident, the trust will be resident if it was formed in the Republic and was registered with the Master.

From the above, it is clear that the meaning of the term “resident” appears to have certain differences for exchange control purposes and for income tax purposes that may create uncertainties. It has been pointed out that the Currency Exchanges Act does not have a definition of the term “resident”. Although Exchange Control Manual D 8 provides a definition of the term, the Exchange Control Manual has no legal status.³⁷ As stated above, its purpose is to give guidance to authorised dealers and their clients on the operation of the exchange

33 Olivier & Honiball at 443.

34 B J Arnold & M J McIntyre *International Tax Premier* 2 ed (2002) at 73.

35 Oliver & Honiabl at 444.

36 In terms of s 1 of the Income Tax Act, trust as a person other than a natural person.

37 Wunsh “The Legal Aspects of Exchange Control” *SALJ* (1995) 407.

control system in the Republic of South Africa and the CMA.³⁸ Thus, the application of definition of the term “resident” in the Exchange Control Manual to a particular situation may be challenged in a court of law.

It is recommended that order to fill the lacuna in the law, the Currency Exchanges Act should be amended to include a definition of the term “resident” that can be used for exchange control purposes. The definition of this term as used in the Income Tax Act could also be applied for exchange control purposes subject to certain exceptions that may be particular to exchange controls (an example is the issue of branches discussed above).

9.4 REGULATIONS WITH RESPECT TO OFFSHORE INVESTMENTS BY SOUTH AFRICAN COMPANIES

Companies which are exchange control residents are subject to all the regulations, unless generally or specifically exempted. With respect to outward payments, the general rule in regulation 2 provides that only authorised dealers may buy, borrow or sell foreign currency, or gold. Furthermore, the authorised dealers may only sell foreign currency to exchange control residents as allowed in terms of the regulations. On application, various exemptions or approvals may be obtained, which may have the effect that the general rule in regulation 2 or any other regulation applies conditionally or unconditionally.³⁹

Direct investments by South African companies outside the CMA

In terms of Exchange Control Manual F 6.1.2.1, South African private companies, public companies and listed companies that wish to make new offshore direct investments outside the CMA, may do so without prior approval of the Exchange Control, if the total cost of such new investments does not exceed R50 million per company per calendar year. To qualify as a foreign direct investment, a South African company must obtain a minimum of at least 10% of the voting rights in the foreign offshore entity. Authorised dealers have the

38 Exchange Control Manual par D4.

responsibility of ensuring that the foreign investment is undertaken by bona fide South African companies for foreign direct investment purposes. All further investments must be reported annually to the Exchange Control, accompanied by audited Financial Statements of the offshore entity and the holding companies.

Where the total cost of the foreign direct investments exceeds the R50 million limit, an application has to be submitted to the Exchange Control, before the investment is made. In general, companies wishing to invest outside the CMA should demonstrate a long term monetary benefit to the Republic, for example, enhanced earnings derived from the export of goods and services.

Reporting of offshore ventures

In terms of Exchange Control Manual F 6.1.2.2, all South African companies that establish subsidiaries, branches, offices or joint ventures abroad are required to annually submit financial statements on these operations to the Exchange Control. In certain instances regular progress reports are also required.

Regulations with respect to the repatriation of profits and dividend

Exchange Control Manual F 6.1.2.3 provides that dividends repatriated from abroad by South African companies may be re-transferred abroad for the financing of approved foreign direct investments or approved expansions. However, such dividends may not be transferred abroad for any other purpose. South African holding companies may also retain offshore dividends declared by their offshore subsidiaries without any recourse to South Africa. Such funds may also not be utilised to fund investments into the CMA and the SADC for any purpose whatsoever via a “loop structure”,⁴⁰ except if the investment is approved.

39 Exchange Control Manual par F.2.

40 The working of the “loop structure” scheme is discussed further on in this chapter.

Regulations with respect to remission of funds to expand offshore operations

In terms of Exchange Manual F 6.1.2.4, an application has to be submitted to the Exchange Control where funds have to be remitted regularly from the Republic to finance the running expenses or working capital of an offshore company that generates insufficient income or does not generate income. The application should be supported by a report on the foreign company's operations of the past year; and an up-to-date of its financial statement.

Prior approval from the Exchange Control is not required where South African companies have to expand their existing offshore business for instance, the acquisition of further assets/equity interests offshore. However, such expansion should be in the same line of business and the South African company should be able to demonstrate that the relevant expansion can enhance monetary benefit for South Africa. The expansion must be financed without recourse to South Africa to fund or guarantee such offshore expansion. All expansion plans, including plans to enhance the monetary benefit for South Africa, must be placed on record with the Exchange Control at an early stage.

Companies that wish to expand their existing offshore operations with recourse to South Africa, i.e. by transferring cash or issuing guarantees from South Africa, have to submit a fully motivated application to the Exchange Control.

Transfer of funds offshore

Exchange Control Manual F 6.1.2.5 provides that, even though South African companies are permitted to make new outward foreign direct investments, the Exchange Control reserves the right to stagger capital outflows in respect of very large foreign investments. This is necessary to manage any potential impact on the foreign exchange market.

Companies that require foreign acquisitions may apply to the Exchange Control

to raise foreign finance on the strength of their South African balance sheet. Companies may also finance their offshore investments or the repay existing offshore debts by applying to Exchange control for permission to engage in the issue of offshore bonds. Authorised Dealers may also extend foreign currency denominated facilities to South African companies for the financing of approved foreign direct investments.

Purchasing of additional shares in existing offshore entities

In terms of Exchange Control Manual F 6.1.2.6, an application has to be made to Exchange Control where a company wishes to purchase additional shares in existing offshore entities so as to expand its offshore business venture.

Loans by residents companies to non-residents

In terms of Exchange Control Manual F 6.1.3, approval from Exchange Control has to be granted before a South African company can grant a loan to a non-resident. Generally, approval is only given in exceptional circumstances, for instance, if the loan is related to an approved foreign investment by a company.

Portfolio investments by residents

In terms of Exchange Control Manual F 6.1.4.1, the export of capital for portfolio investments, for instance in quoted stocks and shares, is prohibited subject to certain exceptions.⁴¹

Foreign portfolio investments by South African institution investors

In terms of Exchange Control Manual F 6.1.4.2, retirement funds, long-term insurers, collective investment schemes and management companies are

41 These exceptions are set out in Exchange Control Manual F 6.1.1.

allowed to transfer funds from South Africa for investment abroad. The limit on foreign portfolio investment by institutional investors is applied to an institution's total retail assets. The foreign exposure of retail assets may not exceed 20% in the case of retirement funds and long-term insurers. Collective investment scheme management companies are restricted to 30% of the total retail assets under management.

Institutional investors are allowed to invest an additional 5% of their total retail assets by if they acquire foreign currency denominated portfolio assets in Africa through foreign currency transfers from South Africa.

Dividend distributions to non-resident shareholders

In terms of section F 2.2.3.1 of the Exchange Control manual, dividend distributions, whether of a capital or revenue nature are freely remittable to non-resident shareholders abroad. However, non-listed companies must provide an authorised dealer with an auditors' certificate that confirms that the amount transferred is derived from profits realised from the normal course of business and is payable to a non-resident who has not previously been a resident. Capital distributions require a letter from an auditor indicating how the capital arose and that the sale price was at arm's length and at fair value. This requirement is to ensure that there is no illegal export of capital and secondly, to ensure that the non-resident entity will not contravene the local borrowings restrictions in paying the dividend.

Royalties and license fees payable to non-residents

In terms of Exchange Control Manual F 2.2.3.2, the Exchange Control allows royalty, license and patent fees derived from the sale of a locally manufactured

product to be paid to non-resident owners of intellectual property, provided prior approval has been obtained. The Exchange Control has delegated some of its authority in this regard to the Department of Trade and Industry (DTI). Applications to the DTI must be supported by a completed questionnaire (MP337(b)) which can be obtained from an authorised dealer, and should be directed to DTI. Where there is no local manufacturing, then any agreement to pay royalty, license or patent fee to a non-resident is subject to the approval of the Exchange Control, not the DTI. The royalty payment must be substantiated by an auditor's report confirming the basis of the calculation and that it is in terms of the relevant royalty agreement.⁴²

Management and administration fees

In terms of Exchange Control Manual F 2.3.7, authorised dealers may approve payment of management or administration fees by a resident company to a non-resident, if there is documentary evidence confirming the amount involved. The amount paid must be reasonable in relation to the services provided. Payments of such fees by wholly-owned subsidiaries of overseas companies are not readily approved where other payments to the same foreign company, like royalties, have been approved. Fees calculated on the basis of a percentage of turn over, income, sales or purchases will generally not be approved.

Offshore listings

Exchange Control Circular D 250 of 1 February 1999 states that it is not government policy to allow South African resident companies to have primary listings on foreign stock markets. Companies will not be allowed to delist from the JSE to list overseas, and only dual listings where the company retains its primary listing in South Africa will be considered. This policy does not affect South African

42 The Directorate of Technology Promotion of the DTI has issued a general information document (Form DTP001) which sets out the guidelines for application for approval of a royalty agreement.

companies which had already moved their primary listings to a foreign stock market before the date of this circular.⁴³

9.5 REGULATIONS WITH RESPECT TO OFFSHORE INVESTMENTS BY SOUTH AFRICAN TRUSTS

Provisions contained in testamentary trusts⁴⁴ relating to the bequest of assets to non-residents do not require the prior approval of the Exchange Control. Income may be transferred through normal banking channels provided there are no excess borrowings by the trust. However the Exchange Control has in place certain restrictions in respect to *inter vivos* trusts.⁴⁵ Exchange Control Manual N 5.6 states that although *inter vivos* trusts are normally established for legitimate purposes in estate planning, they operate like a conduit through which assets pass to the beneficiaries during the lifetime and/or after the death of the donor, and they are sometimes used to export capital from the Republic. Consequently, in December 1985, Exchange Control directed that all requests for the transfer of income and capital distributions to beneficiaries resident outside the CMA, must be referred to the Exchange Control for consideration. The purpose is firstly to ensure that a non-resident is entitled to such a distribution and secondly to prevent the export of capital disguised as income distributions through the trust.⁴⁶

In terms of Exchange Control Manual N 5.6.2, when determining the policy to be adopted with respect to a particular trust, the source of financing is very important. Trusts funded by own assets, rather than third-party funded trusts, get more favourable treatment. Thus, where a trust is established and funded by an emigrant prior to the date of emigration, Exchange Control could consider allowing the income generated subsequent to emigration to be transferred to the

43 Olivier & Honiball at 457.

44 A "testamentary trust" is a trust created in terms of a will, whereby a deceased person leaves his estate to a trustee, who administers the estate assets on behalf of the beneficiaries. See Exchange Control Manual N 5.6. See also AP de Koker *Silke on South African Income Tax* (2007) in par 24.126; R King & B Victor *Law and Estates Planning Easiguide* (2006/2007) in par 16.3.1; F Du Toit *South African Trust Law: Principles and Practice* (2002) at 21.

45 In terms of Exchange Control Manual N 5.6, an *inter vivos* trust is a trust created during a person's lifetime.

46 Exchange Control Manual N 5.6.1; see also Olivier & Honiball at 457.

emigrant. In terms of Regulation 4(2), distributions from trusts established by a South African resident in favour of a non-resident must be placed to the credit of a blocked account.⁴⁷

In terms of Exchange Control Manual N 5.6.4, the rules that apply to third-party funded trusts differ according to whether the beneficiaries are emigrants or non-residents, as well as the timing of the establishment and the nature of the funding thereof. In the case of emigrants, income will be allowed to be distributed if the funding of the trust took place at least five years before the date of emigration. If the funding took place within a period of five years before emigration, then all income distributions to such an emigrant will only be allowed to a blocked account in terms of Regulation 4(2).

Regulations with respect to “loop structures”

“Loop structures” are tax avoidance schemes where by South African residents invest in offshore trusts that, in turn re-invest funds in South African businesses in which the original investors have a stake.⁴⁸ Usually the offshore trust would be funded by using the foreign investment allowance in terms of Exchange Control Manual F 6.1.1.⁴⁹ The Offshore trust would then subscribe for shares or purchases shares in a resident company. This would normally be done directly or

47 A “blocked account” is a bank account from which funds cannot be withdrawn for any of a number of reasons, for example, bankruptcy proceedings, liquidation of a company, or government order when freezing foreign assets. See BNET Business Dictionary. Available at <http://www.dictionary.bnet.com/definition/blocked+account.html> – 43k<, last accessed 11 April 2008. Exchange Control Regulation 4(1) and (2) provides that “blocked account” means an account opened with an authorised dealer for the purposes specified in the succeeding sub-regulations. Whenever a person in the Republic is under a legal obligation to make a payment to a person outside the Republic but is precluded from effecting the payment as a result of any restrictions imposed by or under these regulations, the Treasury may order such person to make the payment to a blocked account. See also Spitz in Part 2 at SECT 2-7.

48 L du Preez “No Sign of Extension to Amnesty Yet” (8 November 2003). Available at <http://www.persfin.co.za/index.php?fSectionId=&fArticleId=280017> last accessed on 20 March 2007. Wiseman Khuzwayo Business Report “FirstRand’s loop legal - Dippenaar” (September 9, 2007). Available at <http://www.busrep.co.za/index.php?fArticleId=4023192> last accessed on 20 March 2007.

49 Olivier & Honiball at 449.

indirectly via an offshore company by using the so-called 74/26 structure.⁵⁰ In terms of this structure, only a 74% interest in the South African company is taken up in this manner but the balance would be held by the South African settler of the offshore trust. The reason for the 74% limit is that local borrowing restrictions apply only where the foreign shareholding is 75% and higher.⁵¹ The South African company would then use the proceeds received from the trust (which was originally the foreign investment allowance) together with the local borrowings from the settler or a bank, to purchase capital assets in South Africa. Should those capital assets have included shares, dividends would be remitted overseas.⁵² On realisation of the capital assets the company would be liquidated and the capital gain would be remitted to the offshore trust.⁵³ Investments in such loop structures have been popular in the Jersey Islands⁵⁴ and they have been offered by numerous financial institutions in South Africa.⁵⁵

Loop structures are considered to be in breach of exchange control regulations⁵⁶ and they have always been frowned upon by the SARB. However, there are conflicting views regarding the applicability of regulation 10(1)(c) to these structures. These views revolve around the meaning of the words “capital” and “indirectly exported” that are used in this regulation. On the one hand it is reasoned that loop structures are not in contravention of the regulation, since the consent of the Exchange Control is normally granted before the export of capital from South Africa. It is also reasoned that the dividend which is remitted comprises revenue profits which cannot be regarded as the export of capital. It is

50 Wiseman Khuzwayo Business Report “FirstRand's loop legal - Dippenaar “ (September 9, 2007). Available at <http://www.busrep.co.za/index.php?fArticleId=4023192>< last accessed on 20 March 2007.

51 Olivier & Honiball at 449.

52 Olivier & Honiball at 449.

53 Olivier & Honiball at 449.

54 C van Gass & C Benjamin “South Africa: Noseweek to Publish As Judge Denies Bank Gag” *Business Day* (21 September 2007).

55 Wiseman Khuzwayo Business Report “FirstRand's loop legal - Dippenaar “ (September 9, 2007). Available at <http://www.busrep.co.za/index.php?fArticleId=4023192>< last accessed on 20 March 2007.

56 Wiseman Khuzwayo Business Report “FirstRand's loop legal - Dippenaar “ (September 9, 2007). Available at <http://www.busrep.co.za/index.php?fArticleId=4023192>< last accessed on 20 March 2007. See also Deney's Reitz Attorneys “Renewed Interest in Secondary Listings”. Available at >http://www.deney'sreitz.co.za/news/item/renewed_interest_in_secondary_listingd,1178.html< last accessed 20 March 2007.

further argued that where a South African company is liquidated, any remittable capital gain, even if regarded as the export of capital, is incidental to the arrangement and cannot be considered to be part of the original transaction.⁵⁷

On the other hand, based on the wide meaning of the word “indirect”, it is argued that any remittance of a capital profit, for example on liquidation of the South African company, is an indirect export of capital and consequently a contravention of the regulation.⁵⁸ It may be argued that loop structures cannot be considered a contravention of regulation 10(1)(c) until the capital gain is remitted from South Africa on liquidation of the South African company. However, Olivier & Honiball⁵⁹ point that when interpreting regulation 10(1)(c), it should be noted that capital does not have to have been exported before this regulation can apply. For example, in *S v De Castro*⁶⁰ where the appellant had made an arrangement for money to be exported, but where the money had not yet been exported, the then Appellate Division held that the appellant had contravened regulation 10(1)(c) even though he had been arrested before the money could be exported.

Exchange Control Circular D 417 and D 405, makes it clear that the Control regards loop structures as a contravention of regulation 10(1)(c). Exchange Control Circular D405 point out that these structures result in the direct or indirect export of capital abroad for the ultimate benefit of a South African resident. The structures also result in the export of dividends arising from increased profits, revenue reserves and/or capital reserves accruing from the introduction of the assets to the resident company. The Circular states:

It has come to the attention of the Exchange Control Department of the Reserve Bank that certain private individuals, resident in South Africa, have entered into a transaction or a series of transactions the purpose, and/or effect of which is to export capital, directly or indirectly from the Republic. These Transactions, which contravene the Exchange Control Regulations, invariably entail the formation, by (or at the behest of) a resident, of an offshore structure which, by a re-investment into South Africa, acquires shares, or some other interest, in a South African resident company or a South African asset.⁶¹

57 Olivier & Honiball at 449.

58 Olivier & Honiball at 449.

59 Olivier & Honiball at 449.

60 1979 (2) SA (1)(A).

61 Exchange Control Circular D417 and D405 issued on 30 September 2003.

The South African Reserve Bank issued this Circular to all authorised dealers giving them instructions as to how loop structures should be dealt with in terms of the 2003 Exchange Control Amnesty (discussed ahead). The Circulars set out certain administrative concessions relating to the unwinding of these structures. The Control undertook not to take further action against residents who unwound these structures in the manner set out in the circulars, provided that this was done on or before 27 February 2004 and that certain levies were paid. These concessions were designed to facilitate application for exchange control amnesty in terms of the exchange control Amnesty and Amendment Act 12 of 2003, and effectively extended the scope of the amnesty, which had a deadline of 29 February 2004.

Despite the fact that “loop structures” are considered to be in contravention of the Exchange Control, the decision of the court in *Pratt v FirstRand Bank and another*,⁶² seems to accept the legality of loop structures. The facts were that Ann Pratt controlled the offshore trust (The Fast Track Trust) which acquired 70% of the shares in her South African company (Ann Pratt & Associates). On 8 May 2000, the Fast Track Trust purchased 700 ordinary shares in Ann Pratt & Associates. In December 2001, Ann Pratt borrowed R25 million from FirstRand Bank to capitalise a close corporation (Classy Living CC) which purchased the shares from the Fast Track Trust. The issue was whether the arrangements contravened Exchange Control Regulation 10(1)(c). After a detailed analysis of the Exchange Control Regulations and Rulings that relate to the transfer of shares to non-residents (Regulation 3(1)(e) and 10(1)(c)), the court ruled that transactions in contravention of these regulations were null and void. It however found that Exchange Control approval had been granted for the respective transactions since the shares in question had been “endorsed” by the Authorised Dealer Bank. It concluded that the endorsement of a share certificate by an Authorised Dealer Bank, following the required procedures (inter alia, ensuring that the market value had been confirmed by an independent valuation), was evidence of compliance with the Exchange Control Regulations. The court ruled that the transference of the purchase price to the non-resident was an authorised

62 [2004] 4 All SA 306 (T).

export of capital. It is submitted that this case was wrongly decided. The bank's confirmation cannot create legality of an otherwise illegal act.

This decision could be regarded as authority for the establishment of a valid loop structure. The decision calls into question the validity of Exchange Control Circular D 405 and D 417, which pointed out that such transactions were contraventions of Exchange Control Regulation 10(1)(c).⁶³

9.6 CONSEQUENCES OF CONTRAVENING THE EXCHANGE CONTROL REGULATIONS

Exchange Control Regulation 10(1)(c) provides that no person shall, except with permission granted by the Treasury enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic. The question that arises is whether a transaction which contravenes the regulations or an agreement which does not have the required consent of the Control is void. In general, where an enactment says "no person shall", the legislature intends that the transaction thus prohibited will be invalid.⁶⁴ However, the decisions of the South African courts in respect to the issue have not been consistent.

In *S v De Castro*⁶⁵ it was held that a transaction which created a "channel" for the future export of capital out of the Republic was null and void. In *Abreu v Campos*⁶⁶ the court cited the general rule in regulation 10(1)(c) and noted that:

Here the purpose of the legislature is to conserve the country's foreign exchange and, to that end, to prohibit dealings in foreign currency without permission. It cannot have been the intention to allow enforcement of contracts involving dealings in foreign currency without permission for that would encourage the very mischief which the legislature seeks to avoid.

