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1 Introduction
In order to minimise their global tax exposure, taxpayers active in international trade often get involved in tax-avoidance schemes. The ensuing fiscal advantages are often achieved when investments are made in low-tax or tax-haven jurisdictions. Most of the tax-planning schemes used to avoid taxes, employ some kind of company or trust structure. One such structure that appears relatively new on the offshore-investment market, and whose characteristics and diverse use baffle many tax authorities, is the ‘protected cell company’ (the ‘PCC’). This structure can sometimes be in a trust form – ‘protected cell trusts’, commonly referred to as unit trusts. In 2009, the Tax Justice NetWork,¹ released a report in which it noted that investments in PCCs contributed to the global financial crisis that begun in 2007.

This article describes the development and the intricacies of offshore PCC and trust structures and how they may be used to avoid taxes. The prevalence of investments in offshore cell structures by South African residents is also analysed to determine whether this matter should be an issue of concern for the South African fiscus. In this vein, the measures, if any, that South Africa has in place to curb the ensuing tax avoidance are discussed. The article also covers a comparative study of equivalent measures, if any, in the United States of America (the ‘USA’) and the United Kingdom (the ‘UK’). These two countries have been selected because they have historically been at the forefront of devising legislation to curb offshore-tax avoidance. From the success story of these two jurisdictions, recommendations are made for the reform of South Africa’s income tax laws if found wanting in this regard.

2 Tax Avoidance and Tax Havens
Before discussing the topic at hand, a brief background explanation of concepts such as ‘tax avoidance’ and ‘tax havens’ is relevant to appreciate the issues to be discussed later.

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The term ‘tax avoidance’ refers to the use of perfectly legal methods of arranging one’s affairs, so as to pay less tax. This is done by utilising loopholes in tax laws and exploiting them within legal parameters. Tax avoidance should be distinguished from ‘tax evasion’ which is illegal and entails non-compliance with tax laws. Although tax avoidance is not illegal, it is generally frowned on by tax authorities where it straddles into what South African Revenue Service (‘SARS’) refers to as ‘impermissible tax avoidance’. This term refers to certain ‘tax avoidance’ practices that extend beyond what is legally acceptable and thus cross the dividing line between tax evasion and tax avoidance. Essentially, these practices entail the use of artificial arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed to manipulate tax laws in order to achieve results that conflict with or defeat the intention of Parliament. The ensuing loss of tax revenue has the effect of limiting any government’s ability to pursue its economic and social objectives.

Impermissible tax avoidance is more disastrous to an economy when taxpayers devise schemes by which they can move their investments out of their countries of residence into offshore tax havens where they will be subject to zero or minimal taxation. According to the Organisation for Economic Cooperation and Development (the ‘OECD’), a tax haven is described as a jurisdiction that actively develops tax policies aimed primarily at diverting finances and other geographically mobile capital from high-tax to low-tax countries. Statistics show that, over the past 30 years, the number of financial transactions that have taken place in or through offshore jurisdictions, have increased at a rapid rate which is showing no sign of abating. It is estimated that 60 per cent of the world’s money is offshore, where it is likely to receive favourable tax treatment and be subject to fewer restrictions, and that a large proportion of the world’s private wealth is owned through complex offshore structures that often involve companies and...

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5 Idem at 4.
8 OECD, ‘About OECD’, available at http://www.oecd.org/pages/0,3417, en_36734052_36734103_1_1_1_1,00.html (accessed 7 Jul 2010).
trusts. An example of such structures is the offshore PCC and trust structure which is the focus of this article.

3 Factors That Led to the Evolution of the PCC Concept

PCCs are one of the relatively recent structures available for corporate tax planning. The following brief description of how they evolved shows that PCCs are a product of the offshore captive insurance industry.

In order to minimise global tax exposure, international insurance companies have historically been known to set up subsidiaries (captive insurance companies) in tax-haven jurisdictions for the purpose of insuring the risks of the group and as an alternative to the use of external insurance markets. This would ensure nil or minimal tax on the premiums of the worldwide risks of the parent company. However, the captive insurance industry, which is essentially in-house self insurance, does not cater for a company which is not financially capable of insuring itself. For such companies, the ‘rent-a-captive structure’ was introduced. In terms of this structure, a company shares the services of a captive insurance company with other companies of relatively similar size, by ‘renting’ a part of the capital of the captive. Unrelated companies can then use the same captive to insure their risks. Although the ‘rent-a-captive structure’ has cost saving advantages, it also has some disadvantages. For example, there is no guarantee or assurance that the funds provided by one company participating in the rented captive structure would not be used to cover any unjustified claims unrelated to the risks the company wanted to insure through the rented captive. Furthermore, there no asset protection is provided for the companies participating in the ‘rent-a-captive structure’ on an individual basis. There are also financial constraints to forming captive structure as companies would have to bear the costs of its capitalisation, licensing and administration. In order to resolve the disadvantages of the ‘rent-a-captive structure’ and to circumvent the deficiencies that result from its single patrimony being exposed to unjustified third-party claims, the insurance industry developed the concept of the PCC.
4  The Working of PCC Structures

APCC is a special type of corporate body that consists of several companies referred to as ‘cells’ within the same legal entity. Each cell functions as an independent unit within the umbrella of the PCC, and each cell has its own assets, liabilities, cellular capital and accounts.\(^{19}\) The segregation or ring-fencing of patrimonies helps to avoid the mingling of funds and assets of the different cells, thus ensuring that no claim against one cell of the PCC would be covered by would threaten funds or assets of another cell.\(^{20}\)

The vital legal point is that the cells are not legal entities. The only legal entity is the PCC, which conducts all operations with the outside world.\(^{21}\) The PCC’s patrimony is composed of general assets (‘non-cellular’ assets), which are separate and distinct from each of the assets composing the protected cells, creating what is commonly known as the ‘core patrimony’. The liabilities unrelated to a specific cell are covered by the non-cellular assets of the PCC.\(^{22}\) In this way, the PCC structure appears to create ‘an impenetrable wall’ against creditors and prying eyes. It is accordingly viewed as a valuable vehicle for purposes of asset protection and financial privacy.\(^{23}\)

5  PCCs: The Genesis in Offshore Tax-haven Jurisdictions

PCCs were first established in Guernsey in 1997. Indeed Guernsey was, and still is, the European home of captive insurance.\(^{24}\) The first PCC was incorporated under the Guernsey Protected Cell Companies Ordinance of 1997 as amended by the Protected Cell Companies (Amendment) Ordinance of 1998.\(^{25}\) Since then, other jurisdictions, primarily tax-haven jurisdictions, have enacted laws to facilitate the formation of PCCs.\(^{26}\) However, the term ‘protected cell companies’ is not always used in all jurisdictions, as they have different rules that regulate such entities. In some jurisdictions PCCs are referred to as ‘Incorporated Cell Companies’, in others the term ‘Segregated Account Companies’ is used.\(^{27}\) Nevertheless, the relevant legislative measures embody the same principle of cellular ring-fencing.\(^{28}\) Other offshore jurisdictions that have followed the Guernsey example include:

\(^{19}\) Widder op cit note 16.
\(^{20}\) Ferreire op cit note 15.
\(^{22}\) Diamond & Diamond op cit note 13 at Bermuda-34.
\(^{23}\) Coddan Company Formation Worldwide op cit note 14; Widder op cit note 16.
\(^{24}\) Coddan Company Formation Worldwide op cit note 14.
\(^{25}\) Ibid.
\(^{28}\) Ferreira op cit note 15.
• The Cayman Islands, where PCCs are referred to as ‘egregated Portfolio Companies’ and mainly used in mutual fund investments.29
• Bermuda, where PCCs are referred to as ‘Segregated Accounts Companies’, and are established under Bermuda’s Providence Mutual Ltd Private Act.30
• Mauritius, where PCCs are established under the Protected Cell Companies Act of 1999 as amended in.31
• St. Vincent and the Grenadines, where the International Insurance (Amendments and Consolidation) Act of 1998 allows the establishment of ‘Protected Premium Accounts’ that have elements of the PCC.32
• The Seychelles, where PPCs are formed under the Protected Cell Companies Act of 2003.33
• Anguilla, where PCCs are incorporated under the Protected Cell Company’s Act of 2004.34
• The Isle of Man which introduced PCC regulations in 2004.35

