CFC translation rules: is the taxpayer currently getting the short end of the stick?

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Abstract
Controlled foreign company (“CFC”) legislation, governed by section 9D of the Income Tax Act 58 of 1962, serves as anti-avoidance legislation in South Africa’s residence-based tax system. Section 9D provides for the calculation of a deemed amount which must be included in the South African resident’s income. This deemed amount is calculated with reference to the net income for the CFC’s foreign tax year. Section 9D(6) provides for this deemed amount, which is denominated in the foreign financial reporting currency, to be translated into South African rand by applying the average exchange rate for that year of assessment. The legislation refers to the South African resident’s year of assessment and not the CFC’s foreign tax year. It is submitted that the average exchange rate for the CFC’s foreign tax year should be used for translation. The author therefore disputes the period to be used in calculating the average exchange rate.

Key words
Average exchange rate South African resident’s year of assessment
CFC’s foreign tax year Section 9D
Controlled foreign company South African resident shareholder
Conversion Translate
Period Translation

1 Introduction
In 1997, controlled foreign company (CFC) legislation was introduced in the Income Tax Act 58 of 1962 (“the Act”) by section 9D of the Income Tax Act 28 of 1997, to protect the South African tax base from the effects of the relaxation of the exchange control regulations that came into effect on 1 July 1997 (SARS Explanatory Memorandum 1997:3). Section 9D initially only taxed passive income but after the introduction of residence-based legislation in 2001, the scope of section 9D was extended to include active income (SARS Explanatory Memorandum 2000:7). The purpose of section 9D is to tax South African residents on their respective shares of net income of the CFC, if certain criteria are not met. Because section 9D is anti-avoidance legislation, it overrides the receipt and accrual principle as found in the gross income definition of section 1 of the Act. Section 9D instead deems certain amounts to be taxed in the hands of South African resident shareholders,
even though no receipt or accrual took place in their hands. It is submitted that the existence and application of CFC legislation deserves its rightful place in South Africa’s residence-based tax legislation.

The deemed amount that must be included in South African residents’ income in terms of section 9D(2) of the Act is their share of the total participation rights of the net income of a CFC. The net income of the CFC must be determined in the financial reporting currency of the CFC (section 9D(6) of the Act). This net income, denominated in a foreign currency, must be translated into South African rand using the average rate of exchange for that year of assessment (section 9D(6) of the Act).

The fact that section 9D(6) of the Act refers to “the average exchange rate for that year of assessment” (emphasis added), indicates that the average rate of exchange for the South African resident’s year of assessment must be used and not the CFC’s year of assessment – that is, the CFC’s foreign tax year. Sources confirm that the year of assessment to which the South African Revenue Service (SARS) refers in section 9D(6) of the Act is the South African resident shareholder’s year of assessment.

The use of the average exchange rate (as opposed to the spot rate) for the purposes of translation is not being disputed. However, the author disputes the use of the taxpayer’s year of assessment (“the period”) to calculate the average exchange rate. The author contends that one should use the average exchange rate for the CFC’s foreign tax year, for reasons that will be elucidated below.

It should be noted that the scope of this article will not extend to the actual receipt or accrual by the South African resident shareholder in the form of a foreign dividend because it is likely that South African group companies would prefer to keep their foreign profits outside the South African exchange control environment. Section 10(1)(k)(ii), which governs the exemption of foreign dividends, was therefore also not considered in the article. Similarly, the provisions of section 25D, which govern the general rules applicable to foreign currency translations, have also not been considered in this article since section 25D only deals with amounts actually received by or accrued to a taxpayer during the year of assessment. The article focuses instead on the deeming provision of section 9D. Amendments relating to section 9D up to 31 August 2009 were taken into consideration.