However in *Barclays National Bank v Brownlee*⁶⁷ the court concluded that a contravention of the prohibition under Regulation 3(1)(e) did not imply that the

63 Bowman Gilfillan Attorneys "Ann Pratt case - New Precedent on Exchange Control Compliance". Available at <http://www.bowman.co.za/LawArticles/Law-Article.asp?id=2132417203> last accessed on 20 March 2007.

64 *Swart v Smarts* 1971 (1) SA 819 (A) at 829-830.

65 1979 (2) SA 1 (A).

66 1975 (3) SA 73 (RA).

67 1981 (3) SA 579 (D).

particular transaction was null and void. The court relied on the following citation in *Standard Bank v Estate van Rhyn*⁶⁸ for its decision:

[b]ut that which is done contrary to law is not *ipso jure* null and void, where the law is content with a penalty laid down against those who contravene it. The reason for all this I take to be that in these and the like cases greater inconveniences and impropriety would result from the rescission of what was done, than would follow the act itself done contrary to the law.

The above contradicting decisions appear to have been settled by the Appellate Division in *Barclays National Bank Ltd v Thompson*,⁶⁹ in which it was held that a contravention of the regulations cannot result in any agreement being void; rather, it prevents performance in terms of the agreement. The court pointed out that in such cases, the legislature prescribes criminal sanctions to enforce compliance with the regulations.

However, even after this Appellate Division decision, in *Couve and Another v Reddot International (Pty) Ltd and Others*⁷⁰ it was held that the transfer of intellectual property and shares to a non-resident without the approval by the Exchange Control was void. Even in the *Prat* case (referred to earlier) the court ruled that transactions in contravention of the Exchange Control Regulations were null and void.

Despite the fact that there have been a number of cases that decided that a contravention of exchange controls is null and void, it is submitted, in agreement with Olivier and Honiball⁷¹ that the Appellate Division's decision in the *Thompson* case is correct. It is submitted that the cases in which it was ruled that transactions that contravene the regulations are null and void, were wrongly decided.

9.7 PENALTIES FOR CONTRAVENING EXCHANGE CONTROL REGULATIONS

68 1925 AD 266.

69 1985 (3) SA 778(A).

70 2004 (6) SA 425 (W).

71 Olivier & Honiball at 460.

In *S v Immelman*⁷² the court made it clear that the contravention of the regulations is a serious offence since it prejudices the economic interest of the state and the general body of its citizens. Regulation 22 sets out certain penalties for contravening the regulations. Where a person is convicted of an offence, a fine in the maximum of R250 000 may be charged. A person could also be imprisoned for a period not exceeding five years. In certain cases, both a fine and imprisonment may be imposed. Money or goods relating to the contravention may also be attached or forfeited.

9.8 THE 2003 AMNESTY FOR PERSONS THAT HAD CONTRAVENED THE EXCHANGE CONTROL REGULATIONS

Of particular relevance to the discussion on curbing offshore tax avoidance in South Africa is the 2003 Exchange Control Amnesty and Amendment of Taxation Laws Act,⁷³ which granted amnesty for certain persons that had contravened the exchange control regulations. According to the preamble to this Act, its objectives are:

- (a) to enable violators of Exchange Control Regulations and certain tax Acts to regularise their affairs in respect to their foreign assets attributable to those violations;
- (b) to ensure maximum disclosure of foreign assets and to facilitate repatriation thereof to the Republic; and
- (c) to extend the tax base by disclosing previously unreported foreign assets.

9.8.1 EXCHANGE CONTROL AMNESTY PROVISIONS THAT RELATE TO COMPANIES

In terms of Exchange Control Amnesty and Amendment of Taxation Laws Act, tax amnesty was granted to certain applicants for the 2003 year of assessment, if they complied with certain conditions. Section 3(1)(a) and (b) of this Act, *inter alia* provides that a close corporation was among the persons that could apply for

72 1978 (3) SA 726 (A).

amnesty.⁷⁴ A close corporation is included in the meaning of a “company” in section 1 of the Income Tax Act. Sections 3(1)(a) and (b) of the Exchange Control Amnesty and Amendment of Taxation Laws Act provide *inter alia* that, a close corporation could apply for amnesty if;

- on 28 February 2003, it held any foreign assets which had been wholly or partly derived from any unauthorised asset, or if
- on the 28 February 2003 it held any foreign assets which had been wholly or partly derived from any amount that was not declared to the Commissioner in terms of the Income Tax Act or the Estate Duty Act 45 of 1955.

For purposes of this thesis, reference will only be made to Exchange Control Amnesty provisions that relate to the Income Tax Act.

In terms of section 6 of the Exchange Control Amnesty and Amendment of Taxation Laws Act, where a close corporation applied for amnesty, in respect of any foreign asset held on the 20 February 2003 in contravention of the Exchange Control Regulations, it was required *inter alia* to:

- disclose the market value of that asset in the foreign currency in which that foreign asset is situated;
- describe the characteristics and the location of that foreign asset;
- submit the market value of that foreign asset in the foreign currency of the country in which it is located;
- disclose receipts or accruals of that foreign asset that were derived from a source outside the Republic that were not disclosed to the Commissioner for the previous year of assessment.

After complying with all the requirements of the Act, the applicant would not be liable for the payment of any amount in terms of the Income Tax Act. The applicant would also be deemed not to have committed any offence in terms of that Act, in respect of any receipts or accruals of a foreign asset that were derived from a source outside the Republic during any year of assessment

73 Act 12 of 2003.

ending on or before 28 February 2002, which were not declared to the Commissioner.⁷⁵

9.8.2 EXCHANGE CONTROL AMNESTY PROVISIONS THAT RELATE TO TRUSTS

The 2003 Exchange Control Amnesty and Amendment of Taxation Laws Act,⁷⁶ is also relevant to offshore trusts. Section 4(1) of the Act provides that a donor in relation to a non-resident discretionary trust could elect that any foreign assets, held by that discretionary trust on the 28 February 2003, be deemed to be held by the donor. Donors were granted amnesty with respect to the foreign assets of the discretionary trust on condition that the donors elected to be treated as directly holding that trust's assets for tax purposes.⁷⁷ The assets contemplated by this provision, were those acquired by the foreign discretionary trust, by way of a donation made by the donor, or assets derived wholly or partly from any unauthorised asset, or from any amount not declared by the donor to the Commissioner, as required by the Income Tax Act 1962 (or the Estate Duty Act 1955).⁷⁸ It was a requirement that at the time of the election, the asset should not have vested in any beneficiary of that discretionary trust. This implied that applicants could only apply for amnesty, if the foreign asset was held by the trust on 28 February 2003.⁷⁹

74 This section also provides that, natural persons (including the deceased estate of a natural person) and trusts, could also apply for amnesty. A discussion of the Exchange Control Amnesty provisions that relate to trusts is dealt with in chapter 7.

75 Section 15 of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003.

76 Act 12 of 2003.

77 Regulation 4 of the Explanatory Memorandum on the Regulations Published in Terms of s 30 of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003.

78 S 4(2) of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003.

79 S 4(2)(c) of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003. See also Regulation 4 of the Explanatory Memorandum on Act 12 of 2003. In terms of s 4(3) of this Act, a person who made such an election in relation to a foreign asset, was deemed to have held that foreign asset from the date that the discretionary trust acquired that foreign asset. For the purposes of the Income Tax Act, for the year of assessment that ended 28 February 2003, if the foreign asset was disposed of by the discretionary trust to any person, the person that made the election was deemed to have disposed of that foreign asset for a consideration equal to its market value on the date of disposal. A deemed disposal could include a transfer of funds to a foreign trust due to under-invoicing or over invoicing (ie sales or purchases at other than fair market value), as well as other forms of indirect donations, such as trust distributions from other trusts

Section 4(3)(b) of the Act provides that where such an election was made, the provisions of sections 7(5),7(8) and 25B of the Income Tax Act 1962, and paragraphs 70,72 and 80 of the Eighth Schedule to the Income Tax Act, would not apply in respect to any income, expenditure or capital gain relating to that foreign asset, while it was deemed to be held by that person.

The enactment of this Act seems to have had an effect on the use of offshore trusts as a tool for tax avoidance. Although the parties that disclosed their investments in offshore trusts were awarded the amnesty, this was for only one year of assessment. For SARS, this amnesty was an exposure of the magnitude of offshore investments that were not taxed, thus creating an opportunity for expanding the South African tax base.

It was noted that after the 2003 Exchange Control Amnesty and Amendment of Taxation Laws Act came in force, the secrecy of offshore trusts, which is one of its appealing features, appears to have been thwarted.⁸⁰ A number of South Africans considered transferring the administration of their offshore trusts onshore, or winding the trusts up and distributing the assets.⁸¹ Some tax advisers encouraged South African offshore investors to explore new offshore investment vehicles as alternatives to offshore trusts.⁸² For instance, Spitz⁸³ advised that South Africans should rather set up offshore companies – for instance companies limited by guarantee, which (unlike offshore trusts) are less difficult and expensive to administer, and can be used either independently or in conjunction with an offshore trust.

acting at the instance of the donor. See Regulation 2 of the Explanatory Memorandum on Act 12 of 2003.

80 B Cameron “Why Offshore Trusts Have Lost Their Appeal” (26 July 2003) *Personal Finance* at 1. Available at ><http://www.persfin.co.za/index.php?fSectionId=706&ArticleId=196524><, last accessed 4 June 2007.

81 Investec Bank (UK) Ltd (Investec Trust) “Post-amnesty Planning: Remain Offshore or Repatriate Funds” at 1. Available at ><http://www.investec.co/NR/rdonlyres/114C2988-0095-45EF-B5C0-40CFE13F1FD9/1433/PostAmenstyplanning.pdf><, last accessed 9 July 2007.

82 Cameron at 1.

83 As quoted by Cameron at 1.

However, some tax advisers were against South Africans transferring trusts onshore, as there could still be tax savings if the trusts were left offshore.⁸⁴ It is, for instance, advised that, if the donor dies, the provisions deeming the income and capital gains to be those of the donor fall away and future income and gains could be accumulated in the offshore trust without being liable to South African tax. In addition, where there is no living South African donor, a beneficiary in respect of a distribution from an offshore trust, who is not resident for South African tax purposes, should not be liable to South African tax (although there may be tax in the country where the beneficiary is resident). With the increasing “globalization” of families, this can prove very advantageous and provide a significant tax saving opportunity. It is also suggested that, if payments to non-resident beneficiaries are timed correctly, it may be possible for subsequent distributions to be made to South African resident beneficiaries without tax liability. The reason being that as income and capital gains are taxed differently in South Africa, offshore trustees can ensure avoidance of tax by identifying suitable investment products that ensure that the returns are in the form of capital gains that are not liable to tax. At the same time, they can defer taxation of the income indefinitely by accumulating it offshore, or investing it in offshore companies.⁸⁵

Results of the Exchange Control Amnesty

The following are the findings of the Treasury,⁸⁶ with respect to the responses to the 2003 Exchange Control Amnesty. The initial deadline for submission of applications was 30 November 2003. Ten thousand applications for amnesty were received in November 2003. The Minister of Finance then announced an extension of the deadline for the submission of applications from 30 November 2003 to 29 February 2004. A taxpayer could regularise his affairs by paying an Exchange Control Levy of 10% of the market value of an illegal asset retained offshore or 5% if that asset was repatriated. Illegal tax liabilities would be forgiven

84 Investec Bank (UK) Ltd (Investec Trust) at 1.

85 Investec Bank (UK) Ltd (Investec Trust) at 1.

86 Treasury “Taxation”. Available at <http://www.treasury.gov.za/documents/mtbps/2004/mtpbs/Chapter%204.pdf> Last accessed on 20 March 2007.

generally without additional cost (or at an additional cost of a 2% levy for certain domestic tax violations). A total of about 43 000 applications were received before the deadline of 29 February 2004. By September 2004, a total of 16 033 applications had been adjudicated with total levies payable of about R826 million. In reaction to a number of representations, further administrative concessions were made in terms of which certain categories of offshore income and assets could be regulated via a declaration to the Exchange Control Department of the South African Reserve Bank. In terms of this concession, approximately 11 300 applications were received by the deadline of 29 February 2004. An additional 1 227 applications were received by the Exchange Control Department of the South African Reserve Bank relating to the unwinding of “loop structures”. Levies amounting to approximately R52 million were paid in this regard by the end of August 2004. In terms of applications approved for emigrants to transfer their remaining blocked assets abroad, a total amount of R238,2 million in respect of the 10 per cent exit charge were credited to the Corporation for Public Deposits.⁸⁷

Conclusions regarding the tax amnesty

Although South Africa lost the tax that it could have been collected from the applicants, the tax amnesty was advantageous to the economy, as it encouraged the relevant taxpayers to repatriate their income to South Africa, where it could possibly be reinvested. To qualify for the amnesty, the applicants were required to disclose and describe their foreign assets, and the countries in which the assets were located. By disclosing previously unreported assets, South Africa’s tax base for the proceeding tax years was expanded without the benefit of amnesty for those years.

9.9 CONCLUSIONS

87 Treasury “Taxation”. Available at <http://www.treasury.gov.za/documents/mtbps/2004/mtbps/Chapter%204.pdf> Last accessed on 20 March 2007.

From the above it can be concluded that the relaxation of the exchange controls ensures that foreign investment is encouraged. However, the Exchange Control Regulations make it illegal to transfer capital out of the Republic without the Exchange Control's approval. In this respect, the exchange controls complement the anti-avoidance legislation in that they prevent the outflow of capital from the South that would result in the depletion of the tax base. For instance the exchange controls have been instrumental in ensuring that "loop structures" are not used to transfer capital out of South Africa.

The complementary role of the exchange controls in preventing the depletion of South Africa's tax base will be even more effective if the Currency Exchanges Act is amended to include a definition of the term "resident" that is similar to the one in the Income Tax Act, subject to certain exceptions that may be particular to exchange controls.

CHAPTER 10

COMPARATIVE ANALYSIS

In chapter 1 of this thesis, it was pointed out that curbing offshore tax avoidance requires a concerted effort at both the international and the national levels. At the international level, harmful tax competition can be prevented if countries adhere to the recommendations of the OECD. In this chapter, a comparative analysis is made of the ways in which the United Kingdom, the United States and South Africa have responded to the OECD recommendations on preventing harmful tax competition. This analysis is followed by comments on the effectiveness of those recommendations in curbing offshore tax avoidance in South Africa.

At the national level, offshore tax avoidance can be prevented if countries have effective anti-tax avoidance legislation in place. This chapter also contains a comparative analysis of the offshore anti-tax avoidance laws and policies of the above-mentioned countries in relation to offshore companies and trusts. Finally, the effectiveness of South Africa's legislation in curbing offshore tax avoidance is commented on.

10.1 INTERNATIONAL MEASURES TO CURB HARMFUL TAX COMPETITION

10.1.1 THE LISTING OF TAX HAVENS

OECD recommendation

The OECD recommended that countries should come up with lists identifying tax-haven jurisdictions and harmful tax regimes so as to ensure that links with those countries are not used to promote harmful tax competition.⁸⁸

United Kingdom

In terms of the controlled foreign company (CFC) provisions, certain countries have been identified and "black-listed" as tax havens. A company resident in one

of the listed territories will only be excluded from CFC provisions if it carries on business in a foreign country, and at least 90% of its income or profits are generated in that country.⁸⁹

United States

Subpart F income includes certain income from “black-listed” countries.⁹⁰

South Africa

South Africa does not have legislation in place which black-lists tax havens. The closest that South Africa has ever come to compliance with this recommendation was the old section 9E(8) (now repealed) of the Income Tax Act, which empowered the Minister of Finance to exclude from CFC provisions specific forms of income derived from designated countries, the list of which was published by notice in the *Government Gazette*.⁹¹

Comments

The repeal of the exclusion from the CFC rules of specific forms of income derived from designated countries is to be commended. A number of countries objected to not being listed, although they had concluded a double taxation agreement with South Africa. It was argued that countries that were not on the

88 OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) in par 75. See discussion in chapter 2 par 2.4.5.

89 United Kingdom Controlled Foreign Companies (Excluded Countries) Regulations 1998 (SI 1998/3081); B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at UK/23; R Chidell & S Laing *Tax Planning: Business* (2005-2006) at 739. See discussion in chapter 5 par 5.1.3.

90 Subpart F income includes: “Certain other income to the extent that the CFC has an ‘international boycott factor, certain illegal payments to government officials and certain income from ‘blacklisted’ countries”. S 952(a)(3), (4), and (5) of the Code.

91 S 9E was repealed by Revenue Laws Amendment Act 45 of 2003 with effect from 1 June 2004. See discussion in chapter 2 par 2.6.

list were potentially black-listed.⁹² It was further contended that the listing of countries could have negative connotations that might prove a disincentive to foreign investment in South Africa.

10.1.2 TERMINATING TREATIES WITH UNCOOPERATIVE TAX HAVENS

OECD recommendation

The OECD recommended that countries should consider terminating their tax treaties with tax-haven jurisdictions that are used to encourage harmful tax competition.⁹³

United Kingdom

The United Kingdom has concluded tax treaties with a number of tax havens, most of which are United Kingdom dependent territories.

United States

The United States applies harsh measures when the treaties it has negotiated with particular tax havens are used to promote harmful tax competition. For instance, the United States terminated the old treaty with the Netherlands, which encouraged harmful tax competition, and a new treaty was renegotiated.⁹⁴ The treaty with the Netherlands Antilles was also terminated.⁹⁵ In 1984, the United States suspended the treaty it had concluded with the United Kingdom-linked territories, like the Virgin Islands, to which the United States/United Kingdom treaty applied by extension.⁹⁶

92 L Olivier & M Honiball *International Tax: A South African Perspective* 3 ed (2005) at 120.

93 OECD 1998 Report in par 76. See discussion in chapter 2 par 2.4.5.

94 M Barrett, HLB Nathans "Trading in Ireland: The Low Corporate Tax Regime" *Offshore Investment.com* (May 2004) Issue 146 at 25.

95 WH Diamond & DB Diamond *Tax Havens of the World* (Release No 108 Jan 2002) vol 1 at INTRO 10.

96 C Doggart "Tax- Havens and their Uses" *The Economist Publication* (1990) Special Report No 1191 at 93-94.

South Africa

South Africa has concluded treaties with a number of tax-haven countries, namely Cyprus, Malta, Mauritius, Singapore, the Seychelles and Luxembourg.⁹⁷ These treaties could encourage harmful tax competition. The treaty with Mauritius, for instance, contains a tax sparing clause that could encourage South African residents to set up offshore companies in Mauritius to take advantage of the tax-sparing benefits.⁹⁸

Comments

Severing treaties with tax-haven countries may not necessarily be the right approach for South Africa. Tax treaties are not generally negotiated on tax considerations alone. Treaties are also used to attract foreign investment and to encourage offshore activities. However, where the loss of tax revenue is significant compared with the other non-tax benefits of a particular tax treaty, steps have to be taken to curb the ensuing tax avoidance.

10.1.3 EXCHANGE OF INFORMATION

OECD recommendation

The OECD recommended that countries should make an effort to intensify international cooperation and exchange of information concerning transactions that constitute harmful tax competition. The OECD came up with a Model Agreement on Exchange of Information on Tax Matters, which serves as a model

97 Olivier & Honiball at 24.

98 See discussion in chapter 2 par 2.6.

for the negotiation of bilateral or multilateral agreements.⁹⁹ This Model Agreement is now being used by a number of countries, and it forms the basis for several tax information exchange agreements between countries.¹⁰⁰

United Kingdom

The United Kingdom signed the OECD Convention on Mutual Administrative Assistance in Tax Matters.¹⁰¹ The Convention makes it easier for tax administrators to work together to enforce their national tax laws.

United States

The United States signed the OECD Convention on Mutual Administrative Assistance in Tax Matters, but reserved the right not to provide any assistance in respect to certain articles of the Convention.¹⁰²

South Africa

South Africa has mutual administrative assistance agreements in place that could serve the same purpose as the OECD Model Agreement on Exchange of Information on Tax Matters. South Africa has signed a number of these agreements with various nations.¹⁰³ Similar agreements have been negotiated

99 OECD "Model Agreement on Exchange of Information on Tax Matters". Available at ><http://www.oecd.org/dataoecd/15/43/2082215.pdf><, last accessed on 18 May 2007.

100 See discussion in chapter 2 par 2.5.

101 OECD "Exchange of Information: UK signs OECD Convention on Mutual Administrative Assistance in Tax Matters". Available at >http://www.oecd.org/documents/35/0,2340,en_2649_33767_38645475_1_1_1_1,00.html<, last accessed on 30 May 2007.

102 OECD "Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters – Declaration from the United States". Available at >http://www.oecd.org/document/55/0,3343,en_2649_201185_2498807_1_1_1_1,00.html<, last accessed on 17 July 2007.

