

THE SOUTH AFRICAN TAX IMPLICATIONS OF CEASING TO BE RESIDENT

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ABSTRACT

In the context of rapid globalisation, skilled South African employees and professionals are often attracted overseas to take up new work opportunities in foreign countries. This may cause these individuals no longer to be “ordinarily resident” in South Africa. At the same time, changes in modes of travel, information and communication channels could result in companies and trusts no longer being considered to be tax resident in South Africa, if the place of effective management for these entities is moved to a foreign country and a double taxation agreement between South Africa and that foreign country deems these entities to be exclusively resident in the foreign country. The objective of this thesis was to analyse the tax implications that could arise when a resident natural person, trust or company ceases to be a resident or when a Controlled Foreign Company (CFC) ceases to be a CFC.

A detailed analysis of the “exit charge” in section 9H of the Income Tax Act was undertaken to understand its normal tax implications when a natural person, trust or company ceases to be a resident or a CFC ceases to be a CFC. This included an analysis of how a natural person, trust or company ceases to be resident or how a CFC ceases to be a CFC.

It was found that certain normal tax principles consistently apply to when a natural person, trust or company ceases to be resident or a CFC ceases to be a CFC. At the same time, certain unique normal tax implications arise for trusts and CFCs since they are impacted by the special tax rules that apply to these entities. Furthermore in the case of a trust, a judicial precedent has established that the “exit charge” remains and is taxable in the trust. For CFCs, there is uncertainty as to whether the “exit charge” could arise when a shareholder ceases to be resident, which results in residents no longer holding more than 50% of the total participation or voting rights in that foreign company.

Key words: South African normal tax, section 9H; exit charge; resident; place of effective management.

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CHAPTER ONE: INTRODUCTION

1.1 Context of the Research

The South African tax system is primarily based on the residency principle. A “resident”, as defined in section 1 of the Income Tax Act No. 58 of 1962 (“the Act”), is taxed on worldwide receipts and accruals. For non-resident persons, only receipts and accruals from a South African source are subject to tax in South Africa. Therefore a person’s liability for South African normal tax is dependent upon the tax residency status of a person.

In the context of a rapid globalisation, skilled South African employees and professionals will be attracted overseas to take up new work opportunities in foreign countries. In many instances this could result in these individuals emigrating from South Africa and becoming permanently resident in a foreign country and no longer “ordinarily resident” as defined in section 1 of the Act. At the same time, foreigners may be attracted to South Africa to take up work opportunities. Although these individuals may only be based in South Africa on a temporary basis, the extent of their physical presence in the country could result in them being deemed to be resident in South Africa for tax purposes. When these individuals finally return to their home countries, this may have the result that they are no longer considered to be tax resident in South Africa.

Changes in modes of travel, information technology and communication have made the world a smaller place in which to conduct business. Juristic persons, in the form of companies and trusts, are considered to be tax resident in South Africa if they are incorporated, established, formed or have their place of effective management in South Africa. However, if the effective management of these entities is moved to a foreign country, they may no longer be considered to be tax resident in South Africa, where a double taxation agreement between South Africa and the foreign country deems these entities to be exclusively resident in the foreign country.

It is against this background that certain South African tax implications arise when a person who was previously considered to be a “resident”, becomes non-resident. Section 9H of the Act, promulgated on the 1 April 2012 and subsequently amended on 8 May 2012, provides for an “exit charge”. A resident natural person, company or trust is deemed to have sold all their assets at market value on the day immediately before ceasing to be resident for an amount equal

to market value on that date. Accordingly ordinary revenue and capital gains tax may arise. Companies also incur an additional charge in the form of dividends tax arising from a deemed dividend *in specie* declared to existing shareholders.

A change in tax residency status under section 9H of the Act also means that a taxpayer's year of assessment is deemed to have ended on the date immediately prior to the day that person ceased to be resident and that taxpayer's succeeding year of assessment is deemed to have commenced on the day that person ceased to be resident. A taxpayer would need to account for normal tax on a worldwide receipts and accruals basis until the day before ceasing to be resident and on a source basis from the date that taxpayer ceased to be resident.

In many instances, natural persons would formally emigrate from South Africa with applications being made to the South African Reserve Bank (SARB). The date that a person ceases to be resident is the date of emigration and therefore certain. Other natural persons may depart permanently from South Africa without formally emigrating. The question then arises: when do these individuals cease to be resident, as this will determine the timing of the exit charge?

Although section 9H(4) of the Act exempts any asset attributable to a permanent establishment in the Republic from the exit charge, the question also arises as to the normal tax implications of a revenue asset, previously not attributable to a permanent establishment of a person in the Republic and which is subsequently sold after that person ceases to be resident.

It is submitted that in the provisions of section 9H of the Act relating to Controlled Foreign Companies (CFCs) have created certain interpretation issues.

- Over the years, changes to the legislation concerning CFCs have created some uncertainties. When section 9H was initially implemented on 8 May 2012, the legislation for CFCs only applied to CFCs that ceased to CFCs in relation to a resident. However, in the subsequent year, the legislation for CFCs appeared to only apply to a CFC that “ceases to be a controlled foreign company, on or after that date”. Accordingly, for that year it appeared that the words “in relation to a resident” for a CFC had been withdrawn. However, from 5 June 2015 it appears that the new 9H(3)(b) provision for CFCs only applies to a CFC that ceases to be a CFC in relation to a resident. Hence, the question arises

as to whether the new section 9H(3)(b) could apply to a CFC that ceases to be a CFC when a shareholder of that CFC becomes non-resident.

- In determining the exit charge under section 9H, the base cost of the assets must be established. The interrelationship between paragraphs 12(1) and 24 of the Eighth Schedule to the Act (dealing with capital gains and losses) and section 9D(2A) of the Act (section 9D deals with the taxation of CFCs) appear to be irreconcilable.
- Foreign exchange implications also arise in the calculation of the exit charge, as there appears to be an intermingling of local currency (Rand) and foreign currency in the deemed capital gain or deemed capital loss calculations when the shareholder of a CFC ceases to be a resident.

It also appears that the provisions of section 9H of the Act relating to trusts have created certain interpretation issues.

- How the exit charge would apply to the emigration of a resident trust also appears to be uncertain. For a resident testamentary trust, it would not be possible for the exit charge to be attributed to a donor since the “donor” is deceased. For a vesting trust, the question arises whether an exit charge could apply to the trust or if there would be any tax implications for the trust beneficiaries who have a vested right to the income and assets of the trust. In the case of a resident discretionary trust, where the beneficiaries have only a contingent right to the assets and the income in the trust, there is uncertainty as to whether it would be practically possible to distribute the deemed capital or revenue gain to a beneficiary and the question also arises whether the anti-avoidance provisions in section 7(2), 7(3), 7(5), or 7(8) of the Act and the attribution rules in paragraphs 68, 69, 70, 71 or 72 of the Eighth Schedule to the Act could apply to deem the capital or revenue gain to be taxable in the hands of the donor of the property to the trust.

There are therefore clearly uncertainties relating to the South African tax consequences attaching to the change in residency of natural persons, companies and trusts, and CFCs ceasing to be CFCs.

An on-line search of “tax emigration from South Africa” reveals numerous news articles¹. A Master’s degree dissertation by Bambeni (2015) investigated whether the South African exit taxation laws could override Double Taxation Treaties and result in a situation where taxpayers would escape taxation in South Africa and the country of emigration. A Master’s degree dissertation by Lottering (2011) studied the theoretical comparison of the tax consequences of South African trusts in South Africa and the United States of America, following the emigration of a South African creator, donor and/or beneficiaries to the United States and also discussed the United States tax consequences for the South African trust following the emigration of the donor and beneficiaries. A journal article by Willemse and Strauss (2014) investigated the interaction between sections 8(4)(a), 9H and paragraph 40 of the Eighth Schedule to the Act to determine whether a recoupment should be included in the taxpayer’s gross income under paragraph (n) of the gross income definition in section 1 of the Act. The South African Revenue Service (SARS) has issued several Interpretation Notes (Interpretation Notes 3, 4 and 6 (2015)) that address the principles applying to ordinary residence, the physical presence test and the place of effective management for persons other than companies, and for companies.

In the case of *The South African Reserve Bank and Another v Shuttleworth and Another*, 2015 (8) BCLR 959 (CC), a prominent South African businessman challenged the constitutional ability of the Minister of Finance and the SARB to levy an exit charge for enabling that businessman to transfer his South African assets when he ceased to be resident in South Africa. The Constitutional Court found in favour of the Minister of Finance and the SARB and for that reason this exit charge was found to be constitutional. Following the judgement, it is not the intention of this research to address whether the exit charge in section 9H of the Income Tax Act complies with the Constitution of the Republic of South Africa, 1996.

Formal emigration with the SARB enables natural persons to remove their South African assets through a travel allowance, a foreign capital allowance and a household and personal effects

¹ The primary focus of several of these articles is the exchange control implications of emigration and dealings with the SARB rather than the tax exit charge that arises under section 9H. One article referred to the change in legislation in section 9H by Daya (2012) ENSight, ENS tax publications: “Revised exit charge upon ceasing to be a resident in South Africa” [available at <https://www.ensafrica.com/news/Revised-exit-charge-upon-ceasing-to-be-a-resident-in-SouthAfrica?Id=892&STitle=tax%20ENSight>].

allowance. It is not the intention of this thesis to address the requirements for formal emigration by a natural person with the SARB and accordingly when the 10% exit charge would be leviable. For this reason, this research will assume that, in the event of formal emigration by a natural person, these requirements would have already been complied with.

The following additional sources addressed questions relating to a change in residence: de Koker and Williams (2016); the Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016); Haupt (2016); and Stiglingh, Koekemoer, van Schalkwyk, Wilcocks and de Swardt (2016). These sources focused on the following matters relating to section 9H of the Act:

- the exit charge that arises following the emigration of a natural person and/or a company;
- the exit charge that arises in the event that a CFC ceases to be a CFC following the disposal and/or issuance of further shares;
- an exemption from the exit charge for a CFC, following the sale of shares in that CFC, which results in that CFC ceasing to be a CFC, thereby providing that the capital gain or loss from the sale of the shares is disregarded under paragraph 64B of the Eighth Schedule;
- confirmation in the Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016) of the principle that the deemed disposal on emigration could result in ordinary income and or capital gains tax consequences;
- the foreign exchange implications that arise from the exit charge; and
- a reference to and examples of the new clawback provisions in section 9H(3)(e) and section 9H(3)(f) of the Act.

Accordingly there would appear to be limited research on the questions to be addressed in the present research.

Given the volume of literature related to double taxation agreements, issues related to tie-breaker clauses and dual residency, these topics are beyond the scope of this thesis. It will be assumed that if the effective management of a company or trust takes place in a foreign country and a double taxation agreement between South Africa and that foreign country applies, that company or trust will become exclusively resident in that foreign country. The research will also not consider *bewind* trusts or headquarter companies.

1.2 Goals of the Research

The main goal of the research is to analyse the tax implications and the exit charges that may arise when a resident natural person, company or trust ceases to be a resident. This will include research regarding how and when a natural person, company or trust ceases to be resident. In achieving this goal, the following sub-goals will be addressed by way of an in-depth analysis:

- the meaning of “ordinarily resident”;
- the meaning of “place of effective management”;
- the exit charge that arises from the disposal of an interest in immovable property in the Republic;
- the tax implications for revenue assets, considered not to be attributable to a permanent establishment in the Republic, of a person that ceased to be resident, that had already been the subject of an exit charge under section 9H and which are subsequently sold;
- with regard to CFCs:
 - the normal tax implications for a CFC when it ceases to be a CFC as a result of a change in the residency of the holders of the participation rights or voting rights, which results in not more than 50% of the total participation rights or voting rights in that CFC being held by residents;
 - the section 9D inclusion in income for a resident that holds a participating interest in a CFC immediately prior to that resident ceasing to be a resident and which results in that CFC ceasing to be a CFC; and
 - the exit charge that arises from the deemed disposal of the shares in a CFC when a resident ceases to be resident;
- the circumstances under which a resident trust will cease to be resident; in the event of a resident vesting trust, whether an exit charge could apply to the trust or whether there could be resultant tax implications for the beneficiaries, if that trust ceased to be resident in South Africa; and whether the capital or revenue gains that arise in a discretionary trust ceasing to be a resident could vest in or be distributed to a beneficiary, revert to the donor or be taxable in the trust;
- the foreign exchange implications that may arise in the calculation of the exit charge.

1.3 Methods, procedures and techniques

An interpretative research approach will be adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology to be applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the legal rules relating to the changes in the residency for natural persons, companies and trusts, and analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2008).

The documentary data to be used for the research consists of:

- legislation in the form of the Income Tax Act;
- relevant case law;
- SARS Interpretation Notes, Comprehensive Guides, External Guides, Tax Brochures;
- articles in accredited journals;
- textbooks and other writings.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions will be ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

As all the data are in the public domain, no ethical considerations arise in relation to their use. Interviews will not be conducted; opinions will be considered in their written form.

1.4 Overview of the chapters

In the following chapters, the normal tax implications of section 9H of the Act and the related exit charge will be discussed. In chapter 2, the South African normal tax implications of a resident natural person, trust, company and a CFC are discussed. In chapter 3, the tax implications of section 9H and the generic tax principles and their application in calculating the exit charge are researched. Then in chapter 4, the unique normal tax implications of the exit charge and their application to a natural person, trust, or company when such a person ceases to be resident is researched. The chapter will also discuss the unique normal tax implications of when a CFC ceases to be a CFC. Chapter 5 concludes the thesis.

CHAPTER TWO: THE NORMAL TAX IMPLICATIONS IN RELATION TO A RESIDENT

2.1 Introduction

When a “resident” ceases to be resident, an exit charge in section 9H of the Act arises. Since the exit charge influences the normal tax implications of a “resident”, the main goal of this chapter is to discuss how the South African normal tax provisions would apply to a “resident” natural person and company. This will include a discussion of such a person’s “taxable income” and the capital gains tax implications that arise following the disposal of an “asset” as defined. Since certain tax rules apply, to a “resident” trust and a Controlled Foreign Company (CFC), this chapter will also discuss the special tax rules applying to these taxpayers.

2.2 Normal Tax

Section 5(1) of the Act determines that a taxpayer’s liability for income tax in South Africa, sometimes referred to as “normal tax”, is based on a person’s or any company’s “taxable income” received or accrued in the twelve months ended on the last day of February each year and, in the case of a company, during the financial year of the company.

The Rates and Monetary Amounts and Amendment of Revenue Laws Act No. 13 of 2016 sets out the progressive rates of normal tax of between 18% and 41% that apply to the taxable income of natural persons or special trusts in respect of any year of assessment that commences on or after 1 March 2016. This Act also specifies the rates of tax to be levied on a trust (other than a special trust) and a company’s taxable income, at 41% and 28% (a Small Business Corporation is taxed at rates varying from 0% to 28%) respectively.

Section 1 of the Act includes “any trust” in the definition of a “person”. Although the definition of a “person” in section 1 of the Act does not include a natural person, the word “person” clearly refers to a natural person. Section 2 of the Interpretation Act No. 33 of 1957 includes a company in its definition of “person”.

A “company” is defined in section 1 of the Income Tax Act and includes *inter alia*:

- a company incorporated in South Africa;

- a company incorporated in a foreign country;
- a close corporation.

In determining a person's "taxable income" as defined in section 1 of the Act certain general and specific deductions are deducted from the "income" of that person. Most of these deductions can be found in section 11 of the Act, which should be read with section 23 of the Act. A person's taxable income also includes amounts that are deemed to be included in the taxable income of that person. Examples of such amounts include allowances as determined in section 8 of the Act and taxable capital gains under section 26A of the Act.

"Income" as defined in section 1 of the Act is the amount remaining from a person's "gross income" after deducting therefrom any amounts that are exempt from normal tax. An example of the income that would be exempt from normal tax would be the local dividend exemption in terms of section 10(1)(k).

The "gross income" definition in section 1 of the Act provides that "any resident" includes worldwide receipts and accruals in gross income. The "gross income" definition also determines that those receipts and accruals exclude receipts or accruals of a capital nature.

Worldwide receipts and accruals of a capital nature, received by a resident, would be subject to capital gains tax. Paragraph 2(1) of the Eighth Schedule to the Act provides that "any asset" of a resident" disposed of after 1 October 2001 will be subject to capital gains tax. However, for capital gains tax to apply, an "asset" must be disposed of. The definition of an "asset" in paragraph 1 of the Eighth Schedule to the Act states that:

"asset" includes—

(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.

Taxable capital gains are included in the "taxable income" of a person in terms of section 26A of the Act.

Stiglingh et al (2016: 875) submit that to calculate a capital gain or loss, four requirements must be met:

- there must be an “asset” as defined in paragraph 1 of the Eighth Schedule to the Act;
- there must be a “disposal” or a “deemed disposal” of an asset during the year of assessment;
- the “base cost” of the asset must be determined; and
- the “proceeds” on the disposal of the asset must be determined.

If a disposal or deemed disposal takes place, the capital gain or capital loss is calculated by deducting the base cost of the asset from the proceeds from the disposal.

In terms of paragraph 7 of the Eighth Schedule to the Act, a person’s aggregate capital loss for a year of assessment is the amount by which a person’s capital losses for the year exceed that person’s capital gains for the year. Paragraph 8 of the Eighth Schedule to the Act provides that a person’s net capital gain for a year of assessment is the amount by which a person’s aggregate capital gain (the sum of all capital gains) for the year exceeds that person’s assessed capital loss for the previous year of assessment. Where the taxpayer is a natural person or a special trust, the aggregate capital gain or capital loss is reduced by the annual exclusion for that year. For the 2017 year of assessment the annual exclusion amounts to R40 000.

Paragraph 10 of the Eighth Schedule to the Act specifies the inclusion rates for determining person’s taxable capital gain. For natural persons and special trusts an inclusion rate of 40% must be applied to a net capital gain in determining the taxable capital gain for inclusion in taxable income. For other taxpayers, including companies and trusts (other than special trusts), the inclusion rate is 80%.

Paragraph 20(1)(a) to paragraph 20(1)(h) of the Eighth Schedule to the Act sets out the qualifying expenditure to be included in the asset’s base cost. Paragraph 20(3)(a)(i) of the Eighth Schedule to the Act provides that an asset’s base cost must be reduced by an amount which has already been allowed as a deduction in determining the taxable income of that person. An example of this is the wear-and-tear or depreciation claimed as a deduction in respect of depreciable capital assets.

Since capital gains tax was implemented on 1 October 2001, special rules apply to assets that were acquired prior to that date. The special rules are captured in paragraphs 25, 26, and 27 of the Eighth Schedule.

Paragraph 35 of the Eighth Schedule to the Act provides for the amount of the proceeds following the disposal of an asset, which must be reduced (paragraph 35(3)) to the extent that an amount has been included in the gross income or income following the disposal of that asset. An example of this is the recoupment in terms of section 8(4) of the Act of allowances granted on depreciable assets following their disposal.

Once a natural person or a special trust's taxable income has been determined, the tax rates applying to natural persons are used to calculate the amount of normal tax. In the case of a natural person, that person's final normal tax liability is further reduced by the rebates provided for in section 6 of the Act. Companies will be taxed at the rate of 28% (or between 0% and 28% in the case of a Small Business Corporation) and trusts, other than special trusts, at a rate of 41%.

2.3 Tax implications for a resident trust

2.3.1 Background to a trust

As discussed in section 2.2 above, a "resident" of South Africa must include worldwide receipts and accruals in gross income. Since the definition of a "person" in section 1 of the Act also includes a trust, a trust will therefore also be liable for income tax in South Africa on its worldwide taxable income. A trust is defined in section 1 of the Act as (emphasis added):

"trust" means 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.

Section 1 of the Act defines the person acting in the fiduciary capacity as the "trustee".

Stiglingh et al (2016: 842) explain there are two categories of trust:

- a testamentary trust; and

- an inter vivos trust.

Stiglingh et al (2016: 842 and 843) explain further that testamentary trusts are normally created following the death of a person and in terms of a will, with the testamentary trust normally receiving a bequest from a deceased estate, and that an *inter vivos* trust is normally created by founders or donors during their lifetime and often for the purpose of reducing their income tax and/or estate duty liability.

The Comprehensive Guide to Capital Gains Tax (SARS: 2016, 525) indicates that *inter vivos* and testamentary trusts confer different rights on beneficiaries. According to the Comprehensive Guide to Capital Gains Tax, these trusts could be described as either vesting or discretionary trusts. The Comprehensive Guide to Capital Gains Tax (2016: 526) describes a vesting trust as a trust where the assets and income of the trust are vested in the beneficiaries of the trust. In a discretionary trust, the trustees have the discretion as to how much of the income and assets are to be distributed to beneficiaries.

The “year of assessment” definition in section 1 of the Act, provides that the year of assessment for a trust ends on the last day of February.

The Act provides for two types of trusts, a trust (other than a special trust) and a special trust. A “special trust” is defined in section 1 of the Act and includes two types of special trusts:

- a special trust created for a person or persons with a disability; or
- a special trust created following the death of a person and in terms of a will for beneficiaries who are relatives of the deceased.

Since only a special trust created for a person with a disability is included in the “special trust” definition in paragraph 1 of the Eighth Schedule to the Act, only that special trust would be eligible for the following capital gains tax exclusions:

- the annual exclusion of R40 000 under paragraph 5 of the Eighth Schedule;
- the primary residence exclusion under paragraph 45 of the Eighth Schedule; and
- the personal use asset exclusion under paragraph 53 of the Eighth Schedule.

2.3.2 Normal Tax Implications

Although the tax liability of a trust follows the normal tax rules that are discussed in section 2.2, separate tax rules also apply to trusts. These tax rules can be found in section 7 and section 25B of the Act.

In the case of *Armstrong v CIR* 10 SATC 1, 1938 AD 343, the court determined that a trust represented a “mere conduit pipe” through which the income flows and hence the income retains its nature when received by the trust, the beneficiaries or the donor.

In terms of section 25B(1) of the Act, where an amount is received by or accrues to a trustee of a trust during a year of assessment in which a beneficiary has a vested right, that amount is deemed to have accrued directly to the beneficiary. Section 25(2) indicates that if a beneficiary acquires a vested right to an amount that was received by or accrued to a trust following the exercise of a trustee’s discretion, that amount is also deemed to have accrued to the beneficiary. However, section 25(1) and section 25(2) of the Act are subject to the provisions of section 7 of the Act.