2 Section 9D: CFC legislation

2.1 Scope

The provisions of section 9D, CFC legislation, are possibly applicable when a foreign company is a controlled foreign company. A foreign company, inter alia, becomes a controlled foreign company when more than 50% of the participation rights or voting rights are held directly or indirectly by South African residents (section 9D(1) – definition of controlled foreign company). There is no requirement that South African residents must be connected. For example, if three unconnected South African residents each hold 20% participation rights in a foreign company, the foreign company will be a CFC, because 60% of the participation rights are held by South African residents. Hereinafter, any percentage holding used or mentioned refers to participation and/or voting rights.
2.2 Implication

If a South African resident (together with connected persons) holds 10% or more in a CFC, there is a deemed amount that may be imputed in the income of the South African resident (section 9D(2) of the Act). There are various exclusions available under section 9D(9), which provide that certain income streams are not subject to the provisions of section 9D, but these exclusions fall outside the scope of this article. The article focuses instead on the scenarios in which the exclusions are not applicable to the CFC or not available to certain of the CFC’s income streams – that is, the provisions of section 9D result in an imputation of income.

Section 9D(2) of the Act determines what deemed amount must be included in the South African resident’s income, and reads as follows:

“(2) There shall be included in the income for the year of assessment of any resident who holds any participation rights in a controlled foreign company —

(a) on the last day of the foreign tax year of that controlled foreign company which ends during that year of assessment, an amount equal to —

(i) where that foreign company was a controlled foreign company for the entire foreign tax year,
the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day” (emphasis added).

It is clear that one must first determine the foreign tax year and then the South African resident’s proportionate amount of the net income of the CFC for that foreign tax year.

Foreign tax year is defined in section 9D(1) of the Act as

“the year or period that will be used for foreign income tax purposes or, where there is no foreign income tax payable, the financial reporting year or period”.

Net income is defined in section 9D(2A) as follows:

“(2A) For the purposes of this section the ‘net income’ of a controlled foreign company in respect of a foreign tax year is an amount equal to the taxable income of that company determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer ...” (emphasis added).

The definition of net income confirms that the period for which the net income calculation must be performed is the CFC’s foreign tax year.

2.3 Translation at average exchange rate for that year of assessment

Section 9D(2A) confirms that the net income of a CFC must be calculated using the CFC’s foreign tax year. Section 9D(6) of the Act provides that the net income of the CFC must be determined in the financial reporting currency used by the CFC, which will typically be in a currency other than South African rand. This provision makes sense because the financial records of the CFC would have been prepared in the financial reporting currency. Section 9D(6) of the Act goes on to state the following:

“(6) ... and shall, for purposes of determining the amount to be included in the income of any resident during any year of assessment under the provisions of this section, be translated to the currency of the Republic by applying the average exchange rate for that year of assessment” (emphasis added).
The fact that section 9D(6) of the Act refers to “the average exchange rate for that year of assessment” (emphasis added) indicates that the average exchange rate for the South African resident’s year of assessment must be used and not the CFC’s year of assessment – that is, the CFC’s foreign tax year. The reason for this is that when the word “that” is used in the legislation, it normally refers to the prior use of the phrase – in this case, “year of assessment”. Since the prior use of the term “year of assessment” is in the context of the South African resident, the same context should be applied to the use of the average exchange rate.

Numerous sources were examined to confirm the above view. Firstly, the original wording of section 9D(6) was considered. Section 9D(6), as introduced in 1997 by the Income Tax Act 28 of 1997, reads as follows:

“The amount apportioned to any resident under the provisions of this section, shall be converted at a date not later than the end of the financial year of the resident to the currency of the Republic and the ruling exchange rate at that date shall be applied to determine the value of the amount to be included in the income of such resident” (emphasis added).

The Explanatory Memorandum issued with the Income Tax Act of 1997 did not provide any explanations or clarity on the conversion. It is submitted that the original section 9D(6) required the South African resident taxpayer to use the spot rate (not the average exchange rate). This view might be supported by the fact that the Act did not, at that time, have a definition for the term “average exchange rate”. However, it would appear that the South African resident taxpayer had a choice about which date to use, since the words in the section refer to “at a date not later than”. It is interesting to note SARS’s original wording of section 9D(6), but it does not provide confirmation that the South African resident’s year of assessment must be used for translation purposes.

