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TAX AND EXCHANGE CONTROL ALERT

IN THIS ISSUE

REGULATORY AMENDMENTS TO TAX FREE INVESTMENTS

On 31 March 2017, Government Gazette (GG) 40758 was published, in terms of which the regulations relating to the requirements for Tax Free Investments (Regulations), were amended by National Treasury (Treasury). The Regulations were originally published in February 2015 in terms of s12T(8) of the Income Tax Act, No 58 of 1962 (Act). The Minister of Finance (Minister) is empowered to make regulations prescribing the requirements to which a financial product must conform in order to constitute a tax free investment (TFI).

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REGULATORY AMENDMENTS TO TAX FREE INVESTMENTS

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By way of background, a TFI is defined in s12T(1) of the Act as any financial instrument or long-term policy (as defined in s1 of the Long-term Insurance Act, No 52 of 1998) which is owned by a natural person, a deceased estate or an insolvent estate of a natural person (Qualifying Taxpayers), and administered by a person or entity designated by the Minister by notice in the GG (Product Provider). Section 12T of the Act provides that any amount received by or accrued to a Qualifying Taxpayer in respect of a TFI is exempt from normal tax and the capital gain or loss from the disposal of such TFI is disregarded for purposes of capital gains tax. In addition, a dividend paid in respect of a TFI is exempt from dividends tax in terms of s64F of the Act.

Contributions in respect of TFIs are required to be made in cash and, as of 1 March 2017, are limited to an annual amount of R33 000 in aggregate during any year of assessment and subject to a lifetime limit of R500 000 in aggregate. The exempt amount received by or accrued to a Qualifying Taxpayer in relation to the TFI is not taken into account in determining whether an excess amount has been so contributed in a given year of assessment or in aggregate. In addition, the transfer of a TFI account, of whatever nature of a Qualifying Taxpayer to another TFI account, of whatever nature of the same Qualifying Taxpayer and any amount received by or accruing in respect of a TFI is not taken into account in determining whether the Qualifying Taxpayer has contributed in excess of the annual and lifetime limits.

Penalties are triggered in the instance where a Qualifying Taxpayer contributes amounts in excess of the abovementioned limits. If during any year of assessment, a Qualifying Taxpayer contributes more than the annual limit, the excess is subject to normal tax at the rate of 40%. Whereas if a Qualifying Taxpayer contributes more than the lifetime limit in aggregate, 40% of so much of the excess as has not previously been taken into account, is deemed to be an amount of normal tax payable in respect of the year of assessment in which such excess was contributed.

The amendments to the Regulations contained in GG 40758 deal with, *inter alia*, the process for the transfers of TFIs, performance fees in underlying funds, restriction on maturity dates, fees to be recovered by Product Providers and various provisions to enable the Financial Services Board (FSB) to adequately administer product offerings.

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The Product Provider will not be able to administer any TFI other than a TFI administered before the date on which the Product Provider is unable to transfer an amount.

Treasury has also, in GG 40757 (published on 31 March 2017), included the South African Postbank Limited in the list of Product Providers empowered to administer TFIs. We discuss the amendments to the Regulations in more detail below.

Transfers of TFIs

GG 40758 provides that, upon request by a Qualifying Taxpayer, a Product Provider must transfer amounts in cash or assets other than cash in respect of a TFI of the Qualifying Taxpayer to another TFI of the same Qualifying Taxpayer:

i) to the extent that the TFI has a maturity date, within 10 business days after the Qualifying Taxpayer's request or after the maturity date;

ii) where the TFI has no maturity date, within 10 business days after the Qualifying Taxpayer's request.

Provision has been made in GG 40758 for Product Providers to refuse to accept any transfer as described in (i) and (ii) above in respect of a TFI. Despite a Qualifying Taxpayer's request, a Product Provider may not transfer any amount in relation to a TFI, in respect of the same natural person, more than twice in a year of assessment and a Product Provider must refuse to transfer any amount in relation to a TFI during the last 10 business days of any year of assessment.

To the extent that a Product Provider is unable to transfer any amount in respect of a TFI to another Product Provider, the first mentioned Product Provider will not be able to accept any further amounts in respect of any TFIs administered by such Product Provider. In addition, the Product Provider will not be able to administer any TFI other than a TFI administered before the date on which the Product Provider is unable to transfer an amount.

GG 40758 goes on further to include the minimum requirements for a valid transfer between Product Providers, such as a transfer certificate and the type of information that must be passed on to the new Product Provider.

Due to the additional administrative requirements imposed on Product Providers, the ability of Qualifying Taxpayers to transfer amounts will be postponed to 1 March 2018 to allow Product Providers sufficient time to prepare for the more onerous responsibilities discussed above.

