DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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NEW MAURITIAN TAX TREATY

Mauritius has been a popular destination for international investors wanting to invest in other jurisdictions.

The main reasons for this are that Mauritius:

- has a vast network of treaties with countries around the world providing for the avoidance of double taxation (tax treaties);
- has no capital gains tax; and
- has a low effective corporate income tax rate.

South Africa has had a tax treaty with Mauritius since 1997 (concluded in 1996) and South African investors have used Mauritius as a vehicle for investing in other countries with which Mauritius has treaties, most notably other African countries. Likewise, international investors from other countries that have tax treaties with Mauritius have used Mauritius as an intermediary to invest in South Africa. South Africa signed a new treaty with Mauritius on 17 May 2013, which will bring about some significant changes for both South African and international investors.

The new treaty still needs to be approved by Parliament and published in the Government Gazette in terms of s108 of the Income Tax Act No 58 of 1962 (Act). The treaty must similarly be ratified by Mauritius. It is expected that the treaty will be effective as of 1 January 2015.

South African investors

A significant change in respect of the new treaty concerns the determination of tax residency, and specifically the tie-breaker rule that applies in cases where both Mauritius and South Africa claim that a particular company is a tax resident in their respective jurisdictions.

The current treaty provides that where a company is a tax resident of both Mauritius and South Africa in terms of each country's domestic law, that company will for purposes of the treaty be regarded as only being resident in the country in which that company has its place of effective management.

The new treaty provides that where a company is a resident of both states, "the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and determine the mode of application of the Agreement to such person." It further also provides that in "the absence of such agreement such person shall be considered to be outside the scope of the Agreement."

The problem that arises is that a Mauritian incorporated company could find itself no longer being a tax resident of Mauritius, for treaty purposes, but a tax resident of South Africa, should Mauritius and South Africa agree. This is so despite the fact that the company may have attempted to arrange its affairs in such a way that its place of effective management is in Mauritius.

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The treaty does not mention what principles will be applied by the two countries in coming to any such agreement. There is also no indication as to the administrative process involved in reaching such agreement and whether the company will be entitled to make representations.

Should no agreement be reached between Mauritius and South Africa, the treaty will simply not apply, and the company, as a dual resident, will be subject to tax in both South Africa and Mauritius. Even though the company could potentially claim relief in terms of s6 *quat* of the Act, it would probably end up paying more tax than it would have otherwise.

Effectively, if the South African Revenue Service (SARS) believes that a Mauritian company is effectively managed in South Africa and therefore a resident in terms of domestic law, SARS will tax that company in South Africa, whether Mauritius agrees the company is resident in South Africa or not.

International investors

International investors investing in South Africa through Mauritius will also be affected.

Under the current treaty a Mauritian tax resident company holding shares in a South African subsidiary will not be subject to capital gains tax on the disposal of such shares, despite the fact that the South African subsidiary holds immovable property and the sale of the shares indirectly constitutes a sale of that immovable property.

Under the new treaty, Mauritian companies holding shares in South African subsidiaries, the shares of which derive more than 50% of their value from immovable property, may now be taxed in South Africa on the gains arising from a disposal of those shares.

A further important change is the provision for withholding tax on interest and royalties.

Under the current treaty interest and royalties paid by South African subsidiaries to their Mauritian holding company would only be subject to tax in Mauritius, provided that the Mauritian company is the beneficial owner, and subject to certain other exceptions.

The new treaty makes provision for South Africa to withhold tax on interest and royalty payments made by South African subsidiaries to a Mauritian holding company. However, tax on interest will be limited to 10% and tax on royalties will be limited to 5%.

In respect of dividends, the current treaty provides that South Africa can only tax dividends at a maximum rate of 5% where the Mauritian company holds at least 10% of the shares in the South African subsidiary. In all other cases the maximum rate is 10%. The new treaty also provides for a maximum rate of 5% where the Mauritian company holds at least 10% of the Shares in the South African subsidiary, but the maximum rate for all other cases has been increased to 15%, which matches South Africa's current dividends tax rate.

These provisions also apply to the extent that Mauritius imposes withholding taxes on dividends, royalties and interest, but Mauritius generally does not impose such taxes (except under limited circumstances).

It would appear that at least one reason for South Africa entering into the new treaty is to discourage investment in Africa through Mauritius, and making the South African headquarter company regime seem more attractive for international investors. SARS and National Treasury would rather see international investors make use of South Africa as a base for investing in other African countries than Mauritius. It remains to be seen whether their efforts will have the desired effect.

Heinrich Louw

TRUSTS - IS THE CONDUIT PRINCIPLE IN PERIL?

The announcement regarding trusts in the 2013 budget is notable for two reasons: its brevity and its lack of detail.

Any comments made in advance of the publication of the first draft of the Taxation Laws Amendment Bill expected in June can therefore only be speculative.

Treasury and the South African Revenue Service (SARS) seem to be concerned about trusts, largely because of the income-splitting opportunities that trust law affords. These are based on the well-established conduit principle in terms of which, if income accrues to a trust and the trustees award it to one or more beneficiaries in the same year, the income retains its nature in the hands of the beneficiary. In fact, the Eight Schedule to the Income Tax Act, No 58 of 1962 provides specifically for this application in the context of capital gains tax (CGT) in that it provides:

- that any gain arising in a trust from distribution of an asset to a beneficiary is taxed as a capital gain in the hands of the beneficiary; and
- that where a capital gain arises in a trust as a result of the disposal of an asset of the trust, the trustees may in the same year award the gain to one or more beneficiaries.

The problem for the fiscus is that the conduit principle may be used for income splitting and deduction splitting. On the income side, interest income is perhaps the best class of income to use in an example. Assume that there are three beneficiaries of a trust, who are natural persons, and in the current year the trust earns interest of R75,000. If the trust retains the interest and pays tax on it, it gets no exemption and the tax liability at 40% is R30,000.

Now assume that the trustees award the interest in equal proportion to the beneficiaries. The tax liability of each beneficiary will be as follows: interest income R25,000, of which R23,800 is exempt (this would be R34,500 for a beneficiary older than 65). The taxable balance is thus R1,200 on which, even at the maximum marginal rate of 40%, the tax would be R480. The total tax payable on the interest would thus be R480 x 3 = R1,440.

For CGT purposes there is a similar result. On a capital gain of R120,000 the trust's tax liability would be 120,000 x 66% x 40% = R32,000. On the same gain distributed equally to them, the three beneficiaries would pay a maximum between them of 120,000 x 33% x 40% = R16,000; and this result ignores the fact that the tax rate of a beneficiary could be as low as 18% depending on the beneficiary's total taxable income.

On the deduction side, the expenditure relating to a particular item of income awarded to a beneficiary is deemed to be that of the beneficiary. However, it is possible, with some astute planning, to retain in the trust more than a proportionate share of expenditure incurred by the trust, where it is most beneficial because of the 40% tax rate applicable to trusts.

How Treasury intends to override the conduit principle is unclear. Are trusts going to be taxed on their income before it is distributed? Will they enjoy a deduction in respect of income then awarded to beneficiaries (which seems to be the intention) and, if so, will the income retain its nature in the hands of the beneficiary or will it be taxable without the benefit of the interest exemption, where it applies? None of this is clear. We await the draft amending legislation with interest.

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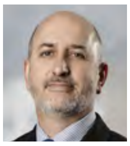

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