Section 9D(6) was amended during 2000 by the Revenue Laws Amendment Act 59 of 2000, when SARS moved the basis of taxation from source-based to residence-based legislation. The amended section 9D(6) reads as follows:

“The amount included in the income of any resident under the provisions of this section, shall be converted to the currency of the Republic on the last day of the foreign tax year of the controlled foreign entity and the ruling exchange rate at that date, or any other exchange rate or rates as the Commissioner may approve, determined with reference to the ruling exchange rates during such year, shall be applied to determine the value of the amount to be included in the income of such resident” (emphasis added).

The Explanatory Memorandum issued with the Revenue Laws Amendment Act 59 of 2000 did not provide any further information on the interpretation of the section. It is submitted that, contrary to the original section 9D(6), the South African resident taxpayer did not have a choice on which date to use for conversion. The legislation was clear that the last day of the CFC’s foreign tax year had to be used as the conversion date. The taxpayer then had a choice between using the spot rate on the date of the CFC’s foreign tax year or any other exchange rate as approved by the Commissioner – for example, it is submitted, an average rate of exchange.

The provisions of section 9D(6) were again amended during 2002 by the Revenue Laws Amendment Act 74 of 2002. The first paragraph of this amended section 9D(6) reads as follows (and is currently still reflected as such in the Act):

“The net income of a controlled foreign company, shall be determined in the currency used by that controlled foreign company for purposes of financial reporting and shall, for purposes of determining the amount to be included in the income of any resident during any year of
The Explanatory Memorandum issued with the Revenue Laws Amendment Act 74 of 2002 states that “the proposed legislation includes a number of technical changes to the CFE provisions, almost all of which are in favour of the taxpayer” (SARS Explanatory Memorandum 2002:14-15). The translation of the net income, however, is not addressed under any of the technical changes headings and there is merely another heading entitled “Textual changes”, which then notes that the proposed legislation includes a number of textual changes. The Explanatory Memorandum therefore sheds no light on the interpretation of the amended section or reason(s) for the amendment. Furthermore, there are no Interpretation Notes, Practice Notes or any Advance Tax Rulings issued by SARS on section 9D to provide confirmation of the fact that the South African resident’s year of assessment should be used for translating the net income of a CFC into South African rand.

The following four tax textbooks, however, also hold that the average exchange rate for the South African resident’s year of assessment must be used:


Chapter 16.3.7 of Notes on South African income tax states the following (Huxham & Haupt 2009:407):

“The net income ... is translated to the currency of South Africa by applying the average exchange rate for the year of assessment of the South African resident” (emphasis added).


The use of the average exchange rate for the South African resident’s year of assessment is also confirmed by the SARS IT 10 form: Controlled Foreign Company (CFC) return (SARS website – www.sars.gov.za).

The IT 10 form is a return which must accompany a South African resident’s annual income tax return if the resident has a participation right in a CFC. The IT 10 return requires information on the South African resident’s interest in a CFC. In Part 5: Composition of the net income of CFC (SARS IT 10 return:2), the following information, inter alia, is required: net amount in reporting currency, proportionate amount of net amount attributable to the South African resident and average exchange rate. In the guidelines for the completion of the IT 10, Parts 5 and 6, the following is explicitly stated:

“The average exchange rate to be applied is the rate applicable to the financial year end of the resident and NOT the financial year end of the CFC.”

It is clear from the research conducted and from SARS IT 10 that SARS requires the South African resident to use the average exchange rate as applicable to the resident’s year of assessment, as opposed to the CFC foreign tax year. However, this begs the question: Is it appropriate to translate the net income of the CFC according to the average exchange rate for the South African resident’s year of assessment? Should the net income not be translated at the average exchange rate for the CFC’s foreign tax year?
2.4 Translation at South African resident’s year of assessment versus CFC’s tax year

The current wording of section 9D(6) of the Act requires South African shareholders to translate their proportionate share of net income of a CFC using the average exchange rate based on the South African taxpayer’s year of assessment. It is submitted that it would be more appropriate to use the average exchange rate for the CFC’s foreign tax year.