Performance fees in underlying funds not allowed

GG 40758 states that performance fees may not be charged by Product Providers in TFIs, whether charged as part of the TFI or in an underlying fund into which the TFI contributions are invested. Accordingly, Product Providers must ensure that TFIs do not, in any way contain any performance fees.

Restriction on maturity date

A Product Provider may not offer any TFI with a fixed-term of which the maturity date occurs more than five years after the date on which that TFI is issued.

REGULATORY AMENDMENTS TO TAX FREE INVESTMENTS

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Where the FSB objects to the intended implementation of a TFI, the Product Provider may not implement the intended TFI until such a time as the grounds of objection have been resolved by the FSB.

Fees to be recovered from the TFI

To the extent that the Product Provider is required to recover any fee in respect of the TFI, the Product Provider may only recover such fee from the TFI.

Compliance with regulations

Product Providers will be required to notify the FSB, within one month before a TFI product is advertised in the market, in order to provide the FSB with an opportunity to review the features of the offering and suggest amendments, if necessary. Such notification must include details of the TFI including the:

i) date from which the TFI will be advertised or when members of the public will be allowed to invest therein;

ii) name and nature of the TFI;

iii) legislation under which the TFI will be issued together with confirmation that the TFI meets the requirements of the legislation; and

iv) a summary of the benefits, terms and conditions and marketing material of the TFI.

GG 40758 requires that any change undertaken subsequently to the launching of the product should also be submitted to the Financial Services Board (FSB), at least one month prior to the date on which the alteration takes effect.

Furthermore, where the FSB objects to the intended implementation of a TFI, the Product Provider may not implement the intended TFI until such a time as the objection has been resolved by the FSB.

It will be interesting to see whether these amendments will ensure that TFIs are offered in a transparent manner and carry fees and charges that are reasonable, in order to ensure that customers derive maximum benefits from the vast number of savings and investment products available in the market.

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DIVIDENDS DECLARED TO NON-RESIDENT COMPANIES AND THE "MOST FAVOURED NATION" CLAUSE IN TAX TREATIES

Relief under a tax treaty in the form of a lower withholding rate generally applies to dividends paid to a non-resident company holding 10% to 25% of the shares (depending on the relevant tax treaty) in the company paying the dividend.

Even where the person owns less than 10% of the shares in the company declaring the dividend, the dividend tax rate is generally limited to 15%.

It was announced by the Minister of Finance in the 2017 Budget that the dividends tax rate would be increased from 15% to 20% with effect from 22 February 2017. While resident individuals and trusts are affected by this change, it is important to note that non-residents may claim a reduction in the dividends tax rate in terms of an applicable international treaty for the avoidance of double taxation (Double Tax Agreement).

Relief under a tax treaty in the form of a lower withholding rate generally applies to dividends paid to a non-resident company holding 10% to 25% of the shares (depending on the relevant tax treaty) in the company paying the dividend. Normally, a lower withholding rate will not be provided for under a tax treaty, if a foreign company holds less than 10% of the shares in the company paying the dividend. The reduced rate in respect of the so-called participation exemption varies between 5% and 10% depending on the particular treaty. However, even where the person owns less than 10% of the shares in the company declaring the dividend, the dividend tax rate is generally limited to 15%.

South Africa / Sweden Double Tax Agreement

Article 10(2) of the South Africa / Sweden Double Tax Agreement, read with the Protocol thereto (SA / Sweden DTA), is an example of the provision of such relief and provides as follows:

> However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident [ie South Africa] and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State [ie Sweden], the tax so charged shall not exceed:
>
> (a) 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds at least 10% of the capital of the company paying the dividends; or
>
> (b) 15% of the gross amount of the dividends in all other cases. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid. [Our insertion]

In essence, the effect of Article 10(2) is that where a Swedish tax resident owns 10% or more of the shares in a South African tax resident company, any dividends declared by that South African tax resident company will be subject to a reduced dividends tax rate of 5% to the extent that the relevant formalities in section 64G(3) of the Income Tax Act, No 58 of 1962 (Act) have been complied with. Furthermore, even where a Swedish company, individual or trust owns less than 10% of the shares in a South African tax resident company, the dividends tax on any dividends declared by that company could be reduced from 20%

DIVIDENDS DECLARED TO NON-RESIDENT COMPANIES AND THE "MOST FAVOURED NATION" CLAUSE IN TAX TREATIES

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The Protocol entered into between South Africa and Sweden introduced further potential relief in respect of dividends. Article 10(6) of the SA / Sweden DTA provides for what is commonly referred to as the "most favoured nation" clause.

to 15%. Generally, this relief is prevalent in the majority of the double tax treaties entered into between South Africa and other countries.