Accordingly, it is submitted that the rules in section 7 of the Act should be considered before applying section 25B. Section 7(1) of the Act confirms the vesting principle, in that an amount is deemed to accrue to a person, even if the amount is re-invested, accumulated or not paid over to the person. Section 7(2) to section 7(8) of the Act directs that any amount received by accrued to a person shall be deemed to have accrued to the donor, if that amount was received by or accrued to that person as a result of any “donation, settlement or other donation” by a donor. Haupt (2016: 814) submits that “donation” under Roman Dutch common law means “a wholly gratuitous disposal, made out of the liberality or generosity of the donor”. For the word “settlement”, Haupt (2016: 814) also submits that: “A settlement is a gratuitous disposal of property subject to specific terms and conditions, usually to the trustees of a trust”. In *Ovenstone v SIR*, 42 SATC 55, 1980 (2) SA 721 (A), the court held that “other disposition” should be read with the words “donation” and “settlement” and therefore the phrase must be read as “donation, settlement or similar disposition”. On that basis, the court held that the word “disposition” meant “any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer”, which therefore involves an element of gratuity.

An example of a donation, settlement or other disposition could be an interest-free or low interest loan. In *CIR v Berold*, 24 SATC 729, 1962 (3) SA 748 (A), an interest-free loan to a company enabled that company to acquire assets from the taxpayer on credit and in the absence of an interest charge enabled the company to distribute dividends to trusts created for the benefit of the taxpayer's children. The court held that the taxpayer's loan to the company represented a continuing donation, and therefore the dividends were included in his income under section 9(3) of the Income Tax Act No 31 of 1941, which was the predecessor to the current section 7(3) of the Act.

In *Joss v SIR*, 41 SATC 206, 1980 (1) SA 674 (T), the court found that the interest-free loan represented a continuing donation and therefore was a "disposition" for the purposes of section 7(3) of the Act. The court directed that the taxpayer be assessed for the disposition under section 7(3) but only to the extent of the dividend distributions.

Although the residency of the donor is only mentioned in section 7(8) of the Act, but not in sub-sections 7(2) to 7(7), since section 7(10) requires that residents should disclose donations made, this appears to imply that section 7 of the Act should only apply to resident donors. Furthermore, since section 7 refers to a "donation, settlement or other disposition" and non-residents are not subject to donations tax, this also supports the view that section 7 of the Act only applies to resident donors.

In the case of a testamentary trust, where the donor is no longer alive, section 7 cannot apply to that trust. Stiglingh et al (2016: 843) submit that with an *inter vivos* trust, where the founder/donor is normally alive, section 7 of the Act could apply to the income received by the trust.

The following sub-sections of section 7 of the Act apply equally to donations, settlements or dispositions made directly to beneficiaries, or indirectly through the medium of a trust. In the case of a trust:

- Under section 7(2), income would be deemed to have accrued to the donor spouse, if the donor spouse made a donation to a trust, which resulted in income accruing to the other spouse, and the sole or main purpose of the donation was the reduction, postponement or avoidance of the donor spouse's liability for tax.

- If a parent of a minor child made a donation to a trust, which resulted in income accruing to the minor child, that income is deemed under section 7(3) of the Act to have accrued to the parent and not the minor child.
- Section 7(4) addresses the situation where a parent (parent 1) makes a donation to a trust for the benefit of a minor child (child 2) of another parent (parent 2) and in return that parent (parent 2) makes a donation to another trust for the benefit parent 1's minor child (child 1). Where income accrues to both child 1 and child 2, following each donation, under section 7(4) of the Act that income is deemed to have accrued to each parent and not each minor child.
- In terms of section 7(5) of the Act the donor will also be liable for tax on income, if the donation, settlement or other disposition to a trust is subject to a stipulation or condition that the beneficiary will be unable to receive the income until the stipulation or condition is met. De Koker and Williams (2016: § 12.28) submit that, where trustees have the discretionary powers to pay amounts to beneficiaries of a trust, it is the SARS practice to apply section 7(5) to the undistributed income and to tax the donor on this income.
- Section 7(6) of the Act provides that the income will be deemed to have accrued to the donor, if the donor retains the right to revoke the right of a beneficiary of a trust to receive the income, or confer that right on another person.
- Under section 7(7) of the Act, the donor will remain liable for the tax on the income, where the donor cedes the right to receive the income from a particular asset but retains the ownership of the asset or retains the right to regain the ownership of that asset.
- Section 7(8) of the Act determines that a "resident donor" to a trust will be liable for the tax on income that accrues to or is received by a non-resident beneficiary of the trust.
- Section 7(9) of the Act provides that, where an asset has been sold for an amount that is less than the market value of the asset, the difference is deemed to be a donation for the purposes of section 7.

In summary, if a beneficiary has a vested right to the income or, following the application of a trustee's discretion, a beneficiary receives a vested right to income, that income will be taxed in the beneficiary's hands. However, if section 7 of the Act applies to that income, then the income will be taxable in the donor's hands. In the absence of a beneficiary with a vested right or where section 7 cannot apply, the income will be taxable in the hands of the trust.

Section 25B(3) of the Act determines that a deduction or allowance may be made against the income to which it relates. For that reason, if the income is determined to have accrued to a beneficiary and a deduction or allowance relates to that income, the deduction or allowance will follow the income and be claimable as a deduction or allowance by the beneficiary. Similarly if the deduction or allowance relates to an amount that had accrued to the trust, the deduction or allowance will be claimable as a deduction or allowance in the trust.

Section 25B(4) of the Act limits the allowance or deduction that arises in section 25B(3) to the amount that was deemed to have received by or accrued to the beneficiary as a result of a vested right under section 25B(1). Where expenditure and allowances arising from section 25B(3) of the Act exceed the amount that was deemed to have received or accrued by a beneficiary, the amount in excess must, under section 25B(5)(a), first be offset against the trust's income but that deduction or allowance is limited to the taxable income of the trust during the particular year of assessment. Deductions or allowances in excess of the taxable income of a trust, are deemed under section 25B(6) of the Act to be a deduction or allowance which could be made against the vested income of that beneficiary in a subsequent year of assessment.

2.3.3 Capital Gains Tax Implications

Although a trust is subject the normal capital gains tax rules as set out and discussed in section 2.2, separate capital gains tax rules also apply to trusts. It is submitted that the following events could result in capital gains tax implications:

- when a trust asset is sold by a resident trust to an independent third party (Stiglingh et al (2016: 859) submit that this will result in a normal capital gains tax calculation);
- when the trustees of a resident trust vest an asset in a resident beneficiary;
- when the trustees transfer or distribute the vested asset to a resident beneficiary; and
- when the trustees of a resident trust vest a capital gain (not the asset itself) from the sale of an asset in a resident beneficiary.

Paragraph 80(1) of the Eighth Schedule stipulates that where a resident beneficiary receives the vested right in a trust asset and a capital gain arises on the vesting of that trust asset, the capital gain will be taxable in that resident beneficiary's hands and will therefore not be taxable in the trust. Paragraph 80(2) provides similarly for the taxation in the hands of the beneficiary

(and not the trust) of the vesting of a capital gain in a beneficiary. Under paragraph 11(1)(d) of the Eighth Schedule, the vesting of an interest in an asset of a trust in a beneficiary represents a “disposal” for the purposes of capital gains tax. The Comprehensive Capital Gains Tax Guide (SARS, 2016: 546) submits that since the trust and the beneficiary are connected persons under paragraph 38(1)(a) of the Eighth Schedule, the proceeds from the disposal must be accounted for at the market value of the vested right. Under paragraph 38(1)(b) of the Eighth Schedule the resident beneficiary is deemed to have acquired the vested right at its market value.

The Comprehensive Capital Gains Tax Guide (SARS, 2016: 537) indicates that once a trust asset has been vested in a resident or non-resident beneficiary there will be no further capital gains tax consequences for the trust, and the beneficiaries must then account for any further capital gains tax implications of their vested rights. The Comprehensive Capital Gains Tax Guide also submits that, after vesting of trust assets, if the trustee continues to hold the assets on behalf of the beneficiary any actions by the trustee in respect of those assets are actions on behalf of that beneficiary. The Comprehensive Capital Gains Tax Guide (SARS, 2016: 537 and 538) further submits by way of an example, that if a beneficiary then requests the trustees to dispose of an asset in which that beneficiary has a vested right, the beneficiary would need to account for the capital gains tax implications of that transaction.

In the third scenario above, if after vesting the trustee transfers the ownership of the asset (distributes the asset) to the vested beneficiary, then the Comprehensive Capital Gains Tax Guide (2016: 538) indicates that no capital gain or loss arises in the trust and paragraph 13(1)(a)(iiA) of the Eighth Schedule determines the time of disposal for the distribution of an asset by a trust to a beneficiary to be the date on which the interest in that asset vested. Paragraph 13(2) of the Eighth Schedule then determines the time of acquisition of the asset by the beneficiary to be the time when that beneficiary acquired a vested interest in the asset. The Comprehensive Capital Gains Tax Guide (SARS, 2016: 534), in example 2, submits that when the trustee transfers the asset, the beneficiary is deemed under paragraph 11(1)(a) to have disposed of his vested interest in the asset for a real right in the asset. The Comprehensive Capital Gains Tax Guide example also confirms the principle that no capital gain or capital loss will arise, since the proceeds represented by the market value of the real right received will equate with the base cost of the vested interest in the asset on the date the asset vested in the beneficiary.

Haupt (2016: 692) submits that if there had been no prior vesting of an asset, but the asset is then distributed to a beneficiary, under paragraph 13(1)(a)(ix) of the Eighth Schedule, the time of disposal is when the asset was distributed to the beneficiary.

Since paragraph 80(1) of the Eighth Schedule to the Act only permits a capital gain from the vesting of an asset to be attributed to a resident beneficiary, if a capital loss occurs on the vesting of an asset in a resident beneficiary, the capital loss will remain in the trust. Furthermore since paragraph 80(1) of the Eighth Schedule only permits a capital gain from the vesting of an asset to be attributed to a resident beneficiary, if the asset was vested in a non-resident beneficiary, the capital gain would be taxed in the trust, unless paragraph 72 of the Eighth Schedule to the Act applies. Paragraph 72 of the Eighth Schedule to the Act provides that when the asset of a resident trust is vested in a non-resident beneficiary, the capital gain that arises from the vesting could be attributed to the resident donor of a trust, if the capital gain arose from the donation.

The Comprehensive Capital Gains Tax Guide (SARS, 2016: 537) indicates that if an asset had already been vested in a non-resident beneficiary, any further capital gains tax consequences will depend upon whether the disposal by the beneficiary of that vested right represents immovable property in South Africa, an interest in immovable property in South Africa or an asset effectively connected to a permanent establishment of that person in South Africa. These assets are listed in paragraph 2(1)(b) of the Eighth Schedule.

For the fourth scenario, it is submitted that paragraph 80(2) of the Eighth Schedule may apply. Paragraph 80(2) of the Eighth Schedule to the Act directs that, in the event that an asset of a trust is sold and a capital gain arises from the sale and that capital gain or a portion of that capital gain is vested in a resident beneficiary, then that capital gain or portion of the capital gain will be taxable in the resident beneficiary's hands and not in the hands of the trust. Paragraph 80(2) of the Eighth Schedule directs that the disposal of the trust asset and the vesting of the capital gain must take place in the same year of assessment. In other words if the capital gain is not vested in a resident beneficiary in the same year of assessment, the capital gain will be taxed in the trust, unless the capital gain can be attributed to the donor under paragraph 70 of the Eighth Schedule to the Act. The Comprehensive Guide to Capital Gains Tax (SARS, 2016: 571) indicates that an attribution under paragraph 70 of the Eighth Schedule normally arises when the vesting of a capital gain is subject to the trustees' discretion, and a capital gain

arose as a result of a “donation, settlement or other disposition” by a donor, which resulted in that capital gain not being vested in a beneficiary.

It follows under paragraph 80(2) of the Eighth Schedule to the Act that if a capital loss arises following the disposal of a trust asset to a third party, the capital loss remains trapped in the trust. Furthermore, under paragraph 80(2) of the Eighth Schedule, if a capital gain is vested by a trust in a non-resident beneficiary, that capital gain will be taxed in the trust, unless that capital gain could be attributed to the donor under paragraph 72 of the Eighth Schedule.

The Comprehensive Guide to Capital Gains Tax (SARS, 2016: 541) indicates that if a capital gain arose in a resident trust in an earlier year and the capital gain was then vested in a beneficiary in a subsequent year, this would merely represent a return of after-tax capital and would have no tax consequences.

Paragraph 80(1) and paragraph 80(2) of the Eighth Schedule to the Act direct that if a trust asset or a capital gain is vested in a resident beneficiary that is:

- the South African government;
- a provincial or local government;
- a tax-exempt public benefit organisation;
- a tax-exempt recreational club;
- a tax-exempt research institution, for example the Council for Scientific and Industrial Research;
- a political party, registered under the Electoral Commission Act; or
- an entity exempt from tax under section 10(1)(d)(iv) or section 10(1)(e),

the capital gain must be taxed in the trust. Paragraph 80(1) also stipulates that if a trust transfers an equity instrument as contemplated in section 8C of the Act to a resident beneficiary, that capital gain must also be taxed in the trust.

Paragraph 80(1) and paragraph 80(2) of the Eighth Schedule to the Act are both subject to the attribution rules in paragraphs, 68, 69, 71 and 72 of the Eighth Schedule. In other words, these rules supersede the application of paragraph 80(1) and 80(2).

The attribution rules provide that if a capital gain arises on the vesting of an asset or the vesting of a capital gain:

- under paragraph 68, in the person's spouse and the asset was acquired as part of a scheme to avoid tax;
- under paragraph 69, in the parent's minor child;
- under paragraph 72, in a non-resident beneficiary; and
- under paragraph 71, where the vesting of the capital gain could be revoked,

and the capital gain arose from a "donation, settlement or other disposition", that capital gain must be taxed in the donor's hands.

Paragraph 73 of the Eighth Schedule to the Act limits the total amount of the income and capital gain that is deemed to be received by a donor as a result of the application of section 7 of the Act and the attribution rules in paragraphs 68, 69, 71 and 72 of the Eighth Schedule, to the benefit derived as a result of the "donation, settlement or other disposition".

2.4 Tax implications for a resident holding a qualifying interest in a Controlled Foreign Company

Stiglingh et al (2016: 604) state that if a resident holds an investment in a foreign company, the anti-avoidance provision in section 9D of the Act will need to be considered. Under section 9D(2) of the Act any resident who directly or indirectly holds "participation rights" in a Controlled Foreign Company (CFC) on the last day of the "foreign tax year" of that CFC must include in their income for that year of assessment, their proportion of the "net income" of that CFC, based on that resident's participation rights in that CFC.

A "foreign company" is defined in section 9D(1) of the Act and includes a "foreign company" as defined in section 1 of the Act. Section 1 of the Act defines a "foreign company" as a company that is not a resident. A CFC is defined in section 9D(1) of the Act and becomes a CFC:

- when more than 50% of the total participation rights in that foreign company are directly or indirectly held by residents; or

- when more than 50% of the voting rights in that foreign company are directly or indirectly exercisable by residents; but
- excludes a headquarter company.

In determining whether a foreign company is a CFC, the voting and participation rights must be separately considered. “Participation rights” are defined in section 9D(1) of the Act as:

- the right to participate in all or part of the benefits of the rights attached to a share; or
- in the event that a foreign company has no shares or the participation rights cannot be determined, the voting rights in that company.

However, the proviso (i) to section 9D(2A) of the Act indicates that the net income of a CFC shall be deemed to be nil:

- under paragraph (aa), when the aggregate of foreign taxes paid by the CFC in respect of a foreign tax year is at least 75% of the amount of tax that would have been payable in respect of the taxable income of the CFC had the CFC been a resident for that foreign tax year; or
- under paragraph (bb), when all the receipts and accruals of that CFC are attributable to a “foreign business establishment” and are not required to be taken into account under section 9D(9A).

It follows that if a CFC paid tax in a foreign country at a rate that was at least 75% of the amount of tax that would have been payable in South Africa if the company had been resident, the net income of that CFC would be deemed to be nil. In the event that all of CFC’s receipts and accruals were attributable to a “foreign business establishment” and were not required to be taken into account under the diversionary rules in section 9D(9A) of the Act, the net income of that CFC would also be deemed to be nil.

Stiglingh et al (2016: 604) state that section 9D of the Act is primarily targeted at the so-called passive income in the form of rentals, interest and royalties. For that reason *bona fide* business income is excluded from the application of section 9D. The “foreign business establishment” is defined in section 9D(1) of the Act and means a fixed place of a business located in a country other than South Africa, that is used or will be used, for the carrying on of the business of that

CFC for a period of not less than one year. Income in a CFC that relates to a “foreign business establishment” is excluded from the application of section 9D under the proviso (i), paragraph (bb) to section 9D(2A) and section 9D(9)(b) of the Act. Although the income from a “foreign business establishment” may be excluded from the net income of a CFC, the diversionary rules in section 9D(9A) should also be considered, since these amounts will not be excluded from the net income of the CFC. The Comprehensive Guide to Capital Gains Tax (SARS, 2016: 739) indicates that since the net income of a CFC includes capital gains, the “foreign business establishment” exemption must also apply to the sale of capital assets related to a foreign business establishment.

Proviso (A)(i) to section 9D(2) of the Act determines that if a resident, together with any connected person, held less than 10% of the participating rights and voting rights of the CFC at the end of the CFC’s tax year, section 9D(2) will not apply to that resident and therefore that resident will not need to include the proportionate share of the net income of the CFC in that resident’s income. Proviso (A)(ii) to section 9D(2) of the Act provides that if a resident, together with a connected person, held less than 10% of the participating rights and voting rights of the CFC immediately before that foreign company ceased to be a CFC, section 9D(2) will not apply to that resident and therefore that resident will not need to include their proportionate share of the net income of that CFC for the period immediately before that CFC ceased to be a CFC in that resident’s income.

Proviso (B) to section 9D(2) of the Act indicates if the participating rights in a CFC are held indirectly through any resident company, section 9D(2) will not apply to that indirect holding. Stiglingh et al (2016: 629) submit that, in that case, the resident company with the direct holding in the participation rights of the CFC could be subject to section 9D of the Act.

Therefore, once it has been established:

- that the foreign company is a CFC;
- that a resident and a connected person of that resident hold not less than 10% of the participating rights in that CFC;
- that the foreign tax paid by the CFC in its country of residence was less than 75% of the amount of tax that would have been payable in South Africa if the company had been resident;

- that none of the receipts and accruals of the CFC are attributable to a foreign business establishment; and
- the receipts and accruals of the CFC include the diversionary income as a result of section 9D(9A),

in terms of section 9D(2), the shareholder's proportional share of that CFC's "net income" must be included in the income of the shareholder.

Section 9D(2A) of the Act provides that the "net income" of the CFC in respect of its foreign tax year is the taxable income of that CFC, determined as if the company had been resident in South Africa for the purposes of the definition of "gross income", section 7(8), section 10(1)(h), section 25B and paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule to the Act. It is submitted that in the context of section 9D(2A) interpretation issues could arise with regard to paragraphs 70, 71 and 72 of the Eighth Schedule since these provisions refer to two persons, a donor and a beneficiary. In that case, there is uncertainty as to whether the reference to these paragraphs contemplates the "resident", which in this case is the CFC, as being either a beneficiary, or the donor, or both.

Several provisos apply to the definition of a CFC's "net income" in section 9D(2A) of the Act. Proviso (a) to the definition of "net income" provides that the deductions and allowances may only be set off against the income of a CFC to the extent of that income. In other words, a loss in terms of section 9D(2) could not be attributed to a South African resident. Proviso (b) to the definition of "net income" provides that any amount in excess of the income, must be carried forward to the immediately succeeding foreign tax year and be deemed to be a balance of an assessed loss which may be set off against the income of the company in that year.

Proviso (e) to the definition of "net income" in section 9D(2A) of the Act provides that when a foreign company becomes a CFC after 1 October 2001, the valuation date for determining any taxable capital gain or assessed capital loss under the Eighth Schedule to the Act will be the day before that foreign company becomes a CFC. It is submitted that the valuation date in this instance links to paragraph 13(1)(g)(i) of the Eighth Schedule, which indicates the time of acquisition of the event referred to in paragraph 12(2)(a) is "the date immediately before the day that event occurs". It follows that under paragraph 12(2)(a) of the Eighth Schedule, when

a foreign company becomes a CFC it is deemed under paragraph 12(1) to have acquired all its assets, except assets referred to in paragraph 2(1)(b) of the Eighth Schedule and its foreign business establishment assets, for an amount equal to the market value of those assets on the day before it became a CFC. The assets that are excluded from the deemed acquisition under paragraph 2(1)(b) of the Eighth Schedule are immovable property in South Africa, an interest in immovable property situated in South Africa and any asset connected to a permanent establishment in South Africa.

Proviso (f) to the definition of “net income” in section 9D(2A) of the Act provides that when the resident shareholder in terms of section 9D(2) is a natural person or special trust, the taxable capital gain of the CFC shall for the purposes of paragraph 10 of the Eighth Schedule be 40% (2017 year of assessment) of that company’s net capital gain in that foreign tax year and therefore 40% of the proportionate share such a net capital gain must be included in that person’s income. Although not specifically stated in the sub-section, where the resident shareholder of a CFC is a company or trust (other than a special trust), it is submitted that 80% of the proportionate share of the taxable capital gains will be included in the company’s or trust’s income under section 9D(2).

Section 9D(6) of the Act provides that the net income of the CFC must be calculated for its foreign tax year in its functional currency and that foreign currency amount must be included in the income of a resident by translating it to the South African currency at the average exchange rate for that foreign tax year. A foreign company’s “foreign tax year” is defined in section 1 of the Act as its year or period of reporting for foreign income tax purposes by that company or if the company is not subject to income tax, the annual period of financial reporting by that company.