103 South African Revenue Service "Current List of Customs Agreements on Mutual Administrative Assistance" (12 December 2006). Available at ><http://www.sars.gov.za/it/DTA/Customs%20Agreement/Current%20List.htm><, last accessed on 17 May 2007.

with other nations, and further agreements are still under negotiation. Acting upon these agreements will help South Africa to obtain the necessary information to curb the harmful tax practices that any of these countries may be involved in, even if they are not tax havens themselves.¹⁰⁴

Comments

South Africa has not entered into mutual administrative assistance agreements with tax-haven countries. It has nevertheless signed double taxation agreements with some tax-haven countries.¹⁰⁵ Signing mutual administrative assistance agreements with tax-haven countries would enhance the exchange of information concerning transactions that constitute harmful tax competition.

10.1.4 EMPLOYING THE RESIDENCE BASIS OF TAXATION

OECD recommendation

The OECD recognises the residence basis of taxation as effective in curbing offshore tax avoidance.¹⁰⁶ A dual-resident entity is deemed to be resident in the state where it is effectively managed, and that state can tax its worldwide income. The “place of effective management” is where the key management and commercial decisions of an entity are made by the most senior persons.¹⁰⁷ However, with technological advances, the OECD meaning of the term “place of effective management” could be manipulated to avoid taxes as e-commerce makes it possible for an entity to be managed in multiple places. This could have the effect of rendering the OECD meaning of the term ineffective as a tie breaker test for dual-resident entities.¹⁰⁸

104 See discussion in chapter 2 par 2.6.

105 The tax-haven countries that South Africa has signed double taxation agreements with are Cyprus, Malta, Mauritius, Singapore, the Seychelles and Luxembourg. See Olivier & Honiball at 24. See also discussion in chapter 2 par 2.6.

106 In terms of art 4(1) of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version).

107 Art 4(3) of the OECD Model Tax Convention on Income and on Capital.

108 See discussion in chapter 3 par 3.7.

United Kingdom

The residence basis of taxation is used to tax the worldwide income of resident entities.¹⁰⁹ A company incorporated in the United Kingdom is a resident, even if it is not managed and controlled there. The “central management and control” of a company is used as a test of residence only in respect of companies registered abroad.¹¹⁰ A dual-resident company is resident where it is effectively managed. Inland Revenue regards the place of effective management as the place where the day-to-day management of a company is carried on, which may not be the place where the highest policy decisions of the company are taken.¹¹¹

United States

The residence basis of taxation is used to tax the worldwide income of entities incorporated in the United States. The “place of incorporation” is used to determine the residence of corporations.¹¹² However, the “place of incorporation” is not an effective tie-breaker test. It may merely reflect a corporation’s formal tie with one country while its entire management, business operations and assets are located in another country. In the present e-commerce environment this test can easily be manipulated for purposes of tax avoidance.¹¹³

South Africa

The residence basis of taxation is used to tax the worldwide income of South African residents. An entity is “resident” if it is incorporated, established or formed, or has a place of effective management in South Africa.¹¹⁴ There is no definition of “place of effective management” in the Income Tax Act, and there is no case law to provide guidance on its interpretation. However, the South African Revenue Service (SARS) regards the “place of effective management” as the

109 B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at UK/4-10.

110 See discussion in chapter 3 par 3.7.

111 G Clarke *Offshore Tax Planning* 9 ed (2002) at 272. See discussion in chapter 3 par 3.7

112 S 11 of the Internal Revenue Code 1954; See discussion in chapter 3 par 3.8.

113 See discussion in chapter 3 par 3.8.

114 The definition of “gross income” in s 1 of the Income Tax Act 58 of 1962.

place where a company is managed on a regular day-to-day basis by the directors or senior managers. This is the place where company policy and strategic decisions are carried out, irrespective of where the overriding control is exercised, or where the board of directors meets.¹¹⁵

Comments

Of the three countries, it is only the United States that does not apply the “place of effective management” as a test for company residence. It uses only the “place of incorporation” test.

In South Africa, SARS’s interpretation of “place of effective management” may limit the possibility of multiple residences, and the possibility of tax avoidance, as the actual implementation of senior managers’ commercial and management decisions is less likely to occur in more than one location. However, SARS’s Interpretation Notes are not law and in a number of cases it has been argued that SARS is not bound by its own Practice Notes and Interpretation Notes.¹¹⁶ Although SARS’s Interpretation Notes may provide some guidance, South African courts are not bound to follow them.

10.1.5 ADOPTING EFFECTIVE ANTI-AVOIDANCE LEGISLATION

OECD recommendation

The OECD has recommended that countries should adopt effective legislation to curb offshore tax avoidance. Such legislation includes “controlled foreign company” (CFC) legislation, which is dealt with in this thesis.¹¹⁷ The OECD has stated that CFC rules help in countering the transfer of profits to low-tax jurisdictions by targeting passive and low-tax income rather than the profits of the CFC itself.¹¹⁸ Paragraph 23 of the “Commentary on article 1” states that CFC

115 Income Tax Interpretation Note 6 of 26 March 2002.

116 *ITC 1675* (1998), 62 SATC 219 (G) at 229A.

117 OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) in par 67-71. See chapter 2 fn 27 and also the discussion in chapter 4.

118 OECD *Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation* (2000) at 10.

rules have been adopted by a significant number of OECD Member and non-Member countries, and that they “are now internationally recognised as a legitimate instrument to protect the domestic tax base”.

United Kingdom

The United Kingdom enacted CFC legislation in 1984.¹¹⁹ In terms of section 747(1) and (2) of the Income and Corporations Taxes Act 1988 (ICTA), a CFC is a foreign company that is controlled by United Kingdom shareholders who hold at least a 25% interest in the foreign company. The foreign company should be subject to “a lower level of taxation” (ie less than 75% of the corresponding United Kingdom tax).

The United States

The United States enacted CFC (“Subpart F”) provisions in 1962.¹²⁰ In terms of section 957(a) and (b) of the Internal Revenue Code (the Code), a CFC is a foreign corporation if more than 50% of the total combined voting power of all classes of voting stock is owned by United States shareholders on any day during the taxable year of the CFC.

South Africa

CFC legislation was introduced in South Africa in 1997.¹²¹ In terms of the current section 9D(1) of the Income Tax Act (the Act), a CFC is a foreign company if one or more South African residents, directly or indirectly, hold more than 50% of the total participation rights of the company, or if more than 50% of the voting rights of that foreign company are held (or exercisable) directly or indirectly by one or more residents.

119 The provisions are set out in ss 747-756 and Schedules 24-26 to the Income and Corporations Taxes Act (ICTA) 1988.

120 Rotterdam Institute for Fiscal Studies *International Tax Avoidance* Vol A (1979) at 272.

121 CFC legislation was introduced in terms of s 9C and s 9D of the Income Tax Act 28 of 1997. The then s 9C has been repealed but s 9D has been amended.

Comments

There are two basic approaches to applying CFC legislation, namely the “jurisdictional approach” and the “transaction approach”. In terms of the “jurisdictional approach” tax-haven companies are identified and the shareholders are taxed on all the income of the companies, regardless of its source or nature. The United Kingdom follows this approach.¹²² In terms of the “transaction approach” only the tainted income (eg passive income) of the CFC is attributed pro rata to domestic shareholders.¹²³ This is the approach followed by the United States. In South Africa the initial CFC legislation followed the “transaction approach”, as only investment income of a foreign company or a foreign trust was attributed to the South African controller.¹²⁴ When South Africa moved to the residence basis of taxation with effect from years of assessment commencing on or after 1 January 2001, the CFC legislation was amended to follow the “entity approach”, as not only investment income but all income, including capital gains that accrue to or are received by a CFC, is attributed to the South African resident controller.¹²⁵

10.2 NATIONAL MEASURES TO CURB TAX AVOIDANCE: OFFSHORE COMPANIES

10.2.1 CFC RULES CONTINUED

In paragraph 9.1.5 above, the workings of the CFC rules in the United Kingdom, the United States and South Africa were briefly compared. This comparison will now be explored in more detail with respect to how the exemptions from the CFC rules work in these countries.

Exemptions from the United Kingdom’s CFC rules

122 BJ Arnold & MJ McIntyre *International Tax Primer* 2 ed (2002) at 94.

123 Arnold & McIntyre at 94.

124 See Olivier & Honiball at 394. The previous s 9C of the Income Tax Act 28 of 1997, which was repealed by s 9 of the Revenue Laws Amendment Act 59 of 2000, defined investment income as including any income in the form of any annuity, interest, rental income, royalty income or other income of a similar nature.

The acceptable distribution policy: In terms of paragraph 2 of Schedule 25 to ICTA, an exemption is granted where a CFC distributes at least 90% of its net chargeable profits for the accounting period to its United Kingdom shareholders, if the dividends are taxable in their hands.

The exempt activities test: In terms of paragraph 7 of Schedule 25 of ICTA, an exemption applies if throughout the accounting period in question the CFC has a business establishment in the territory in which it is resident and its business affairs in that territory are effectively managed there.

The public quotation test: In terms of paragraphs 13-152 of Schedule 25, an exemption applies if the CFC is listed on a recognised stock exchange in the country in which it is resident.

The motive test: In terms of paragraphs 16-19 of Schedule 25, an exemption is granted if the reduction of United Kingdom tax, through the diversion of profits away from the United Kingdom, was not one of the main purposes of the company's existence.

The low profit exemption test: In terms of section 748(1)(d) of ICTA, a CFC charge does not arise if the chargeable profits of the CFC are below £50 000 in any accounting period (the *de minimis* rule).

Exemptions from the United States' CFC rules

Under section 952(a)(1) and (2) of the Code, CFC rules cover two principle categories of income, namely insurance income and foreign base company income.¹²⁶

125 Olivier & Honiball at 394.

126 Note however that subpart F income also includes the following: "Certain other income to the extent that the CFC has an 'international boycott factor, certain illegal payments to government officials and certain income from 'blacklisted' countries". S 952(a)(3), (4), and (5) of the Code.

(1) Insurance income: This income is included in the CFC rules in terms of section 953(a) of the Code. Under section 953(e)(3)(A)-(C) of the Code, insurance income is exempt from CFC provisions if it is income of a “qualifying insurance company”. That is, an insurance company that has a “real business nexus” with a foreign country. It should also be regulated as an insurance company by its home country, and it should derive 50% of its total net written premiums from insurance or reinsurance by such CFC.

(2) Foreign base company income (FBCI): In terms of section 952(a)(3) of the Code, FBCI includes foreign personal holding company income, foreign base company sales income, foreign base company service income and foreign base company oil-related income.¹²⁷

(a) Foreign personal holding company income (FPHCI): The various components of this income are set out in section 954(a)(1).¹²⁸ Only the components of this income that are comparable to South Africa’s CFC legislation are discussed in this chapter.¹²⁹

(i) Dividends are covered under FPHCI in terms of section 954(c)(c)(1) of the Code. There is however an exclusion from FPHCI where dividends are received from a CFC that has a subsidiary which also has a CFC. Dividends from the lower-tier CFC do not trigger a second tax for the United States shareholder.¹³⁰ FPHCI also excludes dividends received from a “related” CFC that was created in the same foreign country as the CFC in issue, where substantial parts of the assets used in the related CFC’s trade are located in the same foreign country.¹³¹

(ii) In terms of section 954(c)(c)(1)(A) of the Code, interest income of a CFC is covered under the FPHCI. This, however, excludes interest derived in the

127 The last category is not discussed in this work owing to its limited relevance in regard to South Africa’s CFC legislation.

128 See chapter 5 par 5.2.1 under the heading “Foreign personal holding company income”.

129 See chapter 5 par 5.2.1 under the heading “Foreign personal holding company income”.

130 S 959(b) of the Code.

131 S 954(c)(3)(A)(i) of the Code; Treas Reg s 1.954-2(b)(1)(i).

conduct of a banking business and “export financing interest”.¹³² CFC provisions also exclude interest received from a “related” CFC that was created in the same foreign country as the CFC in issue, where substantial portions of the assets used in the related CFC’s trade are located in the same foreign country.¹³³

(iii) In terms of section 954(c)(c)(1)(A) of the Code, a portion of the gross income of a CFC that consists of royalties is generally FPHCI. There are, however, exemptions for certain royalties derived in an active business and for certain royalties received from related persons.¹³⁴

(iv) Under section 954(h)(1) of the Code, the “qualified banking or financing income” of an eligible CFC is excluded from CFC provisions. An eligible CFC means a CFC that is predominantly engaged in the active conduct of banking, financing or similar business and conducts substantial activity with respect to that business. But as an anti-abuse measure, this exclusion does not apply to any income, gain, loss or deduction of any entity that is not engaged in regular and continuous transactions with customers that are not related persons.

(b) Foreign base company sales income (FBCSI): This income is included in the CFC provisions under section 954(d) of the Code. A sales transaction generates FBCSI only if a related person is involved as a seller or buyer. Income from a sale is excluded from FBCSI if the goods are manufactured, produced, grown or extracted in the country from which the CFC is organised.

(c) Foreign base company service income: This income is included in the CFC provisions under section 954(e) of the Code. This is income derived from the performance of services, such as technical, managerial, engineering, architectural, scientific, skilled or industrial services. The CFC must perform these services for or on behalf of a related person. The services must be performed in the country where the corporation was created. Income from these services is excluded if it relates directly to the sale or exchange by the corporation of property manufactured, produced, grown or extracted by the

132 S 954(c)(2)(B) of the Code.

133 Treas Reg s 1.954-2(b)(4).

corporation.

The United States has also enacted special provisions to deal with domestic portfolio investments in foreign investment companies. These provisions are referred to as “passive foreign investment company” (PFIC) rules.¹³⁵ They are aimed at the deferral of United States tax on passive income earned abroad through an investment fund that is run from outside the United States and that does not distribute its income annually.

Exemptions from South Africa’s CFC rules

Under section 9D(9)(b) of the Act, a “foreign business establishment” is excluded from CFC rules. For a place of business to qualify as a “foreign business establishment”, there must be an “economic substance” and “a business purpose”.¹³⁶ As an anti-avoidance measure, the Act provides that this exemption does not apply to certain diversionary transactions between a CFC and a connected person.¹³⁷ Section 9D certain circumstances in terms of which the “foreign business establishment” exemption will not be granted. Section 9D(9)(b)(i) deals with rules that relate to diversionary activities and section 9D(b)(ii) deals with reversionary rules.

Diversions activities:

In terms of section 9D(9)(b)(i), no exemption will be granted where the net income of a “foreign business establishment” of a CFC is derived from transactions with its connected person (who is a resident) relating to the supply of goods or services by or to the CFC unless the price at which such transactions take place is an arm’s length price in terms of section 31 of the Income Tax Act.¹³⁸

134 Treas Reg s 1.954-2(b)(1)(iii).

135 See discussion in chapter 5 par 5.2.2.

136 Olivier & Honiball at 374.

137 See discussion in chapter 4 par 4.4 under the heading “The foreign business establishment exemption”.

138 See discussion in chapter 4 par 4.4 under the heading “The foreign business establishment exemption”, particularly the discussion on s 9D(9)(b)(i).

Reversionary rules:

(a) Section 9D(9)(b)(ii)(aa) deals with “CFC in-bound sales”. In terms of this provision, the “foreign business establishment” exemption will not apply to net income that is attributed to any amounts derived from the sale of goods by the CFC to its connected person who is a resident. This provision is, however, subject to certain exceptions.¹³⁹

(b) Section 9D(9)(b)(ii)(bb) deals with “CFC out-bound sales”. In terms of this provision, the “foreign business establishment” exemption does not apply to net income that is attributed to any amounts derived from a sale of goods or any tangible intermediary inputs by the CFC to a non-connected person who is a resident, where these goods were initially purchased by the CFC from a connected person who is a resident. This provision is, however, subject to certain exceptions.¹⁴⁰ For instance, an exception applies where the creation, extraction, production, assembly, repair or improvement of goods undertaken by the CFC amounts to more than minor assembly or adjustment, packaging, re-packing and re-labeling. This provision is similar to the United States’ section 954(d) of the Code, which relates to “foreign base company sales income”. In both countries, CFC provisions apply in respect to the sale of goods between connected or related persons. However, in both countries the CFC provisions do not apply in respect to goods that are manufactured, produced or extracted in the country from which the CFC is organised.

(c) Section 9D(9)(b)(ii)(cc) deals with “CFC connected services”. In terms of this provision, the “foreign business establishment” exemption does not apply to net income that is attributed to any services performed by the CFC to its connected person who is a resident, unless the service is performed outside the Republic

139 See discussion in chapter 4 par 4.4 under the heading “The foreign business establishment exemption”, particularly the discussion on s 9D(9)(b)(ii)(bb).

140 See discussion in chapter 4 par 4.4 under the heading “The foreign business establishment exemption”, particularly the discussion on s 9D(9)(b)(ii).

under certain conditions.¹⁴¹ An example would be services that relate to the extraction or production of goods used outside the Republic. This provision is similar to the United States' section 954(e) of the Code, which deals with "foreign base company service income". In both countries, the CFC provisions do not apply in respect to income from services that relate to the extraction or production of goods by the CFC.

In terms of section 9D(9)(b)(iii), the "foreign business establishment" exemption does not apply to net income that is attributed to any amounts derived from mobile passive income of an enterprise. This provision is, however, subject to certain exclusions. For instance, the provision does not apply when the principal trading activities of the CFC from which the amounts arise are banking or financial services, insurance or rental businesses. An exception applies to the receipts and accruals of a CFC that was a "foreign financial instrument holding company" at the time they were derived.¹⁴² This provision acts as an anti-avoidance provision because it covers "foreign financial holding companies" that are located in tax-haven jurisdictions.¹⁴³ This provision is similar to the United States' section 964(h)(1) of the Code, which excludes the "qualified banking and financing income" of an eligible CFC from the CFC rules. Like the South African provision, the United States' provision contains an anti-abuse measure in that the exclusion does not apply to the banking or financing income of an entity that is not engaged in regular or continuous transactions with customers that are not related persons.

In terms of section 9D(9)(c) of the Act, CFC rules do not apply to income which is attributed to any policy issued by a company licensed to issue long-term insurance policies. This provision is similar to the United States' section 953(e)(3)(A)-(C) of the Code, which exempts insurance income from CFC provisions.

141 See discussion in chapter 4 par 4.4 under the heading "The foreign business establishment exemption", particularly the discussion on s 9D(9)(b)(ii)(cc).

142 See discussion in chapter 4 par 4.4 under the heading "The foreign business establishment exemption", particularly the discussion on s 9D(9)(b)(iii).

143 See Olivier & Honiball at 382.

Under section 9D(9)(e) of the Act, CFC rules do not apply to the net income of a CFC where it is included in the taxable income of the company in the Republic and has not been or will not be exempt or taxed at a reduced rate in the Republic as a result of the application of any double taxation agreements.

Under section 9D(9)(f) of the Act, foreign dividends declared to a CFC by another company from an amount that will be, or has been, included in the income of a resident are excluded from CFC rules. This is intended to avoid the double taxation of income. This provision is similar to the United States' section 959(b) of the Code which exempts from CFC provisions any dividends from a CFC that has a subsidiary which also has a CFC. The dividend from the lower-tier CFC does not trigger a second tax for the United States shareholder.¹⁴⁴

Under section 9D(9)(fA) of the Act, CFC rules do not apply to a CFC's income that is derived from any interest, royalties and rentals that are paid to it, or are deemed to have been paid to it by another foreign company, provided that both companies belong to the same group of companies. This provision appears to be similar to the United States' provisions which deal with "foreign personal holding company income" that relates to dividends, interest, rents and annuities. Although these categories of income are covered by the United States CFC rules, as in South Africa, there are exclusions where the particular income is received from a "related" CFC that was created in the same foreign country where the CFC in issue was created and substantial parts of the assets used in the related CFC's trade are located in the same foreign country.¹⁴⁵

In South Africa, there are no specific anti-avoidance rules that relate to foreign investment schemes, as is the case in the United States. However it is worth noting that section 9D(1) of the Income Tax Act refers to foreign investment schemes (unit trusts). In terms of this provision CFC rules apply where more than 50% of the participation rights or voting rights of a foreign collective investment

144 JD Kuntz & RJ Peroni *US International Taxation* Vol 1 (2005) at B3-78.

145 See s 954(c)(3)(A)(i) of the Code in respect of dividends, Treas Reg s 1.954-2(b)(4) in respect to interest and Treas Reg s 1.954-2(b)(1)(iii) in respect to royalties. For details, see the discussion in chapter 5 par 5.2.1 under the heading "Foreign personal holding company income".

scheme are held by South African residents. But the rules do not apply to residents who are connected persons, if they individually hold less than 5% of the participation rights or voting rights in a foreign collective investment scheme.¹⁴⁶ The intention of this provision is to lessen the administrative burden on tax authorities. This provision acts as a *de minimis* rule.