Consider the following example. A South African resident company, with a December year-end, held 25% in a CFC as at the CFC’s foreign tax year, being April 2008. The CFC derived US$10 000 000 net income for the CFC’s foreign tax year ending April 2008. The South African resident company disposed of its 25% shareholding in the CFC on 1 May 2008. In terms of section 9D(2), the South African resident company should include US$2 500 000 (US$10 000 000 x 25%) as a deemed amount in its income for the year of assessment 2008. The current wording of section 9D(6) of the Act requires the South African resident company to translate the US$2 500 000 using the average exchange rate for the period January 2008 to December 2008 (i.e. the South African resident shareholder’s 2008 year of assessment). In other words, even though the South African resident no longer has a shareholding in the CFC as at 31 December 2008 and therefore cannot share in the retained earnings of the CFC as at 31 December 2008, the current wording of section 9D(6) requires the South African resident to use the average exchange rate for the year of assessment ending December 2008. It is submitted that one should not translate the US$2 500 000 using the average exchange rate for the South African resident’s year of assessment. It is submitted that it would be more appropriate to use the CFC’s foreign tax year, namely May 2007 to April 2008 (i.e. CFC’s 2008 foreign tax year) for translation purposes, for reasons that will be discussed below.

Section 9D(2) of the Act, which is the charging section for the CFC legislation, provides when the deemed amounts must be included in the South African resident’s tax calculation and what deemed amounts must be included. Section 9D(2), inter alia, reads as follows:

“(2) There shall be included in the income for the year of assessment of any resident who holds any participation rights in a controlled foreign company —

(a) on the last day of the foreign tax year of that controlled foreign company which ends during that year of assessment, an amount equal to —

(i) where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day”

(emphasis added).

The charging section can be summarised as follows:

Include in the South African resident’s year of assessment, based on its shareholding as at the end of the CFC’s foreign tax year, the following deemed amount:

\[
\text{Proportionate amount of net income} = \frac{\text{net income for CFC’s foreign tax year} \times \text{SA resident’s %}}{100}\%
\]

It is clear from the legislation that the deemed amount must be included in the year of assessment of the South African resident (i.e. when the deemed amount must be included). In the Appellate Division tax case, *Caltex Oil (SA) Ltd v SIR (1975)*, Botha JA stated the following:
“It is only at the end of the year of assessment that it is possible, and then its imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment.”

The amount that must be included in the South African resident’s income in terms of section 9D can therefore only be determined at the end of the year of assessment. However, it is submitted that even though the determination of the section 9D deemed amount will occur at the end of the year of assessment, in order to determine what the deemed amount should be, consideration must be given to the provisions of section 9D. Section 9D provides that a South African resident’s participation rights on the last day of the foreign tax year of the CFC as well as the total net income of the CFC for that foreign tax year must be used for the purposes of calculating the deemed amount. Therefore, in order to determine what deemed amount must be included in the resident’s year of assessment, consideration is given to the CFC’s foreign tax year only.

Based on the example that a South African resident company, with a December year-end 2008, holds 25% in a CFC and the CFC derived US$10,000,000 net income for the foreign tax year ending April 2008, the effects of the charging section can be illustrated as follows:

The South African resident company must include the following deemed amount in its 2008 year of assessment:

\[
\text{US\$}10\,000\,000 \times \frac{25\%}{100\%} = \text{US\$}2\,500\,000
\]

It is submitted that the translation of this deemed amount, per the provisions of section 9D(6) of the Act, still governs what amount must be included, and not when it must be included. It is submitted that it would be more appropriate to use the average exchange rate for the CFC’s foreign tax year.