Other offshore jurisdictions that have similar regulations include Barbados, Gibraltar and Malta.36

The increase in the number of offshore jurisdictions that have introduced PCC legislation appears to have been prompted by the state of turmoil that the insurance market faced following the destruction of the World Trade Centre on 11 September 2001.37 The state of uncertainty in the insurance and reinsurance markets resulted in the hardening of insurance terms for many corporations. The resultant slowdown in the global economy affected the captive insurance industry and encouraged the investment in PCCs which offered a formalised self-insurance option without the need to commit large amounts of ever-scarcer capital resources.38 It is reasoned that the 2007-2009 global financial crisis also created similar circumstances that have compelled many companies to invest in cell structures.39

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29 Ibid.
30 Ibid.
31 Alliance Mauritius ‘Protected Cell Companies*, op cit note 27.
33 Ibid.
36 Ibid.
38 Ibid.
39 Ibid.
6 The Uses of PCC Structures

Despite being relatively new to the corporate world, the PCC has turned out to be the fastest growing vehicle in the captive insurance industry.40 Although there are no statistics available on the value of assets held through PCC structures, the worldwide portfolio of these companies shows that this value is not insignificant.41 Apart from the fact that the PCC is a viable alternative to ‘rent-a-captive’ insurance schemes, the PCC is also used in the operation of mutual funds, especially in the form of ‘umbrella fund’ investment schemes and for structured finance.42 PCC structures enable collective investment funds to be divided into a number of classes catering for different investment objectives for different individual investors whilst preserving independence for each share class.43

The use of PCC structures have even extended beyond investment funds in that they have fostered the fusion of the banking and insurance sectors in the international business. Indeed, the PCC concept is viewed as one of the most significant developments that the world of corporate finance has seen in many years.44 With the use of PCCs, banks and insurers can transform banking products into insurance products and vice versa. For instance, banks and insurers often form PCCs for use as Special Purpose Vehicles (‘SPVs’) for securitization transactions.45 The term ‘securitization’ refers to the process of pooling various types of debt, for example mortgages, car loans, or credit-card debt. This debt is then packaged as: bonds, pass-through securities, or collateralized mortgage obligations which are sold to investors.46 The principal and interest on the debt underlying the security is paid to the investors on a regular basis depending on the type of security.47 In essence, in a securitization transaction, the PCC issues bonds, notes or other debt securities where the repayment is to be funded from the proceeds of the PCC’s investments.48 Through such securitization transactions, the use of PCC structures has grown both in the offshore and in the onshore world. Indeed, the use of securitisation for investment purposes is steadily spreading through South America, the US and parts of Europe.49 The Bank for International

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40 Greenfield op cit note 17.
41 Nigel Feetham & Grant Jones Protected Cell Companies: A Guide to their Implementation and Use (2008) at 3.
42 Idem at 1; Widder op cit note 16.
43 Greenfield op cit note 17.
44 Willis Global Captive Practice op cit note 37.
47 Ibid.
48 Willis Global Captive Practice op cit note 37.
49 Ferreira op cit note 15.
Settlements, reports that Delaware, in the US, is the most notorious onshore jurisdiction for secret investments in securitizations, whereas, the Cayman Islands is the most notorious offshore jurisdiction in this regard.

7 Investments in PCCs: A Tax Avoidance Vehicle

Although PCCs were designed to fill a gap in the world of international business by improving the techniques for finance and investment, inevitably, investments in PCCs also create opportunities for tax avoidance. The flexibility of PCCs has for instance encouraged their increased use as tax-planning vehicles, especially in the insurance industry. A life insurance company based in an offshore jurisdiction may issue a policy to a single investor, linked to assets in a particular cell. But the aim may be the age-old tax-free roll up, to ensure that the investor is either exempt from tax or taxed at a lower rate. If the PCC is aggressively structured and marketed, it may well just be a sham the main purposes of which are tax evasion or tax avoidance.

Although the legal enforceability of many aspects of the PCC structure is in doubt as they have not been tested in courts of law, the growth of investments in these entities shows no signs of abating. Perhaps the first internationally known case where a court considered issues arising out of a PCC structure is that involving Messenger Insurance PCC Ltd which came before the Royal Court in Guernsey in May 2005. The issues adjudicated upon pertained to the administration of a company and its cells. The Court held that under Guernsey law, each cell is not a separate legal entity and hence does not require separate capitalisation or licensing under the financial services legislation. Although the Court did not adjudicate on the validity and enforceability of contracts negotiated between the cells, these matters pose various legal challenges, including the possibility of manipulating the administration of the PCC structure to avoid taxes. Internationally there does not seem to be guidance or consensus on how PCC structures should be taxed, and neither is there precedent-setting case law that can be relied on to regulate the uncertain legal environment for PCCs. Describing the difficulties of taxing and monitoring investments in PCC structures, the Tax Justice Network gives the following analogy:

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50 Bank for International Settlements op cit note 45.
53 Ibid.
54 Messenger Insurance PCC Ltd (in administration) v Cable and Wireless plc et al (judgment 50/2005, Royal Court, Civil Action file 832, 16 Aug 2005)).
55 Ibid.
The structure of PCCs has been compared to a house with a lock at the entrance and many rooms inside, each room locked separately with its own door, but also with an escape tunnel only accessible from inside the room. If an investigator seeks to find out what is going on in one room inside the house, she first needs to unlock the main outer door. But imagine that by opening that first door everybody inside the building is alerted to the fact that someone has entered the house. Anybody seeking to flee the investigator will be given enough time to do so thanks to the second lock at the individual room door. While the investigator tries to unlock the second door (by filing a second costly information request), the perpetrator has enough time to erase all traces of guilt and escape through the secret tunnel.\textsuperscript{58}

Efforts by national tax authorities to make international enquiries that would expose taxpayers’ investments in PCC structures have not been effective; neither have bilateral mutual assistance agreements between countries been effective in exposing investments in offshore PCCs.\textsuperscript{59} This is because the legal nature of PCCs presents a single corporate front, yet their cells may be used to conceal identities and obscure the ownership of assets. What appears to be a minority ownership from the outside, may in fact be an artificial shell deliberately created to conceal fully-fledged ownership of a cell within the ‘wrapper’ that in reality functions in the same way as a company. The obscurity of ownership interests cannot only be used to shelter illicit assets from view and so facilitate fraud, corruption and all sorts of organized crime; it also encourages tax evasion and impermissible tax avoidance.\textsuperscript{60}

While there is still international uncertainty about the taxation of PCCs, the number of offshore jurisdictions devising legislation that allows for the establishment of PCC structures continues to grow. This is further encouraged by the fact that the main sponsors of offshore PCCs are some of the world’s largest insurance companies and banks, which are confident enough of the offshore PCC legislation that they have invested considerable resources in these structures. Indeed, many banks have taken advantage of the current lack of clear regulation of PCCs and they have deliberately created sophisticated financial transactions that employ the PCC structure for tax-arbitrage purposes. The International Monetary Fund (‘IMF’) released a report in 2009 in which it affirms that the use of PCC structures as SPVs for securitization transactions\textsuperscript{61} have been long employed by many banks to create complex financial instruments (such as swaps and deep discount securities) as part of their tax-arbitrage policies.\textsuperscript{62} Indeed, between 2003 and 2007, the business of a number of big banks such as Lehman Brothers, Goldman Sachs, and the Royal Bank of Scotland, boomed tremendously as a result of investing in offshore PCC securitization transactions.\textsuperscript{63} However, the IMF notes that these huge investments resulted into tax distortions that encouraged excessive

\textsuperscript{58} Ibid.
\textsuperscript{59} Ibid.
\textsuperscript{60} Ibid.
\textsuperscript{61} Bank For International Settlements op cit note 45.
leverage (the ratio of total assets to shareholders equity) and other problems in the financial markets that were the main cause of the global financial crisis. This is confirmed by the report of the Tax Justice Network and also by a report by the Bank for International Settlements, observing that investments in PCC structures using securitization transactions played a major role in the financial crisis that emerged in mid-2007.

