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Corporate chaos – II

Co-operatives, PBOs, equity unit trusts and close corporations

In an article that appeared in the previous issue of this journal,¹ the definition of a 'company' in s 1 of the Income Tax Act as far as it relates to local (domestic) and foreign companies was discussed. In this follow-up article paras (c), (d), (e) and (f) of the definition of a 'company' in s 1 of the Income Tax Act are examined. Entities including co-operatives, certain public benefit organisations (PBOs), collective investment schemes in securities (so-called equity unit trusts), and close corporations are companies for income tax purposes in terms of these paragraphs.

Co-operatives

The definition of a 'company' specifically includes in its para (c), a co-operative.² This is an entity that is unique to South Africa in its current form, although similarly-named entities are found in other countries, like the Netherlands. It is defined in s 1 of the Co-Operatives Act 14 of 2005. It is interesting to note that backdated to 1 January 2007, a co-operative has been included in the definition of a 'foreign company' for CFC purposes.³

Public benefit organisations

An association formed in South Africa that is beneficial to the public or to a section of the public, is specifically included in the definition of a 'company' in its para (d).

Often, these entities will be organised as so-called s 21 companies.

A 's 21' company would fall under para (a) of the definition of a 'company'. Paragraph (d) in this definition of a 'company' therefore applies only to those entities that are organised as common-law associations.

Public benefit organisations that are organised as trusts will not fall under the definition of a 'company'.

Domestic and foreign collective investment schemes

A domestic or foreign collective investment scheme in securities (a so-called equity unit trust) meets the requirements of para (e) of the definition of a 'company'. It will therefore be a company for income tax purposes, irrespective of how it is organised.

Foreign collective investment schemes are often organised either

- as offshore trusts, or

- as so-called protected cell companies (PCCs).

For PCCs, a debate arises as to whether an individual cell within the PCC could itself be a company. Generally, depending on how the PCC is set up, the preferred view is that only the PCC itself can be a company, and that the separate cells within the PCC are not separate companies but rather represent participation right arrangements within the company itself.

The inclusion of entities like trusts and PCCs in para (e) of the definition of a 'company' leads to the same anomalies that were discussed in the previous article with regard to LLPs,⁴ except that for a local entity the definition of a 'shareholder' was amended in 2003 to ensure that the distribution of profits by it is regarded as a dividend as defined.

But a foreign collective investment scheme that is organised as a trust, will not have equity share capital as defined. The result is that dividends declared by a foreign collective investment scheme will generally be taxable. If, however, the relevant profits have already been subjected to South African tax, either the s 10(1)(k)(ii)(aa) exemption, or the s 10(1)(k)(ii)(cc) exemption, would then apply.

If neither of these exemptions apply, the amount could be subject to double tax

- first, under CFC rules, and
- secondly, when the taxable foreign dividend is received by or accrues to a South African resident.

These companies can never be connected persons as defined in para (d)(iv) of the definition of a 'connected person' in s 1 of the Income Tax Act, so that numerous income tax provisions, like transfer pricing rules, cannot apply to them.

1 See 'Corporate Chaos' (2007) 21 *Tax Planning* 118.

2 Section 3(1)(a) of the Revenue Laws Amendment Act 20 of 2006.

3 Section 9 of the Taxation Laws Amendment Act 8 of 2007 (promulgated on 8 August 2007).

4 See (2007) 21 *Tax Planning* 118 at 119.



Michael Honiball

Close corporations

Paragraph (f) of the definition of a 'company' includes a close corporation as a company. A close corporation is an entity unique to South Africa provided for in the Close Corporations Act 69 of 1984. With regard to para (f) of the definition of a 'company' it is also necessary to refer to the definition of a 'foreign company' in s 9D(1) of the Act. A foreign company was defined to include all the types of companies envisaged in s 1, except co-operatives and close corporations, because paras (c) and (f) were specifically excluded from the definition of a 'foreign company'. But this is no longer the situation. The definition of a 'foreign company' was recently amended so that both co-operatives and close corporations can now be foreign companies as defined for CFC purposes.

It is not clear why paras (c) and (f) were previously excluded from the definition of a 'foreign company'. Their exclusion lead to a loophole which is best illustrated by way of the following example:

A Close Corporation (A CC) is formed by X, who is a resident of South Africa. X contributed R2 000 000 to A CC in exchange for his member's interest in it. The contribution was made out of an equivalent amount of American dollars that he held in an offshore bank account which was expatriated from South Africa in terms of the foreign investment allowance. X ensures that A CC is managed and controlled and effectively managed in Mauritius. He remains ordinarily resident in South Africa. Despite not being a resident for tax purposes (see below), A CC was not a CFC because it was not a foreign company as defined in s 9D(1).

As is illustrated by the above example, if a close corporation could not be a CFC by definition, then it was possible to simply incorporate it in South Africa, but then manage and control it and effectively manage it, in Mauritius. Under the domestic laws of Mauritius, a company that is managed and controlled in Mauritius is a resident in Mauritius.

By virtue of being incorporated or established and formed in South Africa, the close corporation is also a resident in South Africa in terms of the definition of a 'resident' in s 1 of the Income Tax Act. Then, under the so-called tie-breaker clause in the tax treaty between South

Africa and Mauritius, a dual-resident company that is effectively managed in Mauritius, is not a resident of South Africa. Under South African domestic law, the definition of a 'resident' then specifically excludes a person who is exclusively a resident of another state for tax treaty purposes. The result is that the close corporation is not a resident, nor is it a CFC for South African tax purposes.

A private limited company, on the other hand, would have been both a foreign company and a CFC in these circumstances.

The result of not being a resident in the above example, is that income, for example, interest accruing to a close corporation that is not from a South African source or deemed source, would not be taxed under the CFC provisions. It could then be remitted back to South Africa as an exempt dividend (s 10(1)(k)(ii)(dd)).

This loophole was practically not easy to use. The normal general avoidance provisions (s 80A and s 80L) could also apply. Nevertheless, this loophole was difficult to understand in the context of South Africa's global tax system. Legislative intervention was therefore essential. Hence the recent amendment to ensure that with effect from 2 November 2007, a close corporation could also be a foreign company as defined.

The amendment was effected by s 9(1)(c) of the Taxation Law Amendment Act 8 of 2007, which substitutes the s 9D(1) definition of a 'foreign company' with the following definition:

'[A] "foreign company" means any association, corporation, company, arrangement or scheme contemplated in paragraph (a), (b), (c), (e) or (f) of the definition of 'company' in s 1, which is not a resident.'

From the above it follows that both co-operatives and close corporations could now also be foreign companies as defined in s 9D(1) in relevant circumstances, thereby closing this loophole.

Conclusion

Legislative intervention is still required to make the application of South African income tax principles clearer with regard to transactions involving unusual types of corporate and other entities incorporated or formed in foreign jurisdictions.