In addition to the foreign business establishment exemption in section 9D(9)(b) of the Act and the diversionary rules in section 9D(9A), there are several other provisos to section 9D(9) that must be taken into account in determining the “net income” of the CFC under section 9D(2A). Proviso (d) to section 9D(9), requires that if interest or royalties were received by a CFC and such income had been subject to a withholding tax in South Africa under section 49B or section 50B of the Act, after taking into account any applicable double taxation agreement, that income must be excluded from the “net income” of the CFC.

Proviso (e) to section 9D(9) of the Act provides that the “net income” of the CFC must exclude the (South African) taxable income of the company. The Comprehensive Guide to Capital Gains Tax (SARS, 2016: 740) submits that, since a CFC is a non-resident and has already been taxed on the amounts it receives from a South African source, this exclusion ensures that a resident shareholder in a CFC is not taxed on the same amount.

Once the “net income” of the CFC has been established, the inclusion under section 9D(2) must be determined. This is based on a resident’s participation rights in that CFC, and the relevant amount must be included on the last day of the foreign tax year of that CFC, which ends during a year of assessment. For example, assume that Mr X, a resident, holds 60% of the participation rights in Offshore Limited, a CFC. Offshore Limited reported a section 9D(2A) “net income” of EUR 500 000 for its financial year ended 30 June 2016. Assume an average exchange rate of EUR 1 = R15 for the foreign tax year ended 30 June 2016 and an average exchange rate of EUR 1 = R16 for the year of assessment ended 28 February 2017. Since Offshore Limited’s foreign tax year (30 June 2016) ends during Mr X’s year of assessment ended 28 February 2017, R4 500 000 (60% x R15 x EUR 500 000) must be included in Mr X’s income under section 9D(2), as section 9D(6) provides that the “net income” of the CFC must be translated to South African currency at the average exchange rate for the foreign tax year of the CFC.

Section 9D(2)(a)(i) provides that, if a foreign company was a CFC for the entire foreign tax year, the amount to be included in a resident’s income is in proportion to that resident’s participation rights to the total participation rights in the company. It follows that, if a resident acquired a qualifying interest in a CFC during that resident’s year of assessment and the foreign tax year of that CFC ended during that resident’s year of assessment, if the foreign company was a CFC for the entire foreign tax year, its income is not apportioned.

Section 9D(2)(a)(ii) includes special rules providing for when a foreign company becomes a CFC during a year of assessment and section 9D(2)(b) includes special rules for when a foreign company ceases to be a CFC during a year of assessment.

Foreign dividends received from a CFC are exempt from tax in terms of section 10B(2)(a) of the Act (an equity shareholding of at least 10 percent) and section 10B(2)(c) (to the extent that the net income of the CFC was included in the taxpayer’s income) Stiglingh et al (2016: 631)

submit that this prevents the income from a CFC from being taxed twice, once as a section 9D inclusion and again as a foreign dividend from the same CFC.

Where a resident holds the shares in a CFC for investment purposes, paragraph 20(1)(h)(iii) of the Eighth Schedule to the Act determines the base cost of those shares. Paragraph 20(1)(h)(iii) requires the following base cost adjustments be made to the shares of a CFC:

- The base cost of the shares is increased by an amount equal to the proportional amount of the net income of that CFC that has been included in the income of that resident shareholder under section 9D in any year of assessment. The paragraph also provides that the full amount of the capital gain must be reflected in the upward adjustment to the base cost, even though these amounts may only have been partially included in the net income under section 9D as a result of the inclusion rate in paragraph 10 of the Eighth Schedule to the Act.
- The base cost of the shares is reduced to the extent that foreign dividends have been received from that company during any year of assessment and these foreign dividends were exempt from tax in terms of section 10B(2)(a) or section 10B(2)(c) of the Act.

If the taxpayer's intention with regard to the holding of shares in a CFC is speculative, in terms of section 22(3)(a)(iii) of the Act, certain cost adjustments are required to the cost price of those shares:

- The cost of the shares must be increased by an amount equal to the proportional amount of the net income of that CFC that has been included in the income of that resident shareholder under section 9D in any year of assessment. The section also provides that the full amount of any capital gains made by the CFC must be added to the cost of the shares, even though these amounts may have only been partially included in the net income under section 9D as a result of the inclusion rate in paragraph 10 of the Eighth Schedule to the Act.
- The cost of the shares must be reduced to the extent that foreign dividends have been received from that company during any year of assessment and these foreign dividends were exempt from tax under section 10B(2)(a) or section 10B(2)(c) of the Act.

In such circumstances, since the cost of a taxpayer's shares in a CFC would be increased by the section 9D(2) inclusion and result in a further section 11(a) deduction, this may nullify the impact of the section 9D(2) inclusion in that taxpayer's income.

Paragraph 64B of the Eighth Schedule to the Act provides that, if a person disposed of shares in a CFC, the disposal of those shares could be excluded from capital gains tax if the person:

- held at least 10% of the equity shares and voting rights in that foreign company;
- held the interest for at least 18 months prior to the disposal;
- disposed of the interest to any person that is not a resident, other than a CFC or any person connected to the person disposing of that interest; and
- for an amount that is equal to or exceeds the market value of the interest.

2.5 Conclusion

This chapter has described the normal tax consequences that arise in respect of natural persons, companies, trusts and CFCs. Worldwide income will be included in the taxable income of a "resident" natural person, company or trust. Similarly the worldwide receipts and accruals of a capital nature received by a South African natural person, company or trust could be subject to capital gains tax and included in the taxable income of that person in terms of section 26A of the Act.

The income and capital gains of a "resident" trust could be taxed either in the hands of the donor to the trust, the beneficiary or the trust itself. If a beneficiary of a trust received a vested right to income, a vested right to an asset, or a vested right to a capital gain and that beneficiary was a resident minor child of the donor to that trust, that income or the capital gain arising from that asset would be taxable in the parent donor's hands, in terms of section 7(3) or paragraph 69 of the Eighth Schedule to the Act. If a donor retained the right to revoke certain rights, or if the donation to the trust was subject to a stipulation or condition, or the resident donor made a donation to a trust that resulted in a non-resident beneficiary receiving the benefit, the donor will ultimately be liable for the tax on either the resultant income under section 7(6), section 7(5) or section 7(8) or the tax on the capital gain under paragraph 71, 70 or 72 of the Eighth Schedule to the Act. If a beneficiary received a vested right to income and section 7 did not apply to that income, the beneficiary will be liable for the tax under section 25B of the Act.

Where section 7 does not apply, a trust will be liable for the tax on all income that is retained in the trust, to which no beneficiary has a vested right.

Where a resident holds a qualifying interest in a CFC, that resident must, in terms of section 9D(2) of the Act, include in income on the last day of that CFC's foreign tax year, the proportionate share of the "net income" of the CFC. Since the "net income" of a CFC includes capital gains, proviso (f) to the definition of "net income" in section 9D(2A) determines that if a resident shareholder is a natural person or a special trust, 40% of the proportionate share of that net capital gain would be included in that person's income. Section 9D(6) determines that the "net income" of the CFC must be determined in its functional currency and then translated to the South African currency at the average exchange rate for that foreign tax year. Special rules determine the income inclusion in section 9D(2) when a CFC becomes a CFC or ceases to be a CFC.

In the following chapter, the normal tax implications relating to the exit charge in terms of section 9H will be discussed. This will include a discussion of how and when a natural person, company or trust ceases to be resident and when a CFC ceases to be a CFC. The chapter will conclude with a discussion of the tax principles that apply in the calculation of the resulting exit charge.

CHAPTER THREE: THE EXIT CHARGE WHEN A PERSON CEASES TO BE A “RESIDENT” AND WHEN A CONTROLLED FOREIGN COMPANY CEASES TO BE A CONTROLLED FOREIGN COMPANY

3.1 Introduction

The main goal of this chapter is to examine the normal tax implications of the exit charge provided for in section 9H of the Act and how it may impact a “resident” natural person, trust, or company when that person ceases to be resident. The chapter will also discuss the normal tax implications of section 9H when a Controlled Foreign Company (CFC) ceases to be a CFC.

The chapter will investigate how and when a natural person, company or trust ceases to be resident. This will include a discussion of the meaning of “ordinarily resident” and “place of effective management”. The chapter will also discuss how and when a CFC ceases to be a CFC.

Certain normal tax principles will apply consistently to the related exit charge under section 9H. Accordingly, this chapter will focus a discussion of the generic tax principles and their application in calculating the exit charge, when a natural person, company or trust ceases to be a resident or when a CFC ceases to be a CFC. Finally, the chapter will close by explaining the exit charge arising from the disposal of an interest in immovable property in South Africa.

3.2 Section 9H definitions

The definitions of “asset” and “market value” are included in section 9H(1) of the Act.

“Asset” as defined in section 9H(1) “means an asset as defined in paragraph 1 of the Eighth Schedule”. Stiglingh et al (2016: 67) submit that since the definition of an “asset” is quite wide, this means that section 9H is applicable to both capital and income assets.

“Market value” is defined in section 9H(1) as “in relation to an asset, means the price, which can be obtained upon the sale of that asset between a willing buyer and a willing seller dealing at arms-length in an open market”.

3.3 “Exit charge” under section 9H(2) - persons other than companies

Section 9H(2)(a) of the Act provides that where a person (other than a company) that is a “resident” ceases during any year of assessment to be a “resident”, that person is:

- deemed to have disposed of each of that person’s assets (except those assets referred to in section 9H(4)) to a person that is resident;
- on a date immediately before the day on which that person ceases to be resident;
- for an amount equal to the market value of the asset on that date;
- and reacquired each of those assets on the day on which that person ceases to be resident;
- for an expenditure equal to the market value that was taken into account for the purposes of the deemed disposal.

Since section 9H(2) of the Act refers to a “person (other than a company)”, this provision applies to a natural person who ceases to be resident. Furthermore, since the definition of “person” in section 1 of the Act includes a “trust”, section 9H(2) would also apply when a trust ceases to be a resident.

Section 9H(4) of the Act specifies the assets to be excluded from the exit charge in section 9H(2). This is discussed in section 3.6 below.

Section 9H(2)(b) of the Act provides that the year of assessment for a natural person and trust is deemed to have ended on the date immediately before the day on which that person ceases to be a resident. In terms of section 9H(2)(c) of the Act the year of assessment of a natural person and trust must be deemed to have commenced on the day on which that person ceases to be a resident. Stiglingh et al (2016: 69) submit that the effect of section 9H(2)(b) and section 9H(2)(c) is that the taxpayer would need to submit two tax returns in the year of emigration. However, they submit that the operational procedures that need to be followed for the submission of tax returns for two years of assessment in a single year are unclear. Stiglingh et al (2016: 69) also submit that if a natural person emigrated on 1 October 2015, that natural person’s 2016 year of assessment:

- as a resident will be from 1 March 2015 to 30 September 2015;
- as a non-resident will be from 1 October 2015 to 29 February 2016; and

- the rebates under section 6 of the Act for each of the periods would need to be apportioned accordingly.

Since the year of assessment of a trust ends on the last day of February, a trust would also need to submit two tax returns in the year that a trust ceased to be resident. The first return for that trust prepared on the basis that that trust was a resident, would be for the period 1 March to the day before that trust ceased to be resident. The second return for that trust prepared on the basis that the trust was non-resident, would be from the day that trust ceased to be resident until the last day of February.

3.3.1 When would a natural person cease to be resident?

In terms of the definition of a “resident” in section 1 of the Act, a natural person is “resident” in South Africa either through being:

- “ordinarily resident” in terms of paragraph (a)(i) of the definition; or
- resident in terms of the so-called physical presence test in terms of paragraph (a)(ii) of the definition.

The term “ordinarily resident” is not defined in the Act and guidance is obtained from case law, particularly in the case of *Cohen v CIR 1946 AD 174, 13 SATC 362* and *CIR v Kuttel 1992 (3) SA 242 (A), 54 SATC 298*. In the *Cohen* case the court determined a person’s ordinary residence to be the place where that person would “return [to] from their wanderings”, their “usual or principal residence”, and what may be described as their “real home”. These principles were also adopted in the *Kuttel* case.

According to paragraph (a)(ii) of the definition of a “resident” in section 1 of the Act, a natural person can only become “resident” in South Africa under the physical presence test if:

- that person was physically present in South Africa for a period or periods exceeding 91 days in the current year of assessment;
- that person was physically present in South Africa for a period or periods exceeding 91 days in aggregate during each of the five preceding years of assessment; and
- that person was physically present in South Africa for a period exceeding 915 days in aggregate during the preceding five years of assessment.

The definition of a “resident” in section 1 of the Act determines that a “resident” excludes any natural person that is deemed to be exclusively resident of another country for the purposes of a double taxation agreement entered into between the government of South Africa and that other country.

On that basis, a natural person would cease to be a “resident” in South Africa in the following instances:

- A natural person who was “ordinarily resident”, emigrates from South Africa. In this case, that natural person would formally emigrate from South Africa with applications being made to the South African Reserve Bank (SARB). Formal emigration with the SARB would enable natural persons to transfer their South African assets through a travel allowance, a foreign capital allowance and a household and personal effects allowance. Interpretation Note 3 (SARS, 2002: 6) states that the date on which a person ceases to be resident is the date of emigration. On that basis, the exit charge under section 9H(2) of the Act would take place on the day immediately before emigration;
- A natural person who was “ordinarily resident”, leaves South Africa permanently but does not formally emigrate. The question arises as to when these individuals cease to be resident, since this will determine the timing of the exit charge.
- A natural person, who is “resident” in South Africa under the physical presence test, permanently returns to his or her home country during a year of assessment. This may occur, for example, when the 330 day rule applies. Proviso B to the definition of a “resident” in section 1 of the Act provides that where a natural person who was “resident” under the physical presence test was outside South Africa for a continuous period of at least 330 full days, that person would be deemed not to be a resident from the day that person ceased to be physically present in South Africa. Accordingly, the exit charge under section 9H(2) of the Act would apply on the day immediately before that person ceased to be physically present in South Africa for a continuous period of at least 330 days.
- A natural person, who is “resident” in South Africa under the physical presence test, is physically present for 91 days or less in aggregate during the relevant year of assessment. In this case, that natural person would not be “resident” in South Africa under the physical presence test in that year and therefore that natural person would cease to be resident on 1 March of that year of assessment. The exit charge under section

9H(2) of the Act would apply on either the twenty-eighth or twenty-ninth day of February, being the last day of the previous year of assessment.

- A natural person, who is “resident” in South Africa under the physical presence test, is physically present for 915 days or less in aggregate during the five preceding years of assessment. In this case, that natural person would not be “resident” in South Africa under the physical presence test in that year and therefore that natural person would cease to be resident on 1 March of that year of assessment. The exit charge under section 9H(2) of the Act would apply on either the twenty-eighth or twenty-ninth day of February, being the last day of the previous year of assessment.
- A natural person, who was “resident” in South Africa, ceases to be resident in South Africa as a result of a double taxation agreement, which causes that individual to be exclusively resident in another country. On that basis the exit charge under section 9H(2) of the Act would take place on the day before that person ceased to be “resident” in South Africa as a result of a double taxation agreement.

There remains uncertainty as to the timing of the exit charge for an individual who was previously “ordinarily resident” and leaves South Africa permanently, but does not formally emigrate through the SARB. Interpretation Note 3 (SARS, 2002: 4) states that the burden would be on the taxpayer to discharge the onus of proving that he or she is not ordinarily resident in the Republic. Interpretation Note 3 (SARS, 2002: 4) also states that: “It is not possible to lay down hard and fast rules” in determining if a natural person is “ordinarily resident”. Accordingly, a natural person in terms of case law principles would need to assess the location of their “country of most fixed or settled residence”, their “real home”, and where that person would naturally “return [to] from his wanderings”.

Since the definition of a “resident” in section 1 of the Act applies to persons who are “ordinarily resident” in the Republic and also to persons resident in terms of the physical presence test, if a natural person was no longer considered to be “ordinarily resident”, as a result of emigration, that person could become “resident” again if the physical presence test applied in the subsequent year of assessment. So the question arises: when does the subsequent year of assessment commence?

Worsdale and Schoeman (2015) state that, in the absence of the application of a double taxation agreement and following the amendments to section 9H(2) of the Act on the 8 May 2012, which resulted in the introduction of section 9H(2)(b) and section 9H(2)(c) whereby:

- a natural person's year of assessment is deemed to have ended immediately before that person ceased to be a resident; and
- that natural person's succeeding year of assessment is deemed to have commenced on the day on which that person ceases to be resident,

that emigrant's year of assessment is deemed to have ended on the day before the date of emigration and that emigrant's succeeding year of assessment for the purpose of the physical presence tests commences on the date of emigration. Worsdale and Schoeman (2015) submit that if a resident emigrated on 1 February 2015, that person would be:

- "ordinarily resident" from 1 March 2014 to 31 January 2015; and
- not "ordinarily resident" from 1 February 2015 to 28 February 2015 and, on that basis, section 9H(2)(c) would consider this to be the succeeding year of assessment.

Worsdale and Schoeman (2015) submit that since the shortened year of assessment (1 February 2015 to 28 February 2015) did not exceed 91 days, the physical presence test could not apply for the next five full years of assessment.

3.3.2 When would a trust cease to be resident?

Paragraph (b) of the definition of a "resident" in section 1 of the Act provides that a trust would be "resident" in South Africa if:

- the trust was established and or formed in South Africa; or
- the trust had its place of effective management in South Africa.

The definition of a "resident" in section 1 of the Act determines that a "resident" excludes any person that is deemed to be exclusively resident of another country for the purposes of a double taxation agreement entered into between the government of South Africa and that other country. Hence, if the effective management of a trust that was established or formed in South Africa was moved to a foreign country that trust may no longer be considered to be tax resident

in South Africa if a double taxation agreement between South Africa and the foreign country would deem that entity to be exclusively resident in the foreign country.

Since the term, “place of effective management”, is not defined in the Act, SARS initially interpreted the term in Interpretation Note 6 (SARS: 2002). However, in the case of *Oceanic Trust Co Ltd NO v C:SARS*, 74 SATC 127, 2011 (WCHC) where the court followed the principles espoused in the English case of *Commissioner for Her Majesty’s Revenue and Customs v Smallwood and Another* [2010] EWCA Civ 778, the court held that the place of “effective management” for a trust was “the place where key management and commercial decisions that were necessary for the conduct of ... business, were in substance made”. Following the judgement, SARS re-issued Interpretation Note 6 (Issue 2) (SARS: 2015) to address these principles. Interpretation Note 6 (Issue 2) (SARS: 2015) now indicates:

- that a company’s place of effective management is where the key management and commercial decisions of a business are made;
- that the company’s place of effective management is where the executive management of the company are located or, where the board meets to make executive decisions; and
- that the operational management of a company has little relevance in determining a company’s place of effective management.

SARS indicated that, although the Interpretation Note 6 (Issue 2) (SARS: 2015) dealt with the effective management of companies, the underlying principles contained therein could also be applied to trusts.

Interpretation Note 6 (Issue 2) (SARS: 2015) appears to be consistent with the approach of the Organisation for Economic Co-operation and Development (OECD) to the term “place of effective management”, since the OECD Commentaries on the Articles of the Model Tax Convention states (OECD: 2014: 90 and 91) that “[T]he place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made”.

Thus, when:

- the trustees of a trust become resident in a foreign country; or
- the trustees’ meetings for a trust take place in a foreign country; or

- the trustees' decisions relating to the affairs of trust take place in a foreign country; or
- the administration of the trust takes place in a foreign country,

the effective management of that trust may be considered to have moved to a foreign country. In that case a trust that was established or formed in South Africa may no longer be considered to be tax resident in South Africa, if a double taxation agreement between South Africa and the foreign country deems that trust to be exclusively resident in the foreign country. If this occurred, the exit charge under section 9H(2) of the Act would apply on the day immediately before the day the trust was considered to be exclusively resident of a foreign country as a result of a double taxation agreement.

Similarly a trust established or formed in a foreign country could also be considered to be "resident" in South Africa if the place of effective management of this entity was in South Africa. However, if at some later stage the place of effective management of such a trust returned to a foreign country, then that trust would cease to be resident in South Africa. If this occurred, the exit charge under section 9H(2) of the Act would apply on the day immediately before the day the trust ceased to be resident in South Africa.

3.4 "Exit charge" under section 9H(3)(a), (c), (e) and (f) - companies

Section 9H(3)(a) of the Act provides that where a company that is a "resident", ceased during any year of assessment to be a "resident", that company is:

- deemed to have disposed of each of that company's assets (except those assets in section 9H(4)) to a person that is resident;
- on a date immediately before the day on which that company ceased to be resident;
- for an amount equal to the market value of the asset on that date;
- and reacquired each of those assets on the day on which that company ceased to be resident;
- for an expenditure equal to the market value that was taken into account for the purposes of the deemed disposal.

Section 9H(4) of the Act specifies the assets to be excluded from the exit charge in section 9H(3)(a). This is discussed in section 3.6 below.

Section 9H(3)(c)(i) of the Act provides that the year of assessment for that company is deemed to have ended on the date immediately before the day on which that company ceased to be a resident. In terms of section 9H(3)(c)(ii) of the Act the year of assessment of that company is deemed to have commenced on the day on which that company ceased to be a resident.

Other than the exit charge that arises from the deemed disposal of the company's assets in section 9H(3)(a) of the Act, an additional exit charge arises in terms of section 9H(3)(c)(iii) which provides that when a company ceases to be resident that company is deemed to have paid, on the day before that company ceased to be resident, a dividend *in specie*, representing the market value of all the shares in that company, on the day before it ceased to be resident, less the contributed tax capital in that company on that date, to persons holding shares in that company in accordance with their effective interest. In terms of section 64EA(b) of the Act a resident company that declares and pays a dividend *in specie* is liable for the dividends tax on that dividend. Under section 64E of the Act this will represent 15% of the value of the dividend *in specie*. However, the dividend *in specie* could be exempt from dividends tax under section 64FA(1)(a) of the Act.

In terms of section 64FA(1)(a) of the Act, the dividend *in specie* would be exempt from dividends tax if:

- by the payment date, the beneficial owner of that dividend had submitted a declaration to the company, to the effect that if the dividend had not been a dividend *in specie*, it would have been exempt under section 64F;
- the beneficial owner of that dividend forms part of the same group of companies, as defined in section 41, as that company; or
- the dividend represented a disposal of immovable property by a share block company under paragraph 67B(2) of the Eighth Schedule.

