



Unintended consequences of the new CFC rules

by **Judith Becker**

In the 2017 South African Budget speech, the Minister of Finance raised government's concern that the current Controlled Foreign Company ("CFC") rules do not capture foreign companies held by interposed trusts or foundations, and it was announced that countermeasures for the treatment of foreign companies held by trusts or foundations will be considered. Treasury, in an attempt to cover these loopholes, has introduced certain changes into the CFC legislation and a section that might have more disadvantages than Treasury intended.

Current CFC rules

South Africa imposes taxes on worldwide income of residents. The Income Tax Act, 1962 (the "Act") contains various anti-avoidance provisions which aim to curb tax avoidance. One of these provisions was the introduction of CFC provisions contained in section 9D of the Act. The CFC rules are aimed at preventing South Africans from shifting income offshore by investing in a CFC.

A CFC is a foreign company where one or more South African residents directly or indirectly hold or exercise more than 50% of the participation or voting rights. The CFC rules make provision for the net income of a CFC to be attributed and included in the income of its South African resident shareholders. However, structures where the offshore company is being held through a foreign trust or foundation do not fall within the ambit of South African CFC rule. The profit of the foreign company therefore falls outside of the South African tax net.

New proposal to curb CFC avoidance

The latest draft Taxation Laws Amendment Bill aims to expand the CFC rules to capture foreign companies held by interposed foreign trusts or foundations. The proposed amendments to section 9D and the inclusion of section 25BC will deem these trusts and foundations as CFCs.

Extension of the CFC definition

It is proposed that section 9D be amended so that a foreign company held through a foreign trust or foundation and whose financial statements form part of the consolidated financial statements of a group of which the parent company is a South African resident will be deemed to be a CFC.

Inclusion of section 25BC

To date, where a foreign company is held by an interposed trust or foundation, the link between the foreign company and the South African resident beneficiary is effectively broken and profits by the foreign company will not be taxable in South Africa. The proposed section 25BC goes a step further and will target any distribution received by a resident (other than a company) from certain foreign trusts or foundations.

This insertion, aimed at individuals and trusts, would apply where the foreign trust or foundation holds a "participation right" in a foreign company. In other words, if the foreign trust or foundation had been a South African tax resident, the foreign company would have been a CFC.

There are, however, a number of circumstances where certain exemptions and exclusions are applicable and it is not necessary to account for the notional income of a CFC which the proposed section 25BC does not take into consideration. One is called the "foreign business establishment" ("FBE") exemption, which means that the foreign company is suitably staffed and equipped to conduct the primary operations of that business. In such an instance, it is not required to include the net profits into the South African shareholder's income for tax purposes, but the proposed section 25BC will still tax the amount distributed regardless of the income being linked to the FBE.

The proposed section 25BC also does not address situations where the income from the foreign trust or foundation does not arise from the CFC. If the trust holds various investments, this could result in excessive taxes, in that any and all distributions from the foreign trust or foundation would be subject to South African income tax, regardless of the fact that such income is not linked to the CFC.

The section may also introduce double taxation. If foreign taxes were paid by the entities in the underlying structure, these taxes would not be creditable against the South African tax that is paid as a result of the new section.

Conclusion

The proposed amendments will come into effect on 1 January 2018. However the proposed section 25BC poses possibilities for double taxation or taxation of residents that would normally fall outside the scope of the CFC rules contained in section 9D.

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