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TAX & EXCHANGE CONTROL **ALERT**

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Important proposed tax amendments pertaining to the exchange control relaxation of loop structures

In the National Budget speech delivered in February this year, the Minister of Finance (Minister) announced the further relaxation of the restriction on loop structures with the caveat that the said relaxation would be accompanied by amendments to the tax laws in order to prevent the mischief that the restrictions were aimed at. We discussed the Minister's announcement in our Tax & Exchange Control Alert of 27 February 2020. This note provides a brief synopsis of the proposed tax amendments in relation to loop structures as proposed in the Taxation Laws Amendment Bill, 2020.

Important proposed tax amendments pertaining to the exchange control relaxation of loop structures

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Background

The so-called loop structure is, in simple terms, the formation, by a South African resident (individual or company), of a foreign company through which the South African resident "*indirectly exports capital*" by investing in the foreign non-resident company that in turn reinvests into the Common Monetary Area (CMA). The reinvestment can take the form of acquiring shares, loans or some other interest in a CMA asset or CMA company. The CMA consists of South Africa, Eswatini, Lesotho and Namibia. The export of capital may then arise in the form of dividends declared by the company in the CMA to the foreign company.

Regulation 10(1)(c) of the Regulations made under the Currency and Exchanges Act 9 of 1933 (Exchange Control Regulations) forms the cornerstone of the general prohibition on loop structures. It states that no person shall, except with permission granted by National Treasury (Treasury) in accordance with any such conditions as may be imposed by Treasury, enter into any transaction whereby capital or any right to capital is directly or indirectly exported from South Africa. The Financial Surveillance Department of the South African Reserve Bank (FinSurv) currently regards transactions that result in or have the potential to result in the direct or indirect export of capital as a contravention of the Exchange Control Regulations.

Given the gradual relaxation of exchange controls in South Africa, there are currently a limited number of circumstances under which a loop structure may be acceptable namely:

- as an exception to Regulation 10(1)(c), South African residents are permitted to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign company which may in turn hold investments in any CMA country;
- where a South African resident has created an unintentional loop structure, by investing with non-resident asset or fund managers who invest in foreign companies that have CMA assets, or in offshore global investment funds that hold CMA investments (directly or indirectly) over which the South African investor has no control; and
- where South African technology, media, telecommunications, exploration, and other research and development companies establish an offshore company to raise foreign funding for their operations, subject to certain conditions.

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Tax legislation is a more appropriate tool to combat tax avoidance, as opposed to the policy restricting the use of loop structures.

The intention is to further relax the exchange control rules relating to loop structures but that this will only be implemented after tax amendments are effected to address the effect of reducing South Africa's tax base by an offshore company in a loop structure. This is in line with the announcement in the National Budget speech earlier this year, that tax legislation is a more appropriate tool to combat tax avoidance, as opposed to the policy restricting the use of loop structures.

Current tax rules applicable to loop structures and reasons for change

Currently where, for instance, a South African resident acquires shares in a non-resident company which then acquires shares in a resident company (referred to herein as Targetco), thereby creating a loop structure, the following may be applicable:

- In terms of section 10B of the Income Tax Act 58 of 1962 (Act) any foreign dividend received by or accrued to a person is exempt from normal tax if that person, whether alone or together with any other company forming part of the same group of companies as that person, holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend. This means that when a non-resident company distributes a dividend to a South African resident, that foreign dividend will be exempt from normal income tax in the hands of the South African resident recipient shareholder (provided the 10% minimum shareholding is met).
- Furthermore, in terms of paragraph 64B of the Eighth Schedule to the Act, the South African resident must disregard any capital gain or capital loss determined in respect of the disposal of any equity share in any foreign company if that South African resident, whether alone or together with any other company forming part of the same group of companies as that person immediately before the disposal, held an interest of at least 10% of the equity shares and voting rights in that foreign company held the interest for a period of at least 18 months prior to the disposal; and the shares are disposed of to a third party non-resident at market value.
- Subparagraph 64B(4) further states that a person must disregard any capital gain determined in respect of a foreign return of capital received or accrued to that person from a foreign company, as defined in section 9D, where that person whether alone or together with any other company forming part of the same group of companies as that person, holds at least 10% of the total equity shares and voting rights in that company.