It is submitted that, since the assets identified in section 9H(4) are excluded from the exit charge in section 9H(3)(a), it would appear that these assets would also need to be excluded from the valuation of that company's shares in section 9H(3)(c)(iii). However, there remains uncertainty as to whether a company's contributed tax capital should be also adjusted, particularly if a portion of a company's contributed tax capital was generated following a contribution of a section 9H(4) asset to the company (refer to section 3.6 below).

The legislative provisions in section 9H(3)(e) and section 9H(3)(f) of the Act came into effect on 5 June 2015. National Treasury in its Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015 (National Treasury: 2015) indicated that section 9H(3)(e) and 9H(3)(f) were introduced in conjunction with amendments to paragraph 64B of the Eighth Schedule and section 11(2)(b) of the Act to address the issue of tax-free migration of companies from South Africa. Section 9H(3)(e) of the Act provides that where a company ceases to be a resident and that company had reported a capital gain from the disposal of foreign equity shares within the three years prior to ceasing to be resident, which been disregarded under paragraph 64B of the Eighth Schedule, any capital gain disregarded within those three years would be deemed to be a net capital gain occurring immediately prior to that company ceasing to be a resident.

Section 9H(3)(f) of the Act determines that where a company ceases to be a resident, and the company had within three years of ceasing to be resident, received a foreign dividend which was exempt from normal tax under section 10B(2)(a), that exempt foreign dividend would be deemed to have been received by that company immediately before the company ceased to be resident. Section 9H(3)(f) of the Act also indicates that the deemed foreign dividend would not be exempt from tax under section 10B(2) of the Act.

3.4.1 When would a company cease to be resident?

In terms of paragraph (b) of the definition of a “resident” in section 1 of the Act, companies are considered to be resident in South Africa if they are incorporated, established, formed or have their place of effective management in South Africa. If the place of effective management for these entities is moved to a foreign country, they may no longer be considered to be resident in South Africa, if a double taxation agreement between South Africa and the foreign country deems such entities to be exclusively resident in the foreign country.

Since a company incorporated in a foreign country, is also a “company” under the definition of a “company” in section 1 of the Act, this entity could also be considered to be “resident” in South Africa if the place of effective management of this entity was in South Africa. However, if at some later stage the place of effective management of this foreign company returned to a foreign country, then this company would cease to be resident in South Africa.

3.5 “Exit charge” under section 9H(3)(b) and section 9H(3)(d) – Controlled Foreign Companies

The background discussion of CFCs is included in section 2.4 of Chapter 2.

Section 9H(3)(b) of the Act provides that where a CFC ceases, otherwise than by way of becoming a resident, to be a CFC during any foreign tax year of that CFC, that CFC is:

- deemed to have disposed of each of that CFC’s assets (except those assets referred to in section 9H(4) – see section 3.6 below) to a person that is resident;
- on a date immediately before the day on which that CFC ceased to be a CFC;
- for an amount equal to the market value of the asset on that date;
- and reacquired each of those assets on the day on which that CFC ceased to be a CFC;
- for an amount equal to the market value that was taken into account for the purposes of the deemed disposal.

The exit charge in section 9H(3)(b) does not apply when a CFC ceases to be a CFC as a result of becoming a resident. So for example, the exit charge in section 9H(3)(b) would not apply if the place of the effective management of a CFC was moved to South Africa, which resulted in that CFC no longer being considered to be a CFC since it was no longer a foreign company.

Section 9H(3)(d)(i) of the Act provides that the foreign tax year for a CFC is deemed to have ended on the date immediately before the day on which that CFC ceases to be a CFC. In terms of section 9H(3)(d)(ii) of the Act the foreign tax year for a CFC must be deemed to have commenced on the day on which that CFC ceases to be a CFC.

It is submitted that section 9H(3)(d) of the Act relating to CFCs has created an interpretation issue. Section 9H(3)(d) states (emphasis added) :

(d) Where a controlled foreign company ceases to be a controlled foreign company during any foreign tax year of that controlled foreign company as contemplated in paragraph (a) (ii) —

- (i) that foreign tax year must be deemed to have ended on the date immediately before the day on which that controlled foreign company so ceased to be a controlled foreign company...

The particular issue concerns the reference to paragraph (a)(ii), since the exit charge for CFCs is included in paragraph (b). An examination of the previous year's legislation reveals that in the amendments to the legislation, the draughtsman appears to have omitted to update this reference.

3.5.1 When does a CFC cease to be a CFC?

The definition of a "CFC" in section 9D(1), determines that a CFC will cease to be a CFC when South African residents no longer hold more than 50% of the "participation rights" or "voting rights" in a foreign company. This could occur if South African residents disposed of their shares in CFCs, or if a CFC issued additional shares, which resulted in the holdings of South African residents being diluted, resulting in holdings of less than 50%.

When section 9H of the Act was initially enacted on 8 May 2012, the exit charge for CFCs applied to CFCs that "ceased to be CFCs in relation to a resident". Therefore at the time, it appeared that the exit charge only applied to a CFC that ceased to be a CFC, other than if a shareholder ceased to be resident in South Africa. In the following year, the legislation in section 9H was amended and applied to a CFC that "ceases to be a CFC, on or after that date". Accordingly, it appeared that the words "in relation to a resident" for a CFC had been withdrawn.

From 5 June 2015 the new section 9H(3)(b) provision for CFCs only applied to a CFC that "ceases to be a CFC in relation to a resident". On that basis, there is uncertainty as to whether the exit charge in section 9H applies to a CFC that ceases to be a CFC, other than if the shareholder in that foreign company ceased to be resident in South Africa. It is submitted that this could have an impact on the final section 9D(2) inclusion in income for a departing shareholder. The potential differences between the normal tax calculations are discussed in chapter 4.8.4 and chapter 4.8.5.

If a South African shareholder emigrates, this does not necessarily mean that a CFC will cease to be a CFC. This will ultimately depend upon whether other resident South African shareholders continue to hold more than 50% of the participating or voting rights in the foreign company.

Under section 9H(5) of the Act, the exit charge in section 9H(3)(b) will not apply if a CFC ceases to be a CFC following the disposal of shares by a resident shareholder. Section 9H(5) of the Act excludes the application of the exit charge in section 9H(3)(b) if the capital gain or capital loss from the share disposal had been disregarded under paragraph 64B(1) of the Eighth Schedule. The requirements of paragraph 64B of the Eighth Schedule are discussed in section 3.8.4 below.

Finally, section 9H(6) of the Act provides that if a CFC ceases to be a CFC as a result of:

- an amalgamation transaction as defined in section 44(1) of the Act to which section 44 applies; or
- a liquidation distribution as defined in section 47(1) of the Act to which section 47 applies,

the exit charge in section 9H(3)(b) of the Act will not apply.

3.6 Assets excluded from the exit charge

Section 9H(4) of the Act specifies the assets to be excluded by a natural person, trust, company and a CFC from the exit charge in section 9H(2), section 9H(3)(a) and section 9H(3)(b) as:

- immovable property situated in the Republic that is held by that person;
- any asset which is attributable to a permanent establishment of that person in the Republic;
- any asset which is attributable to a permanent establishment of that controlled foreign company in the Republic;
- any qualifying equity share under section 8B of the Act that was granted to a person less than five years before the date on which that person ceased to be a resident;
- any equity instrument as contemplated in section 8C of the Act that had not vested at the time the person ceased to be resident; and
- any right of that person to acquire any marketable security as contemplated in section 8A of the Act.

Because immovable property in South Africa is exempt from the exit charge in section 9H(2), section 9H(3)(a) and section 9H(3)(b), this asset would remain subject to capital gains tax in South Africa for the non-resident under paragraph 2(1)(b)(i) of the Eighth Schedule to the Act.

Prior to 12 December 2013, section 9H(4)(b) provided that an interest or a right of whatever nature in immovable property in South Africa as contemplated in paragraph 2(2) of the Eighth Schedule was excluded from the exit charge in section 9H. Then on the 12 December 2013, section 9H(4)(b) was removed from the legislation. From 12 December 2013, if a natural person, trust, company or a CFC owned an interest in immovable property and that natural person, trust or company ceased to be resident, or that CFC ceased to be a CFC, the exit charge provided for in section 9H would apply to that asset. This is discussed in chapter 3.8.3.

A “permanent establishment” as defined in section 1 of the Act:

means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development ...

A “permanent establishment” is defined in article 5(1) of the OECD Model Tax Convention on Income and on Capital 2014 (OECD: 2014: 26) as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. A “permanent establishment” includes a number of specific entities listed in article 5(2) of the OECD Model Tax Convention on Income and on Capital 2014 (OECD: 2014: 26):

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop; and
- a mine, an oil or gas well, and a quarry or place of extraction of natural resources.

Since the definition of “permanent establishment” is fairly broad, it is likely that the “business activities” of a natural person, trust or company in South Africa could be considered to be a “permanent establishment” in South Africa. Accordingly, any asset attributable to the permanent establishment of a natural person, trust or company in South Africa, would be

exempt from the exit charge in section 9H(2) and section 9H(3)(a) if that natural person, trust or company ceased to be resident in South Africa. Furthermore any asset attributable to the permanent establishment of controlled foreign company in South Africa, will also be exempt from the exit charge in section 9H(3)(b) when that controlled foreign company ceases to be a controlled foreign company in any foreign tax year, otherwise than by way of becoming a resident.

The legislative provisions for employee share incentive schemes are set out in section 8A, section 8B and section 8C of the Act. Section 8A of the Act applies to share options received by an employee or director prior to 26 October 2004, in respect of services rendered to that employer. Section 8A(1) of the Act provides that if a gain arose when that employee or director exercised those share options, the gain would be included in that director's or employee's gross income under paragraph (i) of the "gross income" definition in section 1 of the Act. In terms of section 9H(4)(f) of the Act, any share option received by an employee or director before 26 October 2004, that has yet to be exercised, is exempted from the exit charge in section 9H(2). Section 8B of the Act determines that if an employee obtained a "qualifying equity share" in a "broad-based employee share plan", and if that person disposed that "qualifying equity share" within five years of the date of the grant of that share, the gain realised from that disposal would be included in that person's "income". Section 9H(4)(d) of the Act provides that any "qualifying equity share" as contemplated in section 8B is exempt from the exit charge in section 9H(2) where there is a change in the residency status of a person within five years of the grant date. Finally, under section 8C of the Act, when an equity instrument "vests" in an employee or director, the gain or loss that arises must be included in that employee's or director's income. In terms of section 9H(4)(e) of the Act, any "equity instrument" as contemplated in section 8C, which still has to vest, is exempted from the exit charge in section 9H(2).

3.7 The calculation of the exit charge – the general principles

Section 9H(2) and section 9H(3)(a) of the Act provide that when a natural person, trust or company ceased to be a "resident" that natural person, trust or company trust is:

- deemed to have disposed of all of their assets (except those assets in section 9H(4) to a person that is resident;

- on a date immediately before the day on which that natural person, trust or company ceased to be resident;
- for an amount equal to the market value of the asset on that date.

In terms of section 9H(3)(b) of the Act, when a CFC ceases during any foreign tax year to be a CFC that CFC is:

- deemed to have disposed of each of that CFC's assets (except those assets referred to in section 9H(4)) to a person that is resident;
- on a date immediately before the day on which that CFC ceases to be a CFC;
- for an amount equal to the market value of the asset on that date.

In the context of the definition of "asset" in the Eighth Schedule, it is submitted that the disposal of an "asset" referred to in section 9H(2), section 9H(3)(a) and section 9H(3)(b) would involve both capital and revenue assets. Accordingly, capital gains, revenue gains and a deemed recoupment could arise from the deemed disposal of a person's assets when they cease to be resident. This principle was confirmed by the National Treasury in its Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (National Treasury: 2011) and subsequently in the Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016:110).

Since a "resident" is subject to capital gains tax on "any asset of a resident" under paragraph 2(1) of the Eighth Schedule to the Act, the deemed disposal of the worldwide assets of a resident would take place at market value on the day immediately prior to that person ceasing to be resident. Since a "resident" includes worldwide receipts and accruals in their gross income, the disposal of all of the revenue assets of a resident at market value would be included a resident's gross income on the day immediately prior to that person ceasing to be resident.

When a natural person, trust or company ceases to be resident or a CFC ceases to be a CFC, it would first be necessary to establish whether the deemed disposal of a particular asset represents a capital or revenue receipt. If it was determined that the disposal of a particular asset resulted in a capital receipt, the rules governing capital gains tax in the Eighth Schedule to the Act would apply to that disposal. Similarly if the disposal of a particular asset resulted in a revenue receipt, that amount would be included in the gross income of the taxpayer. Since

the capital or revenue nature of a particular receipt has been the subject of significant case law and legal precedent, a discussion is considered to be beyond the scope of this thesis.

In terms of section 9C(2) of the Act, any amount received or accrued (other than a dividend or foreign dividend) to a taxpayer in respect of an “equity share” must be deemed to be of a capital nature if that “equity share” had been held for at least three years. An “equity share” as defined in section 1 and section 9C(1) means any share in any unlisted South African registered and incorporated company, any share listed on the Johannesburg Stock Exchange, a participatory interest in a portfolio of collective investment scheme in securities and a portfolio of a hedge fund collective investment scheme. Since the definition of “disposal” in section 9C(1) includes a disposal under section 9H of the Act, if a taxpayer ceased to be resident or a CFC ceased to be a CFC, and that event took place at least three years after the “equity share” had been acquired, section 9C(2) would deem the exit charge arising from that “equity share” to be capital in nature. Thus, if a taxpayer or a CFC held “equity shares” as trading stock and that taxpayer ceased to be resident or the CFC ceased to be a CFC at least three years after the “equity share” had been acquired, then section 9C(2) would deem the exit charge under section 9H to be capital in nature. In these circumstances, section 9C(5) of the Act would provide for a recoupment in respect of the share for the expenditure previously claimed as deduction under section 11(a) or as opening stock under section 22(2) of the Act.

3.8 General principles - capital gains tax in respect of the exit charge

Chapter 2.2 provides the background discussion to capital gains tax.

Section 9H(2), 9H(3)(a) and 9H(3)(b) provide that the “market value” of an asset, on the day immediately prior to that person ceasing to be resident, or that CFC ceasing to be a CFC, is under paragraph 35 of the Eighth Schedule to the Act deemed to be the “proceeds” from the deemed disposal. The base cost of the asset, would be determined under paragraph 20 and other supporting provisions in the Eighth Schedule to the Act. As explained above, section 9H(4) of the Act identifies the “assets” to be excluded from the exit charge.

Although the definition of “market value” in section 9H(1) of the Act is as follows: “in relation to an asset, means the price, which can be obtained upon the sale of that asset between a willing buyer and a willing seller dealing at arms-length in an open market”, this differs from the

definition of “market value” in paragraph 31 of the Eighth Schedule to the Act, which provides separate rules for different asset types. The existence of two definitions, it is submitted, creates interpretation issues since there is uncertainty as to which definition of “market value” should be applied.

However, further examination of paragraph 31 of the Eighth Schedule reveals that the rules for determining “market value” are in many respects closely aligned to the definition of “market value” in section 9H(1) of the Act, with most of the separate rules for the different asset types in paragraph 31 referring to a “willing buyer and willing buyer seller dealing at arm’s length in an open market”.

However, it is submitted that differences in the valuation of the following assets may arise:

- a fiduciary, usufructuary or similar interest in an asset: if this right or interest had been provided to a person for the remainder of their life, under paragraph 31(1)(d) and 31(2)(b) of the Eighth Schedule, the valuation of this asset would be based on the expected life of that person as determined for estate duty purposes and in the case of a person other than a natural person, the valuation of this asset is based on a period of fifty years; the valuation of this asset at its “market value” for an exit charge under section 9H(1), may differ;
- the market value of shares in a company that is not listed on a recognised exchange must be determined at the value obtained on the sale of the shares between a willing buyer and willing seller, dealing at arms-length in an open market (paragraph 31(3), subject to the proviso that no regard shall be made of the restricted transferability of those shares, and for that reason there is an assumption that such shares are considered to be freely transferable in determining the valuation of the shares; since the transferability of such shares may have a significant impact on the valuation of the shares, the valuation for the purposes of “market value” under section 9H(1) could provide a significantly lower valuation; and
- capital gains and capital losses from the disposal of personal-use assets that are disregarded (paragraph 53 of the Eighth Schedule), and under paragraph 15 of the Eighth Schedule, capital losses from the disposal of the following assets must be disregarded to the extent that such assets are not used in the carrying on of a trade:
 - an aircraft with an empty mass that exceeds 450 kgs;

- a boat exceeding ten metres in length;
- any fiduciary, usufructuary, or other like interest, the value of which decreases over time;
- any lease of immovable property;
- any time-sharing interest as defined in section 1 of the Property Time-sharing Control Act, 1983;
- a share in a share block company, as defined in section 1 of the Share Blocks Control Act with a fixed life, the value of which decreases over time; or
- a right or interest in any of the above mentioned assets.

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016:361) submits that paragraph 37 of the Eighth Schedule is a provision that prevents persons from claiming losses from paragraph 53 and paragraph 15 assets that are held by a company or trust. When a paragraph 15 asset or a personal-use asset as contemplated in paragraph 53 is owned by a trust or company, and the shares or interest therein are held by a natural person, and there is a decrease in the market value of that asset whilst it is held by that company or trust, and subsequently the interest in that company or trust is disposed of, paragraph 37 of the Eighth Schedule provides that the natural person would be deemed to have sold that interest at its market value as if the asset had not decreased in value. However, since the “market value” of any interest in a trust or company must for the purposes of the exit charge under section 9H be determined at its “market value”, it is submitted that there is uncertainty as to whether this valuation should apply or the valuation determined under paragraph 37 of the Eighth Schedule.

3.8.1 Base cost of pre-valuation date assets

As capital gains tax was implemented on 1 October 2001, special rules apply to assets that were acquired prior to that date in determining their base cost on 1 October 2001. The special rules are provided for in paragraphs 25, 26, and 27 of the Eighth Schedule to the Act. Paragraph 25 of the Eighth Schedule provides the base cost of a pre-valuation date asset to be the sum of the valuation date value arrived at under paragraph 26 or 27, and the expenditure allowable in terms of paragraph 20 incurred on or after that valuation date in respect of that asset. If a natural person, trust or company ceased to be resident and any of that natural person’s, trust’s or company’s assets had been acquired prior to 1 October 2001, in determining the exit charge

under section 9H(2) and section 9H(3)(a), paragraph 25, 26, and 27 of the Eighth Schedule would apply, in determining the base cost of those assets. Furthermore, if a CFC ceased to be a CFC, and the CFC's assets had been acquired prior to 1 October 2001, in determining the exit charge under section 9H(3)(b), paragraphs 25, 26 and 27 of the Eighth Schedule would apply in determining the base cost of the CFC assets.

Paragraph 26(1) of the Eighth Schedule to the Act provides that where the proceeds from the disposal of a pre-valuation date asset exceed the expenditure allowable in terms of paragraph 20 incurred before, on and after 1 October 2001 in respect of that asset, the person who disposed of that asset must, subject to subparagraph (3), adopt any of the following as the base cost of that asset on the 1 October 2001:

- the market value of the asset on the valuation date as contemplated in paragraph 29;
- 20% of the proceeds from the disposal of the asset, after deducting from those proceeds an amount equal to the expenditure incurred under paragraph 20 on or after the 1 October 2001; or
- the time-apportionment base cost of the asset as contemplated in paragraph 30.

In terms of paragraph 29(4) of the Eighth Schedule to the Act, the market value of the asset can only be utilised in paragraph 26(1) if:

- the asset was valued within three years after 1 October 2001;
- the price of the asset was published by the Commissioner in the Government Gazette;
or
- the asset was acquired from a spouse, who had previously adopted the market value.

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 260) indicates that taxpayers are relieved from the need to value listed instruments on the Johannesburg Stock Exchange and South African unit trusts, since the prices for these were included in the Government Gazette. The Guide also indicates that, although the prices of shares listed on a recognised exchange outside South Africa are not published in the Government Gazette, SARS permits these prices to be determined at the value of a minority holding on 1 October 2001.

In terms of paragraph 29(5) of the Eighth Schedule to the Act, for certain high-value items, a person would only be able to adopt the market value for the purposes of paragraph 29(4), if adequate proof of the valuation is furnished to the Commissioner.

Paragraph 29(5) of the Eighth Schedule identifies the following assets as high value assets:

- where the market value of an asset exceeds R10 million;
- where the asset is an intangible asset and the market value exceeds R1 million; or
- where the asset is an unlisted share in a company, and the market value of all the shares held by that person in that company exceeds R10 million.

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 262) submits that for a taxpayer to be able to apply a valuation of a high-value asset in terms of paragraph 29(4) of the Eighth Schedule, proof of the high-value valuation must have been submitted to SARS with the first return of income submitted after 30 September 2004.

Paragraph 30 of the Eighth Schedule to the Act provides the formula for determining the time-apportionment base cost of an asset.

Once the taxpayer has determined:

- the market value of the asset on the 1 October 2001 as contemplated in paragraph 29;
- the amount calculated and based on 20% of the proceeds from the disposal of the asset, after deducting from those proceeds an amount equal to the expenditure incurred under paragraph 20 on or after the 1 October 2001 ; or
- the time-apportionment base cost of the asset as contemplated in paragraph 30;

under paragraph 26(1) of the Eighth Schedule, the taxpayer should, in determining the exit charge, elect the option with the highest base cost in order to minimise the capital gains tax.

Therefore, where a natural person, trust or company ceased to be resident or a CFC ceased to be a CFC and that natural person, trust, company or CFC:

- held assets that had been acquired prior to 1 October 2001; and

- the proceeds from the deemed disposal of those assets at market value on the day immediately before that person ceased to be resident;
- exceeded the expenditure allowable in terms of paragraph 20 incurred before and after 1 October 2001;
- the base cost of those assets would be determined under paragraph 26(1) of the Eighth Schedule;
- for the purposes of determining the exit charge under section 9H(2), 9H(3)(a) and 9H(3)(b).

However, paragraph 26(2) of the Eighth Schedule to the Act provides that where the expenditure incurred before 1 October 2001 in respect of a pre-valuation date asset cannot be determined, the person must adopt any one of the following as the base cost on 1 October 2001:

- the market value of the asset on the valuation date as determined under paragraph 29;
- 20% of the proceeds from the disposal of the asset, after deducting from those proceeds an amount representing the expenditure under paragraph 20 incurred 1 October 2001.