Comments

In all three countries, there is some form of *de minimis* rule. The United Kingdom rules do not apply if the chargeable profits of a CFC are below £50 000 in any accounting period.¹⁴⁷ The United States rules apply only if more than 50% of the voting power of all classes of voting stock is owned by United States shareholders on any day during the taxable year of the CFC.¹⁴⁸ In South Africa, the rules apply where more than 50% of the total participation rights or voting rights of a CFC are held by South African shareholders. The rules do not apply to residents who are connected persons if they individually hold less than 5% of the participation rights or voting rights in a foreign collective investment scheme.¹⁴⁹

Unlike the United Kingdom's provisions, the South African CFC rules do not have a motive test that discriminates between genuine investors and those who are not genuine. In this respect, it could be argued that the South African provisions cover such a wide scope of transactions that greater administrative capacity may be required to deal with the numerous issues that could arise. It could also be argued that since the South African provisions do not discriminate between genuine investors and those who are not genuine, this may deter foreign investors. It is, however, worth noting that some of the exemptions to the CFC rules, for instance the "foreign business establishment" exemption, cover situations that concern genuine investors.

The workings of the exemptions to the South African CFC provisions seem to be similar to those of comparable provisions in the United States. It is noteworthy,

146 See the discussion of the South African CFC legislation in chapter 4.

147 S 748(1) (d) ITCA 1988.

148 S 957(b) and s 957(a) of the Code, Treas Reg s 1.951-1(g), 1.957.1.

however, that all three countries have an exemption that deals with “business establishments”.¹⁵⁰ As an anti-avoidance measure, schemes involving the sale of goods or services between related or connected parties are excluded from this exemption.

10.2.2 CFC REPORTING REQUIREMENTS

United Kingdom

Sections 112-113 and Schedule 17 of ICTA bring CFC provisions into line with the United Kingdom corporation tax self-assessment regime, which became effective from 1 July 1999. Any company which has an interest in a CFC must complete a supplementary page to the self-assessment return, unless the CFC falls within the “Excluded Countries Regulations”, or the interest of the United Kingdom company and that of persons connected or associated with it is less than 25%.¹⁵¹ The onus rests on the United Kingdom resident to disclose the details of his interests in foreign subsidiaries and associated companies.¹⁵²

The United States

United States shareholders who own 10% or more of the total combined voting power of all classes of voting stock of a CFC must disclose their names, street addresses and taxpayer identification numbers, their proportionate share of subpart F income and the percentage value of the shares of the CFC that they

149 See comparative study of these countries' CFC legislation as set out above.

150 In South Africa, s 9D(9)(b) previously referred to the “business establishment” exemption to the CFC rules but in terms of the Revenue Laws Amendment Act 20 of 2006, the term “business establishment” was deleted from the Act and replaced by the term “foreign business establishment”.

151 D Whitecross & J Pearse “Controlled Foreign Companies and Self Assessment” (1998) *British Tax Review* at 9-10.

152 See discussion in chapter 5 par 5.1.6.

own.¹⁵³

South Africa

Section 72A(1) of the Income Tax Act imposes a duty on every South African resident who has shares in a CFC, to submit certain information about the CFC to the Commissioner.¹⁵⁴

Comments

The United Kingdom self-assessment provisions and section 72A(1) of the South African Income Tax Act work in a similar manner, in that they place the onus on taxpayers to disclose information about their interests in a CFC.

10.2.3 CONFLICT BETWEEN CFC LEGISLATION AND TAX TREATIES

The OECD's views

Although it is argued that CFC legislation conflicts with certain fundamental principles of tax treaties,¹⁵⁵ the OECD recognises implicitly that CFC legislation does not raise treaty problems.¹⁵⁶ Paragraph 23 of the Commentary on 1 of the OECD Model Convention states that “whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.”

United Kingdom

153 Internal Revenue Code Regulations s 1.883-1. See discussion in chapter 5 par 5.2.3.

154 For details of the information that should be disclosed to the Commissioner, see the discussion in chapter 4 par 4.6.

155 See discussion in chapter 4 par 4.7.

156 Par 23 of the Commentary on art 1 and par 37 of the Commentary on art 10 of the OECD Model Convention.

Section 788(3) of the ICTA provides that the arrangements specified in the treaty shall “notwithstanding anything in any enactment” have effect in relation to income tax and corporation tax in so far as they provide relief from income tax in respect of income or chargeable gains. Upon entry into force in the United Kingdom, the provisions of the treaty are recognised as having the authority of statute law. Where there is a conflict between existing law and the treaty provisions, the treaty will prevail,¹⁵⁷ but where there is a conflict between the treaty as adopted in United Kingdom law and a subsequent legislative enactment, the subsequent enactment prevails. However, the use of the phrase “notwithstanding anything in any enactment” in section 788(3) suggests that treaty provisions would supersede subsequent domestic legislation.¹⁵⁸

The United Kingdom maintains that its CFC legislation is compatible with its tax treaties. This is based on the premise that, in terms of section 747(6)(a) of the ICTA, the CFC legislation calculates the notional corporate tax payable by the CFC as if the CFC were resident in the United Kingdom. The tax can then be apportioned among resident shareholders who hold 25% or more of the CFC’s shares (*Bricom Holdings Ltd v IRC*¹⁵⁹). It is reasoned that this attribution-of-tax approach does not conflict with tax treaties.¹⁶⁰

United States

The legal status and relationship of domestic legislation and tax treaties is governed by the Constitution of the United States of America.¹⁶¹ Article VI(2) of the Constitution provides that federal legislation and treaties to which the United States is a party, as well as the Constitution are supreme law of the land. Thus

157 *Ostime v Australian Mutual Provident Society* (1995) 38 TC 492 at 514.

158 D Sandler *Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries* 2 ed (1998) at 51.

159 [1996] STC (SCD) 228.

160 See discussion in chapter 5 par 5.1.8.

161 The Constitution of the United States is the oldest Federal constitution in existence and was framed by a convention of delegates from twelve of the thirteen original states in Philadelphia in May 1787, Rhode Island failing to send a delegate. The Constitution is the landmark legal document of the United States. The Constitution comprises the primary law of the U.S. Federal Government. It also describes the three chief branches of the Federal Government and their jurisdictions. In addition, it lays out the basic rights of citizens of the United States.

statutes and treaties have equal status under the Constitution.¹⁶² There are provisions in the Internal Revenue Code and in tax treaties to which the United States is a party that operate to limit conflicts between treaties and the Internal Revenue Code. For example, the United States has in its domestic legislation the doctrine of “treaty override” that authorises the revenue authorities to disregard the terms of a double taxation agreement where tax avoidance is anticipated.¹⁶³

The United States maintains the position that its double tax treaties exist for the benefit of non-resident aliens only, not for residents or citizens of the United States. Under its “savings clause”, found in almost all its tax treaties, the United States may tax its citizens and residents as though the treaty had not come into effect. This is intended to limit the impact of the treaty provisions on domestic law to non-resident aliens. Thus its CFC provisions do not conflict with its tax treaties.¹⁶⁴

South Africa

In terms of section 9D(2A) of the Income Tax Act, the “net income” of a CFC is not its actual income, but an amount equal or similar to such is included in the income of a controlling resident, as if it had been a resident for the purposes of certain specified sections of the Act. This would accord with the United Kingdom decision in the *Bricom Holdings* case. As South African residents are taxed on notional amounts, it is unlikely that the courts will hold that South African residents will be entitled to rely on a double taxation agreement on the basis that the same amounts are effectively being taxed. Olivier and Honiball¹⁶⁵ note, however, that although South African residents are taxed on notional amounts, the issue of the conflict between CFC legislation and tax treaties is still unclear.

Comments

162 Sandler at 52.

163 R Rohatgi *Basic International Taxation* (2002) at 372; M Hampton *Offshore Interface: Tax Havens in the Global Economy* (1996) at 12.

164 See discussion in chapter 5 par 5.2.6.

165 Olivier & Honiball at 397. See the discussion in chapter 4 with reference to fn 171-175.

In South Africa, section 108(2) of the Income Tax Act, read with section 231 of the Constitution of the Republic of South Africa, 1996 provides that as soon as the double tax agreement is ratified and has been published in the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act.¹⁶⁶ This implies that treaty provisions and any other provisions of the Income Tax Act (eg section 9D) have equal status under South African law.¹⁶⁷

In effect South Africa's tax treaties do not override domestic law, even if there is a conflict between the two. In order to resolve a potential conflict, a South African court may have to consider domestic interpretation rules (such as *lex posterior derogate legi priori*)¹⁶⁸ and international interpretation rules (in so far as they are relevant). Section 232 of the Constitution of the Republic of South Africa provides that customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament. In this respect, the Vienna Convention on the Law of Treaties and the Commentary on the OECD Model Tax Convention can be referred to in order to resolve the conflict.¹⁶⁹ However, an attempt to interpret the treaty provisions using the various interpretation rules may not be effective in resolving the conflict between CFC rules and tax treaties.¹⁷⁰

It is therefore important that South Africa should come up with a specific provision in its domestic legislation or in its tax treaties that resolves the conflict between CFC legislation and South Africa's tax treaties.¹⁷¹

10.2.4 CHALLENGES E-COMMERCE POSES TO CFC LEGISLATION

OECD recommendations

166 D Meyerowitz *Meyerowitz on Income Tax* (2006/2007) in par 30.11.

167 Olivier & Honball at 30.

168 See the discussion in chapter 4 par 4.7 under the heading "South African rules of interpreting statutes".

169 See discussion chapter 4 par 4.7 under the heading "International interpretation rules".

170 See discussion in chapter 4 par 4.7 under the heading "International interpretation rules".

171 See recommendation in chapter 10 par 10.3.1.

In 1997, the OECD called on countries to cooperate on the formulation of a policy on the taxation of e-commerce.¹⁷² The OECD recommended that e-commerce should not be subjected to a new form of taxation, but that existing tax rules should be amended to cater for the taxation of e-commerce.¹⁷³ Furthermore, the taxation principles which are applied to conventional commerce (neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and the flexibility of taxation) should also apply to the taxation of e-commerce. In taxing e-commerce transactions, the fiscal sovereignty of countries should be maintained, so that each country is able to protect its tax base while at the same time avoiding double taxation and the unintentional non-taxation of e-commerce transactions.

The United Kingdom

Inland Revenue recognises that e-commerce poses challenges to the administration of tax legislation, as it makes it difficult to identify the parties to a business transaction or the place where the transaction was performed. In respect of CFC legislation, Inland Revenue acknowledges that this legislation was introduced in 1984 and largely reflects the world before e-commerce. This legislation may not be adequate to deal with e-commerce transactions. With e-commerce, the exemptions to the CFC legislation could be manipulated for tax avoidance purposes. These exemptions may need to be changed to ensure adequate protection of the tax base.¹⁷⁴

The government is, however, of the view that taxation should not be a barrier to the growth of e-commerce.¹⁷⁵ Tax rules and tax compliance should be neutral

172 See OECD "Dismantling the Barriers to Global Electronic Commerce" (November 1997). Available at http://www.oecd.org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00.html, last accessed on 4 June 2007.

173 OECD Ministerial Conference on Electronic Commerce: Ottawa Canada "A Borderless World" (October 1998). Available at <http://www.ottawaoecdconference.org/English/conference-program/agenda.pdf>, last accessed on 4 June 2007.

174 See discussion in chapter 5 par 5.1.9.

175 Inland Revenue "Electronic Commerce: The UK's Taxation Agenda" (1999) at 54. Available at <http://www.irwa.org.uk/e-commerce/resource/ecom.pdf>, last accessed on 16 July 2007.

between e-commerce and more traditional forms of commerce. The United Kingdom is working hand in hand with the OECD to develop internationally acceptable guidelines for the taxation of e-commerce.

The United States

Treasury recognises that e-commerce poses challenges to the enforcement of tax legislation. In respect of CFC legislation, treasury observed that if CFCs can engage in commerce, through websites located in tax-haven jurisdictions, it may become increasingly difficult to enforce subpart F legislation. Treasury noted that it may be necessary to revise subpart F and the regulations under it, in order to take e-commerce transaction into account.¹⁷⁶

The United States is, however, of the view that e-commerce is still in the early stages of its development and that it should therefore not be subjected to unnecessary regulation, as this would hamper its development. Furthermore, no new taxes should be imposed on e-commerce.¹⁷⁷ Its taxation should be consistent with the established principles of international taxation, should avoid inconsistent national tax jurisdictions and double taxation, and should be simple to administer and easy to understand. The United States is working hand in hand with the OECD in developing internationally acceptable guidelines for the taxation of e-commerce.

South Africa

The Katz Commission Report¹⁷⁸ noted that e-commerce impacts on the basic methods by which international taxation is currently levied, making irrelevant the concept of physical presence in order to trade. The Report noted that there is a need to protect South Africa's tax base from the tax avoidance that might arise

176 United States Treasury *Selected Tax Policy Implications of Global Electronic Commerce* (1996) in par 7.3.5.

177 The White House "A Framework for Global Electronic Commerce" (1 July 1997). Available at ><http://www.technology.gov/digeconomy/frameworkr.htm><, last accessed on 4 June 2007.

178 Katz MM (Chairman) *The Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) at 31.

from e-commerce transactions.

The legal framework in South Africa is currently insufficient to deal with e-commerce issues.¹⁷⁹ In 2002 the Electronic Communications and Transactions Act¹⁸⁰ was enacted. This Act contains certain provisions which, if complied with and effectively enforced, could alleviate some of the identification problems posed by e-commerce.¹⁸¹

Comments

If e-commerce is not regulated and appropriately taxed, the loss of revenue could be tremendous. There is therefore a need for governments to strike a balance between the development of e-commerce and its taxation. Since the challenges e-commerce poses affect the international community, South Africa should work hand in hand with developed and developing nations in order to come up with a feasible way of taxing e-commerce transactions.

10.2.5 HOW THE EFFECTIVENESS OF CFC LEGISLATION IS AFFECTED BY ITS COMPLEXITY

United Kingdom

In 2006, the Tax Reform Commission¹⁸² noted that the United Kingdom's CFC legislation has been complicated by repeated amendments.¹⁸³ As each amendment is introduced, tax advisers exploit the loopholes created and then tax authorities respond with more amendments. The Commission noted that this cycle can be hard to break, and that it makes planning more difficult and investment less attractive.

179 Department of Communications' Green Paper on E-commerce *Making it your Business* (November 2000) at 10-14.

180 Act 25 of 2002.

181 The relevant sections of this Act are discussed in chapter 4 under the heading "South Africa's response to the challenges posed by e-commerce".

182 United Kingdom Tax Reform Commission "Tax Matters: Reforming the Tax System" (October 2006) at 7. Available at ><http://www.taxreformcommission.com/report.php><, last accessed 10 September 2007).

In order to simplify this legislation, it has been recommended that “participation exemptions” should be introduced for all income from qualifying foreign shareholdings.¹⁸⁴ It is argued that the introduction of participation exemptions would remove most of the complexities in the CFC legislation, as most of the complicated rules for calculating underlying tax credits would become redundant. The result would be to make the United Kingdom a lot more attractive as a location for controlling international business.¹⁸⁵

United States

In 2006, the Task Force on International Tax Reform¹⁸⁶ noted that the workings of the components of subpart F income are very complicated. Each type of income is complicated with exclusions that are not easy to understand. As a further complication, there are certain exceptions to the exclusions that make the legislation difficult to interpret in practice. Apart from the exclusions complicated by exceptions, there are also numerous elections that increase the complexity of the legislation and the compliance burdens for taxpayers. It was recommended that the most effective way to reduce the burden of complexity would be to reduce the number of elections that could, in some cases, be the driving force behind numerous tax planning schemes.¹⁸⁷

Commentators on this state of affairs are of the view that the complexity in the United States anti-deferral legislation could be resolved by amending the legislation to end deferral on all kinds of income, instead of the legislation ending deferral mainly for passive income and base company income.¹⁸⁸ An approach that ends deferral for all types of income would significantly simplify the

183 UK Tax Reform Commission Report at 53.

184 UK Tax Reform Commission Report at 82.

185 UK Tax Reform Commission Report at 82-83.

186 Report of the Task Force on International Tax Reform 59 *Tax Lawyer* (2006) at 662. Available at ><http://www.abanet.org/tax/pubs/taskforceintltaxreform.pdf>, last accessed on 15 August 2007.

187 Report of the Task Force on International Tax Reform at 662.

188 CM Boise “Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty”. Available at >http://ssrn.com/sol3/papers.cfm?abstract_id=929587>, last accessed 26 November 2006; RJ Peroni, JC Fleming & SE Shay “Getting Serious About Curtailing Deferral of United States Tax on Foreign Source Income” (1999) 52 *SMU Law Review* at 498.

legislation, as all taxpayers would be subject to a foreign tax credit and would be taxed currently.¹⁸⁹

South Africa

South Africa's CFC legislation is quite difficult to understand, comply with and administer. The complexities in the legislation derive mainly from the following: there are terminological difficulties in that the legislation contains various terms whose interpretation depends on other terms used in defining the original term. Then there are certain ambiguous concepts, the ambit of which creates some interpretation difficulties. The CFC legislation is also complicated by the fact that its application brings into play various provisions of the Income Tax Act, some of which, like transfer pricing, foreign currency transactions and capital gains tax, are quite detailed and difficult to apply in practice. The legislation is also complicated by the fact that it has a number of exemptions to its applicability, limited by various exclusions. In addition, the legislation allows taxpayers to elect whether or not to fall within the ambit of the rules. Although the elections are potentially advantageous to taxpayers, they also add to the complexity of the CFC legislation and the compliance burdens for taxpayers.¹⁹⁰

Comments

While it is necessary to consider how other developed countries have applied their CFC legislation, care should be taken not to introduce rules that have complicated other countries' CFC legislation. South Africa's legislators should take note of the fact that in other countries, like the United Kingdom, CFC legislation has been complicated because of repeated amendments coupled with unclear policy considerations.¹⁹¹ The introduction of major changes followed by successive refinements and/or policy reversals reduces certainty. The instability or unpredictability in the legislation can thus prove a deterrent to international investment.

189 PR McDaniel, HJ Ault & JR Repetti JR *Introduction to United States International Taxation* 5 ed (2005) at 127.

190 See discussion in chapter 4 par 4.9.

10.2.6 LEGISLATION TO ENCOURAGE VOLUNTARY REPATRIATION OF FUNDS

American Jobs Creation Act of 2004

This Act gave United States corporations one year to repatriate earnings from their foreign subsidiaries at a reduced tax rate, compared to the corporate rate normally applicable to dividends paid to United States shareholders by foreign corporations. This was expected to create an incentive for CFCs to voluntarily end deferral, and repatriate foreign earnings to their United States shareholders. However, this Act mainly benefited multinational industries with substantial offshore assets. This was particularly true of pharmaceuticals and technology industries which have large concentrations of intangible assets that make it easier for them to shift income abroad. These industries strongly supported the Act as they potentially had the most to gain from a reduced rate of taxation on repatriated earnings. The Act damaged the public perception of the fairness of the tax system by cloaking its provisions in the garb of job creation, but ultimately benefiting even those corporations that used repatriated earnings to cut American jobs. It was viewed by most taxpayers as a corporate give-away¹⁹²

South Africa's 2003 Exchange Control Amnesty and Amendment of Taxation Laws Act

The Act was intended to enable violators of exchange control regulations and certain tax acts to regularise their affairs in respect of their foreign assets attributable to those violations. The Act was also intended to ensure maximum disclosure of foreign assets, and to facilitate the repatriation thereof to the Republic. Disclosing previously unreported foreign assets would result in the extension of the tax base. In terms of section 3(1) of this Act, the only persons that could apply for amnesty were: close corporations, natural persons (including

191 UK Tax Reform Commission Report at 53.

192 Boise 2006 at 6. See also the discussion in chapter 5 par 5.2.4 under the heading "The American Jobs Creation Act of 2004".

the deceased estate of a natural person) and trusts.

Comments

As South Africa's 2003 Exchange Control Amnesty and Amendment of Taxation Laws Act restricted the categories of persons that could apply for the amnesty, it did not create the same negative effects and sentiments as the American Jobs Creation Act. South Africa should learn from the negative effects of United States' American Jobs Creation Act and not enact legislation of such a nature that it undermines taxpayer confidence in the tax system.

10.2.7 LEGISLATION IN RESPECT OF PARTNERSHIP/CORPORATE HYBRID ENTITIES

The OECD

Paragraph 2 of the Commentary on article 1 of the OECD Model Convention points out that, domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax treaties to partnerships. In 1999, the OECD issued a Report on Partnerships,¹⁹³ but the taxation of partnerships still poses problems. In terms of article 1 of the OECD Model Convention, a treaty applies to persons who are residents of one or both of the contracting states. In terms of article 3(1)(a) of the OECD Model Convention, a partnership as a "body of persons" can be treated as a person for treaty purposes.¹⁹⁴ In terms of article 3(1)(b), a partnership could also be regarded as a "company" if it is treated as a "taxable unit according to the tax laws of the contracting state in which it is organised".¹⁹⁵

However, domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying the tax conventions in relation to

193 OECD *The Application of the OECD Model Tax Convention to Partnerships* (1999).

194 A Easson "Taxation of Partnerships in Canada" 54 *Bulletin for International Fiscal Documentation* (April 2000) at 169.