According to Treasury, the existence of a non-resident company in the loop structure creates a tax planning opportunity for the South African resident with respect to dividends tax. This is because the dividend flowing through the structure may not be taxed at the current dividends tax rate of 20%, but at a reduced rate or in some instances, will be exempt from tax depending on the applicable double taxation treaty.

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A section 6*quat* tax credit would potentially not be of much assistance as that is limited in its application to foreign taxes whereas the dividends tax is imposed by SARS.

In terms of section 9D, also referred to as the controlled foreign company rules (CFC Rules), where one or more South African residents, directly or indirectly hold more than 50% of the total participation rights or voting rights in a foreign company, that company is a Controlled Foreign Company (CFC). In terms of the rules, the proportional amount of the net income of the CFC is imputed in the hands of the resident shareholder based on its percentage of participation rights. Currently when the calculation is performed, all of the CFC's dividend income is excluded, as it is exempt from normal tax in terms of section 10(1)(k) of the Act.

As the restrictions to loop structures are gradually relaxed (e.g. shareholdings in excess of 40% arise), it will thus be possible to set up a structure where a South African resident holds equity shares in a foreign company – i.e. a CFC, that owns a South African resident company (Targetco). This means that any dividends flowing from a company in the CMA through a loop structure to the South African resident may not be subject to dividends tax (or at least be subject to a lower rate of dividends tax given the application of a double tax treaty). Furthermore, the dividends would be excluded from the calculation of the net income of the CFC in terms of section 10(1)(k) of the Act, read with the CFC Rules. The result would thus be that there would be no imputation of the CFC's net income (i.e. dividends) in the hands of the South African resident shareholder.

First Draft Taxation Laws Amendment Bill

In the first Draft Taxation Laws Amendment Bill, 2020 (First Draft TLAB) circulated on 31 July 2020 for public comment, Treasury proposed that changes be made to the CFC rules so that a non-resident company that is a CFC must include a portion of a dividend that is received or accrued from a South African resident company (i.e. Targetco) in its net income. Furthermore, that in order to determine the portion of a dividend that is not exempt, it was proposed that the non-resident CFC included in its net income an amount equal to the ratio of the number 20 to 28 of the dividend that is received or accrued from a resident company. For example, assuming a R100 dividend declared by Targetco, only approximately R72 would have been included in the CFC's net income.

Comments submitted by the public on the First Draft TLAB suggested that the result of the proposed amendment would be that any resident holder of participation rights in a CFC would be subjected to income tax on the dividends received by the CFC in addition to the dividends tax imposed on such dividends when declared by Targetco. Said differently, the dividend declared by the South African resident (i.e. Targetco) would be subject to a dividends tax at a rate of 20% unless reduced in terms of an applicable Double Taxation Agreement (DTA). A portion of this dividend would then be included in the calculation of the CFC's net income which in turn would be imputed in the hands of the South African resident shareholder and taxed at the rate applicable to the South African shareholder of the CFC. A section 6*quat* tax credit would potentially not be of much assistance as that is limited in its application to foreign taxes whereas the dividends tax is imposed by SARS.

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SARS stated that it accepted that the current amendment must be amended such that the aggregate of dividends received or accrued by the CFC in a loop structure during the foreign tax year of that CFC may be reduced with reference to the dividends tax imposed on those dividends.

The First Draft TLAB also proposed that the participation exemption provided for in paragraph 64B should not apply to the disposal of shares in a CFC to the extent that the value of the assets of the CFC is "*derived from assets*" in South Africa. On this aspect, public comments on the First Draft TLAB suggested that this proposed method of apportionment would not be appropriate as it could lead to inequitable results for both the fiscus and the taxpayer. Its was thus suggested that the apportionment should be based on the extent to which the capital gain or loss was "*attributable*" to assets in South Africa. The wording "*derived from assets*" in South Africa arguably encompasses a much broader set of circumstances.