Interestingly, however, the Protocol entered into between South Africa and Sweden introduced further potential relief in respect of dividends. Article 10(6) of the SA / Sweden DTA constitutes what is commonly referred to as a "most favoured nation" clause and states the following:

> If any agreement or convention between South Africa and a third state provides that South Africa shall exempt from tax dividends (either generally or in respect of specific categories of dividends) arising in South Africa, or limit the tax charged in South Africa on such dividends (either generally or in respect of specific categories of dividends) to a rate lower than that provided for in subparagraph (a) of paragraph 2, such exemption or lower rate shall automatically apply to dividends (either generally or in respect of those specific categories of dividends) arising in South Africa and beneficially owned by a resident of Sweden and dividends (either generally or in respect of those specific categories of dividends) arising in Sweden and beneficially owned by a resident of South Africa, under the same conditions as if such exemption or lower rate had been specified in that subparagraph.

In simple terms, this further relief is applicable where South Africa has entered into any other Double Tax Agreement with a third country, which provides for either a complete exemption or reduced dividends tax rate (ie less than 5% in the SA / Sweden DTA). To the extent that this is the case, the outright exemption or further reduced rate will override Article 10(2) and automatically apply to any dividends declared by either a South African or Swedish company to a shareholder who is resident in the other country and who owns 10% of the shares of the declaring company.

South Africa / Kuwait Double Tax Agreement (SA / Kuwait DTA) and application of "most favoured nation" clause

Having regard to the other double tax agreements entered into between South Africa and other countries, it appears only one agreement currently provides for the complete exemption from tax under similar circumstances. Article 10(1) of the SA / Kuwait DTA provides as follows:

> Dividends paid by a company which is a resident of a Contracting State [ie South Africa] to a resident of the other Contracting State [ie Kuwait] who is the beneficial owner of such dividends shall be taxable only in that other Contracting State [ie Kuwait]. [Our insertions]

Hence where a South African resident company declares dividends to a Kuwaiti tax resident company, then Kuwait has the sole taxing rights and South Africa cannot levy any tax on such dividends. The additional benefit of this outright exemption in the SA / Kuwait DTA, is that it triggers the "most favoured nation" clause contained in Article 10(6) of the SA / Sweden DTA, such that any dividend declared by a South African company to

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Other double tax treaties which have similar "most favoured nation" clauses, inter alia, include the SA / Netherlands DTA as well as the SA / United Kingdom DTA.

a Swedish shareholder who owns 10% or more of the shares in the South African company, will not be subject to any South African dividends tax to the extent that the relevant formalities are complied with.

Ruling issued by SARS confirming application of the "most favoured nation" clause

The application and interaction of the "most favoured nation" clause was the crux of the issue in a recent ruling issued by the South African Revenue Service (SARS). SARS confirmed the above principle and ruled in Binding Private Ruling 267 (Ruling) that any dividends declared by a South African tax resident subsidiary company to its Swedish tax resident holding company will not be subject to South African dividends tax to the extent that the documentary requirements in section 64G(3) of the Act are complied with.

While the benefit of the "most favoured nation" clause is clear to see, taxpayers wishing to set up structures in order to take advantage of its application should be aware that most tax treaties which have such provisions also contain an anti-avoidance provision, which states that the "most favoured nation" clause will not apply where the main purpose or one of the main purposes in setting up the structure was to take advantage of the benefits of this clause.

Comment

Interestingly, other double tax treaties which have similar "most favoured nation" clauses, *inter alia*, include the SA / Netherlands DTA as well as the SA / United Kingdom DTA. However, both clauses in those tax treaties have their limitations in comparison to the South Africa / Sweden equivalent provision. In respect of the SA / Netherlands DTA, there is a date limitation in that the "most favoured nation" clause only applies where a further tax treaty between South Africa and a third state was entered into after the date of conclusion of the SA / Netherlands DTA. There is an argument that the SA / Kuwait DTA came into force prior to the SA / Netherlands DTA and hence cannot apply, such that the application of the "most favoured nation" clause in the SA / Netherlands DTA is not triggered. Furthermore, the SA / United Kingdom DTA merely provides that the countries shall enter into negotiations with a view to providing comparable treatment as may be provided for in respect of a tax treaty with a third State.

While the application of the "most favoured nation" clause is certainly beneficial under the specific circumstances, it remains to be seen for how long this exemption will apply. It is interesting to note that while Kuwait remains the only country with an outright exemption in respect of dividends, previously the tax treaties between South Africa and Cyprus as well as Oman also provided for outright exemption under certain circumstances. Both the Cypriot and Omani tax treaties were, however, relatively recently amended by protocols giving the country of source partial taxing rights and removing the outright exemption. As it happens, the Status Overview of All DTAs and Protocols published on the SARS website (last updated on 27 January 2017) reflects that the South Africa / Kuwait Protocol is currently being negotiated and it will, therefore, be interesting to see whether the new Protocol will amend the article pertaining to dividends thereby doing away with the outright exemption of dividends as it currently stands.

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