Controlled foreign companies: look before you leap

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Section 9D of the Income Tax Act, 1962 (the **Act**) is aimed at South African residents who directly or indirectly hold more than 50% of the total participation (broadly speaking shares) or voting rights in a foreign company. A foreign company in this context is classified as a controlled foreign company (**CFC**).

In terms of section 9D, the net income of the CFC is included in the relevant residents income in proportion to the residents effective participation rights in that CFC, thus resulting in the resident being subject to tax on such notional income imputed to it.

The calculation of the net income of a CFC is prepared by treating the CFC:

1. as a resident for certain specified sections of the Act, which include the Eighth Schedule to the Act, containing the capital gains tax (**CGT**) provisions; and
2. as a taxpayer for provisions that do not refer to the resident status of a taxpayer.

There are various CFC-specific exemptions and exclusions, over and above those applicable by virtue of the other provisions of the Act.

Aspects often overlooked in performing the net income

calculation

Residents that hold investments in offshore subsidiaries (qualifying as CFCs) often overlook the South African tax implications that may result from such a foreign investment. We consider below a few of these aspects that often arise and which are preferable to consider prior to any transactions being entered into.

Offshore mergers/reorganisations

One of the aspects often encountered resulting in unforeseen South African tax consequences, is where a reorganisation takes place in relation to offshore companies qualifying as CFCs. Specifically, many foreign jurisdictions have rules permitting the tax-free merger of companies. However, as this merger necessarily has the effect of terminating the existence of at least one of the companies, a number of South African tax implications may arise for such companies in their capacity as CFCs. This includes that the CFC disposes of all its assets and ceases to be a CFC and the disposal of shares by the CFC holding the shares in the CFC ceases to exist, with the resultant CGT implications potentially arising on more than one level.

It is prudent for residents to take advice prior to the implementation of such offshore restructures as it may be possible for such transactions to fall within the corporate rules in the Act, often with minimal changes required to the transaction steps, thus resulting in the transaction being implemented on a tax neutral basis from a CFC perspective.

Ceasing to be a CFC

Section 9H(3)(*b*) of the Act finds application where a CFC ceases to qualify as such. A CFC in this context is deemed to have disposed of each of its assets on the day before it ceased to be a CFC for market value proceeds, thereby triggering adverse CGT implications (assuming the assets are held on capital account and the assets have increased in value).

Such assets may include shares held in another offshore company (which may or may not be a CFC). In this context, it is important to take note of the manner in which the base cost in such shares must be determined.

Paragraph 20(1)(h)(iii)(*aa*) and (*bb*) of the Eighth Schedule of the Act sets out the method for determining the base cost in this regard.

Specifically, the base cost in an asset (being an interest in a CFC (**CFC1**)) held directly by another CFC (**CFC2**), is determined as the sum of:

- the expenditure actually incurred in respect of the cost of acquisition of creation of that asset; and
- an amount equal to the proportional amount of the net income of CFC1 and of any other CFC, in which CFC1 and CFC2 directly or indirectly have an interest and which would have been included in the income of CFC2, had it been a resident during any year of assessment, reduced by the amount of any exempt foreign dividend distributed by CFC1 to CFC2.

Broadly speaking, the base cost in the shares in CFC1 (held by CFC2) would thus include the acquisition costs, plus the net income of CFC1 and any other CFCs in which it holds a proportional interest which would have been included in CFC1/CFC2s income had they been resident.

Interest income

Another aspect often overlooked is the question of interest deductibility where a CFC operates as a group treasury company (T**reasury CFC**) and cash is pooled in the CFC.

Where excess cash from Group CFCs is pooled (essentially placed on loan with Treasury CFC) and that CFC pays interest to the respective Group CFCs, section 9D9(fA)(*i*) of the Act would exclude from the net income of the Group CFCs any interest received from Treasury CFC and, similarly, section 9D(2A)(*c*) would prohibit a deduction of the interest paid by Treasury CFC in determining its net income. However, when Treasury CFC places such excess funds on deposit with a bank in respect of which it earns interest, no exemption applies and the interest must be included in Treasury CFCs net income.

Foreign exchange differences

Similar issues arise in respect of exchange differences, as is explained by way of the following example:

- Treasury CFC raises loan funding from a bank in order to provide loan funding to Group CFCs. To ensure that it is not exposed to currency movements from an economic perspective, Treasury CFC borrows from the bank in the same currency as that in which it will advance a loan to Group CFC (for example, in Euros);
- assuming Treasury CFCs functional currency is USD, the loan owing by Treasury CFC to the bank and the loan owing to Treasury CFC by the Group CFC (which are both denominated in Euros) would qualify as exchange items for purposes of section 24I of the Act;
- on translation of such exchange items to Treasury CFCs functional currency, assuming Treasury CFC realises an exchange loss on the loan advanced to the Group CFC, such exchange loss cannot be deducted by Treasury CFC in the determination of its net income in terms of section 9D(2A)(*c*)(ii) of the Act, as the exchange difference arises in respect of an exchange item between CFCs that form the same group of companies;
- however, the translation of the corresponding loan owing by Treasury CFC to the bank in these circumstances should result in an exchange gain, for which no exemption exists as it is a loan owing to a third party

which must thus be taken into account in determining the CFCs net income.

Conclusion

To avoid unforeseen South African tax consequences resulting from the provisions of section 9D of the Act, taxpayers must pay careful attention to these rules. In particular, considering the intricacies surrounding the tax treatment of CFCs, it is important for South African residents to seek advice at the outset, and also prior to such CFCs entering into restructure transactions of any nature, since it may be a matter of making certain adjustments to a commercial transaction to ensure that such transaction complies with the specific rules which have been included in the Act to provide relief in a CFC context (within a group of companies).

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