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 238) submits that since paragraph 29(4) of the Eighth Schedule, does not apply to paragraph 26(2), there is no need for the market value of a particular asset to be determined by 30 September 2004. However, the Guide also indicates that if paragraph 26(2) applies to a pre-valuation asset and the asset represented a high value item as specified in paragraph 29(5), proof of the valuation of that asset would need to have been submitted to SARS by the due date in order for the taxpayer to utilise that market value.

Paragraph 26(3) of the Eighth Schedule provides that if a taxpayer adopted the market value as the valuation date value in paragraph 26(1)(a) and the proceeds from the disposal did not exceed the market value, the taxpayer would need to substitute, as the valuation date value, the proceeds less the expenditure allowable in terms of paragraph 20 incurred on or after the valuation date for that asset.

In terms of paragraph 27(1) of the Eighth Schedule, where the proceeds from the disposal of a pre-valuation asset do not exceed the expenditure allowable under paragraph 20 incurred before and after 1 October 2001, the valuation date value of the asset must be determined under

paragraph 27. However, it is submitted that given the impact of inflation and the number of years that have elapsed since 1 October 2001, it is probably unlikely that the market value of an asset in today's terms, would be less than the expenditure incurred before and after 1 October 2001. For this reason, a discussion of this paragraph was not considered to be necessary.

Paragraph 26(1) of the Eighth Schedule to the Act prohibits the determination of the base cost of a pre-valuation asset under that provision if the asset was an "identical asset" and the base cost of that asset had been determined utilising paragraph 32(3A) of the Eighth Schedule to the Act.

3.8.2 Base cost of identical assets

Paragraph 32 of the Eighth Schedule provides the base cost for identical assets. "Identical assets" are defined in paragraph 32(2) as a group of similar assets, of which any one of them, if disposed of, would realise the same amount regardless of which asset was disposed of. In terms of paragraph 32(3) of the Eighth Schedule, the base cost of identical assets, subject to paragraph 32(3A), must be determined utilising either a specific identification or the first-in-first-out method. Under paragraph 32(3A), the weighted average method may be applied to calculate the base cost of:

- listed shares;
- participatory interests in a portfolio of a collective investment scheme;
- coins made from gold or platinum; and
- listed instruments as defined in section 24J of the Act.

Accordingly, in determining the base cost of an asset for the purposes of an exit charge under section 9H(2), section 9H(3)(a) or section 9H(3)(b), if the assets represent "identical assets" as defined in paragraph 32(2), it appears that a natural person, trust, company or CFC will have the option of calculating the base cost of these assets using either the specific identification or the first-in-first-out method. For certain types of identical assets, a natural person, trust, company or CFC could determine the base cost of those "identical assets" using the weighted average method referred to in paragraph 32(3A) of the Eighth Schedule in calculating the exit charge.

3.8.3 Deemed disposal of an “interest in immovable property” in South Africa

In terms of paragraph 2(2)(b)(i) of the Eighth Schedule to the Act, an interest in immovable property will remain subject to capital gains tax in South Africa when a person is no longer a resident. Paragraph 2(2)(b)(i) of the Eighth Schedule states (emphasis added):

Subject to paragraph 97, this Schedule applies to the disposal on or after valuation date of—

- (a) any asset of a resident; and
- (b) the following assets of a person who is not a resident, namely—
 - (i) immovable property situated in the Republic held by that person **or any interest or right of whatever nature of that person to or in immovable property situated in the Republic...**

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 42) provides the following as examples of immovable property: “Land, buildings with foundations in the soil, trees, growing crops, real rights over immovable property (for example, a usufruct or a registered lease of not less than ten years)”.

Prior to 12 December 2013 section 9H(4)(b) of the Act provided that an interest or a right of whatever nature in immovable property in South Africa, as contemplated in paragraph 2(2) of the Eighth Schedule, was excluded from the exit charge in section 9H(2) and section 9H(3). On the 12 December 2013, section 9H(4)(b) was removed from the legislation, with the effect that the market value of an interest or a right in immovable property in South Africa would be subject to the exit charge.

Paragraph 2(2) of the Eighth Schedule to the Act defines “an interest in immovable property” in South Africa:

- where that person, whether alone or with other connected persons directly or indirectly owns at least 20% of the equity shares in that company, or ownership or right of ownership of that entity; and
- 80% or more of the market value of the equity shares, ownership or right to ownership is attributable either directly or indirectly to immovable property in South Africa.

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 53) submits that in establishing the extent to which the market value of the shares is attributable to the immovable property, the gross market value of the assets in the company should be assessed, resulting in the liabilities of the company being ignored in completing the calculation. Furthermore, in the analysis of the 80% requirement, paragraph 2(2) of the Eighth Schedule requires immovable property held as trading stock to be excluded from the calculation. Stiglingh et al (2016: 873) also state that the “interest in immovable property” in South Africa could be held by either South African or foreign incorporated companies.

Paragraph 2(2) of the Eighth Schedule to the Act provides that if a beneficiary held a vested right to immovable property in South Africa and the immovable property resided in a trust, if 80% of the market value of that vested interest was related to immovable property in South Africa, that vested interest would also be considered to be “an interest in immovable property” in South Africa. De Koker and Williams (2016: §24.11) submit that in the case of a vested right to an asset in a trust, the second requirement in paragraph 2(2) of the Eighth Schedule of a 20% minimum holding, need not apply.

Accordingly, if a natural person, trust, company or CFC, held shares in a company and those shares represented “an interest in immovable property” in South Africa and that natural person, trust or company ceased to be resident in South Africa or that CFC ceased to be a CFC, an exit charge under section 9H(2), 9H(3)(a) or 9H(3)(b) of the Act would apply to the market value of those shares. Similarly if a natural person, trust, company or CFC held a vested interest in the assets of a trust, and 80% of the market value of that vested interest related to immovable property in South Africa, if that natural person, trust or company ceased to be resident or that CFC ceased to be a CFC, an exit charge under section 9H(2), 9H(3)(a) and 9H(3)(b) would apply to the market value of that “interest in immovable property” in South Africa.

3.8.4 Deemed disposal of foreign shares

Paragraph 64B of the Eighth Schedule to the Act provides that when person disposes of an equity share in a foreign company and:

- that person, whether alone or together with any other person forming part of a group of companies immediately before the disposal held:

- at least 10% of the equity shares and voting rights in that foreign company; and
- held the interest for at least 18 months prior to that disposal unless
 - that person is a company;
 - that interest was acquired by that person from any other company that forms part of the same group of companies; and
 - that person and that other company held that interest for more than 18 months; and
- that interest is disposed of to any person who is not a resident (other than a controlled foreign company or a person that is connected person in relation to the person disposing of that interest) for an amount that is equal to or exceeds the market value of the interest;

that person must disregard the capital gain or capital loss that arises from that disposal. It is submitted that the exclusion of the capital gain or loss under paragraph 64B could not apply to the deemed disposal of foreign shares under section 9H(2), 9H(3)(a) or 9H(3)(b) held by a natural person, trust or company that ceased to be resident or by a CFC that ceased to be a CFC, since paragraph 64B applies to foreign shares disposed of to a person that is a non-resident, whilst section 9H(2)(a)(i), 9H(3)(a)(i) and 9H(3)(b)(i) provide for an exit charge based on the market value if the foreign shares had been sold to a resident.

3.9 General principles – revenue gains tax for the exit charge

If the deemed disposal of an asset was determined to be a revenue receipt, the normal tax rules would apply to that amount and the “market value” of that revenue asset would be included in gross income in terms of the gross income definition in section 1 of the Act. The gross income from the sale of a revenue asset would normally be offset by a deduction for the cost of that asset under section 11(a) of the Act. Where the revenue asset had been acquired in a previous year of assessment, a deduction for the cost of that asset, also known as an opening stock deduction, would be made under section 22(2) of the Act.

Following the deemed disposal of a capital asset on which certain capital allowances had previously been claimed, a deemed recoupment of those allowances under section 8(4)(a) of

the Act would apply to include the amount in the income of the natural person, company, trust or CFC.

3.10 Conclusion

Section 9H(2), 9H(3)(a) and 9H(3)(b) of the Act provides that a natural person and trust, company and CFC are deemed to have sold all of their assets at market value on the day before that person ceased to be resident or that CFC ceased to be a CFC. Section 9H(4) of the Act identifies the types of assets excluded from the exit charge. These are immovable assets situated in the Republic, assets attributable to a permanent establishment in the Republic and equity shares and marketable securities granted to employees and directors in terms of sections 8A, 8B and 8C

Section 9H(5) of the Act provides that in certain circumstances, the exit charge in section 9H(3)(b) will not apply to a CFC, if the disposal of shares in a CFC results in that CFC ceasing to be a CFC. Section 9H(6) determines that the exit charge in section 9H(3)(b) will also not apply when a CFC ceases to be a CFC, as a result of an amalgamation or liquidation transaction. Finally, section 9H(7) of the Act contains the foreign currency translation rules to be utilised following the deemed disposal of an asset previously acquired in a foreign currency.

A natural person will cease to be resident in South Africa, if that natural person:

- emigrates from South Africa;
- permanently leaves South Africa, without formally emigrating;
- was resident in South Africa under the physical presence test, but then permanently returns to their home country;
- was resident in South Africa under the physical presence test, but then fails to meet the physical presence tests in a subsequent year; or
- was “resident” but then ceases to be resident, as a result of a double taxation agreement that deems that person to be exclusively resident in another country.

A company or trust would cease to be resident in South Africa if the place of effective management of that company or trust was moved to a foreign country, and as a result of the change in the place of effective management, a double taxation agreement between South

Africa and that foreign country, deems that company or trust to be exclusively resident in that foreign country.

This chapter discusses the normal tax principles that will apply when a natural person, company or trust ceases to be resident or where a CFC ceases to be a CFC. As the disposal of an “asset” as defined in the Eighth Schedule to the Act includes both capital and revenue assets, the deemed disposal could result in capital gains, revenue gains or a recoupment of previous allowances under section 8(4)(a) of the Act. The Eighth Schedule to the Act would determine the capital gains tax consequences. The market value of that asset would be deemed to be the “proceeds” from the disposal and the base cost of the asset would be determined under paragraph 20 and other supporting provisions in the Eighth Schedule to the Act. Revenue gains would be included in the gross income of the taxpayer. The revenue gains are normally offset by a deduction of the cost of the asset under section 11(a) of the Act.

The following chapter discusses the unique revenue gains and capital gain tax consequences that arise when a natural person, company or trust ceases to be resident. The chapter also discusses certain specific tax consequences of the exit charge which would apply when a CFC ceases to be a CFC.

CHAPTER FOUR: EXIT CHARGE: SPECIAL TAX CONSEQUENCES FOR A NATURAL PERSON, TRUST, COMPANY AND CONTROLLED FOREIGN COMPANY

4.1 Introduction

The main goal of this chapter is to expand on the general tax principles and their application in calculating the exit charge that applies when a person ceases to be a resident of South Africa that were discussed in the previous chapter, by focusing on the certain special tax consequences. Accordingly, this chapter will include a discussion of the unique normal tax implications that could arise from the exit charge under section 9H(2) and 9H(3) of the Act when a natural person, trust or company ceases to be resident or a Controlled Foreign Company (CFC) ceases to be a CFC.

The chapter will address the following special tax issues relating to trusts:

- whether the deemed capital or deemed revenue gains that arise when a discretionary trust ceases to be resident, could be vested in or be distributed to a beneficiary, revert to the donor, or are taxable in the trust;
- in the case of a resident vesting trust, where the assets had automatically vested in the beneficiaries under the trust deed, whether an exit charge could apply to the trust, or whether there would be any resultant tax implications for the beneficiaries when that vesting trust ceased to be resident; and
- the foreign exchange implications for a trust that may arise in the calculation of the exit charge.

This chapter will also address the unique normal tax implications relating to CFCs:

- the normal tax implications for a CFC when it ceases to be a CFC as a result of a change in the residency of the holders of the participation rights or voting rights, which results in not more than 50% of the total participation rights or voting rights in that CFC being held by residents;
- the section 9D inclusion in income for a resident that holds a participating interest in a CFC immediately prior to that resident ceasing to be a resident, and which results in that CFC ceasing to be a CFC;

- the exit charge that arises from the deemed disposal of the shares in a CFC, when a resident ceases to be resident; and
- the foreign exchange implications for a CFC that may arise in the calculation of the exit charge.

Finally, the chapter will discuss the tax implications in relation to revenue assets considered not to be attributable to a permanent establishment in South Africa and previously subject to an exit charge under section 9H when a person ceased to be resident, that are subsequently sold by a non-resident.

4.2 Capital Gains Tax – special issues when a natural person ceases to be resident

4.2.1 Determining the base cost for an immigrant who then ceases to be resident

In determining the exit charge under section 9H, the base cost of a person's assets must be established. Invariably, the base cost of a natural person's assets will be determined under paragraph 20 of the Eighth Schedule to the Act. However, paragraph 12(1), paragraph 12(2)(a)(i) and paragraph 13(1)(g) of the Eighth Schedule to the Act provide that when a natural person becomes a resident, that natural person is deemed to have acquired his or her assets at their market values on the day immediately before the date of immigration. Under paragraph 12(1) of the Eighth Schedule, the market value of these assets is deemed to be the base cost expenditure for the purposes of paragraph 20(1)(a) of the Eighth Schedule. In terms of paragraph 12(2)(a) of the Eighth Schedule, the deemed acquisition rule will not apply to the following assets of an immigrant:

- immovable property in the Republic;
- an interest in immovable property in the Republic;
- rights to variable or fixed payments as consideration of the working of or the right to work mineral deposits, sources and other natural resources;
- an asset effectively connected with a permanent establishment of that person in the Republic; or
- any right to acquire any marketable security as contemplated under section 8A of the Act.

However, paragraph 12(1) of the Eighth Schedule indicates that the base cost of an immigrant's asset is subject to paragraph 24 of the Eighth Schedule, which provides that:

- if a person, after becoming a resident, then disposes of an asset and the proceeds from that disposal and the expenditure allowable in terms of paragraph 20 incurred prior to that date are each lower than the market value as of the time of immigration, that person must be deemed to have acquired that asset at a cost equal to the higher of:
 - the expenditure allowable in terms of paragraph 20 incurred in respect of that asset prior to that date; or
 - the proceeds less the expenditure allowable in terms of paragraph 20 incurred on or after that date in respect of that asset;
- if a person, after becoming resident, then disposes of an asset and the proceeds from the disposal of that asset and the market value of the asset as at the time of immigration are both lower than the expenditure allowable in terms of paragraph 20 incurred prior to that date, then that person must be treated as having acquired that asset at a cost equal to the higher of:
 - its market value; or
 - the proceeds less expenditure allowable in terms of paragraph 20 incurred on or after that date in respect of that asset.

Accordingly, if an immigrant to South Africa subsequently ceases to be resident in South Africa, the base costs of that immigrant's assets for the purposes of the exit charge under section 9H(2) could be subject to a paragraph 24 base cost adjustment.

4.2.2 The foreign exchange implications of the exit charge for natural person

Section 9H(7) of the Act provides that the market value of any asset, under section 9H(2) and 9H(3), must be in the currency of the expenditure that was incurred to acquire that asset. Accordingly the market value of an asset, and hence the proceeds from the deemed disposal of that asset when a natural person ceases to be resident, must be in the same currency as the expenditure incurred to acquire that asset.

Therefore when a natural person ceases to be resident, since the proceeds from the deemed disposal of a capital asset are determined under section 9H(7) of the Act to be in the currency

of the expenditure incurred to acquire the asset, paragraph 43(1) of the Eighth Schedule to the Act would apply to translate the capital gain or capital loss. Paragraph 43(1) requires a natural person to calculate the capital gain or capital loss in that same currency and to translate that capital gain or loss into the local currency (Rands) by applying either the average exchange rate for the year of assessment in which the asset was disposed of or the spot rate on the date of disposal of that asset. A natural person would elect the most favourable exchange rate in calculating the exit charge under section 9H(2) and paragraph 43(1) of the Eighth Schedule to the Act. Under section 9H(2), the date of disposal for the purposes of the spot rate would be the day immediately before the day that natural person ceases to be a resident.

Since “the year of assessment” for a natural person under section 9H(2)(a) is deemed to have ended the day immediately before the natural person ceased to be resident, it is submitted that the average exchange rate for that “year of assessment” would be from 1 March to the day immediately before that natural person ceased to be resident, and not the average exchange rate for the entire 12 month period of that year of assessment.

4.2.3 The “personal-use” assets of a natural person

In terms of paragraph 53(1) of the Eighth Schedule to the Act, a natural person must disregard a capital gain or capital loss that arises from the disposal of a “personal-use” asset. Paragraph 53(2) of the Eighth Schedule provides that a “personal-use” asset of a natural person must be used mainly for purposes other than carrying on a trade. In terms of paragraph 53(3), certain assets are determined not to be “personal-use” assets.

When a natural person ceases to be a resident, that natural person is deemed under section 9H(2) to have disposed of their “personal-use” assets. However, under paragraph 53(1) of the Eighth Schedule, the deemed capital gain or deemed capital loss that arises in respect of the assets specified in paragraph 53(3) must be disregarded and therefore the exit charge that arises under section 9H(2) for these assets would not be disregarded. The assets referred to in paragraph 53(3) are:

- a coin made mainly from gold or platinum;
- immovable property;
- an aircraft, the empty mass of which exceeds 450 kilograms;

- a boat exceeding ten metres in length;
- a financial instrument;
- a fiduciary, usufructuary or other like interest, the value of which decreases over time;
- an insurance policy (other than a short-term policy), that entitles the holder to policy benefits on the happening of an event;
- a short-term insurance policy to the extent that it relates to an asset that is not a personal-use asset; and
- a right or interest of whatever nature to or in any of the assets listed above.

4.2.4 Certain deemed losses to be disregarded in the exit charge

Paragraph 15 of the Eighth Schedule to the Act provides that the capital loss arising from the disposal of the following assets must be disregarded, to the extent that these assets are not used for purpose of carrying on a trade:

- an aircraft with an empty mass that exceeds 450 kgs;
- a boat exceeding ten metres in length;
- any fiduciary, usufructuary, or other like interest, the value of which decreases over time;
- any lease of immovable property;
- any time-sharing interest as defined in section 1 of the Property Time-sharing Control Act, 1983;
- a share in a share block company, as defined in section 1 of the Share Blocks Control Act with a fixed life, the value of which decreases over time; and
- a right or interest in any of the above mentioned assets.

Accordingly, if a natural person ceases to be resident, and immediately prior to ceasing to be resident, that natural person owned any of the assets listed above in paragraph 15, then those assets would be deemed to have been disposed under section 9H(2) of the Act. However, if the deemed disposal of these assets resulted in a capital loss, the capital loss would be disregarded under paragraph 15.

4.2.5 Long-term insurance policies

Paragraph 55 of the Eighth Schedule to the Act determines that the capital gains and capital losses on certain long-term insurance policies are to be disregarded. The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 441) submits that the exclusion only applies to South African policies, since paragraph 55(2) requires a policy to be registered with a person registered or deemed to be registered as a long-term insurer under the Long-term Insurance Act No. 52 of 1988. The Guide explains that since a foreign insurer could not be registered under the Long-term Insurance Act No. 52 of 1988, the capital gains or capital losses from the disposal of foreign policies would not qualify for the paragraph 55 exclusion. In terms of paragraph 55(1), the following South African policies benefit from the exclusion from capital gains tax:

- policies owned by an original beneficial owner or one of the original beneficial owners;
- policies that were ceded to the spouse, nominee or dependent and no amount was paid to the original beneficial owner for the cession of that policy to the spouse, nominee or dependent; and
- policies that were ceded to the former spouse of the original beneficial owner following a divorce order.

Hence, if a natural person ceases to be resident, an exit charge would arise under section 9H(2) for the long-term insurance policies owned by that person. However, the South African policies determined in paragraph 55(1) would qualify for the exclusion from capital gains tax. Other policies identified by the Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 438 and 440) as so-called second hand South African policies and foreign policies would be subject to capital gains tax, and therefore subject to an exit charge when a natural person ceases to be resident.

4.2.6 A beneficiary's vested right to an asset of a trust

The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 537) states that after the vesting of an asset in a beneficiary of the trust, the beneficiary becomes solely responsible for any subsequent capital gains tax implications. Accordingly, if a natural person and beneficiary of a trust ceases to be resident, and that natural person held a vested right to an asset of a trust,

since the vested right to an asset represents a personal right, and therefore an “asset” for the purposes of paragraph (b) of the definition of an “asset” in the Eighth Schedule, that vested right will be subject to the exit charge under section 9H(2). Therefore, when a beneficiary of a trust ceases to be resident, that beneficiary is deemed to have disposed of a vested right to an asset in a trust at its market value on the day immediately before the beneficiary ceased to be resident. Since the vested right to an asset is akin to the ownership of that asset, the market value of the vested right should equate to the market value of the underlying asset. The base cost of the vested right to that asset would offset this. Paragraph 11(1)(d) and 38(1)(a) of the Eighth Schedule would determine the base cost, since the vesting of an interest in an asset of a trust in a beneficiary would represent a “disposal” by the trust and since the trust and a beneficiary are connected persons, the proceeds from that disposal must be accounted for at the market value of the vested right. In terms of paragraph 38(1)(b) of the Eighth Schedule, the resident beneficiary is deemed to have acquired the vested right to an asset at its market value on the date the asset was vested in the beneficiary.

The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 531) submits that a beneficiary with a vested right only has “an interest” in the underlying assets. This principle was confirmed in the case of *Hansen’s Estate v CIR 20 SATC 246 1956 (1) SA 398 (A)*. Although a beneficiary may have received a vested right to an asset of a trust, this only represents “an interest” in the underlying asset until such time as the ownership of that asset is transferred by the trust to the beneficiary. For that reason, the various exclusions from capital gains tax in the Eighth Schedule to the Act could not apply to this asset. For example, if a resident beneficiary held a vested right in a South African long-term insurance policy in a trust and that resident beneficiary ceased to be resident, paragraph 55 of the Eighth Schedule could not disregard the capital gains tax implications that would arise. Similarly if the resident beneficiary held a vested right in a “personal-use” asset in a trust and that resident beneficiary ceased to be resident, paragraph 53 could not disregard the capital gains tax implications that would arise.