In the much-publicized US fraud case involving a lawsuit filed by the US Securities and Exchange Commission against Goldman Sachs bank, using the PCC structure, SPVs worth USD2 billion were assembled in the Cayman Islands resulting in huge losses of US taxes. The Tax Justice Network reports that through the Cayman Islands, Goldman Sachs structured sophisticated insurance-like bets called credit-default swaps that worsened the global economic collapse by enabling major financial institutions to take bigger and bigger risks without reflecting them on their balance sheets. According to the June 2007 and June 2008 IMF surveys of US portfolio liabilities, the Cayman Islands were the largest foreign holders of private-label US mortgage-backed securities that contributed to the financial crisis.

Another fraud case involved the Lehman Brothers Bank which developed complex financial instruments and securitized USD146 billion worth of mortgages in 2006 and 2007. Lehman Brothers' high degree of leverage and its huge portfolio of mortgage securities made it increasingly vulnerable to deteriorating market conditions. With the drop in the US housing market in 2007, and the eruption of the credit crisis, the rising defaults affected Lehman Brother's profitability forcing the bank into bankruptcy.

The same happened with American International Group ('AIG'), the largest insurance company in the US before its collapse in September 2008 under the weight of the bad bets it had incurred insuring mortgage-backed securities. The company, which was later bailed out by the US government, had invested in special-purpose entities using disastrous credit default swaps. With the housing market collapsing, Goldman Sachs demanded USD1.5 billion in

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Footnotes:

64 IMF 'Debt Bias and Other Distortions' op cit note 62.
65 Tax Justice Network 'Mapping the Fault lines' op cit note 1.
66 Bank For International Settlements op cit note 45.
68 Tax Justice Network op cit note 67.
70 IMF 'Debt Bias and Other Distortions' op cit note 62.
collateral from AIG to cover the mortgage-backed securities that AIG’s credit default swaps had insured. That brought the company to its knees.

As mentioned earlier, banks got involved in offshore securitization transactions involving PPC structures mainly for purposes of tax avoidance. The massive funds stashed offshore clearly eroded countries’ tax revenues and even ultimately caused a global financial crisis. One does not need a crystal ball to realise that it is important for countries to have legislation that regulates the taxation of investments in offshore PCC structures.

8 Curbing Tax Avoidance that Results from Investments in Offshore PCCs

8.1 The United States

The US has for a long time had legislation to prevent the avoidance of taxes when taxpayers invest in offshore companies. In general, if a company is incorporated offshore, it is not subject to US tax on its income, unless it is engaged in trade or business in the US, or unless it generates income from sources within the US. However, its earnings will be subject to US tax when dividends are distributed to US shareholders who are subject to worldwide taxation. The effect of this is that US tax on foreign-source income earned by a foreign corporation is deferred until the foreign corporation distributes dividends to its shareholders.

However, if the foreign company is classified as a controlled foreign corporation (a ‘CFC’), the taxation of the undistributed income of such a company is not deferred but its income is taxed in the hands of its domestic shareholders on a current basis. A CFC is defined as a foreign corporation, if more than 50 per cent of the total combined voting power of all classes of voting stock is owned by US shareholders on any day during the CFC’s taxable year. The term ‘US shareholder’ refers to any citizen, resident, partnership, corporation, estate or trust.

74 Sections 881 and 882 of the Internal Revenue Code, 1954 (the ‘Code’).
75 Section 243(b)(1) and (5) of the Code.
77 In terms of s 952(a)(1) and (2) of the Code, income that falls under the CFC provisions (normally referred to as ‘Subpart F income’) consists of two principal categories: insurance income and foreign-base company income. Subpart F income also includes ‘certain other income to the extent that the CFC has an international boycott factor, certain illegal payments to government officials and certain income from “blacklisted” countries’. See s 952(a)(3), (4), and (5) of the Code.
78 Ownership is determined on the basis of stock held directly or indirectly through foreign entities, or owned by reason of broad attribution rules. See s 957(a) and (b) of the Code, and Treasury Regulation (‘Treas Reg’) s 1.957-1(l)g, 1.957.1.
79 Section 951 and 957(d); Treas Reg s 1.957-4.
of a CFC, must include in his income, in each year, his pro rata share of the
CFC’s undistributed income.80 In terms of s 958(a)(1)(A) and (B) of the
Internal Revenue Code, 1954, ‘stock owned’ can be stock owned directly or
indirectly by or for a foreign corporation, foreign partnership, foreign trust or
foreign estate. The stock may be owned proportionately by the entire entity’s
shareholders, partners or beneficiaries. This section acts as a ‘look through’
provision into these foreign entities,81 and so it can be applied to PCCs where
the shareholders of the cells hold more than 10 per cent of the total combined
voting power of all classes of voting stock of the foreign PCC. But if the
shareholders of the cells hold less than 10 per cent of the PCCs total voting
power, the CFC provisions cannot be applied to them. This loophole in the
legislation has been of concern to US taxation authorities as it opens up
opportunities for tax avoidance.

To close this loophole, developments in US tax law show that the Internal
Revenue Service (the ‘IRS’) prefers to regard business that make use of the
PCC structures, as insurance. However, neither the Internal Revenue Code nor
the Regulations under this Code define the terms insurance or insurance
contract. Nevertheless, the courts have come up with certain legal rules as to
what constitutes insurance, and those rules can also be applied in the tax law
context.

In Helvering v LeGierse,82 the US Supreme Court held that in order for an
arrangement to constitute insurance for federal income-tax purposes, both risk
shifting and risk distribution must be present. Risk shifting occurs if a person
facing the possibility of an economic loss transfers some or all of the financial
consequences of the potential loss to an insurer, so that the insured is not
affected by the loss since it is offset by the insurance payment.83 Risk
distribution occurs when the party assuming the risk distributes its potential
liability among others.84 Risk distribution thus entails dispelling the danger of
a potential loss by spreading the risk of loss among policyholders.85

Generally in US law, a transaction between a parent and its wholly-owned
subsidiary does not satisfy the requirements of risk shifting and risk
distribution if only the risks of the parent are insured.86 However, the courts
have held that an arrangement between a parent and its subsidiary may
constitute insurance because the parent’s premiums are pooled with those of
unrelated parties if an insurance risk is present, if the risk is shifted and
distributed, and if the transaction is of the type that is insurance in the

80 Section 951(b) and 957(a); Treas Reg s 1.951-1(g) and 1.957.1.
82 312 US 531 (1941).
83 Beech Aircraft Corp v United States 797 F 2d 920 (10th Cir, 1986) at 922.
84 Ibid.
85 Commissioner v Treganowan 183 F 2d 288 (2nd Cir, 1950) at 291; Ocean Drilling & Exploration
Co v United States 24 CI Ct 714 (1991) at 731.
86 Stearns-Roger Corp v United States 774 F 2d 414 (10th Cir, 1985); Carnation Co v Commissioner 640 F 2d 1010 (9th Cir, 1981).
An arrangement between an insurance subsidiary and other subsidiaries of the same parent may thus qualify as insurance for federal income-tax purposes, even if there are no insured policyholders outside the affiliated group, provided the requisite risk shifting and risk distribution are present.