195 Daniels at 141.

partnerships.¹⁹⁶ Paragraph 3 of the commentary on article 1 of the OECD Model Convention provides that a main source of difficulties is the fact that, some countries treat partnerships as taxable entities, where as other countries treat partnerships as fiscally transparent (not taxable) but the individual partners are taxed on their respective share of the partnership's income. The different treatment of the entity in the two countries creates difficulties with respect to the entitlement to treaty benefits and it also causes many tax planning opportunities.¹⁹⁷ Taxes can be avoided by exploiting the differences between the tax treatment of taxpayers or transactions in the two countries.¹⁹⁸

United Kingdom

The United Kingdom has legislation that deals with Limited Liability partnerships (LLPs). The LLP combines the organisation flexibility and taxation treatment of a partnership but with limited liability for its members.¹⁹⁹ The United Kingdom LLP is thus seen as a "hybrid creature" that is based on the corporate model".²⁰⁰ For purposes of taxation, the LLP is treated as a partnership.²⁰¹

196 OECD Report on the Application of the OECD Model Tax Convention to Partnerships.

197 Arnold & McIntyre at 144.

198 An entity opaque in one jurisdiction but transparent in another jurisdiction can afford opportunities for double-dipping, without the restrictions imposed by the relevant anti-avoidance legislation - e.g. interest paid by an Australian limited partnership of which United Kingdom companies are members may obtain tax relief in both jurisdictions. A similar result can also follow from the use of an entity whose nature can be determined by a "check the box" type election; in this way a "triple-dip" may be obtained. See Richard Edmonds: International Tax Planning Association "Limited Partnerships". Available at <http://www.itpa.org/open/summaries/cannes2003s.html> last accessed on 20 March 2008.

199 Armour at 295.

200 G Morse "Limited Liability Partnerships Law Reform in the United Kingdom" in JA McCahery, T Raaijmakers & EPM Vermeulen *The Governance of Close Corporations and Partnerships US and European Perspectives*(2004) 317 at 325.

201 S 118ZA of the ICTA 1988 provides that for purposes of the Tax Acts, a trade,[profession or business carried on by a limited Liability partnership with a view to profit shall be treated as carried on in partnership by its members (and not by the Limited Liability partnership as such); and, accordingly, the property of the limited liability partnership shall be treated for those purposes as partnership property. Then s 59A of the TCGA 1992 provides that where a limited liability partnership carries on a trade or business with a view to profit –
 (a) assets held by the limited liability partnership shall be treated for purposes of tax in respect of chargeable gains as held by its members as partners, and
 (b) any dealings by the limited liability partnership shall be treated for those purposes as dealings by its members in partnership (and not by the limited Liability partnership as such),
 any tax in respect of chargeable gains accruing to the members of the limited liability partnership on the disposal of any of its assets shall be assessed and chargeable on them separately.

In *Padmore v IRC*²⁰² it was held that a partnership was a “body of persons” so as to be capable of satisfying the definition of “resident” and benefit from the treaty. As a result of the *Padmore* case, the United Kingdom has begun to include specific references to partnerships in treaties recently negotiated.²⁰³ Where neither state regards a partnership as a taxable entity separate from its partners, partnerships are excluded from the definition of a person.²⁰⁴ Where, however, the other treaty state recognises a partnership as a separate entity, such a partnership is regarded as a person but a specific provision to that effect is included in the Convention.²⁰⁵

United States

The United States “Check-the-Box” regulations, which were introduced in 1996, have facilitated tax avoidance techniques that generally involve the use of hybrid entities.²⁰⁶ The Check-the-Box regulations allow a foreign entity to be treated at the taxpayer’s election, as a corporation, a branch or a partnership.²⁰⁷ By exploiting the differences in the United States tax treatment of corporations and disregarded entities, as well as differences in entity classification among different countries, the United States person is able to deflect operating income from a high-tax jurisdiction to a low-tax jurisdiction while avoiding the application of subpart F rules.

The United States is one of the few countries which has adopted a provision in its

202 [1987] S.T.C. 36, affirmed by the Court of Appeal [1989] S.T.C. 493. The UK’s general approach to partnerships is discussed in an exchange of correspondence printed in [1995] B.T.R. 111-114. The Inland Revenue confirmed that a partnership cannot be regarded as a UK resident for treaty purposes as it is not liable to tax in the UK.

203 Some earlier treaties also dealt expressly with partnership. Thus the Conventions with Cyprus (1974, Art. 3(1)(h)) and Bulgaria (1987, Art. 3(1)(e)) expressly exclude partnerships from the scope of the treaty, while that with the United States (1975 Art. 3(1)(c)) expressly included partnerships (the Convention of 1973 with Malaysia, Art. 2(1)(g), originally excluded partnerships; this was amended by Protocol in 1987).

204 For example, Art.3(1)(e) of the U.K. - Ghana Convention of 1993 provides: “the term ‘person’ comprises an individual, a company and any other body of persons, but does not include a partnership;”

205 See Art. 25(1) of the UK/ India Convention of 1993, Art 24 of the UK/Ukraine Convention of 1993.

206 RS Avi-Yonah “To End Deferral As We Know It: Simplification Potential Of Check-The-Box” (1997) 74 *Tax Notes* at 219; CR Sweitzer “Analysing Subpart F in Light of Check-The- Box” (2005) 20 *Akron Tax Journal* at 7-8.

207 See discussion in chapter 5 par 5.2.4 under the heading “Hybrid entity techniques”.

Model tax treaty and domestic legislation dealing with the application of double tax conventions to hybrid entities.²⁰⁸ Broadly, this adopts a “flow-through” approach.²⁰⁹

South Africa

In terms of section 24H(5) of the Income Tax Act, the income of a partnership is taxed in the hands of the individual partners at the time it accrues to or is received by the partnership. The Income Tax Act does not recognise a partnership as a distinct taxable entity. However, the definition of the word “company” in section 1 of the Income Tax Act causes certain anomalies with respect to the taxation of foreign incorporated partnerships. This definition covers both companies incorporated in South Africa and those incorporated outside South Africa. It would for instance cover certain partnerships that are incorporated under the company law of certain jurisdictions. An example is the limited liability partnership (LLP) that is a corporate entity in the United Kingdom but is foreign to South African law.²¹⁰ The unique nature of some foreign incorporated entities creates anomalies in light of the wording of the definition of “company” in the Act. These anomalies can be manipulated to avoid taxes.

Comments

There are no specific tax laws in South Africa that re-characterise an entity on the basis of its tax treatment in another country.²¹¹ In terms of the definition of “company” in South Africa’s Income Tax Act, a foreign incorporated partnership is taxed as a company in South Africa even though it may be taxed as a partnership in its country of incorporation. Where a South African resident invests

208 See the Regulations under the Internal Revenue Code s.894(c).

209 See art 4(1)(d) of the 1996 United States Model Convention.

210 Olivier & Honiball at 464.

211 Olivier & Honiball at 465-466.

in a foreign incorporated partnership (such as the United Kingdom's LLP), it is not clear whether the CFC legislation is applicable to the LLP. Although the United Kingdom LLP is considered a foreign company, it has no share capital.²¹² It could therefore be argued that the CFC legislation which requires that South African residents hold more than 50% of the total participation or voting rights in the foreign company is not applicable to a United Kingdom LLP. There is thus need for legislation in South African to provide for the taxation of income that could be deferred when investments are made in offshore partnerships with corporate features.²¹³

10.2.8 CURBING CONDUIT COMPANY TREATY SHOPPING

OECD

The Commentary on article 1 of the OECD Model Tax Convention suggests specific clauses that can be inserted in tax treaties to curb conduit company treaty shopping. In this work, the "beneficial ownership" provision is discussed. This provision has the effect of denying treaty benefits to a conduit company, unless the beneficial owner is a resident of one of the contracting states.²¹⁴ However, the effectiveness of this provision in curbing treaty shopping is affected by the fact that the term "beneficial ownership" is not explicitly defined in OECD Model Tax Convention or its Commentary.²¹⁵ The OECD only offers certain guidelines to interpreting the term. The first guideline is that a nominee or agent who is a treaty country resident may not claim benefits if the person who has all the control and economic interest in the property (the beneficial owner) is not also a resident. The second guideline is that a conduit company cannot be regarded as a beneficial owner if it has very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.²¹⁶ Apart from the exclusion of agents and the

212 Morse at 324.

213 Olivier & Honiball at 465-466.

214 Par 12.2 of the Commentary on article 10 of the OECD Model Convention.

215 OECD Model Tax Convention on Income and on Capital (Condensed version) (2005). For the remark see OECD International Fiscal Association *The OECD Model Convention - 1998 and Beyond; The Concept of Beneficial Ownership in Tax Treaties* (2000) at 15.

216 OECD 1987 Report in par 14(b).

nominees, it has been argued that the term “beneficial ownership” has not been fully defined.²¹⁷

Article 3(2) of the OECD Model Convention provides that where a term is not defined in the Convention, unless the context otherwise requires, a contracting state can make use of the meaning of the term under the law of that state for the purposes of the taxes to which the Convention applies.²¹⁸ It is however, argued that unilaterally relying on article 3(2) to apply the domestic meaning of the term “beneficial ownership”, is not the right procedure that countries should apply in finding an international meaning to the term. Using the domestic meaning of the term would result into the loss of the uniformity in the OECD Model Convention and its Commentary that has long existed in the interpretation of tax treaties and tax treaty terms. Using the domestic meaning of the term would also result into uncertainty and loss of reliability for taxpayers.²¹⁹

The United Kingdom

In line with the OECD recommendations, the United Kingdom uses the “beneficial ownership” provisions in its tax treaties to curb conduit company treaty shopping. However, there are no cases which have considered the meaning of the term “beneficial ownership” in a treaty context.²²⁰ In the domestic context, the term beneficial ownership has a different meaning for Common law and for Equity.²²¹

One case which provides clarity on how the term should be interpreted in a treaty context is *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch*.²²² In this case, the Chancellor in the Court of Appeal ruled that the term *beneficial ownership* "should be accorded an 'international fiscal

217 Oliver et al at 20.

218 See also OECD 2000 Report of the International Fiscal Association Report at 15.

219 Oliver et al at 45; Jones 1993 at 253.

220 Olivier & Honiball at 349.

221 Oliver et al at 41.

222 [2006] EWCA CV 15. See the more detailed discussion in 5 par 5.1.12 under the heading “Conduit Company Structures: The United Kingdom”.

meaning' not derived from the domestic laws of contracting states".²²³

The United States

The United States makes use of domestic anti-avoidance provisions such as the "substance over form"²²⁴ doctrine and the requirement of "business purpose" in order to disregard treaty shopping schemes. The United States also has specific anti-conduit provisions in its domestic law which prevent treaty shopping if a conduit company lacks sufficient business purpose.²²⁵ The United States also curbs treaty shopping by applying the provisions of the Tax Equity and Fiscal Responsibility Act of 1982. Under section 342 thereof, the IRS must establish procedures to limit the advantage of reduced withholding tax rates under income tax treaties to only those persons entitled to the treaty benefits.

In its tax treaties, the United States insists on using the "limitation of benefits" provision to curb conduit company treaty shopping. The "limitation of benefits" provision is one of the provisions recommended by the OECD for curbing conduit company treaty shopping. This clause lays down objective factors to determine whether a conduit entity was incorporated in one of the contracting states solely to obtain treaty benefits or whether sound commercial reasons exist for its incorporation.²²⁶

South Africa

Although South Africa is not a member of the OECD,²²⁷ most of South Africa's treaties follow to a large extent the OECD Model Tax Convention.²²⁸ In South

223 See the discussion in chapter 5 par 5.1.12 under the heading "Conduit Company Structures: The United Kingdom".

224 Ware & Roper at 77, the 'substance over form' doctrine is described as a doctrine frequently used in Anglo-Saxon legal systems which is similar to the abuse of law doctrine in Western Europe Civil law systems. The doctrine permits the tax authorities to ignore the legal form of a tax arrangement and look at the actual substance of the relevant transaction.

225 S 7701(1) of the IRC

226 Olivier & Honiball at 424.

227 Huxham & Haupt at 357 in par 16.9.4; Olivier & Honiball at 8.

228 Although different countries use various models for drafting their double tax agreements, there are three commonly used models for drafting double taxation agreements. Firstly, there is the Model Tax Convention on Income and Capital, published by the Organisation

Africa, the “beneficial ownership” concept is used in most of its tax treaties to curb conduit company treaty shopping. However, the term “beneficial ownership” does not constitute a clearly defined juristic concept in South African Law.²²⁹ The term is however used in South African company law in respect of the fact that a “nominee” or “agent” of a company’s shares is not considered the beneficial owner of those shares.²³⁰ The company law meaning of “beneficial ownership” appears to be in line with the guidelines offered by the OECD in interpreting the term.

The Income Tax Act does not provide a meaning to the term “beneficial ownership”. In terms of section 108(2) of the Income Tax Act,²³¹ read together with section 231 of the Constitution,²³² when the national executive of South Africa enters into a double tax agreement with the government of any other country, and the agreement is ratified and entered into the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act. Even if such a treaty is considered as part of the Income Tax Act, the lack of a definition of the term “beneficial ownership” in this Act, implies that the Act cannot be relied on to determine the treaty meaning of this term.

Comments

In South Africa, constitutionally tax treaties rank equally with domestic legislation after enactment in terms of section 108 of the Income Tax Act. In order to come up with an interpretation of the term “beneficial ownership”, section 233 of the

for Economic Co-operation and Development “OECD”). This model was prepared by developed countries of the world and embodies rules and proposed by capital exporting countries. Then there is the United Nations Model Double Taxation Convention. This Model has been drafted between developed and developing countries and it attempts to reflect the interests of developing countries. Lastly there is the United States Model which is followed by most treaties that the United States has signed with other countries including South Africa. See K Huxham & P Haupt *Notes on South African Income Tax* (2007) at 357; Edward Nathan and Friedland “Residence Basis of Taxation: Double taxation agreements” (October 2001) http://www.saica.co.za/integritax/935_Double_taxation_agreements.htm last visited 2005/07/21.

229 *CSARS v Metlika Trading Ltd and Others* 66 SATC 346.

230 MS Blackman, RD Jooste & GK Everingham *Commentary on the Companies Act* Vol 1 (2002) in par 98.

231 Act 58 of 1962.

232 Constitution of the Republic of South Africa of 1996.

Constitution requires that the courts must prefer an interpretation that is consistent with international law. Although international interpretive rules can be used to interpret the term, the problem is that the OECD Commentary provides little guidance on what the term means, other than to imply that an agent or a nominee can never be a beneficial owner.

By concluding tax treaties which contain the concept “beneficial ownership”, knowing that it is not a well-defined concept in domestic tax law, it must be surmised that the South African authorities have intended that an internationally accepted meaning of the concept must apply. This international meaning should be in line with the guidelines offered by the OECD in this regard.

10.3 NATIONAL MEASURES TO CURB TAX AVOIDANCE: OFFSHORE TRUSTS

The OECD initiatives against harmful tax practices target offshore trusts as one of the vehicles used by taxpayers to hide the identity of the beneficial owner of offshore assets. The OECD recommended that countries exchange information about taxpayers’ beneficial ownership in offshore trusts as requested by onshore countries in the enforcement of their laws and tax policies.²³³

10.3.1 JURISDICTION TO TAX OFFSHORE TRUSTS

United Kingdom

Under English law, a trust does not have a residence, since it is not considered to be a separate legal person. The residence of the trust depends on the residence status of the trustees. For income tax purposes, where all the trustees are resident in the United Kingdom, the trust will be resident there. Where some trustees are resident in the United Kingdom and others are not, the residence of the trust will depend on the residence and domicile status of the settlor.²³⁴

233 OECD “Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices” (2000) in par B. Available at <http://www.tax-news.com/asp/res/MOUrev20novR1.pdf>, last accessed 10 July 2007.

234 S 110 of the 1989 Finance Act.

United States

A trust is a separate taxpaying entity, and it is liable for income tax. In terms of section 7701(a)(30) of the Code, a trust is a domestic trust for tax purposes if United States courts can exercise primary supervision over the administration of the trust and if one or more United States persons have the authority to control all substantial decisions of the trust.

South Africa

In terms of section 1 of the Income Tax Act, a trust is included in the definition of a “person” for income tax purposes. A trust is deemed a resident of the Republic if it is established or formed in the Republic or if it has a place of effective management there.

Comments

Although the rules used to determine the residence status of trusts seem to differ in the three countries, the emphasis seems to fall on the place where the trustees administer the trust.

10.3.2 TAXING A DONOR THAT RETAINS AN INTEREST IN THE TRUST

United Kingdom

In terms of section 660A of ICTA, income arising under a settlement (whether resident or non-resident) is deemed to be that of the settlor if he retains an interest in the settlement or if he receives a benefit from the settlement.

Under section 660G(3) of ICTA, income arising under a settlement that is situated inside or outside the United Kingdom is taxed in the hands of the settlor if it is either income chargeable to income tax or income which would have been so chargeable if received by a person resident and domiciled in the United

Kingdom.

United States

In terms of section 671 of the Code, “grantor trust” rules are used to prevent foreign trusts from being used to defer the taxation of the income of United States persons. Most foreign trusts created by United States persons are treated as “grantor trusts”. Any income received by a grantor trust is deemed to have been received by the grantor.

- Under section 673(a) of the Code, a grantor is taxed on income of the trust if he has a reversionary interest in the income or the principal worth over 5% of the value of the trust.
- Under section 674 of the Code, a grantor is taxed on income if he or his spouse has the power to control another’s beneficial enjoyment of the income of the trust.
- In terms of section 675 of the Code, grantor trust rules apply where the grantor enjoys self-serving administrative powers over the trust.
- In terms of section 676 of the Code, grantor rules apply if the trust is revocable.
- In terms of section 677 of the Code, grantor trust rules apply if the trust can be used to benefit the grantor.

South Africa

Certain subsections of section 7 of the Income Tax Act can be used to prevent tax avoidance in respect of discretionary trusts. In terms of section 7(5) of the Act, a donor will be liable to tax if he makes a donation, settlement or other disposition that is subject to a condition to the effect that a beneficiary will not receive income from the trust until the happening of some event.

Section 7(6) of the Act provides that income is deemed to be that of the donor if a donation, settlement or other disposition contains a stipulation to the effect that the right to receive any income thereby conferred may, under the powers

retained by the person by whom the right is conferred, be revoked or conferred upon another.

Comments

The United States grantor trust rules and the United Kingdom provisions in section 660A of ICTA appear to work in a similar manner to the provisions of section 7(5) and 7(6) of South Africa's Income Tax Act in that the relevant provisions result in the taxation of a donor, thereby preventing any tax avoidance that could arise through the use of discretionary trusts. Nevertheless, the applicability of South Africa's section 7(5) and 7(6) to offshore discretionary trusts is limited. If an offshore trust is dual resident, it may be deemed to be resident in South Africa if it is effectively managed here. In order to apply the above provisions to such a trust, a trust deed has to be procured to prove whether it is conditional. Procuring the trust deed of a dual resident trust (eg, if it was incorporated in a tax-haven jurisdiction) may be difficult where the applicable laws contain secrecy provisions.

10.3.3 TAXING INCOME TRANSFERRED TO OFFSHORE TRUSTS

United Kingdom

Section 739 of ICTA provides for a charge on the settlor where assets have been transferred abroad with a view to avoiding income tax, resulting in income being paid to a person resident or domiciled outside the United Kingdom. A settlor is liable to a charge where he has "power to enjoy" any income of a non-resident or non-domiciled person, or where he may receive, or may be entitled to, any "capital sum" in any way connected to the transfer or any associated operation. The section is, however, subject to the motive defense test in section 741 of ICTA.

United States

Under section 679 of the Code, a United States person transferring property to a foreign trust will be treated as the owner of the trust assets under the grantor rules, for any year in which a United States person is a named beneficiary of any portion of the trust.

South Africa

Section 7(8) of the Income Tax Act deems any amount received by, or accruing to, a non-resident (which would have constituted “income” as defined in the Income Tax Act had that person been a resident) and arising from a donation by a resident donor to be income of the donor.

Comments

In general, the workings of the United Kingdom and the United States provisions are similar to the South African provision in so far as they tax the resident donor on any income accruing to a non-resident that arises from a donation by the donor.