To substantiate the submission, the remaining provisions of section 9D(2) are also considered. They read as follows:

“(ii) where that foreign company became a controlled foreign company at any stage during that foreign tax year, at the option of the resident, either —

(aa) an amount which bears to the proportional amount determined in accordance with subparagraph (i), the same ratio as the number of days during that foreign tax year that the foreign company was a controlled foreign company bears to the total number of days in that foreign tax year; or

(bb) the proportional amount determined in the manner contemplated in subparagraph (i) (as if the day that foreign company commenced to be a controlled foreign company was the first day of its foreign tax year), of the net income of that company for the period commencing on the day that the foreign company commenced to be a controlled foreign company and ending on the last day of that foreign tax year; or

(b) immediately before that foreign company ceased to be a controlled foreign company at any stage during that year of assessment before the last day of the foreign tax year of that controlled foreign company, an amount which shall be equal to, at the option of the resident, either —

(i) an amount determined in accordance with paragraph (a) (ii) (aa); or

(ii) the proportional amount determined in the manner contemplated in paragraph (a) (i) (as if the day that foreign company ceased to be a controlled foreign company was the last day of its foreign tax year), of the net income of that company determined for the period commencing on the first day of that foreign tax year.
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tax year and ending on the day before the company so ceased to be a controlled foreign company” (emphasis added).

The remaining provisions of section 9D(2) of the Act deal with scenarios in which a foreign company became a CFC during any time of the foreign tax year or where a CFC ceased to be a CFC during any time of the foreign tax year. These scenarios, as in the scenario dealt with in the first paragraph of section 9D(2) noted earlier, make no reference to the year of assessment of the South African resident, only to the foreign tax year of the CFC. Hence for the entire section 9D(2), and thus, for the purposes of calculating what deemed amount must be included in the South African resident’s income in terms of section 9D, only the CFC’s foreign tax year’s financial information is taken into consideration.

For the reasons noted above, the author is of the opinion that the translation of the deemed amount (the South African resident shareholder’s proportionate share of net income of the CFC), per the provisions of section 9D(6), still governs what amount must be included, and not when it must be included. Hence it is submitted that it would be more appropriate to use the average exchange rate for the CFC’s foreign tax year.

As an additional consideration, the author also considered the financial impact on the South African resident shareholder as a result of the current wording of section 9D(6). As noted earlier, at the time of the change of section 9D(6) per the Revenue Laws Amendment Act 74 of 2002 to reflect section 9D(6) as it is currently in the Act, the Explanatory Memorandum issued with the Amendment Act stated the following: “the proposed legislation includes a number of technical changes to the CFC provisions, almost all of which are in favour of the taxpayer” (emphasis added) (SARS Explanatory Memorandum 2002:14). The author will now show by way of an example that the change to the wording of section 9D(6) per the Revenue Laws Amendment Act 74 of 2002 was generally not in the taxpayer’s favour.

To illustrate the possible financial impact of the two different methods, that is, translation at the average exchange rate for

1 the South African resident’s year of assessment, or
2 the CFC’s foreign tax year,

a number of examples will be used.

To illustrate the examples, a portion of the IT 10 return will be used (SARS IT 10 return: Part 5). Furthermore, the actual average exchange rates as published on SARS’s website have been used for translation purposes in all the examples (SARS website: Average exchange rates for a year of assessment – table A).

<table>
<thead>
<tr>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assume a South African resident company holds 25% in a CFC.</td>
</tr>
<tr>
<td>The company’s financial year-end, and therefore its year of assessment, is 31 December 2008.</td>
</tr>
<tr>
<td>Assume the CFC’s financial year-end is 30 April 2008.</td>
</tr>
<tr>
<td>The CFC’s foreign financial reporting currency is US dollars.</td>
</tr>
<tr>
<td>Assume the CFC’s net income for the foreign tax year April 2008 amounts to US$10 000 000.</td>
</tr>
</tbody>
</table>
Example 1: Using US dollars as the foreign financial reporting currency

Example 1.1: Using the average exchange rate for the South African resident’s year of assessment

<table>
<thead>
<tr>
<th>Part 5: Composition of the net income of the CFC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net amount in reporting currency</strong></td>
</tr>
<tr>
<td>-------------------------------</td>
</tr>
<tr>
<td>US$10 000 000</td>
</tr>
</tbody>
</table>

Thus the amount that will be included in the South African resident company’s tax return for the 2008 year of assessment will be R20 629 250.

