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Proposed tax changes to facilitate the relaxation of exchange control require refinement

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In the Budget Speech which was delivered on 25 February this year it was announced that the exchange control system would be restructured towards what was called a new capital flow management framework. The premise on which the framework is based is a system of "positive bias" where all cross border transactions will be allowed except those that are subject to the capital flow management measures in respect of transactions which pose a high risk in respect of illegitimate cross border financial flows. It was stated that one of the main features of the capital flow management framework is to strengthen the measures that will fight tax evasion.

The Financial Surveillance Department of the South African Reserve Bank (FinSurv) views offshore structures established by a resident (or in which a resident has an interest) that re-invests into the Common Monetary Area (CMA) by acquiring shares or other interests in a CMA company or CMA asset as a contravention of the Exchange Control Regulations. This is colloquially referred to as a 'loop structure'.

The FinSurv view such structures as resulting in or have the potential to result in the direct or indirect export of capital abroad to a non-resident company or other relevant non-resident trust or entity for the ultimate benefit of a resident. The export of capital could be in the form of dividends arising from increased profits, revenue reserves or capital reserves from CMA growth assets of the CMA company.

Until 31 October 2019 South African resident individuals were not allowed to hold shares in an offshore company that in turn held investments in South Africa as this would have constituted a prohibited loop structure. From 31 October 2019, South African exchange control resident individuals may hold up to 40% in a foreign company that in turn holds investments in South Africa. A similar rule exists for South African corporates.

In instances where South African resident individuals or South African corporates intend to acquire an interest in an offshore company which exceeded 40% and such company held or was to hold investments in the CMA, exchange control approval can only be given by National Treasury, which can take up to 12 months to obtain, if at all.

One of the changes to the current exchange control rules envisaged above is the relaxation of the approval that is required for loop structures where the 40% shareholding is exceeded. This is a welcome relaxation. However, it was stated in Budget Review that the relaxation of exchange control rules in respect of loop structures will be implemented after the tax amendments are implemented to address the effect of reducing South Africa's tax base by an offshore company in a loop structure. While the proposed "loop structure" relaxation has focused on outbound shareholdings by South African residents in foreign companies, it is worth noting that the FinSurv holds the view that a "loop structure" can arise in various forms, including through offshore discretionary trusts. The relaxation referred to above which applies since 31 October 2019 does not extend to offshore trusts in which South African residents are beneficiaries, but is limited to the situation where resident individuals in their personal capacities hold interests in foreign companies which in turn hold assets in South Africa.

The main tax benefits that have been identified in relation to a loop structure appear to be the treatment of dividends and capital gains on the sale of shares in a foreign company. In respect of the former, dividends withholding tax on a dividend which is declared by a South African company to an offshore company which is resident in a country that is a signatory to a double taxation agreement with South Africa can be reduced from the domestic dividends tax rate of 20% to as low as 5%. Should the offshore company declare a dividend to a South African tax resident shareholder which holds at least 10% of the equity shares and voting rights in such company, the dividend will be exempt from income tax. On a simplified basis, if the South African resident shareholder (which is not a company) receives a dividend from

the South African company directly and not via the offshore company, the shareholder would have been subject to dividends tax at 20% whereas through the "loop" structure the dividend is subject to an effective 5% tax. This of course assumes that the offshore company is resident in a country which does not levy any withholding tax on dividend distributions.

However, it is worth noting that this treatment only applies if the shareholder in the offshore company is not a corporate. If, however, the shareholder is a corporate, a "loop" structure could give rise to a greater tax cost relative to a direct investment in the South African company that is declaring the dividend. This is because the first dividend distributed to the offshore company would be subject to dividends tax at a reduced rate of 5% and if such dividends are received by the South African shareholder in the offshore company and are ultimately declared by the South African company to non-corporate shareholders, dividends tax at 20% will be levied on the final dividend. This could result in a total dividends tax liability of 24% (i.e. 5% + (20% of 95%)) on amounts which are ultimately sourced from the same after-tax profits of the initial South African company which declared the dividend to the offshore company.