Furthermore, the qualification of an arrangement as an insurance contract does not depend on the regulatory status of the issuer. For instance, in Commissioner v Treganowan, an arrangement with a stock exchange ‘gratuity fund’ was treated as life insurance because the requisite risk shifting and risk distribution were present. Also, in terms of Revenue Ruling 83-172, 1983-2 CB 107, a group issuing workmen’s compensation insurance is taxable as an insurance company even though it is not recognized as an insurance company under state law. And, under Revenue Ruling 83-132, 1983-2 CB 270, a non-corporate business entity is taxable as an insurance company if it is primarily engaged in the business of issuing insurance contracts.

Where an arrangement constitutes insurance for federal income tax purposes, s 162(a) of the Code read together with reg 1.162-1(a) of the Treasury Regulations, provide for a deduction of insurance premiums incurred by a business as part of its ordinary and necessary expenses in carrying on any trade or business. In general, these principles would also apply to determine the insurance contract status of an arrangement involving a cell of a PCC.

Although the IRS prefers to regard businesses that use the PCC structure as insurance, there is no clarity as to how such businesses should be taxed. Consequently, in 2005, the IRS issued a notice requesting comments on how best to determine whether cell captive arrangements constitute insurance. As a result, a ruling was released in which the IRS provided guidance on the circumstances under which a cell of a PCC would be treated as a separate insurance company for federal income-tax purposes, the consequences of such treatment, as well as the treatment of a PCC in a non-insurance context. The IRS provided the following three examples of situations in which US companies can and cannot take tax deductions for premiums paid in PCC structures:

87 AMERCO Inc v Commissioner 979 F 2d 162 (9th Cir, 1992); Revenue Ruling (‘Rev Rul’) 2002-89, 2002-2 CB 984.
89 Supra note 85.
90 Notice 2005-49.
91 Revenue Ruling 2008-8.
Payments in single-parent captive arrangements, in which the only risks assumed by the captive are those placed by the parent of the captive, do not constitute ‘insurance premiums’.93 Payments in brother-sister affiliate arrangements, in which only a small portion (from five to 15 percent) of the captive’s total risk is from any one affiliate of the captive, do constitute ‘insurance premiums’.94 Payments in group captive arrangements, in which a small group of unaffiliated companies form a captive, also constitute ‘insurance premiums’.95

Thus, as to whether a PCC arrangement is to be treated as ‘insurance’ for tax purposes depends on whether the cell is a single parent, a subsidiary structure, or if there are other brother-sister affiliates in the structure. This is determined on a cell-by-cell basis. In effect, whether a transaction with a particular cell is treated as insurance has no bearing on whether transactions of each of the other cells in the PCC are treated as insurance.

If the only risks placed with a cell are those of the cell’s shareholder parent, such an arrangement lacks the elements of risk shifting and distribution necessary to qualify as insurance. In that case, the cell’s parent-participant is not entitled to deduct the premiums it pays to the cell. But if a cell takes over the risks of multiple brother-sister affiliates, the arrangement is deemed to involve risk transfer and risk distribution. Contracts between such a cell and its affiliates are thus ‘insurance contracts’ and allow the insured affiliates to deduct their premiums.

Further guidance in the above mentioned Revenue Ruling also included a rule to the effect that for federal income-tax purposes, a cell of a PCC would qualify as an insurance company separate and apart from any other company (including the PCC) if:

- its assets and liabilities are segregated from those of other cells and of the PCC, so that creditors of other cells or the PCC may not look to the assets of the cell for satisfaction of any liabilities, including insurance claims (except to the extent that another cell or the protected cell company has a direct creditor claim against the cell); or
- based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company for federal income tax purposes (the activities of a cell that qualifies for treatment as an insurance company for tax purposes would be disregarded in determining the tax status of the PCC as an insurance company).

From the above, it appears that the IRS advocates for the separate-entity approach in the taxation of PCCs. However, it is not clear whether the same

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93 Revenue Ruling 2002-89.  
94 Revenue Ruling 2002-90.  
95 Revenue Ruling 2002-91.
rules should apply in respect of foreign entities. Thus, in Revenue Notice 2008-19, the IRS requested public comments on this and other matters. One commentator on the IRS’s proposed separate-entity treatment of each cell, cautioned that this approach requires segregation of the equity ownership rights (such as earnings and liquidation rights) in one cell that in another. Without such segregation, if a cell is treated as a corporation for federal income-tax purposes, it may be difficult to determine the owner of the stock or equity interest of each cell and whether such interest is common or preferred stock. If there are no requirements that limit the corporate equity ownership rights in each cell to the earnings and liquidation value of that cell, identification of the stockholders could become difficult because individuals having an equity interest in one cell may also have varying degrees of equity interests in another cell, creating cross-ownership patterns among the cells. If this matter is not addressed, issues regarding the identification of the owners of interests in each cell may pose taxation difficulties, the more so if the above guidelines are applied to foreign entities.

8.2 The United Kingdom

Like the US, the UK has for long had legislation to prevent tax avoidance when its residents invest in offshore companies. Such companies are liable to tax in the UK in terms of CFC legislation. Section 747(1) and (2) of the Income and Corporations Taxes Act, 1988 (the ‘ICTA’), defines a CFC as a company that is resident outside the UK and is controlled, or deemed to be controlled, by persons resident in the UK, but is subject to a lower level of taxation (that is, less than 75 per cent) in the territory in which it is resident than the corresponding UK tax on those profits. For instance, in Cadbury Schweppes plc v Commissioner of Inland Revenue, the UK Company, Cadbury Schweppes, established a captive for employee benefits in 2003 in the Dublin International Financial Services Centre. The rate of tax applicable in this jurisdiction was 10 per cent as compared with 33 per cent in the UK. Her Majesty’s Revenue and Custom (‘HMRC’) in the UK challenged Cadbury Schweppes’ right to the lower tax rate under CFC rules. Although this case was transferred to the European Court of Justice where it was decided on matters regarding freedom of establishment in the European Union, it is an example of how CFC legislation is applied in the UK.

If in any accounting period a company is a CFC for UK purposes and none of the exemptions set out in the ICTA apply, then an apportionment is made among UK residents who have interests in the CFC. In terms of s 747(4) of the ICTA, where chargeable profits are apportioned to a UK resident

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97 Section 750(1) of the ICTA.
99 Ibid.
company, an amount equal to corporation tax on the apportioned profits is charged on the company. Section 747(4) of the ICTA further provides that in order to qualify as a CFC, a non-resident company should be controlled by UK shareholders who hold at least a 25 per cent interest in the foreign company. Section 749(5) of the ICTA provides that persons who are deemed to have an interest in a CFC, include shareholders who have the capacity to directly or indirectly ensure that the company’s assets are dealt with for their benefit, and any other person who, alone or with others, has control of the company.¹⁰⁰

Previously the UK granted an exemption to the CFC rules where a CFC distributed at least 90 per cent of its net chargeable profits for the accounting period to its UK shareholders and if the dividends are repatriated to the UK within 18 months of the end of the accounting period to ensure that those dividends are taxable in the shareholders hands.¹⁰¹ With effect from July 2009, the 90-per-cent distribution was increased to 100 per cent and the 18 month deferral period was removed.¹⁰²

Even though CFC legislation may be applied to offshore captive companies, it may be difficult to apply this legislation to offshore PCC structures.¹⁰³ The key technical difference between a PCC cell and a captive is that a captive is considered a CFC, whereas a PCC cell may not necessarily be a CFC. Central to this matter is the status of the owner of the PCC. As observed earlier, the CFC rules provide in s 747(4) of the ICTA that a non-resident company qualifies as a CFC if it is controlled by UK shareholders who hold at least a 25 per cent interest in the foreign company. Where the shareholders of cells hold less than a 25 per cent interest in the PCC, those cell shareholders may fall outside the CFC rules.¹⁰⁴

Indeed, PCCs have for long been used in the UK for tax avoidance purposes, especially for capital gains tax deferral.¹⁰⁵ In order to bring into the tax net income that escaped the CFC rules, the UK had to introduce amendments to the law that would regulate the taxation of investments in offshore PCCs. In terms of UK law, cells in a PCC are currently taxed in terms of the rules that relate to offshore funds.¹⁰⁶ Previously the tax definition of an offshore fund was based on the regulatory definition of a collective investment

¹⁰⁰ In terms of s 755D(1) of the ICTA, a person is said to have control of a company if he has the power to ensure that its affairs are conducted according to his wishes and that power may be exercised in relation to either the company under review or another company. This includes the possibility of a company being treated as a CFC, notwithstanding the fact that one or two persons who exercise control are not actually resident in the United Kingdom.