The South African tax liability (before taking into account possible foreign tax credits) on the imputed section 9D amount is R5 776 190 (R20 629 250 at 28%).

Example 1.2: Using the average exchange rate for the CFC foreign tax year

<table>
<thead>
<tr>
<th>Part 5: Composition of the net income of the CFC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net amount in reporting currency</strong></td>
</tr>
<tr>
<td>-------------------------------</td>
</tr>
<tr>
<td>US$10 000 000</td>
</tr>
</tbody>
</table>

The South African tax liability (before taking into account possible foreign tax credits) on the imputed section 9D amount is R5 029 780 (R17 963 500 at 28%).

The South African resident company therefore has to pay an additional R746 410 in taxes merely because of the period that must be used for calculating the average exchange rate (i.e. the resident company’s year of assessment as opposed to the CFC’s foreign tax year). It is also worthwhile to note that the taxes payable as a result of the application of section 9D are payable irrespective of whether the South African resident shareholder actually received cash or cash equivalent from its investment in the CFC. In other words, the section 9D taxes are payable whether or not the CFC declared a foreign dividend to the South African resident shareholder (i.e. an actual receipt or accrual for the South African resident).

To substantiate the findings of the negative tax effect on the South African resident, consideration was also given to two other major foreign currencies: the euro and the British pound.

The negative tax effect on the South African resident, based on these two currencies, can be illustrated as follows:

Example 2: Using the euro as the foreign financial reporting currency

Example 2.1: Using the average exchange rate for the South African resident’s year of assessment

<table>
<thead>
<tr>
<th>Part 5: Composition of the net income of the CFC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net amount in reporting currency</strong></td>
</tr>
<tr>
<td>-------------------------------</td>
</tr>
<tr>
<td>€10 000 000</td>
</tr>
</tbody>
</table>
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The South African tax liability (before taking into account possible foreign tax credits) on the imputed section 9D amount is R8 436 190 (R30 129 250 at 28%).

**Example 2.2: Using the average exchange rate for the CFC foreign tax year**

**Part 5: Composition of the net income of the CFC**

<table>
<thead>
<tr>
<th>Net amount in reporting currency</th>
<th>Proportional amount of net amount attributable to South African resident</th>
<th>Average exchange rate</th>
<th>Amount converted to rand</th>
</tr>
</thead>
<tbody>
<tr>
<td>€10 000 000</td>
<td>€2 500 000</td>
<td>10.3352</td>
<td>R25 838 000</td>
</tr>
</tbody>
</table>

The South African tax liability (before taking into account possible foreign tax credits) on the imputed section 9D amount is R7 234 640 (R25 838 000 at 28%).

The South African resident company therefore has to pay an additional R1 201 550 in taxes merely because of the *period* that must be used for calculating the average exchange rate.

**Example 3: Using the British pound as the foreign financial reporting currency**

**Example 3.1: Using the average exchange rate for the South African resident’s year of assessment**

**Part 5: Composition of the net income of the CFC**

<table>
<thead>
<tr>
<th>Net amount in reporting currency</th>
<th>Proportional amount of net amount attributable to South African resident</th>
<th>Average exchange rate</th>
<th>Amount converted to rand</th>
</tr>
</thead>
<tbody>
<tr>
<td>GBP10 000 000</td>
<td>GBP2 500 000</td>
<td>15.1254</td>
<td>R37 813 500</td>
</tr>
</tbody>
</table>

The South African tax liability (before taking into account foreign tax credits) on the imputed section 9D amount is R10 587 780 (R37 813 500 at 28%).