4.2.7 Other items

In terms of section 12T(3) of the Act, the capital gain or capital loss that arises from the disposal of a “tax free investment” as defined in section 12T(1) shall be disregarded. Under paragraph 54 of the Eighth Schedule to the Act, a capital gain or capital loss that arises from

the deemed disposal of a lump sum benefit from a pension, retirement annuity and provident fund must also be disregarded. When a person subsequently ceases to be resident and is deemed to have disposed of his or her assets, no capital gain will arise in respect of these assets.

4.3 Revenue gains – special issues when a natural person ceases to be resident

4.3.1 The foreign exchange implications of the exit charge for a natural person

The Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 115) submits that section 9H(7) of the Act was primarily directed at the foreign exchange implications that apply to the deemed disposal of a capital asset, and therefore the application of paragraph 43 of the Eighth Schedule to the Act. However, in the case of the deemed disposal of a revenue asset that had been acquired in foreign currency, it is submitted that section 25D of the Act would apply to translate the revenue gain or revenue loss. Since section 9H(7) of the Act deems the proceeds to be in the same currency as the currency incurred for the acquisition of the asset, the market value of the asset must be determined in the currency of the expenditure incurred.

In terms of section 25D(1) and section 25D(3) of the Act, a natural person would have the option of translating the deemed revenue gain or deemed revenue loss at either:

- the amount received or accrued, at the spot rate on the date of the disposal; and
- the expenditure incurred, at the spot rate on the date the expenditure was incurred; or
- the amount received or accrued and the expenditure incurred, at the average exchange rate for that year of assessment.

A natural person would elect the most favourable exchange rate in calculating the exit charge under section 9H(2) and section 25D of the Act. It is also submitted that, under section 9H(2), the date of disposal for the purposes of the spot rate would be the day immediately before the day that natural person ceases to be a resident. Since “the year of assessment” for a natural person under section 9H(2)(a) is deemed to have ended the day immediately before the natural person ceased to be resident, the average exchange rate for that “year of assessment” would be from 1 March to the day immediately before that natural person ceased to be resident, and not the average exchange rate for the entire 12 month period of that year of assessment.

4.4 Capital Gains Tax – special issues when a company ceases to be resident

4.4.1 The foreign exchange implications of the exit charge for a company

In terms of section 9H(3)(a) of the Act, an exit charge arises when a company ceases to be resident in South Africa. If a company, in acquiring an asset, incurred expenditure in a foreign currency, paragraph 43(1A) of the Eighth Schedule to the Act would apply to the deemed disposal of that asset and the capital gain or capital loss from the deemed disposal of an asset under section 9H(3)(a) would be determined as follows:

- the base cost of the asset would be the expenditure incurred on that asset in foreign currency, translated to local currency (Rands) at either the average exchange in the year of assessment when the asset was acquired or at the spot rate on the date the asset was acquired; and
- since section 9H(7) of the Act deems the proceeds to be in the same currency as the currency incurred for the acquisition of the asset, the market value of that asset must be determined in currency of the expenditure incurred and translated to local currency (Rands) at the average exchange rate for the year of assessment in which the asset is disposed of, or at the spot rate on the date of disposal of the asset. It is also submitted that, under section 9H(3)(a), the date of disposal for the purposes of determining the timing of the spot rate, would be the day immediately before the day that the company ceases to be resident.

Hence, a company would elect the most favourable exchange rates in determining the exit charge under section 9H(3)(a) and paragraph 43(1A). Since the “year of assessment” for a company under section 9H(3)(a) is deemed to have ended the day immediately before that company ceased to be resident, the average exchange rate for that “year of assessment” would be from the first day of the company’s financial year until the day immediately before that company ceased to be resident, and not the average exchange rate for the entire 12 month period of that financial year of assessment.

4.5 Revenue gains – special issues when a company ceases to be resident

4.5.1 The foreign exchange implications of the exit charge for a company

Where revenue assets of a company had previously been acquired in a foreign currency, the deemed disposal of such an asset, it is submitted, would mean that section 25D(1) of the Act would apply to translate the revenue gain or loss. Since section 9H(7) of the Act deems the proceeds to be in the same currency as the currency incurred for the acquisition of the asset, the market value of the asset must be determined in the currency of the expenditure incurred. Section 25D(1) provides that the translation of the deemed revenue gain or deemed revenue loss would be determined by applying the spot rate on the date of disposal and spot rate on the date the expenditure was incurred.

4.6 Capital Gains Tax – special issues when a trust ceases to be resident

4.6.1 The exit charge applies to capital assets held by the trust

It is submitted that the first step in determining the exit charge under section 9H(2) of the Act when a trust ceases to be resident, is to establish which assets are owned by the trust, and then to determine which of those assets have yet to be vested in a beneficiary. This principle is confirmed by the Comprehensive Guide to Capital Gains Tax (SARS: 2016: 538) which states that: “The assets of a discretionary trust are treated as those of the trust until an unconditional right to those assets is vested in a beneficiary”.

Since the vesting of an asset by a trust represents a disposal under paragraph 11(d) of the Eighth Schedule to the Act, the Comprehensive Guide to Capital Gains Tax (SARS: 2016: 539) submits:

After the asset has been vested in a resident or non-resident beneficiary the trust is out of the picture for CGT purposes since it has disposed of its asset under paragraph 11(1)(d) and has nothing more to dispose of. After acquiring the vested interest in the asset, the beneficiary must account for any further capital gain or loss that arises when the asset is disposed of to a third party. The trustees’ role after vesting becomes that of a pure administrator whose actions are performed on behalf of the beneficiary.

Accordingly, after vesting, the beneficiary of the trust becomes solely responsible for any further capital gains tax implications. For that reason, an exit charge under section 9H(2) will only arise in a trust if and when a trust ceases to be resident and no beneficiary has an unconditional vested right to the assets held by the trust. In terms of section 9H(4), certain assets would be excluded from the exit charge. If a trust was carrying on a trade, it would be necessary to establish if the trade is carried on in a permanent establishment in South Africa. If this was the case, the assets of that permanent establishment would, in terms of section 9H(4), be excluded from the exit charge in terms of section 9H(2).

It is submitted that in the event of a vesting trust, where all of the assets of the trust automatically vested in its beneficiaries under the trust deed, no exit charge can arise under section 9H(2), since the trust has no assets. It follows that if a vesting trust ceased to be resident, there would be no tax implications for the beneficiaries. However, if a beneficiary of a trust ceases to be resident an exit charge under section 9H for the beneficiary could arise. This is discussed in section 4.2.6 above.

The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 548) states that, if a beneficiary has a vested right to the trust capital, this does not necessarily mean that the beneficiary has a vested right to the trust assets. The Guide also indicates that if the word “capital” was not be defined in the trust deed it would usually mean the assets of the trust less the liabilities of the trust. For that reason, the Guide submits that “[T] the terms of the trust deed must also be carefully scrutinized to determine the ultimate destination of the trust assets”.

4.6.2 Can the deemed capital gain be vested in a beneficiary?

The question arises as to whether a deemed capital gain or deemed capital loss that arises from the exit charge under section 9H(2) could be vested in a resident beneficiary under paragraph 80(2) of the Eighth Schedule to the Act. Since paragraph 80(2) only permits the vesting of a capital gain in a resident beneficiary, it is submitted that a deemed capital loss arising from section 9H(2), would be taxable in the trust. The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 552) states that it could be impossible for a trustee to vest a capital gain, since a capital gain is an artificial tax concept which may bear little resemblance to the accounting capital profit. However, the Guide also states, “[B]ut the legislation has to be given meaning,

and the legislation no doubt intended that the vesting of a capital gain should as far as possible follow the real-life vesting of accounting capital profits”.

The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 552 and 553) states:

- that a capital gain can only be vested in a beneficiary to the extent that a capital profit is available for vesting; and
- that the principle that a trustee cannot vest deemed income was established in the case of *Hulett v CIR 13 SATC 58, 1944 NPD 263* where the court held:

...that the provisions of section 9(5) of Act 31 of 1941 were not applicable to a fictional or notional income, which did not in fact accrue to the trust and was not available for distribution by the trustees, who, accordingly, could not exercise any discretion in its outlay or withholding.

On the basis of judicial precedent, and since the deemed capital gain arising from an exit charge under section 9H(2) of the Act represents a fictional and notional amount, it is submitted that the trustees would be unable to vest that capital gain under section 80(2) in a resident beneficiary. It follows that since the trustees would be unable to vest a deemed capital gain in a resident beneficiary, the attribution rules in paragraph 68, 69, 71 and 72 of the Eighth Schedule to the Act could also not apply to attribute the deemed capital gain to the donor of the trust.

Support for this position is confirmed in the Comprehensive Guide to Capital Gains Tax (Issue 5) (SARS: 2016: 550), which indicates that for an actual vesting of a capital gain to occur, there must be a distribution of cash or an asset *in specie*, or by crediting the beneficiary’s loan account. Accordingly, since a deemed capital gain arising from section 9H(2) could not be represented by either a distribution of cash or an asset *in specie*, it would appear that a credit to a beneficiary’s loan account could resolve the position. However, this may also prove to be impossible, since a trustee of a trust would be unable to credit a beneficiary’s loan account for a capital gain that represents a fictional and notional amount.

Furthermore, it is also submitted that it may be practically impossible for trustees to vest a capital gain (but not the asset), since the deemed capital gain takes place on the day before the trust ceases to be resident. Since the year of assessment for that trust is also deemed to have

ended on the day before the trust ceases to be resident, it would be practically impossible for the trustees to back-date the vesting of that capital gain (but not the asset) to the date before the trust ceased to be resident.

4.6.3 Could the capital gain be attributed to the donor?

Paragraph 70 of the Eighth Schedule to the Act provides that if a discretionary *inter vivos* trust realised a capital gain from the disposal of an asset during the year of assessment and the trustees did not vest that capital gain in any resident beneficiary in that year of assessment, the capital gain will be deemed to vest in the resident donor of the trust. Since the donor of a testamentary trust is already deceased, it would not be possible under paragraph 70 of the Eighth Schedule to attribute a deemed capital gain arising from section 9H(2) to the donor.

Following the judicial precedent in the *Hulett* case, which prevents the trustees of an *inter vivos* trust from vesting a deemed capital gain in a beneficiary under paragraph 80(2) of the Eighth Schedule, since the deemed capital gain remains in the trust, the question arises as to whether that deemed capital gain could be attributed to a resident donor under paragraph 70 of the Eighth Schedule? In this regard, it is submitted that, the principles from the *Hulett* case could also apply.

The legislation at the time of the *Hulett* case permitted the taxable income of a company to be apportioned, and deemed to have been received by its shareholders. Since the main shareholder of a particular company was a trust, the taxable income of the company was then apportioned and deemed to have been received by the trustees of that trust. It is submitted that the important issue was that the taxable income of the company was deemed to have been received by the trust, and for that reason the income was considered to be purely fictional. The trust deed provided that if the trustees did not exercise their discretion and distribute that income to the beneficiaries, the income would be deemed to accrue to the settlor or the donor of the trust under section 9(5) of the Act 31 of 1941. This provision, in some ways, mirrored the existing provisions in section 7(5) and paragraph 70 of the Eighth Schedule to the Act. Since the trustees in the *Hulett* case did not distribute the deemed income to the beneficiaries, SARS then sought to tax the deemed income in the settlor or donor's hands. However, in the *Hulett*

case the court held "... that the provisions of section 9(5) of Act 31 of 1941 were not applicable to a fictional or notional income, which did not in fact accrue to the trust".

Accordingly, since the *Hulett* case determines that the fictional or notional amount did not to accrue to the trust, this would prevent a deemed capital gain arising under section 9H(2) of the Act from being attributed to the donor of a trust under paragraph 70 of the Eighth Schedule. For that reason, the deemed capital gain will be taxed in the trust.

4.6.4 Personal-use assets of a special trust

The definition of a "special trust" was set out in Chapter 2.3.1. Under paragraph 53(1) of the Eighth Schedule to the Act, a special trust must disregard a capital gain or capital loss that arises from the disposal of a "personal-use" asset. Paragraph 53(2) of the Eighth Schedule provides that a "personal-use" asset of a special trust must be used mainly for purposes other than carrying on a trade. Paragraph 53(3) identifies certain assets that are not to be "personal-use" assets.

When a special trust ceases to be a resident, that special trust is deemed under section 9H(2) of the Act to have disposed of all of its assets. However, under paragraph 53(1) any deemed capital gain or deemed capital loss that arises from the disposal of the special trust's personal-use assets must be disregarded. Since the assets specified in paragraph 53(3) of the Eighth Schedule are not personal-use assets, the exit charge that arises from these assets would not be disregarded.

4.6.5 The foreign exchange implications of the exit charge for a trust

4.6.5.1 *A non-trading trust*

Section 9H(7) of the Act provides that the market value of any asset for the purposes of the exit charge in section 9H(2) and section 9H(3), must be in the currency of the expenditure that was incurred to acquire an asset. Accordingly, in the event of a deemed disposal of a trust asset under section 9H(2), since section 9H(7) determines that the market value and hence the proceeds from the disposal must be in the same currency as the expenditure incurred in respect

of the acquisition of that asset, then paragraph 43(1) of the Eighth Schedule to the Act would apply to a trust, provided the trust was not carrying on a trade. In terms of paragraph 43(1), a non-trading trust must calculate the capital gain or capital loss in that same currency, and then that capital gain or loss must be translated into the local currency (Rands) by applying either the average exchange rate for the year of assessment in which the asset was disposed of, or the spot rate on the date of disposal of that asset. In determining the translated amounts, the non-trading trust would elect the most favourable exchange rate in determining the exit charge under section 9H(2) and paragraph 43(1). In determining the exit charge, the date of disposal for the purposes of the timing of the spot rate, would be the day immediately before the day that non-trading trust ceases to be a resident.

Since the year of assessment for a trust, under section 9H(2)(a), is deemed to have ended the day immediately before that trust ceased to be resident, the average exchange rate for that year of assessment, would be from 1 March to the day immediately before that trust ceases to be resident, and not the average exchange rate for the entire 12 month period of that year of assessment.

4.6.5.2 *A trading trust*

Paragraph 43(1A) of the Eighth Schedule to the Act provides the translation rules for assets acquired and disposed of in foreign currency, other than paragraph 43(1) transactions. Accordingly, paragraph 43(1A) applies to foreign currency transactions entered into by:

- companies;
- trading trusts; and
- natural persons and non-trading trusts that did not acquire and dispose of an asset in the same foreign currency.

Paragraph 43(1A) determines the capital gain or capital loss for the person disposing of an asset by translating:

- the proceeds into the local currency (Rands) at the average exchange rate for the year of assessment in which the asset is disposed of, or at the spot rate on the date of disposal of the asset; and

- the expenditure incurred in respect of that asset into the local currency (Rands) at the average exchange rate for the year of assessment when the asset was acquired, or at the spot rate on the date the asset was acquired.

In terms of section 9H(2), an exit charge would apply to the assets of a trading trust when it ceases to be resident, other than the section 9H(4) assets. Accordingly, since a trading trust would be carrying on a trade, it is submitted that it would be necessary to identify whether any of the trust assets relate to a permanent establishment in South Africa, since these assets would be excluded from the exit charge. If a trading trust had incurred expenditure to acquire any of its assets in foreign currency, paragraph 43(1A) of the Eighth Schedule would apply to the deemed disposal of those assets. It follows that in calculating the capital gain or capital loss from the deemed disposal of such an asset under section 9H(2):

- the base cost of the asset would be the expenditure incurred on that asset in foreign currency, translated to local currency (Rands) at either the average exchange for the year of assessment when the asset was acquired, or at the spot rate on the date the asset was acquired; and
- since section 9H(7) of the Act deems the proceeds to be in the same currency as the currency incurred for the acquisition of the asset, the market value of that asset must be determined in currency of the expenditure and be translated to local currency (Rands) at the average exchange rate for the year of assessment in which the asset is disposed of, or at the spot rate on the date of disposal of the asset.

Section 9H(2) of the Act would deem the date of disposal, for the purposes of determining the timing of the spot rate, to be the day immediately before the day that trading trust ceases to be a resident. Since the year of assessment for a trading trust, under section 9H(2)(a), is deemed to have ended the day immediately before that trust ceased to be resident, the average exchange rate for that year of assessment, would be from 1 March to the day immediately before that trust ceases to be resident, and not the average exchange rate for the entire 12 month period of that year of assessment.

4.7 Revenue gains – special issues for when a trust ceases to be resident

4.7.1 The exit charge applies to revenue assets held by the trust

Following the discussion in section 4.6.1, it is submitted that the exit charge under section 9H(2) would apply to all the revenue assets held by the trust, other than those which have been vested in a beneficiary. Although it might be considered unlikely, it is submitted that, it would be possible for a revenue asset, for example in the form of trading stock held by a trust, to be vested in a beneficiary. Accordingly, in determining the exit charge under section 9H(2) of the Act, it would be necessary is to determine which revenue assets are held by a trust and to apply the exit charge only to the revenue assets that have yet to be vested in a beneficiary.

Since the definition of “asset” in the Eighth Schedule to the Act also includes a revenue asset, the vesting of such an asset in a beneficiary would represent a disposal for the purposes of the Eighth Schedule to the Act. Hence, after vesting, the beneficiary of the trust will become solely responsible for any further normal tax implications relating to that asset.

However, in determining the exit charge for a trust under section 9H(2), the assets listed in section 9H(4) of the Act must be excluded from the exit charge. Accordingly, if a trust carried on a trade, it would be necessary to establish if the trade represented the carrying on of a permanent establishment in South Africa. If this was the case, the revenue assets of that permanent establishment would under section 9H(4), be excluded from the exit charge in section 9H(2).

Section 25B(1) of the Act addresses the vesting of “an amount” in a beneficiary, which would normally represented by some form of gross or net income, it is submitted that this will not necessarily imply that the underlying revenue asset had been vested in a beneficiary. Accordingly, unless a revenue asset had been specifically vested in a beneficiary, the exit charge in section 9H(2) would apply to these assets held in trust. However, the assets listed in section 9H(4) would be excluded from the exit charge.

4.7.2 Could the deemed revenue gain arising from the exit charge be vested in a beneficiary or attributed to the donor?

It is necessary to determine if a deemed revenue gain that arises in the trust from the exit charge under section 9H(2) of the Act:

- could under section 25B(1) of the Act, be vested in a beneficiary; or
- following the exercise of a trustee's discretion, under section 25B(2) of the Act, be distributed to the beneficiaries; or
- be attributed under section 7(5) of the Act, to the donor of the trust.

Following the judicial precedent established in the *Hulett* case, the trustees would not be able to

- vest the deemed revenue gain in a beneficiary under section 25B(1); or
- exercise their discretion under section 25B(2) and distribute the deemed revenue gain to a beneficiary.

Furthermore, the judicial precedent established in the *Hulett* case, would prevent a deemed revenue gain remaining in the trust from being attributed to the donor under section 7(5) of the Act. On that basis, a deemed revenue gain that arises from an exit charge under section 9H(2) will be taxed in the trust. Since section 25B(4) of the Act prevents the vesting of or the distribution of losses to beneficiaries, any losses arising from the exit charge would remain in the trust.

4.7.3 The foreign exchange implications of the exit charge for a trust

Section 9H(7) of the Act provides that the market value of any asset for the purposes of the exit charge in section 9H(2) must be in the currency of the expenditure that was incurred to acquire an asset. Accordingly, in the event of a deemed disposal of a revenue asset in a trust under section 9H(2), since section 9H(7) determines that the market value and hence the proceeds from the disposal must be in the same currency as the expenditure incurred in respect of the acquisition of that asset, section 25D of the Act would apply to translate that revenue gain or revenue loss.

Section 25D(1) and section 25D(3) of the Act provide that a non-trading trust would have the option of translating the revenue gain or revenue loss at either:

- the amount received or accrued, at the spot rate on the date of the disposal; and
- the expenditure incurred, at the spot rate on the date the expenditure was incurred; or
- the amount received or accrued and the expenditure incurred, at the average exchange rate for the year of assessment.

However, in the case of a trading trust, only section 25D(1) could apply. This would mean that the revenue gain or revenue loss would be translated at the spot rates on the date of disposal and the date the expenditure was incurred. However, before proceeding to the translation, it would be necessary to identify the assets that relate to a permanent establishment in South Africa, since these assets would under section 9H(4) of the Act be excluded from the exit charge.

4.8 Exit charge – special issues for when a CFC ceases to be a CFC

Section 3.5 and section 3.5.1 of chapter 3 explain that, in certain circumstances, when a CFC ceases to be a CFC, an exit charge under section 9H(3)(b) arises. On the assumption that section 9H(3)(b) applies, a CFC is deemed to have sold all of its assets at market value on the day immediately before it ceased to be a CFC. In relation to a CFC, the following assets listed in section 9H(4) of the Act are excluded from the exit charge:

- immovable property situated in the Republic held by the CFC; and
- any asset which is attributable to a permanent establishment of that controlled foreign company in the Republic.

In terms of section 9H(3)(d), the CFC's foreign tax year is deemed to have ended on the day, immediately before that CFC ceases to be a CFC.

4.8.1 Proportional amount of “net income” included in the shareholder's income

Section 9D(2) of the Act requires the resident shareholder to include in income the proportional share of the “net income” of that CFC for that foreign tax year, determined in terms of the sub-section as the proportional share of that resident's participation rights in that

controlled foreign company. Furthermore, section 9D(2) determines that the proportional share must be included in the income of the shareholder on the last day of the foreign tax year, which under section 9H(3)(d) would be the day before that CFC ceases to be a CFC.

Section 9D(9)(b) of the Act provides that net income attributable to any “foreign business establishment” of a CFC must be excluded from the “net income” of a CFC. Owing to the “foreign business establishment” exclusion in paragraph 9D(9)(b) of the Act, the revenue assets of the “foreign business establishment” would be excluded from the deemed disposal under section 9H(3)(b). The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 739) states that, since the “net income” of a CFC includes capital gains, the “foreign business establishment” exclusion would also exclude the capital assets of the “foreign business establishment” from capital gains tax implications.

