Proposed amendments to Section 9D could offer a simpler means to avoid controlled foreign company imputations

Author: Bruce Russell, tax consultant, Grant Thornton Cape

The controlled foreign company (CFC) provisions seeks to reduce the opportunity for income to be diverted and taxed offshore in the hands of foreign companies where:

1. South African tax residents may exercise, directly or indirectly, a majority of the voting rights in the foreign companies or
2. where South African tax residents may participate, directly or indirectly, in the majority of the benefits attached to shares of the foreign companies.

In terms of Section 9D of the Income Tax Act, a hypothetical taxable income, "net income", is calculated as if the CFC is South African tax resident. This net income may be included in the taxable income of the South African tax resident shareholders.

Section 9D offers the following relief measures that avoid subjecting the CFC's net income to South African income tax:

1. the net income of the CFC is deemed nil, where all foreign tax incurred by the CFC is at least equal to 75% of the South African income tax computed on that net income
2. amounts, other than tainted income, that are attributable to a "foreign business establishment" (FBE)

are excluded from net income.

Where a CFC conducts a genuine business established at premises outside of South Africa, with sufficient on-site managerial and operational staff, it is usually evident that the CFC conducts business through a FBE. In contrast, determining whether foreign taxes incurred by the CFC will reach the 75% threshold can be a time consuming and complicated computation, especially if the South African taxpayer has numerous CFCs.

If a FBE exists and no tainted income is attributable to that FBE, no net income will need to be declared. This result is regardless of whether foreign taxes incurred by the CFC meet the 75% threshold.

However, as noted in the Explanatory Memorandum to the 2014 Taxation Laws Amendment Bill, the current structure of Section 9D still requires the 75% threshold computation to be performed despite the fact that the net income of the CFC is attributable to a FBE. This computation would also need to be declared in an IT10B return that accompanies the annual tax return of the South African shareholder.

In recognising this unnecessary burden, the 2014 Taxation Laws Amendment Bill proposes that a CFC's net income will also be deemed nil where:

1. all of the receipts and accruals of the CFC are attributable to a FBE and
2. none of those receipts or accruals relate to tainted income

This logical amendment removes the compliance burden where CFCs conduct business through a FBE that does not derive tained income.

A word of caution – the tainted income provisions of Section 9D(9A) are complicated and therefore should be considered

carefully before relying on this FBE relief. Tainted income includes the following passive and diversionary income earned by CFCs from South African tax resident connected persons:

- interest
- royalties in respect of the use of intellectual property
- rental of certain movable property
- goods sold by the CFC
- services performed by the CFC, other than certain services performed outside of South Africa

In conclusion, if the proposed amendments in the 2014 Taxation Laws Amendment Bill are enacted, the presence of an FBE can reduce the compliance burdens associated with a CFC. However, careful consideration must still be given to establish the existence and the impact of tainted income.