¹⁰¹ Par 2 of sched 25 of the ICTA.

¹⁰² Section 39 of the Finance Act, 2009.


¹⁰⁶ Chapter 5 of part 17 of the ICTA; see also ss 756A-756C of that Act.
scheme as set out in the Financial Services and Markets Act, 2000. But the tax and regulatory definitions applied in quite different contexts. This caused uncertainty for investors and the funds industry, and the reliance on the regulatory definition was undermining the effectiveness of the tax rules. Consequently, ss 40A to 40G of the Finance Act, 2008 were enacted to specify the characteristics of arrangements that fall within the scope of the offshore-fund regime clearly. The move to a characteristics-based approach redefined the boundaries of the offshore-funds regime to ensure that it became more effective at delivering the intended policy objectives. The characteristics-based approach applies to each ‘arrangement’ that may or may not meet the definition of an offshore fund and it ensures that all UK investors in the same offshore fund face the same set of tax rules.

For UK purposes, the current definition of an offshore fund refers to ‘mutual funds’ which are resident or based in a territory outside the UK. Examples include ‘umbrella funds’ and ‘protected cell companies’ which are taxed under s 40C of the Finance Act, 2008. In terms of this provision, ‘umbrella funds’ are defined as ‘arrangements’ that provide for separate pooling of the contributions of the participants (sub-funds) and the profits or income out of which payments are made to them. For tax purposes, the umbrella arrangement is disregarded and not treated as an offshore fund. Instead, each sub-fund is treated as an offshore fund in its own right. The same approach applies to the individual cells within a protected cell company. The residence basis of taxation (worldwide taxation) is applied to each separate arrangement or each cell. In applying this basis of taxation, each separate arrangement or cell is deemed to have the same residence status as the overall umbrella arrangement or PCC. In terms of UK law, the test of company residence is where the central management and control of the company’s business actually resides. A company’s central management and control would normally be exercised by its directors who make the fundamental policy decisions that constitute the exercise of central management and control of the company. Thus, the place where the directors’ meetings are held is a very important factor in determining the residence of a corporation. In the case of an umbrella arrangement of a PCC,

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108 Ibid.
109 Ibid.
111 Ibid.
114 Ibid.
each separate arrangement or each cell would be considered to be under the 'central management and control' of the directors of the PCC or company which constitutes the overall arrangement. Thus, if a PCC is incorporated outside the UK, but all or some of its directors are resident in the UK where the company’s board meetings also take place and decisions on general and financial policy are also made, the cells of the PCC would be considered resident in and taxable in the UK.

In the case of a unit trust scheme (which takes on a trust structure), the residence basis of taxation that applies to trusts is applied to each unit trust. Under English law, a trust does not have a residence, since it is not considered a separate legal person in its own right. It is the residence status of the trustees, and not that of the settlor or the beneficiaries, that determines whether a trust is a UK trust or a foreign trust. For income-tax purposes, the general rules for determining the residence status for individuals have to be applied to each trustee. Where all the trustees are resident in the UK, the trust will be a UK resident trust. Thus, for purposes of taxing offshore funds, the trustees of the overall trust arrangements will also be considered the trustees of each separate arrangement, as their residence status determines the residence of the fund.

From the above, it appears that the UK has taken on the separate-entity approach in taxing the cells of PCC. As mentioned earlier, this is the same approach that the Americans are contemplating.

9 South Africans and Investments in PCC Offshore Structures

Since South Africa rejoined the global economy from 1994, there has been increased international interest in the country and this has encouraged South Africans to participate actively in and become reintegrated into the global economy. The heightened competition and the mobility of capital in the modern world have also encouraged South African residents to make considerable investments offshore and also to look for ways of minimising their global tax exposure.
The ability of South Africans to invest offshore has been enhanced by the continuous relaxation of the Exchange Control Regulations of 1961 that began in July 1997. Currently, the Exchange Control Regulations permit South African residents to make direct offshore investments of up to SAR4 million. A number of South Africans have made use of these funds to invest in PCC structures in the form of offshore ‘collective investment schemes’. Usually such ‘collective investment schemes’ operate in two different structures. Some of them operate under a corporate structure, while others operate under a trust structure.

Where ‘collective investment schemes’ operate under the trust structure, they are commonly referred to as ‘unit trusts’ in South Africa. In some offshore jurisdictions they are referred as ‘mutual funds’ or ‘protected cell trusts’. If a ‘unit trust’ is set up in a tax haven, investors’ funds, securities and other assets bought with those funds are held in a trust. The fund normally appoints a trustee to look after the assets in the trust. The money pooled in these investments is normally divided into equal portions called units. Unit trusts ensure that investments are properly diversified across different countries, currencies, economic sectors, industries and companies. Indeed, South Africans often invest in such unit trusts to hedge against the devaluation of the South African currency. Offshore unit trusts are also often used by South Africans who have liabilities in foreign countries. And in some cases investments in well-structured unit trusts have proved to have tax advantages.

In South Africa, banks usually play a major role in encouraging investments in offshore investment funds. Groups of banks are often parent companies of such offshore investment funds. The bank secrecy provisions that are upheld by tax-haven banks attract individuals (such as expatriate employees of international corporations who earn substantial salaries, or independent professionals earning high fees), to invest in offshore investment funds where they can accumulate capital offshore and thus hide their wealth from ‘onshore’ tax authorities. Examples of tax havens that have legislation catering for offshore unit trusts or mutual funds include Jersey, Guernsey, the Isle of Man, Luxembourg, Bermuda, Cyprus, the Cayman Islands, the British Virgin Islands and Mauritius. Unit trusts find it advantageous to set up in the Bahamas where the infrastructure and background of banking and trust

126 Ibid.
129 Tolley op cit note 128 at 10.
management expertise are well developed. South Africans have been involved in setting up a wide variety of tax-efficient strategies involving offshore companies and trusts in some of these jurisdictions. The Isle of Man is a particular favourite for outward investment for South Africans, with at least 35 of the largest South African companies operating on the island. The Isle of Man is also used by many South African individuals for personal investment and wealth management. As the Isle of Man introduced PCC regulations in 2004, this is yet another vehicle that may be employed by South Africans for offshore investment.

Mauritius is another jurisdiction that has been attractive for South African offshore investors. Although Mauritius is not among the jurisdictions listed in the 2002 OECD list of tax havens, the island is an established treaty haven for offshore activities, particularly in India, China and South Africa. It has developed an offshore regime that allows the establishment of offshore companies that are taxed at a very low rate. The PCC legislation that was introduced in Mauritius under the Protected Cell Company Act of 1999 and that came into force in January 2000, is an avenue that provides opportunities for South Africans to invest in PCCs that can provide flexibility and security for international investment structuring. PCCs incorporated in Mauritius may be used to access the Mauritian network of double taxation treaties. They may be structured as a Category 1 Global Business Company that can be incorporated under the Financial Services Development Act of 2001. In terms of this Act, a PCC may be employed to carry out two types of global business, namely global insurance business and investment funds (that is, collective investment schemes). The treaty benefits that a PCC registered in Mauritius would enjoy include the avoidance of capital gains taxes and the reduction of withholding taxes on dividends and interest.