Unlike the United Kingdom provision, South Africa’s section 7(8) casts a wider net, as its application is not limited to the donor’s subsequent power to enjoy the income, or to the receipt of any capital payment from that income. Unlike the United States provision, which applies if there is a United States beneficiary, the South African provision casts a wider net because as long as a resident makes a donation to a non-resident the resident donor will be liable for tax.

10.3.4 TAXING BENEFICIARIES OF OFFSHORE TRUSTS

United Kingdom

Section 740 of ICTA taxes a beneficiary who is ordinarily resident in the United Kingdom on any income that is received from a person resident or domiciled

outside the United Kingdom. The section is, however, subject to the motive defense test in section 741 of ICTA.

United States

Section 643(i) of the Code provides that if a foreign trust makes a loan of cash or marketable securities, directly or indirectly, to a United States grantor or beneficiary, or to any person who is related to the grantor or beneficiary, the amount of the loan will be treated as a distribution taxable in the hands of the recipient.

South Africa

Section 25B(2A) of the Income tax Act provides that where in a year of assessment a resident acquires a vested right to any amount representing the capital of a non-resident trust, that amount must be included in the income of that resident in that year. The income is included if the capital of the non-resident trust would have constituted income if that trust had been a resident in any previous year of assessment during which that resident had a contingent right to that income. That amount should not have been subject to tax in the Republic in terms of the Act.

Comments

In general, South Africa's section 25B(2A), which relates to the taxing of beneficiaries of offshore trusts, works in a similar manner to the provisions applicable in the United Kingdom. It is worth noting, however, that South Africa's 25B(2A) is not subject to the motive defense as is the case with the comparable section 740 of the United Kingdom's ICTA. The application of the South African provision is therefore wide, as it leaves South African taxpayers no avenues for rendering the section inapplicable and thereby avoiding tax.

10.3.5 TAXING THE CAPITAL GAINS OF OFFSHORE TRUSTS

United Kingdom

In terms of section 2(1) of the Taxation of Capital Gains Act (TCGA) of 1992, when a settlor who is resident, or ordinarily resident, in the United Kingdom settles assets in an offshore trust, he makes a disposal and is liable for Capital Gains Tax (CGT).

In terms of section 12(1) of the TCGA, a CGT charge arises on the disposal of assets situated outside the United Kingdom when they are received in the United Kingdom. In terms of section 86 of the TCGA, a CGT charge arises where a settlor retains an interest in an offshore settlement.

In terms of section 87(3) of the TCGA, where in any tax year the trustees of a settlement are resident outside the United Kingdom throughout the year, and a beneficiary who is both resident and domiciled in the United Kingdom receives a capital payment from that settlement, the beneficiary will be chargeable when the gain is deemed to accrue to him.

In terms of section 91 of the TCGA, United Kingdom-domiciled resident beneficiaries are liable to a CGT charge if the offshore trustees do not make capital payments and so indefinitely defer CGT. A further deterrent to the deferral of CGT is that in terms of the 1991 Finance Act interest is charged on capital payments from offshore trusts received by beneficiaries.

In the past, dual resident trusts were often used to avoid taxes in the United Kingdom. In terms of section 83 of the TCGA if, by virtue of a double taxation treaty, dual resident trustees use their residence status in another country to avoid a United Kingdom CGT charge, the trustees are deemed, immediately before becoming dual resident, to have disposed of the assets and reacquired them at market value.

In addition to the above, the United Kingdom has legislation in place to prevent

the use of specific schemes for avoiding CGT. For example, in terms of Schedule 26 to the 2000 Finance Act, “flip-flop” schemes which result in gains being extracted from a trust tax-free, or with minimum taxation, by making use of borrowed money are prohibited.²³⁵ In terms of Schedule 4C to the TCGA, the anti-avoidance provision in Schedule 26 of the FA 2000, that prevents the use of “flip-flop” schemes, also extends to offshore trusts, in that beneficiaries are charged in respect of gains accruing to offshore trustees by virtue of a transfer of value made to them.

Another scheme that is utilised to avoid taxes in the United Kingdom involves bringing a trust onshore and then exporting it again. The gains on the trust property escape a CGT charge, because they were realised while the trust was onshore, and the beneficiary pays little or no tax on the sale of an interest in the trust, because of the rule providing for its value to be uplifted when the trust leaves the United Kingdom. Section 94 of the Finance Act of 2000 amended section 85 of the TCGA to block such schemes, with the result that there is no uplift where the trust is “pregnant” with gains not attributed to beneficiaries.

United States

Section 643(a)(6) and section 667(a) of the Code provide that gains accumulated and distributed by a foreign trust lose their character as capital gains and are taxed as ordinary income. The capital gains are included in distributable net income.

Deferral of tax on income accumulated in a foreign trust is further prevented by a “throw-back” rule (or penalty rule), which results in an increased tax rate on the accumulation distribution, by taxing the income passed out to the United States beneficiary at the ordinary income tax rates that would have applied if the distribution had been made in the year in which the income was earned.

On top of the additional tax imposed by the “throw-back” rules, in terms of

235 As to how the “flip-flop” schemes work, see the discussion in chapter 8 par 8.1.3.

section 668 of the Code an annual interest charge is imposed to eliminate the benefit of paying the tax later. The interest is charged against the artificially high tax liability created by the throw-back rule, as if this were the tax previously deferred. In addition, the interest charge is compounded and is not deductible when computing net taxable income.

South Africa

Certain paragraphs of the Eighth Schedule to the Income Tax Act are applied when taxing the capital gains of offshore trusts. Paragraph 70 provides that when a person has made a donation, settlement, or other disposition that is subject to a stipulation or condition imposed by any person, which is to the effect that a capital gain or portion of it will not vest in the beneficiaries until the happening of some fixed or contingent event, the capital gain is taken into account in determining the aggregate capital gain or loss of the person who made the donation, settlement or other similar disposition.

Paragraph 71 provides that where a trust deed confers on a resident beneficiary a right to receive a capital gain, but the person conferring the right has the power to revoke it, or confer it upon another person, the capital gain will be deemed to be that of the person who conferred the right and not that of the beneficiary.

Paragraph 72 provides that if a resident has made a donation, settlement, or other similar disposition to a non-resident during a year of assessment, and there is a capital gain attributable to the donation, settlement, or other similar disposition vested in any non-resident (including a non-resident trust), then the capital gain must be taken into account when determining the aggregate capital gain or loss of the resident donor, who will then have to pay tax on the capital gain.

Paragraph 80(3) provides that when a resident acquires a vested right to an amount representing capital of any non-resident trust, and that capital arose from a capital gain of the trust determined in any previous year of assessment, during which the resident had a contingent right to the capital or to any amount

which would have constituted a capital gain of the trust if the trust had been a resident; and the capital gain has not been subject to tax in the Republic, that amount must be taken into account for the purposes of calculating the aggregate capital gain or loss of the resident in the year of assessment in which he acquires the vested right.

Comments

South Africa's CGT provisions appear to work in a similar manner to those of the United Kingdom. A distinctive aspect of the provisions applicable in the United States and the United Kingdom is the penalty charging of interest on gains accumulated in offshore trusts. In South Africa, interest charges are not imposed on income accumulated offshore.

It is noteworthy that the United Kingdom legislators have endeavoured to come up with specific provisions to deal with certain tax avoidance schemes as they arise (eg the "flip-flop" schemes). South Africa does not seem to have a policy of enacting specific provisions to deal with notorious anti-avoidance schemes. This could be ascribed to the fact that South Africa's provisions cast a wider net in certain respects. For example, section 7(8) of the Income Tax Act can be applied to tax a donor on an amount that has arisen "by reason of or in consequence of any donation, settlement, or other disposition" made to a non-resident.

10.3.6 OFFSHORE TRUSTS' REPORTING REQUIREMENTS

United Kingdom

In terms of section 745 of ICTA:

- Where a person transfers property to an offshore trust, he is expected within 12 months to report details of the property transferred, the date of transfer, the consideration (if any), and the identity of the trust.
- Within 12 months of becoming domiciled in the United Kingdom either as a resident or as an ordinary resident, a settlor of an offshore trust

must report his name, address, date of creation of the trust, and the names and addresses of the trustees.

- The trustees of a United Kingdom resident trust that emigrates from the United Kingdom must within 12 months file a return specifying the date of creation of the trust, the name and address of each person who was a settlor immediately before emigration, and the names and addresses of each trustee before emigration.
- Within three months of creating an offshore trust, the settlor must report his address and the names and addresses of trustees and the date of creation of the trust. This obligation does not extend to non-domiciled settlors, or settlors who, although domiciled in the United Kingdom, are neither resident nor ordinarily resident.

United States

In terms of section 6048(a) of the Code, as amended by the Tax Reform Act 1996, a person who transfers property to a foreign trust under the grantor rules, or a person who receives a gift or a bequest from a foreign trust, is supposed to comply with certain reporting rules. Section 6048(a)(1) of the Code provides that such a person must within 90 days inform Revenue Services about the foreign trust and transfers of property to the trust.

South Africa

Section 7(10) of the Income Tax Act places the onus of disclosing a taxpayer's donation, settlement or disposition on the taxpayer, who must report in writing to the Commissioner when submitting a tax return. There are certain penalties in the event of default or omission to file a return.

Failure to disclose the obligation in section 7(10) can lead to a penalty under section 75 of the Act, whereby the taxpayer may be liable for a fine, or for imprisonment for a period of not more than 24 months. The taxpayer may also be subjected to additional assessment under section 79 of the Act. In terms of

section 78 of the Act, where the Commissioner has reason to believe that a resident has not declared or accounted for any funds or assets owned outside the Republic which could be attributed to that resident in terms of section 7 or Part X of the Eighth Schedule the Commissioner must estimate the amount of foreign currency of such funds, or the market value of those assets.

Comments

Section 7(10) of South Africa's Income Tax Act only places the onus on a taxpayer to disclose any donation, settlement or disposition when submitting a tax return. It does not contain specific provisions concerning dates when assets were transferred offshore and details of the names of the parties involved, nor does it set time limits within which the parties concerned must comply with the provision. This may give taxpayers leeway not to disclose certain information, and to report on their dealings in their own time and at their own pace.

10.4 CONCLUDING COMMENTS

In the light of the cryptic comparative analysis provided in this chapter, which – in essence – summarises the key issues discussed in the previous chapters, some recommendations for the reform of South Africa's offshore anti-avoidance legislation that relates to offshore companies and trusts are suggested in the next (final) chapter.

CHAPTER 11

CONCLUSIONS AND RECOMMENDATIONS

It has been pointed out in this thesis that, the globalisation of trade and investment and, the removal of exchange controls and other barriers to the free movement of capital, have resulted in increased international trade. This has in turn led to increased competition among businesses in the global marketplace. In order to remain competitive in the global marketplace, taxpayers often avoid or defer domestic taxes by inventing strategies that exploit variations in international tax rates. This is often done when investments are made offshore in “tax-haven” jurisdictions, or in low-tax countries.²³⁶ An increasing number of investors around the world are attracted by these offshore jurisdictions, where they can establish a business in the form of an offshore company, or an offshore trust.²³⁷ This, however, often results in the depletion of the tax bases of the countries of residence of such investors. This thesis has dealt with the effectiveness of some the measures that are proposed and/or applied in order to prevent or deter offshore tax avoidance.

It has been explained in this thesis that, the increasing ability of residents of a

236 A Ginsberg *International Tax Havens* 2 ed (1997) at 5. BJ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 62 also states that taxation is a factor in foreign investment decisions. HCAW Schulze “Legal Aspects of Offshore Transactions” (1994) xxvii *CILSA* at 26; Rotterdam Institute for Fiscal Studies (Vol A): *International Tax Avoidance* (1979) at 29.

237 It is estimated that around 60% of the world’s wealth is held offshore in offshore accounts by using offshore companies or offshore trusts and that around 50% of the world’s trade in goods is transacted through various offshore jurisdictions. See DeltaQuest Offshore Incorporation & Investment “Secure your future – Protect Your Assets – Go Offshore”. Available at <http://www.mydelataquest.com/english/>, last accessed on 4 June 2007.

country both to transfer capital to offshore companies and trusts, and to defer or avoid taxes in their countries of residence, results from a combination of two main factors. Firstly, offshore tax avoidance is encouraged by the continued existence of tax-haven jurisdictions and preferential tax regimes.²³⁸ These jurisdictions provide a responsive legal environment and favourable tax regime - thereby offering a potential investor, incentives to operate offshore rather than from his or her country of residence. This often causes harmful tax competition that may result in the depletion of countries' tax bases. Secondly, offshore tax avoidance is encouraged by the fact that taxpayers are able to make use of the structural features of trusts and companies to avoid taxes by taking advantage of the loopholes in their countries of residence's own legislation. In this thesis, a critical analysis has been done of the recommendations of international organizations, such as the OECD, in order to curb harmful tax competition.

In this chapter, recommendations are offered as to how South Africa can enhance the effectiveness of its offshore anti-avoidance legislation by adhering to the OECD recommendations that it has not yet implemented. Suggestions are also offered as to how the OECD can enhance the effectiveness of its own recommendations on curbing harmful tax competition.

With reference to the comparative study of the United Kingdom and the United States anti-tax avoidance legislation that deals with offshore companies and trusts, this chapter also provides some recommendations on how the effectiveness of South Africa's comparable legislation can be enhanced.

11.1 RECOMMENDATIONS WITH REGARD TO INTERNATIONAL MEASURES TO CURB HARMFUL TAX COMPETITION

It has been explained in this thesis that tax-haven jurisdictions and preferential tax regimes are sovereign countries that have the right to determine their own tax policies, which include setting up their countries as tax havens. Other countries cannot enact legislation to remove the existence of tax-haven jurisdictions; all

238 OECD *Studies in Taxation of Foreign Source Income: Controlled Foreign Company*

they can do is to enact legislation to prevent their own residents from avoiding domestic taxes when they invest in those jurisdictions. The tax-haven status of these jurisdictions can only be addressed at an international level, if at all.²³⁹ From the discussion in the thesis, it is clear that international bodies such as the European Union (EU) and Organisation for Economic Cooperation and Development (OECD) are unlikely to desist from their desire to curb many of the “harmful tax practices” of the world’s tax havens and preferential tax regimes. For instance, the sanctions imposed by various countries in response to the OECD recommendations cannot be underestimated or ignored by these jurisdictions.

11.1.1 RECOMMENDATIONS ON EXCHANGE OF INFORMATION

Despite criticisms of the OECD’s approach in dealing with the tax-haven problem, the OECD has played a major role in areas such as persuading tax-haven jurisdictions to cooperate on information exchange. Its “Model Tax Information Exchange Agreement”, which is intended to address the problems that relate to the exchange of information, is a valuable tool in this regard.

Although South Africa is not a member country of the OECD, the OECD Guidelines have become a globally accepted standard.²⁴⁰ Following these guidelines is an important means of helping South Africa curb offshore tax avoidance. Regarding the OECD recommendation that countries should exchange information concerning transactions that constitute harmful tax competition, South Africa has signed “Mutual Administrative Assistance Agreements” with the customs administrations of certain countries, but these countries are not necessarily tax havens.²⁴¹ These agreements could serve the

Legislation (2000) at 15.

239 RL Doernberg, L Hinnekens, W Herrerstein & L Jinyan *Electronic Commerce and Multi-jurisdictional Taxation* (2001) at 92-93.

240 See South African Revenue Service (SARS) *Practice Note. 7, section 31 of the Income Tax Act 1962 (the Act): Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (1999) in par 3.2.1.

241 South African Revenue Service “Current List of Customs Agreements on Mutual Administrative Assistance” (12 December 2006). Available at ><http://www.sars.gov.za/it/DTA/Customs%20Agreement/Current%20List.htm><, last accessed on 17 May 2007.

same purpose as the OECD “Model Agreement on Exchange of Information on Tax Matters”. It is recommended that South Africa should consider negotiating similar agreements with tax-haven countries, especially those with which it has already signed double-taxation agreements. These countries are: Cyprus, Malta, Mauritius, Singapore, the Seychelles and Luxembourg.²⁴² Negotiating Mutual Administrative Assistance Agreements with these countries will help South Africa obtain the necessary information to curb the harmful tax competition that could be encouraged by these countries.

It is however worth noting that, if some tax-haven jurisdictions cooperate in the area of information exchange, tax avoiders are likely to shift their funds from those jurisdictions to the non-cooperating ones, thereby rewarding the non-cooperating jurisdictions and deterring others from cooperating. This could be one of the reasons why some jurisdictions have refused to cooperate. The OECD’s endeavours in this respect would be more successful if, instead of merely imposing sanctions on uncooperative jurisdictions, incentives could be provided for those jurisdictions that cooperate with information exchange. This could be done by for instance encouraging the signing of double-taxation treaties with the cooperative jurisdictions. This approach could encourage some of the uncooperative jurisdictions to comply.

11.1.2 RECOMMENDATIONS ON HOW THE OECD COULD ENHANCE THE EFFECTIVENESS OF ITS CAMPAIGN AGAINST “HARMFUL TAX COMPETITION”

It has been argued that, although some OECD member countries create the impression in the political arena that they are committed to curtailing harmful tax practices, this may not necessarily be the case.²⁴³ For some of these countries, it may well be that harmful tax practices are of little significance compared to the investments that flow into these countries from the tax-haven jurisdictions.²⁴⁴ The common perception that the benefits of being a tax haven flow primarily to

242 L Olivier & M Honiball *International Tax: a South African Perspective* 3 ed (2005) at 24. See also discussion in chapter 2 par 2.6.

243 M Grundy *Essays in International Taxation* (2001) at 6-7.

residents of the tax haven is misguided. It has also been observed that funds cannot remain in tax-haven jurisdictions and be productive.²⁴⁵ Rather than merely sheltering their funds in the tax havens, most taxpayers have their funds reinvested in economies that have a better infrastructure and more political stability. It has been argued that it is possibly because major powers have a lot to gain from such investments, that their governments do not have the actual political will to stop harmful tax competition.²⁴⁶ Avi-Yonah and Cohn²⁴⁷ suggest that, if the political will existed, harmful tax competition could be curtailed, if the major powers could, for instance, deny certain tax exemptions in respect to transactions with non-cooperating tax havens. They could also restrict the ability of financial institutions to provide services with respect to tax-haven operations.

Some commentators²⁴⁸ are of the view that, the OECD initiatives would be more attainable, if the OECD provided a “level playing field”, where all the countries concerned could be involved in the discussions about harmful tax regimes. The question, however, is whether it is possible to attain a level playing field in international financial and fiscal issues. The concept of a level playing field appears to be a “utopian” goal. While it may be theoretically and logically desirable to have one, it is doubtful whether this ideal can be achieved. Human nature seems to incline to the optimistic belief that any problem or issue can be resolved by the application of pure reason. We live in a society where advancement is largely based on merit, and talent is by no means equally distributed across the population. The legal framework protects people against certain forms of discrimination, but unequal results are positively encouraged.²⁴⁹

It is also worth acknowledging that, in spite of the OECD’s campaign against

244 Grundy at 6-7.

245 RS Avi-Yonah & Il Cohn “Hearing on Offshore Transactions” (1 August 1 2006) in par 6(e). Available at <http://hsgac.senate.gov/files/STMAviYonahUafMI.pdf#search=%22Prepared%20testimony%20of%20Avi-Yonah%20before%20permanent%20subcommitte%20>, last accessed on 20 October 2006.

246 Grundy at 6-7; Avi-Yonah & Cohn in par 6(e).

247 Avi-Yonah & Cohn in par 6(e).

248 A review commissioned by the International Tax and Investment Organisation and The Society of Trust and Estate Practitioners conducted by E Stikeman *Towards a Level Playing Field: Regulating Corporate Vehicles in Cross Border Transactions* (2002) at 16.

249 T Bennett *International Initiatives Affecting Financial Havens* (2001) at 33.

“harmful tax competition”, tax competition is probably here to stay. International tax competition in the global marketplace is due to the high tax rates that individuals and multinational enterprises face in their countries of residence. Because of these high taxes, people are increasingly developing global strategies in order to maximise profits, and their links with any single country with a favourable tax climate are becoming stronger. It is a well known fact that in all business transactions, tax is an expense, and if businesses are to remain competitive, taxes should not be too high.²⁵⁰ The OECD has tried to campaign against the negative effects of international tax competition, terming it “harmful tax competition”,²⁵¹ but its endeavours have been criticised as a means of forging a “World Tax Organisation”.²⁵² It is hard to imagine any government agreeing to join such an organisation. Tax nationalism is likely to ensure that this will not materialise.