4.8.2 Foreign exchange implications of the “net income” of a CFC

Section 9D(6) of the Act determines that the “net income” of a CFC must be determined in its functional currency, by applying the average exchange rate for that foreign tax year. Since the foreign tax year for a CFC under section 9H(3)(d) is deemed to have ended the day immediately before that CFC ceased to be a CFC, the average exchange rate for that foreign tax year would be from the first day of the financial year of the CFC, until the day immediately before that CFC ceased to be a CFC, and not the average exchange rate for the entire 12 month period of that foreign tax year.

If a revenue gain in foreign currency was realized, following the deemed disposal of a revenue asset (excluding a section 9H(4) asset and an asset attributable to a foreign business establishment) when that CFC ceased to be a CFC, section 9D(6) of the Act requires that the net income of the CFC shall be determined in its functional currency, and then for the purposes of determining the section 9D(2) inclusion in the income of the resident, that revenue gain must be translated at the average exchange rate for the foreign tax year. Since section 9H(7) of the Act applies and deems the revenue gains to be in the same currency as that of the expenditure, if the original expenditure was in the functional currency of the CFC, then the revenue gain or revenue loss would be translated at the average exchange rate for that foreign tax year.

However, SARS in Interpretation Note 63 (Issue 2) (SARS: 2015:17) indicates that neither section 9D nor section 25D of the Act prescribe specific rules for translating other currencies to the functional currency of a CFC. In the absence of these rules, SARS states in Interpretation Note 63 that it would accept the following approaches:

- to translate the other currencies to the CFC's functional currency at the spot rate;
- to translate the other currencies to the CFC's permanent establishment's functional currency at the spot rate;
- to translate the different functional currency of a CFC's permanent establishment, to the functional currency of the CFC at the average exchange rate for the foreign tax year.

However, since section 9H(4) of the Act excludes the asset of a permanent establishment of a CFC situated in the Republic, when a CFC ceases to be a CFC, the exit charge in section 9H(3)(b) would not apply to these assets.

In the case of the deemed disposal of a capital asset (excluding a section 9H(4) asset and an asset attributable to a "foreign business establishment") when a CFC ceases to be a CFC, section 9D(6) of the Act requires that the net income of the CFC shall be determined in its functional currency and, for the purposes of determining the section 9D(2) inclusion in the income of the resident, that capital gain or capital loss will be translated at the average exchange rate for the foreign tax year. Since section 9H(7) of the Act applies and deems the proceeds to be in the same currency of the base cost expenditure, if the base cost expenditure of the capital asset was in the functional currency of the CFC, then the capital gain or capital loss would be translated at the average exchange rate for that foreign tax year.

Although SARS in Interpretation Note 63 (Issue 2) (SARS: 2015:17) provides some guidance for translating other currencies to the functional currency of a CFC, there would be also appear to be no specific rules in paragraph 43 of the Eighth Schedule to the Act for determining how to translate the capital gain or capital loss for assets acquired in currencies other than the functional currency of a CFC.

4.8.3 Proportional amount of the capital gains included in income

Since the Comprehensive Guide to Capital Gains Tax (SARS: 2016: 733) states that the “net income” of a CFC includes capital gains, the proportional amount of these amounts must also be included in the income of the shareholders under section 9D(2) of the Act. Proviso (f) to the “net income” definition in section 9D(2A) determines that if the resident shareholder under section 9D(2) is a natural person or special trust, the taxable capital gain of the CFC shall for the purposes of paragraph 10 of the Eighth Schedule be 40% of that company’s net capital gain in that foreign tax year. Accordingly, if the resident shareholder of a CFC is a natural person or special trust, proviso (f) to section 9D(2A) determines that 40% of the proportionate share of such a net capital gain must be included in that person’s income. If the resident shareholder of a CFC is a company or trust, it is submitted that 80% of the proportionate share of the taxable capital gains will be included in that company’s or trust’s income under section 9D(2).

4.8.3.1 *Base cost of pre-valuation assets*

The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 733) states that since a CFC is deemed to be resident for the purposes of paragraph 2(1)(a) of the Eighth Schedule to the Act, by implication the pre-valuation date rules in paragraph 25, 26, 27, 29, 30, 31 and 32 of the Eighth Schedule would apply to any assets that the CFC acquired before 1 October 2001. Accordingly, the Guide also states that the CFC must use the 1 October 2001 determined valuation, in calculating the deemed capital gain or deemed capital loss from the disposal of its pre-valuation date assets. The Guide indicates that since a CFC is considered to be resident, in order to rely upon the market value of an asset, the CFC would have needed to have valued its assets by 30 September 2004, unless the valuation of the asset was published in the Government Gazette.

4.8.3.2 *Base cost adjustments under paragraph 24 of the Eighth Schedule*

In determining the exit charge under section 9H(3)(b) when a CFC ceases to be a CFC, the base cost of the assets must be established. Paragraph 12(1), paragraph 12(2)(a)(ii) and paragraph 13(1)(g) of the Eighth Schedule to the Act determine the base cost of the assets

when a foreign company becomes a CFC. Under paragraph 12(1) and paragraph 13(1)(g), a CFC is deemed to have acquired its assets at market value on the day before that foreign company became a CFC. However, paragraph 12(2)(a)(ii)(aa) and paragraph 12(2)(a)(ii)(bb) of the Eighth Schedule indicate that the deemed acquisition will not apply to immovable property in the South Africa or the assets of a permanent establishment of a CFC in South Africa.

Paragraph 12(1) of the Eighth Schedule provides that when a CFC becomes a CFC, the base cost of its assets is subject to paragraph 24 of the Eighth Schedule. Paragraph 24 contains loss limitation rules for adjustments to the base cost of assets, when those assets are subsequently disposed of at a loss. The inclusion of paragraph 24 of the Eighth Schedule in section 9D(2A) of the Act, confirms the principle that the base cost of the assets could be affected by paragraph 24, which may ultimately impact the exit charge under section 9H.

However, paragraph 24(1) of the Eighth Schedule to the Act determines this provision only applies to the base cost of assets other than:

- assets as listed under paragraph 2(1)(b)(i) and 2(1)(b)(ii) of the Eighth Schedule as:
 - immovable property in South Africa;
 - an interest in immovable property in South Africa; and
 - any asset effectively connected with a permanent establishment of that CFC in South Africa.
- assets, if sold, would result in the receipt or accrual being taken into account in determining the net income of a person under section 9D of the Act.

Since CFCs are deemed under section 9D(2A) of the Act to be resident for the purposes of paragraph 2(1)(a) of the Eighth Schedule, this would mean that to all intents and purposes, all of the assets of a CFC (other than assets of a foreign business establishment) would be taken into account in determining the net income of a person under section 9D. On that basis it would appear that paragraph 24 could not apply, in some instances, to most of the assets in a CFC (other than the assets of a foreign business establishment) in determining the exit charge under section 9H. Furthermore, since the following assets:

- immovable property in South Africa; and

- any asset of a CFC, that is attributable to a permanent establishment of that CFC in the South Africa;

are excluded from the deemed acquisition in paragraph 12(2)(a)(ii) of the Eighth Schedule and the exit charge in section 9H(4), paragraph 24 would also not need to be considered for these assets. Since the assets of a foreign business establishment of a CFC are not subject to tax in South Africa, it would appear that the inclusion of paragraph 24 in paragraph 12(1) of the Eighth Schedule to the Act is primarily directed at the base cost adjustments that would be necessary if and when a CFC becomes resident in South Africa. The Comprehensive Guide to Capital Gains Tax (SARS: 2016: 118) states that paragraph 24 applies in determining the base cost of a CFC's foreign business establishment assets, when that CFC becomes resident in South Africa. However, since this is beyond the scope of this thesis, this has not been considered.

4.8.4 An illustrative example

Section 3.5 and section 3.5.1 of chapter 3 discuss when a CFC ceases to be a CFC under section 9H(3)(b) of the Act. Section 3.5.1 concluded that there was uncertainty as to whether the exit charge would apply when a CFC "ceased to be a CFC in relation to a resident". For that reason there is uncertainty as to whether the exit charge in section 9H applies when a CFC that ceases to be a CFC, other than if a shareholder in that foreign company ceases to be resident in South Africa.

To assist with the interpretation of the legislation, an illustrative example has been included. The solution to this illustrative example assumes that the exit charge in section 9H(3)(b) will apply when a CFC ceases to be a CFC as a result of a shareholder ceasing to be a resident. The illustrative example is based on the assumption that, since the shareholder ceases to be resident in South Africa, residents no longer held more than 50% of the participation or voting rights in the CFC.

Mr Jones, a South African resident, owns all of the shares in Emirate Limited, a foreign company. Mr Jones's shareholding interest matches his participation and voting interests. Mr Jones acquired the shares in Emirate Limited from a non-resident. Emirate Limited owns a residential property in that foreign country and during the 2017 year of assessment it earned net rentals of USD5 000 per month. The company had no other operating costs. The financial year for Emirate Limited ends on the last day of February and the company does not carry on a foreign business establishment. The company also pays no tax in that foreign country. Emirate Limited is not listed on a stock exchange.

Mr Jones acquired the shares in Emirate Limited, on 1 January 2012 for USD500 000. The shares are held for investment purposes. The market value of the residential property on 31 December 2011 was USD600 000. The shares in Emirate Limited were valued on a net asset value basis.

On 1 March 2015 Emirate Limited acquired a vacant plot of land in a foreign country for USD100 000 from an independent third party. Emirate Limited's intention vis-à-vis the vacant plot of land was speculative.

On 1 September 2016, Mr Jones ceased to be resident in South Africa. The market value of Mr Jones's shares in Emirate Limited on 31 August 2016 was USD1 000 000. The shares in Emirate Limited were valued on a net asset value basis.

The market value of the residential property, held by Emirate Limited, was USD1 000 000 on 31 August 2016. The market value of the plot of land was USD150 000 on 31 August 2016.

Until 29 February 2016, the section 9D(2) inclusions in Mr Jones's income, relating to Emirate Limited, amounted to R250 000.

Until 29 February 2016, Mr Jones had received foreign dividends amounting to the Rand equivalent of R100 000 from Emirate Limited, which were exempt from tax under section 10B(2)(a).

Emirate Limited did not declare any dividends between 1 March 2016 and 31 August 2016. Emirate Limited's functional currency is in USDs.

The average exchange rate of USD 1 = R15.50 applied for the year of assessment ended 28 February 2017. The average exchange rate of USD 1 = R15.00 applied for foreign tax year ended 31 August 2016 (1 March 2016 to the 31 August 2016). The spot rate of USD 1 = R16.00 applied on 31 August 2016.

Solution

Emirate Limited is a CFC since:

- it is a foreign company and therefore is not resident in South Africa; and
- residents hold more than 50% of the participation and voting rights in Emirate Limited.

Mr Jones will have a section 9D(2) inclusion in his income since:

- none of the income of Emirate Limited relates to a “foreign business establishment”;
- the high tax-threshold exclusion in the second proviso to section 9D(2A) does not apply; and
- Mr Jones holds at least 10% of the participation and voting rights in Emirate Limited.

Since Mr Jones ceases to be resident in South Africa on 1 September 2016, Emirate Limited ceases to be a CFC on that date. Assuming that section 9H(3)(b) applies, Emirate Limited is deemed to have disposed of all of its assets on the 31 August 2016 (i.e the day before it ceases to be a CFC).

Mr Jones’s section 9D(2) inclusion while he was “ordinarily resident” between 1 March 2016 and 31 August 2016:

Net rental income of CFC - USD5 000 x 6 months		USD30 000
Section 9H(3)(b) deemed disposal of revenue assets: Deemed “gross income” from the sale of the land	USD150 000	
Section 11(a) deduction for the cost of the land	<u>(USD100 000)</u>	USD50 000
Section 9H(3)(b) deemed disposal of capital assets: Deemed proceeds from the sale of the residential property	USD1 000 000	
<u>Less: Base cost</u>	<u>(USD 600 000)</u>	
Capital gain	<u>USD 400 000</u>	
Inclusion rate for Mr Jones (40%)		<u>USD160 000</u>
Net income		<u>USD240 000</u>
Section 9D(6) translates at average exchange rate for the foreign tax year at USD 1 = R15.00		
Section 9D(2) inclusion for Mr Jones		<u>R3 600 000</u>

Section 9D(2)(b) of the Act provides special rules for a section 9D(2) inclusion when a CFC ceases to be a CFC and determines that when a CFC ceases to be a CFC during a year of assessment and before the last day of the foreign tax year, the resident shareholder has the option of including either:

- under section 9D(2)(b)(i), the proportional net income for the year, based on the net income for that foreign tax year at the ratio of the number of days in the foreign tax year the foreign company was a CFC relative to the number of days in the foreign tax year; or
- under section 9D(2)(b)(ii), the actual net income for the period that the foreign company was a CFC, commencing on the first day of the foreign tax year and ending the day before that CFC ceased to be a CFC.

However, section 9H(3)(d) of the Act determines that the foreign tax year of the CFC is deemed to have ended the day immediately before that CFC ceased to be a CFC. In that case, since the CFC was a CFC for its entire foreign tax year (a shortened foreign tax year), it is submitted section 9D(2)(a)(i) of the Act should apply, rather than section 9D(2)(b). In terms of section 9D(2)(a)(i) of the Act, the taxpayer must include the proportionate share of the actual net income for that period.

Mr Jones’s taxable income computation while he was “ordinarily resident” between 1 March 2016 and 31 August 2016:

Section 9D(2) inclusion		R3 600 000
Deemed disposal of shares under section 9H(2): Paragraph 43(1) to apply to deemed disposal of Emirate Limited shares:		
Proceeds	USD1 000 000	
Base cost	<u>(USD500 000)</u>	
	USD 500 000	
In terms of section 25D(3) translated at the average exchange of USD1 = R15.50	<u>R7 750 000</u>	
Base cost adjustments under paragraph 20(1)(h)(iii) of the Eighth Schedule:		
Section 9D(2) inclusions to 29 February 2016	(R250 000)	
Exempt foreign dividends under section 10B(2)(a)	R100 000	

Section 9D(2) inclusions to 31 August 2016:		
Net rentals USD30 000 x R15.00	(R450 000)	
Section 9H(3)(b) deemed revenue gain from land: USD50 000 x R15.00	(R750 000)	
Section 9H(3)(b) deemed capital gain from residential property USD400 000 x R15.00	(R6 000 000)	
Less Annual exclusion	<u>(R40 000)</u>	
	<u>R360 000</u>	
Paragraph 10 of the Eighth Schedule inclusion at 40%		R144 000
Taxable income		<u>R3 744 000</u>

4.8.5 An illustrative example – alternative solution

The solution to Mr Jones in section 4.8.4 above was prepared on the assumption that the exit charge in section 9H(3)(b) would apply when Mr Jones ceased to be resident in South Africa. However, following the discussion in section 3.5.1 of chapter 3 and given the uncertainty concerning the interpretation of section 9H(3)(b) when a CFC “ceased to be a CFC in relation to a resident”, the solution to the Mr Jones example has been re-worked. The revised solution has been prepared on the basis that the exit charge in section 9H(3)(b) will not apply when a CFC ceases to be a CFC, as a result of a shareholder ceasing to be resident.

Mr Jones’s section 9D(2) inclusion while he was “ordinarily resident” between 1 March 2016 and 31 August 2016:

Net rental income of USD5 000 x 6 months	USD30 000
Net income	<u>USD30 000</u>
Section 9D(6) translates at average exchange rate for the foreign tax year at USD 1 = R15.50	
Section 9D(2) inclusion for Mr Jones	<u>R465 000</u>

It is submitted that, since the exit charge in section 9H(3)(b) of the Act does not apply, section 9H(3)(d) also cannot apply, and therefore the foreign tax year cannot be deemed to have ended immediately before that CFC ceased to be a CFC. Accordingly, Mr Jones will have an option under section 9D(2)(b) to elect either the actual “net income” of the CFC for the period it was a CFC, or to use the proportional “net income” of the CFC for the foreign tax year based on the ratio of the number of days in the foreign tax year that the foreign company was a CFC, relative to the total number of days in the foreign tax year. In this case, Mr Jones would have the option of utilising either USD30 000 or USD 30 246 (USD 5 000 x 12 x 184/365).

Mr Jones’s taxable income computation while he was “ordinarily resident” between 1 March 2016 and 31 August 2016:

Section 9D(2) inclusion		R465 000
Deemed disposal of shares under section 9H(2): Paragraph 43(1) to apply to deemed disposal of Emirate Limited shares:		
Proceeds	USD1 000 000	
Base cost	<u>(USD500 000)</u>	
	USD 500 000	
In terms of section 25D(3) translated at the average exchange of USD1 = R15.50	<u>R7 750 000</u>	
Base cost adjustments under paragraph 20(1)(h)(iii) of the Eighth Schedule:		
Section 9D(2) inclusions to 29 February 2016	(R250 000)	
Exempt foreign dividends under section 10B(2)(a) Section 9D(2) inclusions to 31 August 2016:	R100 000	
Net rentals USD30 000 x R15.50	(R465 000)	
Less Annual exclusion	<u>(R40 000)</u>	
	<u>R7 095 000</u>	
Paragraph 10 of the 8 th Schedule inclusion at 40%		R2 838 000
Taxable income		<u>R3 303 000</u>

Accordingly, depending upon an interpretation of the provision “ceased to be a CFC in relation to a resident”, it is submitted that the taxable income of a taxpayer could be significantly different if the exit charge in section 9H(3)(b) was applied when the shareholder ceased to be resident.

4.8.6 Foreign exchange implications of the deemed disposal of the CFC shares

Foreign exchange implications also arise for the shareholder in the calculation of the exit charge under section 9H(2), section 9H(3)(a) and section 9H(3)(b). When a resident shareholder of a CFC ceases to be resident, that person is deemed to have disposed of his or her shares in a CFC at market value, on the day immediately before the shareholder ceases to be resident. Since it is likely that the shareholding interest in the CFC is likely to have been acquired in a foreign currency, section 9H(7) determines that the market value of the shares for the purposes of the deemed disposal must be determined in the currency that was incurred to acquire the asset. If the shares in the CFC were held for investment purposes, paragraph 43 of the Eighth Schedule to the Act would need to be considered. Where the shareholder of the CFC was a natural person or a non-trading trust, paragraph 43(1) of the Eighth Schedule would apply and the deemed capital gain or capital loss would need to be determined in the foreign currency and translated into local currency (Rand) by applying either the average exchange rate for the year of assessment or the spot rate on the date of the disposal of the asset. However, a complicating factor arises, since paragraph 20(1)(h)(iii) of the Eighth Schedule requires that certain base cost adjustments be made to the shares of a controlled foreign company. Paragraph 20(1)(h)(iii) requires that:

- the base cost of the shares are increased for an amount, equal to the proportional amount of the net income of that controlled foreign company, which has been included in the income of that resident shareholder under section 9D in any year of assessment;
- the base cost of the shares are reduced to the extent that foreign dividends have been received from that company during any year of assessment and these foreign dividends have been exempt from tax under section 10B(2)(a) or 10B(2)(c) of the Act.

Since the section 9D amount and the exempt foreign dividend amounts are reflected in the taxpayer’s return in local currency (Rand), this complicates the calculation of the deemed capital gain or deemed capital loss calculation. This is because there is an intermingling of

local currency (Rand) and foreign currency in the deemed capital gain or deemed capital loss calculations. Haupt (2016: 625) in an example submits that, the most logical way of addressing this issue would be:

- to calculate the capital gain or capital loss from the disposal of the shares in foreign currency, and then to translate this gain or loss at either the average exchange rate in the year of assessment or spot rate on the date of disposal; and
- to adjust the calculated amount by the paragraph 20(1)(h)(iii) base cost adjustments (in local currency) to determine the final capital gain or capital loss amount.

This approach has been adopted in the solutions to the Mr Jones example. In contrast, Stiglingh et al (2016: 633) submit by way of an example that the paragraph 20(1)(h)(iii) base cost adjustments should be processed in their original currency which ensures that the capital gains tax calculation remains in foreign currency, until the final amount is translated.

4.9 Normal tax implications for the disposal of revenue assets after ceasing to be resident

The gross income definition in section 1 of the Act provides that non-residents are only taxed on receipts and accruals from a South African source. Although “source” is not defined in the Act, section 9 of the Act provides rules for the “source of income”. Whilst section 9 of the Act provides source rules for various types of income, for example interest and dividend income, section 9 also provides specific source rules for the disposal of certain revenue assets. These rules are located in section 9(2)(j) and section 9(2)(k) of the Act.

Section 9(2)(j) of the Act determines that if an amount is received by or accrues to a non-resident from the disposal of immovable property or an interest in immovable property in South Africa, such amount would be considered to be from a South African source. Since separate capital gains tax rules apply to the assets of a non-resident, it follows for this source rule to apply, the immovable property or interest in immovable property in South Africa must be a revenue asset.

Section 9(2)(k)(ii) of the Act determines that if an amount is received by or accrues to a non-resident from the disposal of an asset that is attributable to a permanent establishment of that

person in South Africa, such amount would be considered to be from a South African source. Since separate capital gains tax rules apply to the assets of a non-resident, it follows for this source rule to apply the asset attributable to a permanent establishment in South Africa must be a revenue asset.

Although immovable property in the Republic and any asset attributable to a permanent establishment of a person in the Republic are exempt from the exit charge in terms of section 9H(4) of the Act, when a person ceases to be resident, the subsequent receipts or accruals that result from the sale of these assets by the non-resident person will be considered to be from a South African source in terms of section 9(2)(j) and section 9(2)(k)(ii) and will be included in the gross income of the non-resident. The inclusion in gross income will be offset by a deduction for the cost of that asset under section 11(a) of the Act. If the revenue asset had been acquired in a previous year of assessment, then the deduction for the cost of that asset, also known as an opening stock deduction, would be made under section 22(2) of the Act.

Since section 9(2)(j) of the Act provides that an amount received by or accrued to a non-resident from the disposal of an interest in immovable property in South Africa is from a South African source, the subsequent sale of such a revenue asset by a non-resident will result in that receipt or accrual being included in the gross income of the non-resident. However, since an exit charge under section 9H(2) or section 9H(3) would have already applied to an “interest in immovable property” in South Africa when that natural person, trust or company ceased to be resident in terms of section 9H(2)(a)(ii) and 9H(3)(a)(ii), that interest in immovable property would have been reacquired at market value on the day before that resident ceased to be resident. Accordingly, this will result in a revised section 11(a) deduction for the cost of the interest in immovable property in South Africa, which will be deductible against the gross income when the asset is eventually sold by the non-resident.