Mauritius is also well known as a platform for open-ended ‘protected cell trusts’ or mutual funds. The Mauritian National Mutual Fund Ltd was

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131 Ginsberg op cit note 9 at 594-5.
133 Vanderplank et al op cit note 35; Willis Global Captive Practice op cit note 37.
137 Aamil Global Financial Services Mauritius ‘Protected cell Companies’ op cit note 21; Alliance Mauritius ‘Protected Cell Companies’ op cit note 27.
138 Alliance Mauritius op cit note 27.
established in 1990. A large number of Mauritian mutual funds are listed in
Mauritius and/or on major international stock exchanges such as London,
New York or Hong Kong. The bulk of these investments are directed towards
India, China and South Africa. Mauritius seeks to consolidate and develop the
client base of its mutual funds/collective investment schemes by emerging as
an alternative to the comparatively costlier international financial centres in
the Caribbean-Pacific region. The island’s close proximity to South Africa
and its stated policy of preferring to conclude double tax agreements with
African countries, along with its membership of regional bodies such as the
South African Development Community and the Common Market for Eastern
and Southern Africa render it an ideal location for South Africans to set up
offshore entities.

The Seychelles is another tax-haven jurisdiction located in the Indian
Ocean, close to South Africa, that has PCC legislation potentially attractive to
South African investors. Seychelles PCC legislation was introduced in the
under the Protected Cell Companies Act of 2003. The Seychelles has
negotiated a double-tax treaty with South Africa, though it is not yet in
force. The Seychelles views the negotiation of tax treaties with its trading
partners as an important part of its scheme to develop as a key financial hub in
the Indian Ocean.

With the international financial crisis that began in 2007, one does not need
a crystal ball to realise that investing in PCCs is going to become an ideal
attraction for South Africans. This is because such investments can be made
without committing large capital resources and also because there is the added
advantage of saving on taxes. In fact, company cell structures have actually
been considered as an option in the development of the South African
insurance sector, in the light of the growing importance and rapid expansion
of micro-insurance (insurance services geared to low-income clients) industry
that is largely unregulated. Cell structures have been considered as a viable
option since entities that provide micro-insurance may not have the capacity
(in terms of minimum upfront capital, operational capabilities, and skills) to
register as a fully-fledged long-term or short-term insurer under either the
Long-term Insurance Act\textsuperscript{147} or the Short-term Insurance Act\textsuperscript{148} In April 2008, the National Treasury produced a discussion paper entitled ‘The Future of Micro-insurance Regulation in South Africa’\textsuperscript{149} that considered formalising micro-insurance in South Africa. Consequently, specific guidelines for the activities of cell captives have been developed.\textsuperscript{150}

Despite these developments, South Africa does not have any PCC regulations. Rather, cell-captive insurers are subject to special insurance licensing conditions. So, for example, no cross-subsidisation is allowed across cells and each cell is required to be individually sound.\textsuperscript{151} Although the cell-captive mechanism may be considered an appropriate tool for the development of the insurance market in South Africa, without proper regulation these structures can be manipulated to avoid taxes, especially where investments are made in offshore cell captives.

Aware of the above concerns, the National Treasury indicated its plans in the 2010 Budget Review to come up with a robust tax policy that will contribute to financial recovery from the global financial crisis. This plan entails initiatives to improve tax compliance so as to broaden the tax base and also initiatives to close sophisticated tax-avoidance schemes which cause substantial loss of revenue. Schemes involving investments in offshore PCCs were among those the Treasury identified for closure.\textsuperscript{152} It pointed out that the growing existence of offshore PCCs and the fact that the nature of their cell structure can be easily used to avoid taxes, was a major risk to countries’ tax revenues.\textsuperscript{153}

\section*{9.1 Is South Africa’s Legislation Effective in Taxing Investments in Offshore PCCs?}

For purposes of South African tax law, PCC structures – generally and formally referred to as unit trusts – are categorised as collective investment schemes (‘CIS’), an investment vehicle operating on behalf of portfolio unit holders.\textsuperscript{154} In terms of s 1 of the Collective Investment Schemes Control Act,\textsuperscript{155} a ‘collective investment scheme’ means

\begin{itemize}
  \item \textsuperscript{147} 52 of 1998.
  \item \textsuperscript{148} 53 of 1998.
  \item \textsuperscript{150} Centre for Financial Regulation and Inclusion op cit note 146.
  \item \textsuperscript{151} Ibid.
  \item \textsuperscript{153} Richard Murphy ‘South Africa to Investigate Protected Cell Companies’, available at \url{http://www.taxresearch.org.uk/Blog/2010/05/11/south-africa-to-investigate-protected-cell-companies/} (accessed 12 May 2010).
  \item \textsuperscript{154} Silke op cit note 125 in par 13.9.
  \item \textsuperscript{155} 45 of 2002.
\end{itemize}
‘a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which –

(a) two or more investors contribute money or other assets to and hold a 35 participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and

(b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed’.

It should be observed, though, that the rules pertaining to the taxation of distributions from a CIS differ depending on whether the CIS is a domestic CIS or a foreign CIS.

The law regarding the taxation of distributions by domestic CISs changed on 1 January 2010.

Prior to that date, a portfolio of a domestic CISs was included in the definition of ‘company’ in terms of (the now repealed) s 1(e)(i) of the Income Tax Act and was thus considered a public company for tax purposes.156 Distributions to holders of participatory interests in such schemes were treated as dividends. However, a number of statutory provisos ensured that the portfolio of a CIS was effectively free from tax at the CIS level.157 Since the distribution by a CIS was treated as a dividend, there was no reference to the underlying character of the source of income giving rise to that distribution. Special provisions existed that indirectly allowed flow-through benefits. However, these provisions were not clear in certain respects.158

To address this problem, s 25BA was introduced into the Income Tax Act.159 In terms of this measure, a domestic CIS no longer falls under the definition of company and is no longer treated as though it were a company. A domestic CIS now falls under the definition of ‘person’ in s 1 of the Act. Distributions by a domestic CIS are thus no longer treated as ‘dividends’ and the exemption provided for in s 10(1)(k)(i) has been repealed. A non-capital amount received by or accruing to a portfolio of a domestic CIS, to the extent that it is within 12 months of its receipt distributed to a shareholder holder of a participatory interest in that portfolio, is deemed to have accrued directly to, and is therefore taxable in the hands of, that shareholder on the date of the distribution.160 In effect the CIS functions as a conduit, in much the same way as a trust. To the extent that an amount is not distributed, it is deemed to have accrued to, and is therefore taxable in, that portfolio on the last day of the

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157 These sections have been repealed after the coming into force of s 10(1)(iB) and s 25BA of the Income Tax Act.
158 See the Explanatory Memorandum to the Taxation Laws Amendment Bill of 2009.
159 Section 39 of the Taxation Laws Amendment Act 17 of 2009.
160 Silke op cit note 125 in par 13.19. Note that although in terms of s 25BA the CIS has lost its identity as a company, it retain company status for two limited purposes. Firstly, the CIS is deemed to be a company for purposes of the ‘connected person’ test because the ‘connected person’ test for trusts is too broad (ie, all beneficiaries are connected, meaning that all CIS unit holders would otherwise be connected). Secondly, the CIS is treated as a company for re-organization purposes under ss 42 and 44 of the Income Tax Act.
12-month period commencing on the date on which it was so received by the portfolio.\textsuperscript{161}

These principles do not apply to a foreign or offshore CIS. This is because, although par (\textit{e})(i) of the definition of company (that dealt with a domestic CIS) was repealed, par (\textit{e})(ii) which includes a foreign CIS in the definition of company, is still in force. This paragraph states that the term company also includes

'any arrangement or scheme carried on outside the Republic in pursuance of which members of the public are invited or permitted to invest in a portfolio of a CIS, where two or more investors contribute to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participation interest.'