**Example 3.2: Using the average exchange rate for the CFC foreign tax year**

**Part 5: Composition of the net income of the CFC**

<table>
<thead>
<tr>
<th>Net amount in reporting currency</th>
<th>Proportional amount of net amount attributable to South African resident</th>
<th>Average exchange rate</th>
<th>Amount converted to rand</th>
</tr>
</thead>
<tbody>
<tr>
<td>GBP10 000 000</td>
<td>GBP2 500 000</td>
<td>14.4118</td>
<td>R36 029 500</td>
</tr>
</tbody>
</table>

The South African tax liability (before taking into account possible foreign tax credits) on the imputed section 9D amount is R10 088 260 (R36 029 500 at 28%).

The South African resident company would therefore have to pay an additional R499 520 in taxes merely because of the *period* that must be used for calculating the average exchange rate.

It is clear from the above examples that, currently, based on the actual devaluation of the South African rand against other major currencies (see the graphs on the pages below), South African taxpayers are definitely getting the short end of the stick because they have to use their year of assessment as opposed to the CFC’s foreign tax year. However, the opposite is also true: Should the South African rand strengthen against foreign currencies, the taxpayer would be in a more advantageous position and SARS would get the short end of the stick.
However, to substantiate the view that the South African rand has devaluated against other major currencies, graphs are provided below showing the devaluation of the rand against the three currencies covered in this article, namely the US dollar, euro and British pound. For the purposes of the graphs, the average exchange rates in table A, as published on the SARS website, have been used (SARS website: Average exchange rates for a year of assessment – table A). The periods covered are from January 2006 to February 2009.

**Figure 1** The South African rand against the US dollar

**Figure 2** The South African rand against the euro
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It should be noted that the South African tax liability as calculated in the examples above is the liability before taking into account any possible foreign tax credits, because the impact of the foreign tax credits falls outside the scope of this article. It should be noted that section 6quat of the Act, the section governing the claiming of foreign tax credits against the South African taxpayer’s tax liability, uses the average exchange rate for the South African resident’s year of assessment. This fact could have been the reason for the change in section 9D(6) as per the Revenue Laws Amendment Act 74 of 2002 to use the average exchange rate as for the South African resident’s year of assessment. The authors concedes that if one uses the average exchange rate for the South African resident’s year of assessment for the purposes of calculating the imputed section 9D amount and then again for claiming any foreign tax credits, there is an alignment in terms of the overall fiscal policy. However, it is submitted that this particular alignment is not necessarily appropriate.

One should first possibly determine what deemed amount must be included in the South African resident’s income for the purposes of section 9D of the Act and section 6quat must then be aligned to ensure that the overall fiscal policy is aligned.

Finally, consideration was also given to one reputable foreign tax authority which also has CFC legislation in place. This was done in order to see what translation rules this authority applies for translating amounts attributable from a CFC. Specific consideration was given to the Australian Taxation Office. Section 960-80, Subdivision 960-D, Part 6-1, Chapter 6 of the Income Tax Assessment Act 1997, deals with translation rules. Section 960-80(7) provides that an entity must comply with the regulations in translating an amount into Australian currency. Regulation 960-80.03, subdivision 960D of Part 6 of the Income Tax Assessment Regulations 1997, deals with the translation rules applicable for translating attributable income of a CFC from the functional currency into Australian currency. Regulation 960-80.03(4) stipulates the following:

“For subsection 960-80(7) of the Act, if, on or after the day on which the Income Tax Assessment Amendment Regulations 2005 (No 2) are registered, an entity that is an attributable taxpayer in

Figure 3 The South African rand against the British pound

[Graph showing the exchange rate from January 2006 to January 2009]
relation to a CFC translates an amount that is the attributable income of a CFC from the applicable functional currency into Australian currency on a day in accordance with an item of the table in subsection 960-80(1) of the Act, the entity must translate the amount using:

(a) an exchange rate that is an average of all of the exchange rates during the period, not exceeding 12 months, in which the CFC carries on the relevant business or other activity; or

(b) if the entity makes an election in writing to use the exchange rate applicable on the last day of the CFC’s statutory accounting period - that exchange rate” (emphasis added).