It should be noted that, although the OECD’s recommendations represent an indispensable first step towards limiting harmful tax competition, they are incomplete.²⁵³ These recommendations are not legally binding. For example, the “Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices”,²⁵⁴ only requires jurisdictions identified as tax havens to demonstrate their commitment to transparency and effective co-operation. It is hard to imagine how such formal commitments will be turned into real tax reforms that will change the way the respective countries administer their tax systems to prevent harmful tax competition. The OECD has also acknowledged that more work still needs to be done to fully implement the standards it has set, so that national tax laws can be fairly and effectively enforced.²⁵⁵ At present,

250 Grundy at 1-2. See also Ginsberg at 5; Arnold at 62.

251 OECD *Harmful Tax Competition – An Emerging Global Issue* (1998) in par 75.

252 Bennett at 35.

253 RS Avi-Yonah “Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State” 113 *Harvard Law Review* (May 2000) No 7 at 66.

254 OECD “Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices”. Available at >[http://www.ois.oecd.org/olis/2000doc.nsf/c707a7b4806fa95c125685d005300b6/c125692700623b74c12569a100492e0c/\\$FILE/JT00100664.PDF](http://www.ois.oecd.org/olis/2000doc.nsf/c707a7b4806fa95c125685d005300b6/c125692700623b74c12569a100492e0c/$FILE/JT00100664.PDF)<, last accessed 10 July 2007.

255 P Ciocca, Chair of OECD Committee on Fiscal Affairs” Committee on Fiscal Affairs Releases Outcome of Review of Preferential Tax Regimes in OECD Member Countries”. Available at >http://www.oecd.org/document/31/o.3343.en_2649_37427_37446047_1_1_1_37427,...<, last accessed 3 July 2007.

individuals who reside in one OECD member country can invest in another OECD member country through a tax-haven entity and escape the exchange-of-information net. It is not clear whether the exchange of information programme envisaged by the OECD report will be able to overcome this problem.²⁵⁶ Comparing the effectiveness of OECD initiatives to those of the EU, it is worth noting that although the EU Code of Conduct is also not a legally binding document; the directives it has issued against harmful tax competition are legally binding on member countries.²⁵⁷ In addition, the European Court of Justice, which enforces tax harmony so as to ensure the creation of a single European market, also makes the EU stand a better chance in curbing harmful tax competition among its own members. However, any success the EU achieves internally may simply make it more vulnerable to tax competition from non-EU countries.²⁵⁸

Tax havens and preferential tax regimes have been around for decades, and it appears that they will continue to survive in the foreseeable future. The fact that they are still around, in spite of the domestic and international onslaught against them, is an indication that it may not be so easy to have them abolished, although the continual onslaught has taken its toll.

11.2 RECOMMENDATIONS WITH REGARD TO NATIONAL MEASURES TO CURB OFFSHORE TAX AVOIDANCE

As mentioned above, it is not only the presence of tax-haven jurisdictions and preferential tax regimes that encourages offshore tax avoidance. The benefits offered by companies and trusts also encourage offshore tax avoidance when they are utilised to take advantage of the loopholes in a country's legislation. On the basis of the comparative study made of the United Kingdom, United States and South African legislation, recommendations for the reform of the South African legislation are suggested below, where such legislation has been found wanting.

256 Avi-Yonah at 1665.

257 See discussion in chapter 2 par 2.4.1.

258 Bennet at 35.

11.2.1 RECOMMENDATION ON HOW TO ENHANCE THE EFFECTIVENESS OF SOME ASPECTS OF THE RESIDENCE BASIS OF TAXATION

The study has demonstrated that the residence basis of taxation, that is applied in all three countries, is an effective tool in curbing offshore tax avoidance, as the worldwide income of residents is taxable, even if it is invested in offshore jurisdictions. In South Africa, a person other than a natural person (such as company or a trust) is considered a “resident”, if it is incorporated, established, or formed in the Republic of South Africa, or if it has a place of effective management in South Africa.²⁵⁹ Of all these tests, the one that is of particular relevance to offshore investments is the “place of effective management”. This test is an important tool in curbing offshore tax avoidance that could result where an entity is a dual resident. In terms of South Africa Revenue Service (SARS) Interpretation Note 6,²⁶⁰ where an entity is dual resident, for instance if it is resident in a tax-haven jurisdiction by virtue of the fact that it was incorporated there, but is also resident in South Africa because it is effectively managed here, it is deemed resident in South Africa, and its worldwide income may be subject to tax here.

Although this test of residence can be an effective measure in curbing the tax avoidance that could result from the dual residence of entities, the effectiveness of this test is hampered by the fact that South Africa does not have a statutory definition of the concept “place of effective management”. Although SARS has an interpretation for the term,²⁶¹ SARS Interpretation Notes are not law.²⁶² South African courts are, however, bound to follow the international interpretation of the term as used in the OECD Model Tax Convention.²⁶³ However, as was discussed

259 S 1 of Income Tax Act 58 of 1962 as amended.

260 SARS Income Tax Interpretation Note 6 of 26 March 2002.

261 SARS Income Tax Interpretation Note 6.

262 ITC 1675, 62 SATC 219.

263 In *CIR v Dowling* 1975 (4) SA 518 (A) at 523 the court held that South Africa is bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention. S 231 of the Constitution of South Africa provides that courts are bound to apply customary

in chapter 3, with the continuous growth of e-commerce, the OECD interpretation is not effective in curbing tax avoidance, as the interpretation results in multiple residences.²⁶⁴ Although SARS's interpretation of the term has some unsatisfactory details that need to be clarified,²⁶⁵ it is a better tie breaker test than the alternative OECD interpretation that recognises central control as an indicator of effective management. It is recommended that the SARS's interpretation of the term should be refined and be given legal force. This could be done by expanding the meaning of "resident" in section 1 of the Act and adding a subsection that incorporates the SARS's interpretation. It is worth noting that in 1997 the Katz Commission Report²⁶⁶ recommended that the term "place of effective management" should be defined in the Income Tax Act but this recommendation was never followed. It is suggested that the subsection to the definition of "resident" could for instance read as follows:

The "place of effective management" is the place where an entity is managed on a regular or day-to-day basis by the directors or senior managers of the company. That is, the place where the board of directors executes and implements the entity's policy and strategic decisions, irrespective of where the overriding control is exercised, or where the board of directors meets.

(i) If management functions are exercised at a single location, that location will be the place of effective management.

(ii) If management functions are not exercised in one place, for example if the directors or senior managers exercise their management functions by using distance communication networks, the place of effective management is where the business operations are actually carried out.

(iii) If business operations and activities are controlled from various locations, the place of effective management is the place with the strongest economic nexus.

11.3 RECOMMENDATIONS TO CURB TAX AVOIDANCE IN RESPECT TO OFFSHORE COMPANIES: CONTROLLED FOREIGN COMPANY

international rules and practices.

264 See discussion in chapter 3 par 3.6.

265 See discussion in chapter 3 under the heading "Does SARS's interpretation of the term "place of effective management" achieve the tie breaker purpose?"

266 Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa *Fifth interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) in par 6.1.2.1. See the discussion in chapter 3 under the heading "The limitations of applying SARS's interpretation of "place of effective management".

LEGISLATION

Although the “residence basis of taxation” can ensure the worldwide taxation of the income of a country’s residents, taxes can still be avoided, if such income is invested in an offshore company. In most tax systems, the income of a foreign company is not subject to domestic tax, since the foreign company is incorporated and recognised as a separate juridical entity in another jurisdiction.²⁶⁷ This implies that a country cannot apply the “residence basis” to tax the worldwide income of an offshore company, unless the income is distributed to the shareholders as dividends.²⁶⁸ As long as the income is not distributed, taxation can be avoided, or deferred, or postponed, implying that the taxes due currently are postponed to a future year.²⁶⁹ To prevent the deferral of taxes, the countries studied have “controlled foreign company” (CFC) legislation that ensures that the undistributed income of a controlled foreign company is not deferred, but is taxed in the hands of its domestic shareholders on a current basis.²⁷⁰ There are however certain issues about South Africa’s CFC legislation that could hinder its effectiveness as an anti-avoidance measure.

11.3.1 RECOMMENDATIONS TO RESOLVE THE CONFLICT BETWEEN CFC LEGISLATION AND TAX TREATIES

Although CFC legislation is viewed as an effective measure in curbing the deferral of taxes, this study has demonstrated that the applicability of this legislation may be challenged on the grounds that it may be in conflict with a country’s tax treaties.

In South Africa, residents who directly or indirectly hold more than 50 percent of the voting rights or participation rights in a CFC, are taxed on notional

267 J Arnold & MJ McIntyre *International Tax Primer* 2 ed (2002) at 87.

268 Arnold & McIntyre at 87.

269 Olivier & Honiball at 358; WH Diamond & DB Diamond *Tax Havens of the World* (Release No 108 Jan 2002) Vol 1 at INTRO/1; Arnold & McIntyre at 87.

270 Arnold at 131; Arnold & McIntyre at 91. See also Olivier & Honiball at 358.

amounts.²⁷¹ This is in line with the United Kingdom position, as it was explained in *Bricom Holdings Ltd v IRC*.²⁷² As South African residents are taxed on notional amounts, it may be argued that it is unlikely that a South African court will hold that a South African resident will be entitled to rely on a tax treaty on the basis that the same amounts are effectively being taxed. Despite the fact that South African residents are taxed on notional amounts the issue of the conflict between South Africa's CFC legislation and its tax treaties still unclear.²⁷³

It has been argued that the manner in which a domestic court will resolve the conflict between CFC legislation and a tax treaty, depends on whether it is the CFC legislation or the tax treaty that takes precedence.²⁷⁴ In South Africa, section 108(2) of the Income Tax Act, read with section 231 of the Constitution of South Africa²⁷⁵ provides *inter alia* that as soon as the double tax agreement is ratified and has been published in the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act.²⁷⁶ This implies that treaty provisions and any other provision in the Income Tax Act (eg section 9D) have equal status under South African law, even if the Income Tax Act contains a provision that is inconsistent with the treaty.²⁷⁷ Thus, although the Constitution of South Africa sets out the procedure of incorporating treaties into domestic law, where a treaty conflicts with a particular provision of domestic law, section 108(2) of the Income Tax Act provides no solution. The country could therefore, be faced with a host of challenges to the applicability of its CFC legislation for being incompatible with its tax treaties. Indeed, some countries have had their CFC legislation challenged on this basis.²⁷⁸

271 S 9D(1) of the Income Tax Act. See also the discussion of this issue in chapter 4 par 4.7.

272 [1996] STC (SCD) 228.

273 Olivier & Honiball at 397.

274 D Sandler *Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries* 2 ed (1998) at 99.

275 Act 108 of 1996.

276 Huxham & Haupt at 356.

277 Olivier & Honball at 30.

278 In the United Kingdom, the compatibility of CFC legislation with its tax treaties was challenged in *Bricom Holdings Ltd v IRC* [1996] STC (SCD) 228. The compatibility of art 209B of the French Tax Code with its tax treaties was challenged in cases such as: *Schneider SDA v DVNI and TA Strasbourg* Decision of 21 November 1995, Lower Administrative Court of Paris, No 207093/1 (as read from Sandler at 213); *Strafor Facom SA v DG*, Decision of 12 December 1996, Lower Administrative Court of Strasbourg, No 9158. In Finland the applicability of CFC legislation and Finland's tax treaties was

In order to fill the lacuna in the law and thus resolve this conflict, it is recommended that South Africa comes up with a safeguarding clause that authorises its CFC legislation to override its tax treaties.²⁷⁹ Alternatively, South Africa should insist on inserting a specific CFC clause in the new treaties it negotiates.²⁸⁰ The problem in the existing and older treaties could be resolved by renegotiation. A clause of this nature could be inserted in article 23(1) of South Africa's respective double taxation agreements which normally deals with the elimination of double taxation. A sub-article 23(1)(a) could be inserted, to read as follows:

Nothing in the Convention shall prevent South Africa from applying the provisions in section 9D of its Income Tax Act or any substantially similar provisions that may amend or replace the provisions of this section.²⁸¹

11.3.2 RECOMMENDATIONS ON HOW CFC LEGISLATION CAN BE SIMPLIFIED

The complexity of CFC legislation is an aspect of this legislation that could hinder its effectiveness in curbing offshore tax avoidance. Although there is a need to protect countries tax bases against erosion, it is also necessary to ensure that the legislation does not make it difficult for taxpayers to compete internationally, so that they are forced to give up their residence status in favour of residence in a jurisdiction with more favourable tax rules.²⁸² These complexities create traps for the unwary taxpayers and in turn undermine taxpayer confidence in the fairness and efficiency of the tax system. In a country like South Africa, it is important that the CFC legislation is not so overcomplicated that it results in a significant compliance burden for taxpayers and requires excessive administrative costs to government, if it is to curb abuse. Commentators and tax

challenged in *A Oyj Abp*, KHO:2002:26, (2002) 4 *International Tax Law Reports* at 1009. For details see chapter 5 fn 63.

279 Olivier & Honiball at 392-393.

280 After the French decision in *Schneider SDA v DVNI and TA Strasbourg* Decision of 21 November 1995, Lower Administrative Court of Paris, No 207093/1 (as read from Sandler at 213), the French tax authorities have insisted on including a clause allowing for the application of CFC legislation in all new treaties negotiated. See also Olivier & Honiball at 392-393.

281 It is noteworthy that in the France/South Africa treaty, France has a similar provision (art 23(1)(b)(iii)). The intention is to prevent France's art 209B of its Tax Code (which is similar to CFC provisions) from being challenged as being in conflict with the treaty. The treaty is published in Government Gazette 16681 of 1995-09-27. This treaty came into force on 1995-11-01.

reform commissions in different countries suggest different means of simplifying the specific problems in their CFC legislation.²⁸³ However, certain general principles of how the CFC legislation can be simplified have been pointed out and these, can be emulated in South Africa.

The discussion on the complexities in South Africa's CFC legislation²⁸⁴ shows that, there are numerous anomalies and tax ambiguities that complicate it, which need to be resolved. One way of resolving these complexities is by picking on specific ambiguous provisions and rectifying the uncertainties and complexities they create. One such provision is the definition of a "controlled foreign company" which *inter alia* refers to one or more South African residents, directly or indirectly, holding more than 50% of the total participation rights of a foreign company.²⁸⁵ The use of the word "indirectly" in respect to participation rights in a CFC, is rather confusing as it seems that those rights are not limited to interests in the shares of the foreign company, but also include indirect interests in the profits or reserves of a foreign company, such as the interests of unsecured creditors of a company. An unsecured creditor cannot be said to have a direct right to participate in the profits or reserves of the company but merely an indirect right to do so. In order to clarify the interpretational problems caused by this aspect of this legislation, the definition of a "controlled foreign company" in section 9(D)(1) should be amended to make it clear that the word "indirectly" refers to holding through another company and not to conditional holdings. Proviso (d) could be added to the other provisos to the definition of a controlled foreign company to read as follows:

A 'controlled foreign company' means any foreign company where more than 50 per cent of the total participation rights in that foreign company are held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents: Provided that:
 (d) *No regard be had to conditional participation rights, such as the holdings of an unsecured creditor.*

Another confusing provision, that needs to be clarified, is the one that was that was created by the introduction of the definition of the term "country of residence"

282 Olivier & Honiball at 358.

283 See discussion in chapter 5 par 5.1.10 and 5.2.9.

284 See discussion in chapter 4 par 4.9.

285 S 9D(1) of the Income Tax Act.

in section 9D. As explained in chapter 4,²⁸⁶ a “country of residence in relation to a foreign company means the country whether it has its place of effective management”. The Explanatory Memorandum to the Revenue Laws Amendment Bill of 2006 provides that, the South African tax law interpretation of the term “place of effective management” should be applied, and yet as pointed out above, South Africa has no statutory or case law definition of the term. Although SARS Interpretation Note 6²⁸⁷ provides a definition of this term, SARS Interpretation Notes are note law and courts are not bound to follow them. To fill this lacuna in the law, and thus resolve the complexities created by the introduction of the definition of “country of residence”, it is reiterated that SARS interpretation of the term be given legal force, by incorporating it in the Income Tax Act.

Although the need to minimise uncertainty has encouraged every possible circumstance to be defined, this has to be done with adequate consultation. The process of major changes followed by successive refinements and/or policy reversals reduces certainty. It is recommended that the amendment process must allow sufficient time for proper consultation. The study has shown that most amendments appear to be “stop-gap” responses to perceived abuses without significant consideration of underlying policies.²⁸⁸ The result may well be that the legislation may become more complicated, susceptible of abuse, economically inefficient, and extremely difficult to administer.²⁸⁹ In the United Kingdom, it was recommended that instead of mainly relying on amendments to the legislation, by introducing new definitions to rule out the uncertainties, reliance should rather be placed on principles and the intention of the law. This principle based approach has the advantage of reducing the complexity of the legislation.²⁹⁰ It is recommended that the principle based approach be introduced in South Africa, as it will alleviate the need to amend the legislation now and then. For example,

286 See discussion in chapter 4 par 4.9.

287 SARS Income Tax Interpretation Note 6 of 26 March 2002.

288 American Bar Association “Report of the Task Force on International Tax Reform” (2006) 59 *The Tax Lawyer* at 661.

289 RJ Peroni, C Fleming & SE Shay “Getting Serious About Curtailing Deferral of United States Tax on Foreign Source Income” (2005) 52 *SMU Law Review* at 508; see also CR Sweitzer “Analysing Subpart F in the Light of Check-The-Box” (2005) 20 *Akron Tax Journal* at 7.

290 UK Tax Reform Commission Report at 106; see discussion in chapter 5 par 5.1.10.

since most of South Africa's treaties largely follow the OECD Model Tax Convention,²⁹¹ and since South African courts are bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention,²⁹² the OECD's interpretations of terms used in the CFC legislation (such as the term "permanent establishments") should be relied upon rather amending the legislation now and then.

Perhaps the most complicated aspect of most countries CFC legislation, relates to the exemptions to the rules that cover situations where the presence of a company in an offshore jurisdiction, is not mainly for tax avoidance purposes, but for genuine business reasons. Often, these exemptions contain numerous complex exclusions, exceptions to the exclusions, and also provisions for the selection of various options. In South Africa, an example is the "foreign business establishment" exemption to the CFC rules, which is rife with numerous exclusions that are difficult to navigate.²⁹³ It is recommended that, SARS issues an Interpretation Note on section 9D that would serve to explain the complex provisions of this section. Although the National Treasury has issued a detailed explanation of the section, it is unclear to what extent, if any, SARS considers itself bound by this explanation.²⁹⁴ For the present, it remains to be seen whether section 9D will achieve its objective of curbing tax avoidance that results from foreign investment by South African residents, or whether it will merely lead to an increase in specialised tax structuring to circumvent its application. It is however, submitted that, a degree of simplicity in South Africa's CFC legislation is attainable, especially if there is the political will to do so.²⁹⁵

11.4 RECOMMENDATIONS TO CURB TAX AVOIDANCE THAT RESULTS FROM INVESTING IN PARTNERSHIP/CORPORATE HYBRID STRUCTURES

291 Olivier & Honiball at 8; Huxham & Haupt at 341.

292 *CIR v Dowing* 1975 (4) SA 518 (A) at 524; s 231 of the Constitution of South Africa, 1996.

293 See discussion in chapter 4 par 4.9

294 Oliver & Honiball at 228.

295 Australia is a good example. See chapter 5 fn 95.

This work has shown that tax avoidance can result when South African residents invest in offshore hybrid entities that are treated as corporations in one jurisdiction and as partnerships in another.²⁹⁶ Where an entity is treated as a partnership, the partners are taxable on their share of the income of the entity. Where the entity is treated as legal person, it is subject to tax on its income. The different treatment of hybrid entities in the two countries creates many tax planning opportunities.²⁹⁷

Where a South African resident has an interest in a tax transparent foreign partnership, he will be taxed in South Africa on his share of the partnership income (section 24H(5) of the Income Tax Act). The partnership is not liable to tax since it has no existence as a taxable entity. However, the definition of the word “company” in section 1(b) of the Income Tax Act, which includes foreign companies, creates certain anomalies with respect to the taxation of foreign incorporated partnerships. This definition would for instance cover limited liability partnership (LLPs) that are considered companies in some countries like the United Kingdom, but are foreign to South African law. If a South African resident and a United Kingdom resident decide to incorporate an LLP in the United Kingdom, the tax implications are not clear. It may be argued the LLP is foreign company, CFC legislation can be applied to the LLPs. However for this legislation to apply, South African residents should hold more than 50% of the total participation or voting rights in the LLP.²⁹⁸ Although the United Kingdom LLP comes into existence upon incorporation,²⁹⁹ it has no shareholders or share capital.³⁰⁰ In this respect, it is doubtful whether CFC legislation can be applied to the members of a United Kingdom LLP.³⁰¹ Investments in such entities could thus be used to avoid taxes. The above shows that the unique nature of some foreign incorporated entities creates anomalies based on the current wording of the definition of “company” in the Act.

296 BJ Arnold & MJ McIntyre *International Tax premier 2 ed* (2002) at 144; Olivier & Honiball at 464-465.

297 Arnold & McIntyre at 144.

298 S 9D(1) of the Income Tax Act.

299 Freedman at 304; Jones et al at 292; D Armour *Tolley's Limited Liability Partnerships: The New Legislation* (2001) at 2.