In effect, this definition shows that a foreign CIS still falls under the definition of a company that is recognised for South African tax purposes. Thus, if South African residents invest in a foreign CIS, they are liable to tax on the residence-basis of taxation.\textsuperscript{162} Paragraph (\textit{k}) of the definition of ‘gross income’ provides that any income received or accrued by way of a dividend is taxable in the Republic. Although s 10(1)(\textit{k})(i) exempts South African dividends from taxation, dividends received by South African residents from a portfolio of a foreign CIS are taxable.\textsuperscript{163} However, such dividends are exempt from taxation under s 10(1)(\textit{k})(ii) if

• the profits out of which the dividend has been declared have been taxed in South Africa or arose from dividends declared by a South African company to the company declaring the dividend;
• the dividend is declared by a foreign company which is listed in South Africa and in a foreign country;
• the dividend does not exceed the profits that have been taxed in the shareholders’ hands in terms of s 9D; or
• the shareholder holds at least 20 per cent of the foreign company’s equity share capital and voting rights.

In a situation where the above exemptions do not apply, and a foreign CIS does not distributed dividends to its shareholders, its foreign source income is in principle not subject to domestic tax until such income is distributed to the shareholders as dividends.\textsuperscript{164} This implies that the taxation of such income may be deferred, even indefinitely.

To counter such deferral and to bring the income earned by South African shareholders in foreign companies into the tax net, Controlled Foreign Company (‘CFC’) legislation under s 9D of the Income Tax Act is applied to tax South African shareholders notwithstanding the fact that the actual income is received by or accrues to the foreign company.\textsuperscript{165} Through the use of CFC

\textsuperscript{161} Silke op cit note 125 in par 13.19.
\textsuperscript{162} See the definition of ‘gross income’ in s 1 of the Income Tax Act.
\textsuperscript{163} Huxham & Haapt op cit note 2 at 345-6.
\textsuperscript{165} RD Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 SALJ 473 at 473-4; Silke op cit note 125 in par 8.10.2.
legislation, the delay or deferral of taxes is curbed by taxing the South African shareholders on the income earned by the foreign company as if the company had distributed the income as soon as it was earned.\textsuperscript{166} Section 9D(1) of the Income Tax Act provides that an offshore CIS is indeed a foreign company to which CFC legislation can be applied. However, the legislation can be applied only if one or more South African residents, directly or indirectly, hold more than 50 per cent of the total participation rights in the company, or if more than 50 per cent of the voting rights of that foreign company are held or are exercisable, directly or indirectly, by one or more residents. The term ‘participation rights’ as used in this legislation, refers to the right to participate in the share capital, share premium, current or accumulated profits or reserves of the foreign company. Voting rights will only be taken into account where a company has no shares and only has voting rights. If a person has a right to participate in the equity of the company (no matter how simple) then the voting rights are disregarded.\textsuperscript{167} The definition of a CFC excludes residents who are connected persons, who in aggregate hold more than 50 per cent of the participation rights or voting rights in a foreign listed company or a foreign CIS or arrangement, but individually hold less than 5 per cent of the participation rights or voting rights in the listed company or ‘foreign collective investment scheme’ or arrangement\textsuperscript{168} as contemplated in par (e)(ii) of the definition of a company. However, these exclusions do not apply where connected persons collectively own more than 50 per cent of the foreign company. This is intended to ensure that the provision cannot be circumvented by a group of economically linked parties arranging their affairs so as to stay clear of the 5 per cent and 50 per cent thresholds respectively.

Jurisdictions often advertise offshore investments in which (at least two) members of the public are invited or permitted to invest in a portfolio of an offshore CIS. A number of South African banks with offshore operations offer foreign CIS or equity unit trusts in order to accommodate South African residents who wish to utilise their Exchange Control Foreign Investment allowances.\textsuperscript{169} In such cases it is possible that more than 50 per cent of the participation rights or voting rights in the foreign collective investment scheme may be held by South African residents. However, only residents who individually hold 5 per cent or more of the participation rights or voting rights in such a scheme will be regarded as participating in a CFC for the purposes of s 9D. Thus, if South African residents invest in cells of a foreign PCC, it may be possible to avoid CFC legislation if each of the individual cells of the PCC holds less than 5 per cent of the ‘participation rights’ or ‘voting rights’ in the PCC. It is reasoned that this exclusion from CFC rules of South African shareholders with an interest in less than 5 per cent is presumably to lessen the administrative burden on tax authorities as it is often difficult to determine the

\textsuperscript{166} Jooste op cit note 164 at 474.
\textsuperscript{167} Huxham & Haupt op cit note 2 at 307.
\textsuperscript{168} Section 9(1) of the Income Tax Act; see also Olivier & Honiball op cit note 143 at 364.
\textsuperscript{169} Olivier & Honiball op cit note 142 at 364.
identity of those who own shares in large-scale entities where the interest is less than 5 per cent. Nevertheless, the above account shows that these exclusions from the CFC can create opportunities for tax avoidance where investments are made in offshore PCCs.

Currently, there is no legislation in South Africa that targets the taxation of small percentages of voting or participation rights in cells of a foreign CIS. Although s 72A(1) of the Income Tax Act imposes a duty on every South African resident who has shares in a CFC to submit to the Commissioner certain information about the CFC – for instance the shareholder’s voting percentage and class of participation rights – and although s 75 imposes penalties for the non-disclosure of such information, such voluntary disclosure requirements do not necessarily ensure that taxpayers will be forthright regarding their offshore investments, as most offshore investments are marred with secrecy.

As noted above, in its 2010 Budget Review the National Treasury indicated that it would devise a robust tax policy that would contribute to the country’s financial recovery from the effects of the international financial crisis. This plan entailed closing up sophisticated tax-avoidance schemes, like investments in offshore PCC structures, which have been blamed as a major cause of substantial loss of revenue to the country. As a follow up, in May 2010 the National Treasury issued a statement to the effect that it had embarked on an ongoing review and investigation of the tax issues relating to PCCs before any legislation concerning the same is enacted. In the statement, the Treasury acknowledged the need to balance legitimate commerce against anti-avoidance concerns. It thus embarked on engaging with relevant stakeholders before legislation in this regard would be enacted. The Treasury has accordingly devised certain proposals as to how the taxation of PCCs may be addressed, and has called on public comment on those proposals. The Treasury suggested that the ownership criteria in the CFC legislation should be tightened by ensuring that each cell in an offshore PCC is deemed a separate company. Furthermore, it proposed that the test of residence of each cell (its place of effective management) should be determined on a cell-by-cell basis rather than on a company-by-company basis. The goal is to neutralise the tax benefits of an offshore cell company as compared to an onshore cell company.

In my view, the proposal to tighten the ownership criterion in the CFC rules and that of taxing each cell of a PCC as a separate company are steps in the right direction. This approach is also followed by the UK and the US, jurisdictions historically known to be the leaders in developing international...
tax laws. However as a US commentator on this approach has pointed out, there may be difficulties in identifying ownership interests in individual cells. These difficulties will have to be addressed if this approach is to be an effective means of taxing PCCs. The National Treasury’s further approach of determining the residence of cells on a cell-by-cell basis is also in line with the UK and US approach. If the shareholders of the cell are South African residents, then the cell will be deemed to be effectively managed in South Africa and taxable in here.

As the time of writing this article, the Treasury’s proposals and any revisions of it as proposed by stakeholders have not yet been enacted into law. Nevertheless, indications are that legislation to curb offshore tax avoidance that results from investments in offshore PCCs is going to be enacted in South Africa sooner rather than later.