Section 9(4)(d) of the Act provides that if the disposal of an asset fails to meet the requirements of section 9(2)(j) and section 9(2)(k)(ii), the amount received or accrued to that person in respect of that asset must be from a source outside South Africa. In that case if a non-resident disposed of a revenue asset in South Africa and that asset that did not meet the requirements of section 9(2)(j) and section 9(2)(k)(ii), the related receipt or accrual could not be included in the gross income of the non-resident.

4.10 Conclusion

Certain unique revenue gains and capital gains tax consequences arise from the exit charge in terms of section 9H(2) and 9H(3) when a natural person, trust or company ceases to be resident in South Africa. Depending upon the nature of the taxpayer, that person would need to consider whether any of the capital gains tax exclusions in the Eighth Schedule to the Act could apply, which would result in any of their deemed capital gains and deemed capital losses being disregarded.

When a trust ceases to be resident, the exit charge in section 9H(2) would only apply to assets of the trust to the extent that the assets have yet to vest in a beneficiary. Following the precedent established in the *Hulett* case, and since the exit charge for a trust represents a notional and fictional amount, the trustees would be unable under section 25B(1), section 25B(2) or paragraph 80(2) of the Eighth Schedule to the Act to vest that deemed revenue or deemed capital gain in a resident beneficiary.

When a CFC ceases to be a CFC, section 9H(3)(b) determines that the CFC is deemed to have disposed of all of its assets (other than assets referred to in section 9H(4) and the “foreign business establishment” assets) on the day immediately before that CFC ceased to be a CFC. Interpretation issues arise as to whether the exit charge under section 9H(3)(b) will apply, since the provision refers to a CFC that “ceased to be a CFC in relation to a resident”. For that reason there is uncertainty as to whether the exit charge applies when a CFC ceases to be a CFC, other than if a shareholder in a foreign company ceases to be resident in South Africa. Depending upon the interpretation, the illustrative example provided in this chapter indicates that the normal tax positions could be significantly different.

The foreign exchange implications of the exit charge are determined by section 9H(7) of the Act, which provides that the market value of the asset, and hence the proceeds from the deemed disposal of that asset, must be in the same currency as the expenditure incurred to acquire that asset. Despite this translation rule, the foreign exchange implications are also dependent upon the identity of the taxpayer and the nature of the asset. For example, if the taxpayer was a natural person or a non-trading trust and the underlying asset was of a capital nature, paragraph 43(1) of the Eighth Schedule to the Act would apply to translate the capital gain or loss that

arises from the deemed disposal of an asset. In contrast, if the taxpayer was a company or a trading trust and the underlying asset was of a revenue nature, section 25D(1) of the Act would apply to translate the deemed revenue gain or deemed revenue loss.

When a resident ceases to be resident, section 9H of the Act determines that an exit charge would apply to the revenue assets of a taxpayer. Since section 9(2)(j) of the Act determines that the receipts and accruals from the disposal of an interest in immovable property are from a South African source, if a non-resident subsequently sold such an asset, the receipts and accruals from the disposal of that asset would be included in the non-resident's gross income in South Africa. However, since an interest in immovable property in South Africa would already have been subject to the exit charge in section 9H, when a resident ceases to be resident this would result in a revised section 11(a) deduction for the cost of the asset.

In the following chapter, the conclusions for the thesis will be discussed.

CHAPTER FIVE: CONCLUSION

5.1 Introduction

The main purpose of this research was to analyse the tax implications and the exit charge that could arise when a resident natural person, company, or trust ceases to be resident in South Africa. The research will also analyse the tax implications for when a Controlled Foreign Company (CFC) ceases to be a CFC.

In achieving the main purpose of the research, the following sub-goals were also addressed:

- the meaning of “ordinarily resident”;
- the meaning of “place of effective management”;
- the exit charge that arises from the disposal of an interest in immovable property in the Republic;
- the tax implications for revenue assets, considered not to be attributable to a permanent establishment in the Republic, of a person that ceased to be resident, that had already been the subject of an exit charge under section 9H, and which are subsequently sold;
- with regard to CFCs:
 - the normal tax implications for a CFC when it ceases to be a CFC as a result of a change in the residency of the holders of the participation rights or voting rights, which results in not more than 50% of the total participation rights or voting rights in that CFC being held by residents;
 - the section 9D inclusion in income for a resident that holds a participating interest in a CFC immediately prior to that resident ceasing to be a resident and which results in that CFC ceasing to be a CFC; and
 - the exit charge that arises from the deemed disposal of the shares in a CFC when a resident ceases to be resident;
- under what circumstances a resident trust will cease to be resident; in the event of a resident vesting trust, whether an exit charge could apply to the trust or whether there could be resultant tax implications for the beneficiaries, if that trust ceased to be resident in South Africa; and whether the capital or revenue gains that arise in a discretionary trust ceasing to be a resident could vest in or be distributed to a beneficiary, revert to the donor or are taxable in the trust;

- the foreign exchange implications that may arise in the calculation of the exit charge.

5.2 Findings

The South African normal tax implications of being a “resident” as defined in section 1 of the Act were discussed in chapter 2. A “resident” is taxed on the basis of worldwide receipts and accruals, with the income included in that person’s gross income, whilst receipts and accruals of a capital nature would be subject to capital gains tax, provided that an “asset” as defined in the Eighth Schedule was disposed of. Separate tax rules apply to resident trusts and CFCs and these were also discussed in chapter 2. For example in the case of a resident trust, the income and capital gains of that trust could be taxed either in the hands of the donor to the trust, the beneficiary of the trust or the trust itself. This will depend upon whether a beneficiary received a vested right to income, a vested right to an asset, or a vested right to a capital gain and whether the donor to the trust is alive. As to CFCs and where a resident holds a qualifying interest in a CFC, that resident must, in terms of section 9D(2) of the Act, include in income on the last day of that CFC’s foreign tax year, the proportionate share of the “net income” of the CFC.

The main purpose of the research was addressed in chapters 3 and 4. Chapter 3 explained that when a natural person, trust or company ceases to be resident, section 9H of the Act determines that the person is deemed have disposed all of their “assets” at market value on the day immediately before that person ceased to be resident. For the purposes of the fifth sub-goal relating to CFCs and the exit charge, chapter 3 clarified that if a CFC ceases to be a CFC, section 9H deems that CFC to have disposed of all of its “assets” at market value on the day immediately before that CFC ceased to be a CFC. The disposal results in a deemed capital gain or deemed revenue gain, and a deemed recoupment of previous allowances. This is also referred to as the exit charge.

Chapter 3 also indicated that when a natural person, trust or company ceases to be resident, section 9H of the Act determines that the year of assessment is deemed to have ended on the day immediately before the day on which that person ceased to be resident. Section 9H also provides that the new year of assessment for that person is deemed to have commenced on the day that person ceased to be resident. This will mean that a natural person, trust or company

would need to submit two tax returns in that year of assessment. The first return would be prepared on the basis of worldwide receipts and accruals since, based on the fact that South Africa levies normal tax on a residence basis, the taxpayer is a resident. However, for the second return, since the taxpayer is no longer resident, the return would only include receipts and accruals from a South African source.

Chapter 3 also disclosed that where a company ceased to be resident, an additional exit charge under section 9H(3)(c)(iii) of the Act would arise. Section 9H(3)(c)(iii) of the Act provides that when a company ceases to be resident that company is deemed to have paid, on the day before that company ceased to be resident, a dividend *in specie* to persons holding shares in that company in accordance with their effective interest. The company would therefore be liable for the Dividends Tax of 15% on the *in specie* dividend.

Chapter 3 then explained that a natural person ceases to be “resident” in South Africa when the person:

- emigrates from South Africa;
- permanently departs from South Africa, without formally emigrating;
- was “resident” in South Africa under the physical presence test, but then permanently returns to his or her home country;
- was “resident” in South Africa under the physical presence test, but then fails to meet the physical presence test in a subsequent year of assessment; or
- ceases to be “resident” in South Africa as a result of a double taxation agreement which deems that person to be exclusively resident in another country.

It was submitted that there remains some uncertainty as to an individual’s tax residency, following the permanent departure from South Africa, without formally emigrating with the SARB. Since the burden of proof in terms of section 102 of the Tax Administration Act, 28 of 2011 would remain with the taxpayer to discharge the onus of proving that he or she is or is not “ordinarily resident” in South Africa, the taxpayer would need to assess his or her own “mode of life” and, using a combination of case law principles and the indicators set out in Interpretation Note 3 (SARS: 2002), to prove that, despite his or her departure from South Africa, he or she remains “ordinarily resident” in South Africa and would therefore not be liable for the exit charge.

It was also explained that a company or a trust ceases to be resident in South Africa, if the effective management for that entity is moved to a foreign country and a double taxation agreement between South Africa and that foreign country deems that entity to be exclusively resident in that foreign country.

The first sub-goal of the research: the meaning of “ordinarily resident” was discussed in chapter 3. Since the term “ordinarily resident” is not defined in the Act guidance is obtained from case law, particularly in the case of *Cohen v CIR 1946 AD 174, 13 SATC 362* and *CIR v Kuttel 1992 (3) SA 242 (A), 54 SATC 298*. In the *Cohen* case the court determined a person’s ordinary residence to be the place where that person would “return [to] from their wanderings”, their “usual or principal residence”, and what could be described as their “real home”. These principles were also adopted in the *Kuttel* case.

The second sub-goal of the research: the meaning of the place of “effective management”, was discussed in chapter 3. Although the place of “effective management” is not defined in the Act, Interpretation Note 6 (Issue 2) (SARS: 2015) interprets the term to mean the place where the key management and commercial decisions of a business or trust are made, and where the executive management of a company is located, or alternatively, where the trustees of a trust are located.

Chapter 3 then discussed the exit charge that arises when a CFC ceases to be a CFC. Section 9H(3)(d)(i) of the Act provides that the foreign tax year for a CFC is deemed to have ended on the day immediately before the day on which that CFC ceases to be a CFC. In addressing the fifth sub-goal of the research – the implications for a CFC and the holder of a participation right in the CFC – it was explained that a CFC ceases to be a CFC when South African residents no longer hold more than 50% of the participation or voting rights in a foreign company. This could occur if South African residents disposed of their shares in the CFC or if a CFC issued additional shares which resulted in the holdings of South African residents being reduced to 50% or less than 50%. However, the exit charge for CFCs appears only to apply to CFCs that “cease to be a CFC in relation to a resident”. Therefore, there is uncertainty as to whether the exit charge in section 9H should apply if a resident shareholder of a CFC ceases to be resident. The exit charge for a CFC under section 9H will also not apply if the disposal of those shares by a resident shareholder meets the requirements of paragraph 64B of

the Eighth Schedule and section 9H(5) of the Act. Paragraph 64B of the Eighth Schedule to the Act provides that when a resident disposes of an equity share in a foreign company, that the capital gain or capital loss from that disposal must be disregarded if the person holding that share held at least 10% of the equity shares in that foreign company, the share was held for at least 18 months prior to disposal, and the share was disposed of to a non-resident for an amount that is equal to or exceeds the market value of that interest.

Chapter 3 listed the assets are excluded from the exit charge in section 9H(4). For example, some of the assets listed in section 9H(4) include immovable property situated in South Africa and the assets of a permanent establishment of a person in South Africa. Chapter 3 also explained that the calculation of the exit charge in section 9H is based on certain normal tax principles that will apply consistently when a natural person, company or trust ceases to be resident or a CFC ceases to be a CFC. For “assets” that are determined to be of a capital nature, the Eighth Schedule to the Act would apply and the “market value” of that asset would represent the proceeds from the disposal of the asset. If the asset was determined to be revenue in nature, the resultant “market value” of that asset would be included in the gross income of the person.

It was demonstrated in chapter 3 that, owing to the existence of two definitions for “market value”, with the first definition being located in section 9H(1) and a further definition in paragraph 31 of the Eighth Schedule, this has created some uncertainty as to which definition to use.

Chapter 3 explained that the base cost of each asset must be determined in terms of paragraph 20 of the Eighth Schedule and for assets acquired prior to 1 October 2001 the base cost must be determined after considering paragraphs 25, 26 and 27 of the Eighth Schedule. Paragraph 25 of the Eighth Schedule provides the base cost of a pre-valuation date asset to be the sum of the valuation date value arrived at under paragraph 26 or 27, and the expenditure allowable in terms of paragraph 20 incurred on or after that valuation date in respect of that asset. Paragraph 26(1) of the Eighth Schedule to the Act provides that where the proceeds from the disposal of a pre-valuation date asset exceed the expenditure allowable in terms of paragraph 20 incurred before, on and after 1 October 2001 in respect of that asset, the person who disposed of that asset must, adopt any of the following as the base cost of that asset on the 1 October 2001:

- the market value of the asset on the valuation date as contemplated in paragraph 29;
- 20% of the proceeds from the disposal of the asset, after deducting from those proceeds an amount equal to the expenditure incurred under paragraph 20 on or after the 1 October 2001; or
- the time-apportionment base cost of the asset as contemplated in paragraph 30.

In contrast, paragraph 27 of the Eighth Schedule to the Act determines the valuation basis for the base cost, where the proceeds from the disposal of a pre-valuation asset do not exceed the expenditure allowable under paragraph 20 incurred before and after 1 October 2001. However, given the impact of inflation and the number of years that have elapsed since 1 October 2001, it is considered unlikely that the market value of an asset in today's terms would be less than the expenditure incurred before and after 1 October 2001. For this reason, the mechanics of this provision were not discussed.

In the case of a revenue asset, where the exit charge results in the "market value" of the asset being included in gross income, it was explained that the taxpayer would be able to claim a section 11(a) deduction for the cost of that revenue asset.

The third sub-goal of the research, which relates to the exit charge that arises from an "interest in immovable property" in South Africa, was discussed in chapter 3. Paragraph 2(2) of the Eighth Schedule defines an "interest in immovable property" in South Africa as a person owning at least 20% of the equity shares in a company and where 80% of the market value of those shares is attributable to immovable property in South Africa. Accordingly, if a natural person, trust, company or CFC, held shares in a company and those shares represented "an interest in immovable property" in South Africa and that natural person, trust or company ceased to be resident in South Africa or that CFC ceased to be a CFC, an exit charge under section 9H(2), 9H(3)(a) or 9H(3)(b) of the Act would apply to the market value of those shares.

Chapter 4 focuses on the unique normal tax implications that could arise from an exit charge when a natural person, company or trust ceases to be resident or a CFC ceases to be a CFC. It was shown that when a natural person ceases to be resident, that person would also need to consider whether the capital gains tax exclusions for "personal-use" assets and long-term insurance policies could apply and the exit charge would be disregarded. Where a natural

person and beneficiary of a trust holds a vested right to a particular asset of a resident trust, since that individual only holds an “interest” in the underlying asset, none of the exclusions for capital gains tax would be available to offset an exit charge that arises from this asset.

The seventh sub-goal, which relates to the foreign exchange implications of the exit charge for a natural person, is discussed in chapter 4. If a natural person had acquired an asset in a foreign currency, then section 9H(7) and paragraph 43(1) of the Eighth Schedule to the Act would apply. Section 9H(7) provides that the proceeds from the deemed disposal of a capital asset must be in the currency of the expenditure incurred to acquire the asset. Paragraph 43(1) determines that the capital gain or loss must be translated into the local currency (Rands) by applying either the average exchange rate for the year of assessment in which the asset was disposed of or at the spot rate on the date of disposal of that asset. However, in the case of a deemed disposal of a revenue asset by a natural person, the deemed revenue gain or deemed revenue loss would need to be translated under either section 25D(1) or 25D(3) of the Act. In terms of section 25D(1) and 25D(3), a natural person would have the option of translating the amount received or accrued at the spot rate on the date of the disposal, and for the expenditure incurred, at the spot rate on the date the expenditure was incurred or the amount received or accrued and the expenditure incurred, at the average exchange rate for that year of assessment.

As to the foreign exchange implications of the exit charge for a company, section 9H(7) and paragraph 43(1A) of the Eighth Schedule to the Act would determine that the capital gain or loss must be translated into the local currency by applying either

- the average exchange rate or the spot rate to the base cost in the year the asset was acquired or the date that the asset was acquired; and
- the average exchange rate or the spot rate to the proceeds in the year the asset was disposed of or the date the asset was disposed of.

However, in the case of a deemed disposal of a revenue asset by a company, the deemed revenue gain or deemed revenue loss would need to be translated under section 9H(7) and section 25D(1) of the Act. On that basis, the translation of the deemed revenue gain or deemed revenue loss would be determined by applying the spot rate on the date of disposal, and the spot rate on the date the expenditure was incurred.

The sixth sub-goal, which concerns the impact of the exit charge on a resident trust, is discussed in chapter 4. It was concluded that an exit charge under section 9H only applies to assets held by a trust where no beneficiary has an unconditional right to any of those assets. In the event of a vesting trust where all of the assets have already been vested in beneficiaries, no exit charge will under section 9H will arise, since the trust holds no assets. Following the judicial precedent set in the case of *Hulett v CIR, SATC 58, 1944 NPD 263*, since the exit charge represents fictional and notional income, a trustee would be unable to vest a deemed capital gain under paragraph 80(2) of the Eighth Schedule to the Act in a resident beneficiary. Since a trustee would be unable to vest a deemed capital gain in a resident beneficiary, the attribution rules in paragraphs 68, 69, 71 and 72 of the Eighth Schedule to the Act could not apply to that amount. The attribution rules in paragraphs 68, 69, 71 and 72 provide that if a capital gain arises on the vesting of an asset or the vesting of a capital gain in a

- person's spouse and the asset was acquired as part of a scheme to avoid tax;
- in a parent's minor child;
- in a non-resident beneficiary; and
- where the vesting of the capital gain could be revoked,

and the capital gain arose from a "donation, settlement or other disposition", that capital gain must be taxed in the donor's hands.

The judicial precedent established in the *Hulett* case would also prevent the retention of deemed capital gain in a trust from being attributed back to the donor of the related asset under paragraph 70 of the Eighth Schedule. Since a deemed capital gain remains in a trust, that amount would be subject to an inclusion rate of 80% and taxed at a flat rate of tax of 41%. However, in the event that a special trust ceased to be resident, a deemed capital gain would be subject to an inclusion rate of 40% and then tax would be levied at the progressive rates that apply to natural persons. This is since paragraph 10 of the Eighth Schedule to the Act provides that an inclusion rate of 40% must be applied in determining the taxable capital gain for inclusion in the taxable income of a special trust. At the same time, the Rates and Monetary Amounts and Amendment of Revenue Laws Act No. 13 of 2016 sets out the progressive rates of normal tax of between 18% and 41% that must apply to the taxable income of natural persons or special trusts in respect of any year of assessment that commences on or after 1 March 2016. To improve the tax efficiency, the trustees could, in anticipation of a change in

the residency of the trust (other than a special trust), cause the assets of the trust to be vested in the resident beneficiaries. In doing so the capital gains tax implications could be transferred to the beneficiaries, who may be paying tax at lower levels.

The sixth sub-goal of the research, which relates to the exit charge resulting from a deemed revenue gain and its impact on a resident trust, is also dealt with in chapter 4. The judicial precedent established in the *Hulett* case would also prevent a trustee from vesting that deemed revenue gain in a beneficiary under either section 25B(1) or 25B(2) of the Act.

The seventh sub-goal of the research and the foreign exchange implications of the exit charge for a resident trust are discussed in chapter 4. It was explained that, if the trust was a non-trading trust, then section 9H(7) and paragraph 43(1) of the Eighth Schedule to the Act would apply. These provisions would determine that the proceeds from the deemed disposal of a capital asset must be in the currency of the expenditure incurred to acquire the asset, and then the capital gain or loss must be translated into the local currency (Rands) by applying either the average exchange rate for the year of assessment in which the asset was disposed of or at the spot rate on the date of disposal of that asset.

For the fifth sub-goal of the research, the special features that would apply to the exit charge on a CFC were discussed. Section 9D(2) of the Act provides that a resident's participation rights in a CFC determines the proportional share of a CFC's "net income" to be included in the income of the shareholder on the last day of the foreign tax year. Since the "net income" of a CFC includes capital and revenue gains, the deemed disposal of a CFC's assets on the day before that CFC ceases to be a CFC, will result in either capital gains or revenue gains tax implications for a CFC. The section 9H(4) assets and the assets of a "foreign business establishment" would be excluded from the exit charge for a CFC. For example, immovable property of a CFC situated in South Africa, and any asset of a CFC attributable to a permanent establishment of that CFC in South Africa would be excluded from the exit charge by section 9H(4). Since there is uncertainty as to whether the exit charge in section 9H should apply when a shareholder ceases to be resident, the illustrative examples provided in chapter 4 demonstrate the tax consequences of the alternative calculations.

The research for the fourth sub-goal and the tax implications for revenue assets, previously subject to an exit charge under section 9H, and which are subsequently sold is discussed in chapter 4. It was shown that the only revenue asset, which had previously been the subject of an exit charge when a person ceased to be resident, and that remained subject to tax in South Africa when it is subsequently sold, is an “interest in immovable property” in South Africa. This is since section 9(2)(j) of the Act determines that the receipts and accruals from the disposal of such an asset are from a South African source.

As this was a thesis of limited scope, the research coverage of certain aspects was limited. Accordingly, further research into the capital gains tax implications and the exclusions available for certain assets could have been included. The research could also have considered the normal tax implications arising when a shareholder ceases to be resident, and the shares in a CFC were held as trading stock. The research also did not determine how SARS would administratively identify a change in the residency status of a person.

5.3 Suggestions for further research

Suggestions for further research could include:

- research into the operational procedures in SARS for the submission of two returns in a year of assessment and the e-filing considerations;
- research as to the mechanisms and the techniques used by SARS to identify a change in residency;
- research as to the valuation methods and criteria used by SARS for valuing the shareholding interests in privately owned and unlisted companies;
- an international comparison of the exit charge applying in various countries; and
- research into the ability, in practice, of a resident shareholder in a foreign company to identify the residency status and or the change in residency status of other shareholders in a foreign company, which may result in that foreign company commencing or ceasing to be a CFC.

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