

TAX

Exchange control relaxation: removal of loop

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On 4 January 2021 the Financial Surveillance Department of the South African Reserve Bank (FinSurv) issued a circular on the removal of the so-called "loop" prohibitions contained in the *Currency and Exchanges Manual for Authorised Dealers* (the Manual), wherein are set out the approved practices as set out by for use Authorised Dealers, i.e. the commercial banks.

At the outset, it must be noted that (a) the basis of what is allowed or not allowed under the Manual is what is contained in the Exchange Control Regulations, 1961, and the discretions given to FinSurv and the Minister thereunder, but nowhere in those regulations does one find the word "loop", or any prohibition against such a "loop". This is entirely an interpretation of the prohibition in regulation 10(1)(c) of those regulations (the Regulation) that a South African resident may not, without approval, export capital or the right to capital from South Africa.

While sending out money to invest back into South Africa might well, in certain circumstances, represent a breach of the Regulation, hitherto FinSurv (and as a result, the Authorised Dealers) have given the prohibition a far wider interpretation than a proper legal interpretation would allow, and there is no doubt, in my view, many of the so-called unlawful structures would, if brought before the courts, be found not to be in breach of the Regulation, where the courts would apply proper rules of interpretation of statutory instruments.

Be that all as it may, whereas originally the prohibition of a loop – where a South African resident invests in an offshore structure (e.g. a foreign company or a foreign trust) which, in turn, invests into South African assets – was in place to protect South Africa's foreign currency reserves from an exchange control point of view, for many years FinSurv has not been terribly concerned about this aspect, but has enforced the prohibition rather for the purpose of protecting the tax base. For example, whereas interest on a loan would normally be taxable at the rate of 45%, if the loan came from abroad the withholding tax might be limited to 15% (or less, if the lender is resident in a country with a suitable double tax agreement with SA); whereas dividends tax is at the rate of 20%, if the investment came from a foreign company resident in a suitable jurisdiction with a favourable double tax agreement, the withholding tax might be reduced to as low as 5%; and whereas shares in a South African company held locally would be subject to CGT, if held through an offshore structure it would usually be exempt from CGT.

And if there was any doubt about this motivation, it was dispelled in last year's Budget where it was announced that the loop prohibition would be removed following amendments to the Income Tax Act, 1962 which removed, in certain instances, the benefits I have mentioned in relation to dividends and CGT. And now that those amendments have been passed by Parliament, we are seeing the removal of the loop prohibitions contained in the Manual.

In summary, the changes are as follows:

- Up until now, South African resident individuals, using their foreign investment allowances, South African corporates, using their allowances to make foreign direct investments and South African private equity funds wishing to invest abroad, between them would be entitled to hold up to 40% of a foreign company which, in turn, had invested into South Africa. (Originally nothing would have been allowed, but the rules were gradually relaxed.) The changes now allow the individuals, corporates and private equity funds with authorised foreign assets themselves to invest into South African, (though it is not quite clear how this will be designated so as to enable the income to flow abroad, and any profits to be able to be remitted abroad, as opposed to the investment effectively constituting a repatriation of the capital).
- In addition to what is stated above, the individuals/corporates/funds may invest in South African assets through an offshore structure (i.e. a loop structure). In this case, however, the investment must be reported to an Authorised Dealer and there must be an annual

progress report to FinSurv via the Authorised Dealer. Moreover, the Authorised Dealer must view an independent auditor's confirmation or suitable documentary evidence verifying the transaction is concluded on an arm's length basis, for a fair and market-related price.

- Similarly, individuals who received foreign inheritances were prohibited from investing them back into South Africa. This prohibition has been removed.
- When South African residents borrow from abroad they had to confirm that there was no direct or indirect South African interest in the foreign lender. This requirement has been abolished.
- Interestingly, whereas previously the prohibition on investing from offshore related to investing into any Common Monetary Area (CMA) country – being, in addition to South Africa, Lesotho, Swaziland and Namibia – now the requirement to report to the Authorised Dealer, as set out above, applies only to investments into South Africa. The absence of a prohibition to invest via offshore into another CMA country, and limiting the requirement to report only when investing into South Africa, gives rise to a clear implication that there is no longer any restriction upon a South African investor investing into one of the other CMA countries via an offshore structure, without the need to report. On the basis that the loop prohibition was to protect the tax base, which is no longer necessary, this makes perfect sense, because an investment into another CMA country is simply a foreign investment for tax purposes, no different to any other foreign investment. And the fact that it is a requirement for the investment into SA via an offshore structure to be reported to FinSurv seems to indicate that this information is being gathered so it can be shared with SARS.
- Even while the previous relaxations allowed South African resident individuals to invest into offshore companies which invested into South Africa, subject to the 40% maximum, the relaxation never went so far as to allow offshore trusts with South African beneficiaries to invest into South Africa. Given the wide wording of the new rules, i.e. the circular uses the expression "offshore structure", it is now clear that an offshore trust investing back into South Africa, either directly or through an offshore company, is no longer prohibited – what is required is that it be reported.

From a tax perspective, in brief, when South African residents hold the majority shares in a foreign company which, in turn, holds shares in a SA company, (a) the usual exemption from SA tax on the foreign dividend will not be available to the extent that the foreign dividend is attributable any dividend received by the foreign company on the shares in the SA company, and (b) the usual exemption from CGT on sale of the shares in the foreign company will not be available to the extent that the gain is attributable to the shares in the South African company held by the foreign company.



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