It should be pointed out that the new dividend tax, that will replace ‘Secondary Tax on Companies’ and that will be effected on a date determined by the Minister of Finance by notice in the Government Gazette may also have implications for PCCs. How this dividend tax will work out in practice with regard to PCCs is beyond the scope of this paper.

9.2 How Investments in Offshore Cell Trusts are Taxed in South Africa

Where the legal nature of a PCC takes the form of an offshore trust, as is the case with many offshore mutual investment funds, tax avoidance that results from investing in such structures may be caught by various anti-tax avoidance provisions that deal with investments in offshore trusts. These are not dealt with in any detail here.

In summary, s 7(8) of the Income Tax Act deems any amount received by, or accruing to, a non-resident (for example an offshore cell trust) by reason of a donation, settlement or disposition made by a resident, to be that of the resident donor and thus taxable in her hands, if that amount would have constituted ‘income’ had the non-resident been a resident. Section 7(8) could apply in a wide range of circumstances. The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 states that the section can for instance apply where a South African resident donates funds to a foreign trust, which in turn transfers the funds to a foreign collective investment scheme and then the scheme generates foreign dividends that are paid to the foreign trust. In terms of s 7(8), the foreign dividends would be attributable to the donation made by the South African resident and thus taxable in his or her hands.

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175 Baker op cit note 96.
176 Levied under ss 64B-64D of the Income Tax Act.
177 See the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 in par 3.4(iv).
178 Olivier & Honiball op cit note 142 at 361.
179 As amended by s 5(1) of the Revenue Laws Amendment Act 32 of 2004.
180 Silke op cit note 125 in par 12.25A; A Duncan ‘Hidden Assets’ Jul 2004 De Rebus 32.
Another provision that could be applied to tax investments in offshore
funds is s 25B(2A) of the Income Tax Act181 which provides as follows:

'Where during any year of assessment any resident acquires any vested right to any amount
representing capital of any trust which is not a resident, that amount must be included in the
income of that resident in that year, if –
(a) that capital arose from any receipt and accruals of such trust which would have
constituted income if such trust had been a resident, in any previous year of
assessment during which that resident had a contingent right to that income; and
(b) that amount has not been subject to tax in the Republic in terms of this Act.'

This provision may be applied to tax South African residents on any capital
that arises from receipts and accruals of the offshore trust which would have
constituted income, if the trust had been a resident.

Often offshore unit trusts are used to defer the liability for capital gains tax
('CGT') on the disposal of the shares of the fund. This is especially so where
what would be ordinary income, is converted into capital gains.182 If such a
fund is based in a tax haven, the tax advantages are multiplied as such havens
usually levy no tax or only minimum tax on capital gains.183 The taxes
deferred will leave the income in the fund intact over a period of years.184

However, there are CGT provisions that may be applied to curtail such tax
loss. Generally, non-resident trusts are not liable to CGT, except in the case of
South African immovable property, or where a non-resident trust has a
permanent establishment in South Africa.185 There is no CGT liability where
the non-resident trust disposes of assets anywhere in the world.186 However,
distributions of capital made to a resident beneficiary, which represent earlier
capital gains in the trust, are subject to CGT in the beneficiary’s hands in the
year that the asset is sold.187 As an anti-avoidance measure, where the
non-resident trust has been funded by a gratuitous disposition from a resident,
par 72 of the Eighth Schedule to the Income Tax Act applies to attribute CGT
to the resident donor. This provision works like s 7(8) as described earlier.

In terms of par 80(3) of the Eighth Schedule to the Income Tax Act, when a
resident beneficiary acquires a vested right in the capital of any non-resident
trust, which arose in a previous year of assessment when the resident had a
contingent right to that capital, the capital gain is attributed to the resident if it
has not yet been subject to tax in the Republic. This provision is similar to
s 25B(2A), mentioned earlier, in that it prevents tax avoidance where capital
is accumulated in a non-resident discretionary trust and is only distributed to
the beneficiaries in subsequent years.188

It should also be observed that s 7(10) of the Income Tax Act places the
burden of disclosing investments in offshore trusts on the taxpayer.189 The

181 As amended by s 27 of the Revenue Laws Amendment Act 32 of 2004.
182 Arnold at 123; Arnold & McIntyre op cit note 164at 86.
183 Hampton op cit note 13 at 26.
184 C Doggart ‘Tax Havens and Their Uses’ (1990) at 38.
186 Ibid.
187 Paragraph 80(3) of the Eighth Schedule to the Income Tax Act.
188 Meyerowitz op cit note 2 in par 39.16.9.
189 Silke op cit note 125 in par 4.67B.
section requires that when submitting a tax return, taxpayers must disclose to the Commissioner in writing any donation, settlement or disposition. Failure to comply with the disclosure requirements in s 7(10) may lead to criminal sanctions. It could also result in the taxpayer being subjected to additional assessment under s 79 of the Income Tax Act. Section 7(10) thus prevents taxpayers from pleading ignorance in mitigation where penalties are imposed in cases where they have failed to disclose s 7(8) income, and their non-disclosure is discovered.

Then, in terms of s 78 of the Income Tax Act, where the Commissioner has reason to believe that a resident has not declared, or accounted for, any funds or assets owned outside the Republic, the Commissioner must estimate the amount of such funds, or the market value of those assets, and include the estimated amount in the taxable income of that person. The estimation could be based on information such as any funds or assets transferred by that resident from the Republic; any amount received by, or accrued to, that resident from any source outside the Republic; or the period that has elapsed since those funds or assets were transferred outside the Republic.

With the above provisions in place, one could conclude that the tax net seems to have closed on opportunities for South African residents to avoid taxes by investing in offshore trust structures such as mutual funds or cell trusts or unit trusts. However, investments in these structures have not outlived their usefulness as tax-avoidance tools. The current legislative environment appears to have 'simply altered the terrain and landscape' in which taxpayers use trusts for tax avoidance. As Ware and Roper observe, sophisticated offshore structures involving trusts and company components will continue to be a versatile tax-avoidance tool.

10 Conclusions and Recommendations

From this analysis, one may predict that the use of cell structures will continue to grow and prosper. PCCs are currently acting as the catalyst for the fusion of capital and insurance markets, and are providing a structure and capability to move the world of risk financing into the twenty-first century. Company and trust cell structures are an inevitably innovative way to help organisations to finance risk and are flexible enough to offer a wide range of possible products and solutions. As one commentator has put it, 'just as Limited Liability Companies and partnerships were once a new concept, so

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190 Sections 75 and 104 of the Income Tax Act.
the introduction of limited liability cells should be seen as a part of the evolutionary process of commerce’.194

With these developments in mind, it is important that countries come up with legislation that will effectively tax investments in these structures in order to prevent the depletion of their tax bases. The above account has shown that for the US, the UK and even South Africa, investments in the cells of offshore PCCs escape taxation because the CFC legislation that deals with the taxation of investments in offshore companies is limited by the percentage of shareholders’ interests in such companies. In the US, the rules do not apply if a shareholder owns less than 10 per cent of the voting power of the CFC. In the UK, it is 25 per cent, whereas in South Africa, the CFC rules do not apply if shareholder has less than 5 per cent of voting rights or participation rights of the CFC. Although the South African percentage is much lower, and one may argue that the fiscal threat is not great at present, there is, needless to say, a loophole in the law that may be used to avoid tax.

The National Treasury’s proposals as to how this loophole may be closed are indeed laudable. Since these proposals are in line with US and UK measures, it is recommended that, after taking cognisance of South Africa’s special circumstances and the public comments on the Treasury’s proposals, legislation should be enacted in South Africa that taxes PCCs using the separate-cell approach and so that the residence of the cells in the structure should be determined on an individual basis.

194 Willis Global Captive Practice op cit note 37.