It is clear from the Australian Taxation Office’s Regulations to their Income Tax Assessment Act 1997 that, for translating attributable income of a CFC into Australian currency, reference is only made to the CFC business periods and not the Australian shareholder’s year of assessment.

In addition, consideration was given to the translation rules applicable to the unilateral tax relief available to an Australian resident who has attributable income of a CFC included in his or her taxable income. On 24 September 2007, the Australia Taxation Office introduced new foreign income tax offset rules that replaced the former foreign tax credit rules (Tax Laws Amendment [2007 Measures No. 4] Act 2007 143 of 2007). These new tax offset rules apply in relation to income years, statutory accounting periods and notional accounting periods starting on or after 1 July 2008. However, the new foreign income tax offset rules did not amend the translation rules.

In essence, the translation rules provide that foreign tax offset amounts be translated into Australian currency on the dates when the taxes are paid, unless one of the regulations applies. (Foreign exchange [forex]: functional currency – accounting and reporting guide.) If an Australian resident is an attributable taxpayer in relation to a CFC, the regulations apply (Regulation 960-80.03, Subdivision 960D of Part 6 of the Income Tax Assessment Regulations 1997). Hence the same regulations as used for translating attributable income of a CFC (as quoted above) apply to an Australian resident who can claim a foreign income tax offset. In other words, any foreign taxes suffered by a CFC that may be claimed by an Australian resident as a tax offset are translated from the functional currency into Australian currency using the average exchange rate for the 12-month business period of the CFC or, if so elected, the exchange rate applicable on the last day of the statutory accounting period of the CFC.

It is clear from the discussions above that the Australian Taxation Office only gives regard to the business periods of the CFC for translation purposes. The author submits that this is the correct approach. Furthermore, the Australian Taxation Office translation rules in relation to attributable income of a CFC and the corresponding foreign income tax offsets are aligned.

3 Conclusion

The existence and application of CFC legislation deserves its rightful place in South Africa’s residence-based tax legislation. If South African residents in aggregate own more than 50% of the participation rights in a foreign company, the foreign company will be a controlled foreign company. If a South African resident (together with connected persons) holds 10% or more in a CFC, there is a deemed amount that may be imputed in the income of the South African resident, even though no actual receipt or accrual took place in the
hands of the shareholder. In other words, South African residents are taxed in terms of section 9D if they have 10% or more participation rights in a CFC (together with connected persons) which does not meet certain criteria necessary for exclusion from the provisions of section 9D.

The deemed amount to be included in the South African resident’s income is referred to as the net income of the CFC. The period for which the net income calculation must be performed is the CFC’s foreign tax year. However, the net income, determined in the foreign financial reporting currency, must be translated using the average exchange rate for the South African resident’s year of assessment. The period used for calculating the average exchange rate will therefore be the resident’s financial year and not the CFC’s financial year. It is submitted that, given the steady decline of the South African rand against other major currencies, a South African taxpayer is generally getting the short end of the stick if the net income of a CFC attributable to the South African shareholder is translated using the average exchange rate for that resident’s year of assessment. It is conceded that should the rand strengthen against foreign currencies, SARS will be getting the short end of the stick. Either way, it is submitted that the net income of a CFC attributable to the South African shareholder must be translated into rand, using the average exchange rate for the CFC’s foreign tax year, for the following reason: The deemed amount that must be included in the South African resident’s income per section 9D of the Act (i.e. the resident’s proportionate share of net income) is calculated with reference to the CFC’s foreign tax year and the translation of this deemed amount per section 9D(6) still governs what amount must be included and not when. It is therefore submitted that it would be more appropriate to use the average exchange rate for the CFC’s foreign tax year.

**Bibliography**


Caltex Oil (SA) Ltd v SIR 1975(1) SA 665 (A)