Response to comments

On 13 October 2020, SARS published the Draft Response Document on, amongst others, the 2020 Draft Taxation Laws Amendment Bill which addressed some of the concerns raised with regards to the proposed amendments.

In response to the comment that the resident holder of participation rights in a CFC would be subject to income tax on the dividends received by a CFC, in addition to the CFC being subject to dividends tax on such dividends, SARS stated that it accepted that the current amendment must be amended such that the aggregate of dividends received or accrued by the CFC in a loop structure during the foreign tax year of that CFC may be reduced with reference to the dividends tax imposed on those dividends.

The amended wording of the Taxation Laws Amendment Bill, 2020 introduced to National Assembly on 28 October 2020 (Second Draft TLAB) now takes into account dividends tax already imposed on the dividends declared by Targetco. The amendment to section 9D now provides for a sliding scale in terms of which a deduction from the aggregate amount of dividends received by or accrued to a CFC is available.

It provides for a deduction of:

- 100% of the amount of any dividends in respect of which dividends tax has been paid at 20%; or
- 50% of the amount of any dividends in respect of which dividends tax has been paid at 10%; or
- 40% of the amount of any dividends in respect of which dividends tax has been paid at 8%; or
- 37.5% of the amount of any dividends in respect of which dividends tax has been paid at 7.5%; and
- 25% of the amount of any dividends in respect of which dividends tax has been paid at 5%.

The above deductions are based on the various percentages provided for in the DTAs entered into between South African and foreign jurisdictions with the most common being the 10% relief and the relief that reduces dividends tax to 5%. Some DTAs provide for a maximum dividends tax rate of 15% although interestingly the current draft bill does not reflect this percentage.

SARS noted that in relation to the proposed paragraph 64B amendment, the changes were made as a result of the proposed changes to the current exchange control rules and not aimed at raising any revenues. In addition, from a practical point of view, it may be difficult to do valuations of capital gains on individual assets and that the method may be challenging when a CFC has a relatively large number of assets.

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The cumulative result of the amendments is that dividends declared by the resident company (i.e. Targetco) to the CFC, will be subject to dividends tax at a rate of 20% unless reduced by an applicable DTA.

The new wording of the proposed amendment to paragraph 64B in the Second Draft TLAB now states that paragraph 64B must only apply in respect of any capital gain or loss determined in respect of the disposal of any share in a CFC to the extent that the value of the assets of that CFC is "*attributable*" to assets directly or indirectly located, issued or registered in the Republic.

Conclusion

The cumulative result of the amendments is that dividends declared by the resident company (i.e. Targetco) to the CFC, will be subject to dividends tax at a rate of 20% unless reduced by an applicable DTA. Thereafter a portion of that income will be included in the calculation of the net income of the CFC in terms of section 9D with reference to the rate of dividends tax imposed. Where the dividend has already been taxed at 20% it will be fully deducted resulting in an effective 20% tax rate. The resident shareholder of the CFC will be taxed on the income as determined in terms of the CFC Rules, to the extent that the amount has not been subject to dividends tax.

When the CFC declares a dividend to the resident shareholder, this shareholder may be able rely on section 10B(2)(a) or (c) for purposes of exempting that foreign dividend from normal tax depending on which provision would provide a full (or partial exemption) of the dividends declared by the CFC.

Finally, it is interesting to observe that, where a South African resident company sets up a loop structure, dividends declared by the South African target company will be subject to dividends tax at least at the rate of 20% as opposed to being exempt from dividends tax where the South African resident shareholder company held the shares directly in the South African target company (and not through a foreign company loop structure). We still await final publication of the amended provisions; however, one would be well advised to carefully consider the tax consequences pertaining to these types of structures given the various changes.

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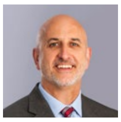

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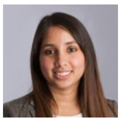

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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