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CFC Rules and SA Dividends – A Trap for the Unwary

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Introduction

The controlled foreign company (CFC) rules are contained in section 9D of the Income Tax Act, 1962 (the Act) and are designed as an anti-avoidance provision to prevent accumulation of (essentially) passive income in foreign companies owned by South African-resident shareholders, as opposed to being taxed in South Africa.

The CFC rules are lengthy and complex with a number of exemptions and exceptions to the exemptions, and these are beyond the scope of this article. What I wish to focus on is an amendment introduced a couple of years ago as an adjunct to the exchange control relaxation of the so-called "loop" rules.

General principles

The general principle in relation to the CFC rules is that the foreign company's taxable income (where any of the exemptions does not apply) is calculated in terms of the requirements under the Act, and then an amount equal thereto is included in the (taxable) income of each South African-resident shareholder, pro-rata to the shareholding.

In doing so, no account is taken of the identity of the South African shareholder. For example, if a CFC makes a capital profit on disposal of an asset, the capital gain is calculated as being 80% thereof, so that if an individual is a shareholder, he or she will be taxed at 45% of that capital gain, giving rise to an effective tax rate of 36%, as opposed to the effective CGT rate otherwise applicable to natural persons, being 18%.

A similar problem arises with foreign dividends. In general, if a South African-resident company earns a foreign dividend which is taxable here, the taxable portion of the dividend is determined by multiplying the dividend by the ratio of 20 to 27. When that taxable portion is multiplied by the company tax rate of 27%, the effective tax rate is 20% (ie R100*20/27*27% = R27). On the other hand, a foreign dividend received by an individual results in a taxable amount equal to the foreign dividend multiplied by the ratio of 20 to 45, and when this taxable amount is multiplied by the individual rate of 45%, the effective rate of tax on the dividend is also 20% (ie R100*20/45*45% = R45).

However, for CFC purposes the taxable portion of the foreign dividend is still multiplied by the corporate ratio of 20 to 27. So if the shareholder is an individual and the taxable portion of the dividend is multiplied by 45%, the effective rate is not 20% but 33.33%.

The loop provisions

As is well-known, there used to be a total prohibition imposed by the Reserve Bank on so-called loop arrangements, where South African residents were directly or indirectly interested in an offshore structure that, in turn, held assets in South Africa. These rules have gradually been relaxed and, while theoretically they have been abolished, in practice there are still certain restrictions thereon.

One of the requirements to facilitate further relaxation of the loop rules was that certain amendments needed to be made to the Act, and particularly in relation to the CFC rules. For the purposes of this article, the focus is on the treatment of South African dividends payable by a South African company to an offshore holding company which is a CFC.

Prior to the amendment

As we all know, the rate of dividends tax to be withheld from a dividend distributed by a South African company is 20%. In the case of a foreign shareholder this rate may be reduced in terms of an appropriate double tax agreement. Particularly in the case of corporate shareholders, the rate could be reduced to as low as 5%.

So assume that the shares in a South African company (SACo 1) are held by a holding company in Mauritius (MCo), the rate of withholding tax will, under the double tax agreement between the two countries, be reduced from 20% to 5%. If the shares in MCo were held by South African residents to the extent of more than 50%, then MCo would be a CFC. However, because MCo's taxable income had to be determined in terms of the Act, the dividend from SACo 1 was not taxable, because South African dividends are exempt from income tax (albeit subject to the dividends tax, which is a separate tax).

Subsequent to the amendment

As mentioned, the purpose of the amendment was to facilitate the relaxation of the loop rules for exchange control purposes, but without resulting in a reduction of the South African tax base. As demonstrated, this could result in a reduction of dividends tax from 20% to 5%.

Accordingly, the exemption from income tax normally applicable to South African dividends was partially removed under section 9D of the Act in calculating the CFC's taxable income. The removal of the exemption depended upon the extent to which dividends tax was actually payable. So, for example, if the dividends tax rate was at 20% (because the CFC was resident in the jurisdiction where there was no double tax agreement), then the South African dividend effectively retained its full exemption for CFC purposes. But if the withholding rate was only 5%, such as under the treaty with Mauritius, then effectively 75% of the dividend was brought into the net, and then that amount of 75% was multiplied by the ratio of 20 to 27 to give the taxable amount.

Effect of the amendment

So consider the situation where a South African company (SACo 2) is the shareholder of MCo. In computing the taxable income on a dividend from SACo 1 of, say, R1 million, from which 5% or R50 000 was withheld as dividends tax, 75% of the dividend would be multiplied by the ratio of 20 to 27 to arrive at the taxable income of MCo. That taxable income would then be taxable in the SACo 2's hands at the rate of 27%, and the tax so computed will amount to R150 000 (ie R1 000 000*75%*20/27*27%). So if this amount is then added to the R50 000 withheld by SACo1 as dividends tax, it results in a total South African tax of R200 000, which represents the headline withholding tax rate of 20% on a dividend of R1 million.

Problems with this approach

The first problem is to ask why a South African corporate shareholder of the CFC – SACo 2 here – should be subject to 20% tax on the dividend from the South African company – SACo 1 here. After all, if MCo had not been interposed between SACo 2 and SACo 1, SACo 2 would not have been taxable on the dividend at all because a dividend from one South African company to another South African company is exempt from dividends tax. So here a dividend is being subject to tax at 20% where, but for the loop, it would have been zero. One must therefore ask where is the prejudice to the South African tax base? In fact, with the MCo being interposed there is still the withholding of R50 000, which would not have been payable had MCo not existed in the chain of ownership. And, what is more, with SACo 2 having been taxed directly and indirectly to the extent of R200 000, if it receives a dividend from MCo and on-distributes it to its (non-corporate) shareholders, there will be further South African dividends tax at the rate of 20%.

The second problem arises where the shareholder of MCo is an individual or a trust. Once again, applying the formula, the taxable income of MCo under the CFC rules will be 75% of the dividend of R1 million multiplied by the ratio of 20 to 27. When this taxable income is taxed under the CFC rules in the hands of the shareholder, it is multiplied by 45%. This results in tax payable of R250 000 (ie R1 000 000*75%*20/27*45%) so that, when added to the withholding tax of R50 000, gives a total effective tax rate of 30% – much more than the 20% by which the tax base has supposedly been prejudiced. This now becomes punitive rather than it merely being a case of protecting the tax base to enable the fiscus receive what should have been received but for the interposition of MCo.



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