Within this context the restriction on "loop" structures will be relaxed on the premise that the proposed amendments to the taxation of dividends received by a controlled foreign company (CFC) as well capital gains from the sale of shares in a CFC will address the apparent mischief. A CFC is an offshore company in which South African residents, either alone or collectively, hold more than 50% of the participation rights. The CFC rules provide for the taxable income of the CFC to be calculated as if the CFC was a South African taxpayer and to be attributed to and taxed in the hands of the resident shareholders. In view of the fact that domestic dividends are included in gross income under paragraph (*k*) of the definition of "gross income" in the Income Tax Act (Act), but may qualify for exemption under section 10(1)(*k*)(i), such dividends would typically not be included in the net income of the CFC.

The CFC rules are currently such that if a South African individual held more than 10% of the equity shares and voting rights in a CFC, and that CFC received dividends from a South African company, which it on-declared to the South African shareholder, that shareholder would receive the dividends tax free. Similarly, under the current rules, a South African tax resident shareholder of a CFC could dispose of his or her shares in a CFC at a profit to an unrelated non-resident, without triggering any tax. This is often referred to as the CGT participation exemption. This exemption is beneficial in that if the CFC disposed of its investment in a South African company the resultant gain would generally be subject to tax in the hands of the shareholders, whereas a sale of the shares in the CFC would not be subject to CGT.

In terms of the proposed draft changes to the Act contained in the Draft Taxation Laws Amendment Bill, 2020 (Draft TLAB) it is proposed that the Act will be amended to tax South African resident shareholders of CFCs, under the CFC rules, on domestic dividends paid to a CFC in a loop structure. The tax on the dividends will be based on a 20/28 ratio, so that 20/28 of the dividend will be included in the taxable income of the CFC, and this is intended to tax the dividend at an effective rate of 20% (i.e. 20/28 * 28% = 20%). This ratio achieves this objective where the shareholder of the CFC is a company, however, where the shareholder is a natural person or a trust the dividend could be subject to an effective tax rate of 32.14% (i.e. 20/28 * 45% = 32.14%).

Further, in its current form, the Draft TLAB does not provide a credit for the dividends tax that the CFC is subject to, which will give rise to an effective tax on the dividend distributed to the CFC of at least 25%, which is 5% greater than the domestic dividends tax rate. The proposed changes to the Act also fail to recognise the fact that a corporate shareholder in a CFC will be required to withhold dividends tax on a distribution it distributed to its non-corporate shareholders. The effect of this is that a single dividend distributed by a South African company to a CFC could ultimately be subject to three levels of taxation, the first being dividends tax at a reduced rate (the lowest of which is 5%), tax on an amount equal to the dividend received by the CFC in the hands of the resident shareholder at 20% and potentially a further 20% withholding tax on dividends distributed by the corporate shareholder of the CFC if the same amounts are received by the corporate shareholder and distributed as a dividend.

In addition to the proposed amendments on the taxation of dividends received by a CFC, it is also proposed that the CGT participation exemption should not apply to the disposal of shares in a CFC to the extent the value of the assets of the CFC are derived from South African assets. It would be for the taxpayer to determine what portion of the gain is derived from the South African assets and which portion is exempt, which will add complexity to taxpayers' compliance.

A number of submissions have been made to National Treasury to rectify the multiple levels of taxation. In particular, that a credit be granted to the CFC for dividends tax withheld and that CFC inclusion only applies to CFC's which are held by non-corporate shareholders. Assuming the submissions are taken into account and given effect, it remains to be seen how effective these changes will be as, in our experience, CFC structures predominantly exist within corporate groups.

While the proposed "loop structure" relaxation has focused on outbound shareholdings by South African resident in foreign companies, it is worth noting that the FinSurv holds the view that a "loop structure" can arise in various forms, including through offshore discretionary trusts. The Draft Explanatory Memorandum to the Draft TLAB states that there is no need to provide for specific legislation in this regard.

The reason is that, in terms of section 25B(2B) of the Act, introduced two years ago, if an offshore trust holds more than 50% of the participation rights in an offshore company, any dividend received by the trust (even if the dividend is sourced from profits comprising a dividend from a South African company) which is capitalised and then in a later year is distributed to a South African resident beneficiary, will be taxable at the effective rate of 20% in the hands of the beneficiary; and that is only if, in the year it is received by the trust it is not taxable in the hands of the South African resident donor under the attribution rules in section 7(8) of the Act and similar rules apply for CGT purposes.



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