300 Morse at 324.

301 Olivier & Honiball at 434.

It is recommended that the definition of the term “company” in the Income Tax Act be amended to rectify the current anomalies that create loop holes for tax avoidance.³⁰² It is further recommended that in order to create legal certainty South Africa’s tax legislation must be amended to specifically provide for the treatment of hybrid entities as tax transparent limited partnerships under the Act.³⁰³ However, this proposal should not be implemented without careful consideration and analysis. Specific mechanisms exist in other jurisdictions (such as the United Kingdom and the United States) which ensure the equitable tax treatment of the partners of these entities.³⁰⁴ This is currently not in place under South Africa’s tax law.

11.5 RECOMMENDATION TO CURB CONDUIT COMPANY TREATY SHOPPING

In this thesis it has been pointed out that “treaty shopping” is one of the commonly used offshore tax avoidance schemes. “Treaty shopping” is, a term which refers to the use of double tax treaties by the residents of a non-treaty country to obtain treaty benefits that are not supposed to be available to them.³⁰⁵ This is mainly done by interposing or organising a “conduit company” in one of the contracting states so as to shift profits out of those states. It has pointed out³⁰⁶ that one of the methods recommended by the OECD to curb this type of tax avoidance is by inserting a “beneficial ownership” provision in a tax treaty. Although this provision can be used to curb conduit company treaty shopping, its effectiveness is hindered by the fact that there does not seem to be a clear international meaning of the term “beneficial ownership”. Even the OECD does not provide a definition of the term. It only offers certain guidelines to the

302 Olivier & Honiball at 434

303 S Zaiman “Paragraph (b) of the Definition of Company: Anomalies Arising in Respect of Certain Foreign Incorporated Entities” (February 2007, Issue 12) *KPMG International Tax Newsletter* at 4.

304 Zaiman at 4.

305 H Becker & F J Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) at 1; S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) at 119.

306 See chapter 4 par 4.1 under the heading “Specific treaty provisions suggested by the OECD to curb “conduit company treaty shopping”.

understanding of the term. The OECD Commentary on article 1 provides that a nominee or agent can not be considered a beneficial owner. Further that a conduit company cannot be regarded as a beneficial owner if, it has very narrow powers which render it a mere fiduciary or administrator acting on account of other interested parties.³⁰⁷ Article 3(2) of the OECD Model Convention provides that where a term is not defined in the Convention, the domestic meaning of the term may be applied. It is, however, argued that unilaterally relying on article 3(2) to apply the domestic meaning of the term “beneficial ownership”, is not the right procedure that countries should apply in finding an international meaning to the term.³⁰⁸

Although South Africa is not a member of the OECD, most of South Africa’s treaties to a significant degree follow the OECD Mode Tax Convention.³⁰⁹ The “beneficial ownership” provision is used in most of South Africa’s tax treaties to curb conduit company treaty shopping. However, the term “beneficial ownership” does not constitute a clearly defined juristic concept in South African law.³¹⁰ The Income Tax Act does not have a definition of the term. However, company law defines the term in respect to the ownership of shares whereby, nominees and agents are not considered to be beneficial owners of shares. In terms of section 108(2) of the Income Tax Act,³¹¹ read together with section 231 of the Constitution of South Africa,³¹² when tax treaty is ratified and entered into the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act. Although a treaty is considered as part of the Income Tax Act, the lack of a definition of the term “beneficial ownership” in this Act, implies that this Act cannot be relied on to determine the treaty meaning of the term.

Olivier and Honiball³¹³ submitted that by concluding tax treaties which contain the

307 OECD 1987 Report in par 14(b).

308 J D B Oliver, J B Libin, S van Weeghel & C Du Toit “Beneficial Ownership and the OECD Model” (2000) 1 *British Tax Review* at 45.

309 Huxham & Haupt at 357 in par 16.9.4; Olivier & Honiball at 8.

310 Olivier & Honiball at 413.

311 Act 58 of 1962.

312 Of 1996.

313 Olivier & Honiball at 350.

concept “beneficial ownership”, knowing that it does not have a domestic tax law meaning of the term, South Africa has intended that an internationally accepted meaning of the concept must apply. It is this author’s submission that any attempt to define the term in a treaty context should be in line with the guidelines offered by the OECD.

In coming up with a meaning of the term, section 233 of the Constitution requires that the courts must prefer an interpretation that is consistent with international law. Since the South African company law meaning of the term “beneficial ownership” seems to be in line with the guidelines offered by the OECD, it is recommended that our legislators should take cognise of the company law meaning, refine it and then come up with a meaning of the term in the Income Tax Act. Care should however be taken to ensure that the definition is not limited to a narrow South African interpretation, but it should carry a wide international meaning that is in line with the guidelines offered by the OECD. This would be in line with the recent United Kingdom Court of Appeal decision in *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch*³¹⁴ which ruled that in the context of tax treaties, the term “beneficial ownership” should be accorded an international fiscal meaning, taking into account the OECD literature, and that the meaning should not be restricted to a meaning in terms of domestic law.

11.6 RECOMMENDATIONS TO CURB TAX AVOIDANCE IN RESPECT TO OFFSHORE TRUSTS

Regarding the legislation intended to curb investment in offshore trusts, although there are differences in the way the legislation works in the countries studied, the gist of the legislation is the same. Most perceived abuses that involve shifting income between trust settlors and beneficiaries appear to have been covered. The legislation also seems to have covered most schemes that take advantage of the discretionary powers of trustees. For example, it has been noted that where a founder seeks to protect funds from taxation, by investing them in a discretionary trust, but uses devices such as letters of wishes or protectors, to

³¹⁴ [2006] EWCA CV 158.

retain control of the funds, the courts are now seeing right through the trust and declaring the assets to be still vested in the hands of the founder.³¹⁵ In South Africa, the 2003 Exchange Control Amnesty and Amendment of Taxation Laws Act³¹⁶ also had the effect of discouraging residents from investing in offshore trusts.³¹⁷ The “secrecy”, which is one of the appealing aspects of investing in offshore trusts, seems to have been thwarted by this Act, as tax amnesty was granted to the relevant applicants only when they disclosed their assets in foreign trusts. Although this amnesty was only for the 2003 year of assessment, the disclosure of assets in foreign trusts had the effect of extending South Africa’s tax base. It therefore appears that, for the ordinary taxpayer, investing in offshore trusts to avoid taxes is no longer a worthwhile tax planning device.

This does not mean, however, that the offshore trust has altogether outlived its usefulness as a tax planning vehicle. For the more sophisticated taxpayers, offshore trusts are still a vehicle for tax avoidance. This is mainly the case, where both company structures and trusts are used to achieve tax advantages. South African legislators should therefore not relax in their effort to prevent the use of the trust as an offshore tax avoidance tool. Evidence shows that, when laws are enacted, taxpayers soon find ways of circumventing them in order to avoid taxes. The United Kingdom has responded to this phenomenon by being vigilant and enacting legislation to curb specific tax avoidance schemes as they arise.³¹⁸ This does not seem to be the case in South Africa, where tax avoidance in respect of offshore trusts is curbed by relying mainly on section 7(8) and section 25B(2A) of the Income Tax Act. Although these provisions appear to cover a wide range of possible offshore schemes, they could still be circumvented by sophisticated tax planners. South Africa could fruitfully emulate

315 B Cameron “Why Offshore Trusts Have Lost Their Appeal” (26 July 2003) *Personal Finance* at 1. Available at <http://www.persfin.co.za/index.php?fSectionId=706&ArticleId=196524>, last accessed on 4 June 2007

316 Act 12 of 2003.

317 Cameron at 1.

318 As discussed in chapter 8 par 8.1.3, in the UK the anti-avoidance provision in Schedule 26 to the Finance Act 2000, which prohibits the use of “flip-flop” schemes, also extends to offshore trusts, in that beneficiaries are charged in respect of gains accruing to offshore trustees by virtue of a transfer of value made to them. Also, s 94 of the FA 2000 amended s 85 of the TCGA 1992 to block schemes that were utilised to avoid taxes in the United Kingdom where trusts are brought onshore and then exported.

the United Kingdom by being open to enacting scheme-specific legislation as the schemes arise.

11.6.1 RECOMMENDATION TO ENHANCE THE EFFECTIVENESS OF DISCLOSURE REQUIREMENTS IN RESPECT TO OFFSHORE TRUSTS

The study demonstrates that one of the means used to curb tax avoidance that results from investing in offshore trusts is to require residents to disclose their offshore investments. Both the United Kingdom and the United States have comprehensive reporting requirements in place that require the parties concerned to disclose the details regarding the dates when assets were transferred offshore, the names of the parties involved, and the time limits within which the parties concerned have to comply with the provisions.³¹⁹ This is not the case in South Africa. Section 7(10) of the Income Tax Act merely places the onus of disclosing offshore investments on the taxpayer, who must report in writing to the Commissioner when submitting a tax return. Lack of comprehensive reporting requirements could give taxpayers the leeway not to disclose certain information, and to report their dealings in their own time and at their own pace. Comprehensive reporting requirements, with time limits, such as those in the United Kingdom and the United States, should be adopted in South Africa. It is recommended that section 7(10) be amended to include subsections that could possibly be worded as follows:

- (i) Where a person creates a non-resident trust, he/she/it must within 12 months report his/her/its address and the names and addresses of trustees and the date of creation of the trust.
- (ii) Where a person creates a non-resident trust or, transfers property to a non-resident trust, he/she/it is expected within 12 months to report details of the property transferred the date of transfer, the consideration (if any) and the identity of the trust.
- (iii) A founder of a non-resident trust that becomes a South African resident is expected, within 12 months of becoming a resident, to report his/her/its name, address, date of creation of the trust, and the names and addresses of the trustees.

11.6.2 RECOMMENDATION TO ENHANCE THE EFFECTIVENESS OF PENALTIES IN RESPECT TO INCOME ACCUMULATED IN

319 See discussion in chapter 8 par 8.1.4 on the details of the United Kingdom's reporting requirements as provided for in s 745 of ICTA 1988.

OFFSHORE TRUSTS

This study has shown that, in addition to requiring residents to disclose their investments in offshore trusts, the legislation of the three countries imposes certain penalties on taxpayers who fail to comply with the disclosure requirements. Under United Kingdom and United States legislation, one of the penalties imposed is the charging of interest on income that is accumulated in offshore trusts.³²⁰ In South Africa, in terms of section 75 of the Income Tax Act, where a taxpayer fails to comply with the disclosure requirements of section 7(10), he may be liable for a fine or imprisonment for not more than 24 months. The taxpayer may also be subjected to additional assessment under section 79 of the Income Tax Act. Further, in terms of section 78 of the South African Income Tax Act, where the Commissioner has reason to believe that a resident has not declared, or accounted for, any funds or assets owned outside the Republic, which could be attributed to that resident in terms of section 7 or Part X of the Eighth Schedule, the Commissioner must estimate the amount of foreign currency of such funds, or the market value of those assets. In addition to the above penalties, the practice of charging interest on income that is accumulated offshore could well be emulated in South Africa to strengthen the above provisions. Taxpayers would then be compelled to comply with the legislation for fear of interest charges. Section 75 of the Income Tax Act, which deals with penalties for failure to comply with reporting requirements, could be amended to include a subsection that deals with the charging of interest. The subsection could read as follows:

Interest shall be charged on any income from a non-resident entity that accrues to a resident during a year of assessment, if that income is not repatriated, but is accumulated in a non-resident entity.

11.7 RECOMMENDATIONS ON HOW TO DEAL WITH THE CHALLENGES POSED BY E-COMMERCE

320 In the United Kingdom, in terms of the Finance Act of 1991, interest is charged to beneficiaries who receive capital payments from offshore trusts. See discussion in chapter 8 par 8.1.2. In the United States, in terms of s 668 of the Code, an annual interest charge is imposed on income accumulated in a foreign trust. In terms of s 671(a) of the Code, interest charges may also apply where an item is not included in computing taxable income. See discussion in chapter 8, par 8.2.3 and 8.2.5.

Although the countries studied have legislation in place that can be used to curb income tax avoidance that may result when investments are made in offshore trusts and companies, this study demonstrates that the efficacy of this legislation could be challenged by technological developments. The legislation that is in place today was designed when cross-border economic activity consisted mainly of the sale of manufactured goods and certain services. Today, services and transfers of intangible property have dramatically increased in importance. International tax rules based on a paradigm of property being manufactured and sold do not readily accommodate the deconstruction of the economic functions that characterise modern business.

E-commerce may be conducted without regard to national boundaries, with the result that there may be no link between an income-producing activity and a specific location. In general, the current anti-deferral legislation specifically and income tax systems generally are in effect a vestige of the past, based on the physical world that presupposes operation within a relatively closed economy. Today, capital can traverse the world in a matter of nanoseconds; information is immediately accessible; and western capitalistic principles are sweeping throughout most of the formerly centrally planned economies. The current legislation is based on the physical – not the virtual – world, and it is therefore not yet in tune with the world's emerging electronic economy. International initiatives against offshore tax avoidance seem to be more concerned about the erosion of countries' tax bases than about addressing the inadequacies in the legislation that have resulted from e-commerce. There is no doubt that, if these inadequacies are not addressed, the tax revenues of various countries will continue to shrink with the growth of the Internet.

It has been suggested that the correct response to this looming problem would be to adapt tax systems to this "new world", rather than to attempt to adapt this "new world" to old tax systems.³²¹ In essence, countries have to adapt their tax

321 MB Weiss "International Tax Competition: An Efficient Or Inefficient Phenomenon?" 16 *Akron Tax Journal* (2001) at 130.

systems to accommodate the new international reality.³²² This study has discussed some of the challenges that e-commerce poses to the current legislation.³²³ In response to these challenges, the OECD has called on countries to cooperate and begin formulating a policy on the taxation of e-commerce, where e-commerce flourishes and also where national sovereignty and neutrality of taxation are maintained.³²⁴ It has also been suggested that the taxation principles which are applied to conventional commerce (neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and the flexibility of taxation) should also apply to the taxation of e-commerce. It has further been suggested that e-commerce should not be subjected to a new form of taxation, but that existing tax rules should be amended to cater for the taxation of e-commerce.³²⁵

It is acknowledged that e-commerce is still in the early stages of its development, so it should not be unnecessarily regulated, as this would distort its development. It is also acknowledged that government attempts to regulate e-commerce are likely to be outmoded by the time enactments are made.³²⁶ However, it is a fact that with the world-wide exposure to the Internet, not only big enterprises, but also small companies and individuals are encouraged to engage in international trade, because of the various advantages e-commerce offers.³²⁷

322 Office of Tax Policy, US Department of the Treasury "Selected Tax Policy Implications of Global Electronic Commerce" (1996) at 1. Available at ><http://www.ustreasury.gov/taxpolicy/internet.pdf><, last accessed 26 October 2006.

323 See chapter 4 par 4.9; chapter 5 par 5.2.5.

324 See OECD "Dismantling the Barriers to Global Electronic Commerce" (November 1997). Available at >http://www.oecd.org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00.html<, last accessed on 4 June 2007; see also OECD 6th Global Forum "Taxation Aspects of E-commerce: Addressing the Challenges and Opportunities" (September 2001). Available at ><http://www.oecd.org/dataoecd/38/42/2349701.pps#279,1,6th Annual Global Forum><, last accessed on 4 June 2007.

325 OECD Ministerial on Electronic Commerce: Ottawa Canada "A Borderless World" (October 1998). Available at ><http://www.ottawaoecdconference.org/English/conference-program/agenda.pdf><, last accessed on 4 June 2007.

326 The White House "A Framework for Global Electronic Commerce" (1 July 1997) at 3. Available at ><http://www.technology.gov/digeconomy/framework.htm><, last accessed on 4 June 2007.

327 For instance, through e-commerce, services can be outsourced to related or unrelated providers and manufacturing may be performed at multiple locations, using related or unrelated vendors that employ just-in-time inventory and modern logistics. Intangible values are recognised in the market and legally protected intangibles are used as commercial swords and shields. In addition, funds can easily be transferred electronically to offshore jurisdictions without such transfers being reported to tax authorities. See The

Rather than encouraging countries to amend existing tax rules to cater for the taxation of e-commerce,³²⁸ the OECD should encourage the world's economies to begin to adapt their tax systems to the inevitable, instead of attempting to postpone the unavoidable.³²⁹ The current methods of amending or "patching" the old legislation to curb the new electronic developments should be changed, and new international provisions adopted that take the new developments into consideration.³³⁰

Since the challenges brought about by e-commerce affect the international community,³³¹ South Africa should work hand-in-hand with developed and developing nations, in order to come up with a feasible way of taxing e-commerce transactions, so that the tax avoidance loopholes that e-commerce has created in the legislation can be closed. Although South Africa may have to await international trends as to how e-commerce should be taxed, in the meantime, in order to prevent the depletion of the tax base, it is recommended that South Africa should come up with means of resolving the identification problems that e-commerce poses (ie identifying the parties to a given transaction, and discovering where the transaction took place). In chapter 4, it was pointed out that the Electronic Communications and Transactions Act³³² was enacted to provide for the facilitation and regulation of electronic communications and transactions. The Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce.³³³ On the whole, however, the Act does not provide for taxation issues in respect of e-commerce transactions.

The Income Tax Act³³⁴ does not contain any provisions that can be used to identify parties to electronic transactions, or discover where the transaction took

328 White House's Framework for Global Electronic Commerce at 3.
 329 OECD 1998 Report on "A Borderless World".
 329 Weiss at 131.
 330 American Bar Association at 658.
 331 For a discussion on how the OECD has responded to the challenges of e-commerce, refer to chapter 5 in par 5.2.5.
 332 Act 25 of 2002.
 333 Refer to chapter 4 under the heading "South Africa's response to the challenges posed by e-commerce" for the sections of the Electronic Communications and Transactions Act that could be used to identify persons involved in e-commerce.

place. It can therefore, not be relied upon to curb any tax avoidance that may result from e-commerce. Although in 2003, section 74(1) of the Income Tax Act was amended to allow for electronic record keeping,³³⁵ this amendment does not contain any means of verifying whether a particular electronic document or piece of information is linked to a particular taxpayer. It is recommended that section 74(1) of the Income Tax Act be further amended, to provide that the provisions of the Electronic Communications and Transactions Act³³⁶ shall be applied, in order to identify and tax parties to electronic transactions. A subsection could be added to section 74(1) to read as follows:

For the purposes of charging income tax, taxpayers that submit electronic documents and electronic information shall be identified, and the authenticity of the electronic documents and information shall be verified by reference to the Electronic Communications and Transactions Act 25 of 2002.

11.8 RECOMMENDATIONS WITH RESPECT TO SOUTH AFRICA'S EXCHANGE CONTROL REGULATIONS

The discussion in chapter 9 of this work has shown that South Africa's Exchange Control Regulations make it illegal to transfer capital out of the Republic without the Exchange Control's approval. In this respect, the exchange controls complement the anti-avoidance legislation in that they prevent the outflow of capital from the South that would result in the depletion of the tax base. For instance the exchange controls have been instrumental in ensuring that "loop structures" are not used to transfer capital out of South Africa.

The complementary role of the exchange controls in preventing the depletion of South Africa's tax base will be even more effective if the Currency Exchanges Act is amended to include a definition of the term "resident" that is similar to the one in the Income Tax Act, subject to certain exceptions that may be particular to exchange controls.

334 Act 58 of 1962 as amended.

335 S 67 of the Revenue Laws Amendment Act 45 of 2003 amended s 74 of the Income tax Act to provide that a "document" includes any printout of information generated, sent, received, stored, displayed or processed by electronic means. And that "information" includes electronic representations of information in any form.

11.9 CONCLUDING REMARKS

In conclusion, it has to be pointed out that, in adopting the above recommendations, care should be taken to give due cognisance to South Africa's unique economic circumstances, in that it combines aspects of a developed and a developing economy.³³⁷ As a developing economy, South Africa should be careful not to introduce laws that are so rigid that they hinder international investment. However, it should not be forgotten that South Africa's other identity as a developed economy has encouraged trade with developed nations. These nations (such as the United Kingdom and the United States) have a long history of curbing offshore tax avoidance, and most of the tax-haven jurisdictions are nations off the coastline of these nations. As South African residents get increasingly involved in international trade, they are exposed to the finer points of tax avoidance schemes, which our legislation may not be able to cope with. There is thus a need to strike a balance, so as to ensure international investment, and at the same time to ensure that our tax base is not eroded by offshore schemes, such as those involving offshore trusts and offshore companies.

336 Act 25 of 2002.

337 SARS "Discussion Paper on a Proposed System for Advance Tax Rulings" (2003) at 7. Available at <http://sars.gov.za/legislation/Discussion20%Papers/Discussion%20proposed%20sytem20%Advance20%Tax20%Rulings.pdf>, last accessed 7 November 2007.

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