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TAX & EXCHANGE CONTROL ALERT

IN THIS **ISSUE**

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Amendments to paragraph 39 of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) have been proposed in National Treasury's draft Taxation Laws Amendment Bill (draft TLAB), as published in July 2018 for public comment. Per the Explanatory Memorandum on the draft TLAB, the proposed amendment seeks to clarify that capital losses between connected persons will be ring-fenced, where a person redeems its interest in the other person (such as a company) and the two persons are connected persons, in relation to each other.

CROSSING BORDERS: THE NOT-SO-GOLDEN LOOP STRUCTURE

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TREASURY CLARIFIES THE CLOGGED-LOSS RULES

Paragraph 39 of the Eighth Schedule to the Act is a capital gains tax (CGT) anti-avoidance provision which requires a capital loss to be treated as a "clogged loss" where a person disposes of an asset to a connected person and incurs a capital loss.

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The clogged-loss rule

Paragraph 39 of the Eighth Schedule to the Act is a capital gains tax (CGT) anti-avoidance provision which requires a capital loss to be treated as a "clogged loss" where a person disposes of an asset to a connected person and incurs a capital loss. The clogged-loss rule comes into play when determining the disposer's aggregate capital gain or aggregate capital loss and requires that the loss be entirely disregarded. In this way, the capital loss is ring-fenced and may be set off only against capital gains arising from disposals to the same connected person.

Restrictions in the rules

The clogged-loss rule restricts the deduction of capital losses if the asset in question is disposed of to a person who was a connected person in relation to the disposer of the asset immediately prior to the disposal, or if the asset is disposed of to a person which, immediately after the disposal of the asset, is a member of the same 'group of companies' as the disposer or is a trust with a company beneficiary that is a member of the same group of companies as the disposer.

The ring-fencing restrictions are extended so that the capital losses, in addition to only being permissibly deducted from capital gains arising from disposals of assets to the same connected person, may only be deducted from the arising capital gains during the same or a subsequent year of assessment.

The timing of the disposal is governed by a further restriction, in that the disregarded capital loss may be deducted only if the other person to whom the subsequent disposals are made, is still a connected person in relation to the disposer at the time when the disposer makes the disposals.

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TREASURY CLARIFIES THE CLOGGED-LOSS RULES

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The provisions of paragraph 39 become relevant where, for example, a shareholder disposes of an asset to his company, which is a connected person, and incurs a capital loss.

The relevance of ring-fencing

The provisions of paragraph 39 become relevant where, for example, a shareholder disposes of an asset to his company, which is a connected person, and incurs a capital loss. In this situation, the capital loss may not be brought into account when determining the shareholder's aggregate capital gains or losses for the year of assessment in which the transaction took place and, instead, the disregarded capital loss may only be deducted against capital gains made from the shareholder's disposal to his company during the same or subsequent years of assessments, provided that the company is still a connected person to the shareholder at the time of any subsequent disposals.

Confusion in the clogging

Paragraph 39 is only applicable where an asset has been "disposed" of "to" a person. Taxpayers have often been confused by this aspect of paragraph 39, as many situations give rise to an asset having been disposed of "to" no one in particular. The South African Revenue Service's (SARS) 6th Issue of its Comprehensive Guide to Capital Gains Tax demonstrates that "disposing to" no one is a common scenario which occurs, for example, in the scrapping or extinction of an asset or when an asset is deemed to be disposed of and the deeming provision does not specify an acquirer.

The difficulty that arises where there is no transfer to a connected person of an asset or of the rights encapsulated by the asset was brought to the Tax Court's consideration in the 2012 Income Tax Case No. 1859 (IT 1859). The court in this instance had to consider the applicability of paragraph 39 where Company A purchased redeemable preference shares in Company B (within the same group of companies from various third-party banks), shortly following which Company B redeemed the shares and Company A incurred a resultant capital loss on the redemption. In this way, the court needed to determine whether the redemption of shares constituted a "disposal to". The court identified the difficulty herein as, whilst the wording of paragraph 39 clearly covers transactions such as sales or the transfer of assets and shares from the disposer to a connected person, the legislation is not clear where there is no transfer of the asset.

According to the courts - meaning of disposal

IT 1859 was a landmark case for the interpretation of "disposal" in terms of paragraph 39. As part of its considerations, the court relied on the "canons of construction" to conclude that the use of the preposition "to" in paragraph 39(1) cannot be ignored. It was therefore held that, while the redemption of shares

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Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

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For the purposes of disregarding capital losses in terms of paragraph 39, where a company redeems its shares, the holder of those shares must be treated as having disposed of them to that company.

constituted a "disposal" as defined in paragraph 11 of the Eighth Schedule to the Act, the redemption was not a "disposal to any other person" as envisaged in paragraph 39. The court reasoned that the redemption of shares results in the extinction and not the transfer of the rights embodied in the shares to the redeeming company.

A precedent has since been set that the redemption of shares is not subject to paragraph 39 because the shares contemplated herein have not been disposed of as set out in the provisions. The court demonstrated that a literal interpretation of the legislation must be utilised, and relied on the meaning of the word "to" in the Concise Oxford Dictionary to decide that "the disposal of the asset must thus be 'in the direction of', or 'so as to reach' the connected person".

Meaning unclogged

The draft TLAB has directly addressed the discrepancies ensuing from the IT 1859 decision by specifically setting out that, for the purposes of disregarding capital losses in terms of paragraph 39, where a company redeems its shares, the holder of those shares must be treated as having disposed of them to that company. As such, though the literal interpretation of paragraph 39 will still have to be managed due to the impact of IT 1859, the draft TLAB has clarified the position in respect of redemption of shares.

Jessica Carr

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CROSSING BORDERS: THE NOT-SO-GOLDEN LOOP STRUCTURE

it is important that taxpayers consider South Africa's exchange control rules and ensure that where an offshore investment is made, they comply with these rules.

Loop structures entail the formation by a South African resident of an offshore structure which, by reinvestment into the Republic, acquires shares, loan accounts or some other interest in a South African resident company or a South African asset.

As time goes on, our world becomes smaller. One of the ways in which this manifests is in the world of doing business and investing, where it has become easier for individuals and businesses to invest and do business abroad. South African individuals will often consider investing abroad to diversify their investment portfolio or to take advantage of a favourable tax regime that is applicable in another country. South African companies, especially those that operate in the financial sector, would also often consider setting up offshore tax structures in an attempt to lawfully reduce their tax liability. In deciding whether to invest abroad and which country to invest in, taxpayers would potentially consider whether South Africa has a double tax agreement with a specific country.

However, it is important that taxpayers also consider South Africa's exchange control rules and ensure that where an offshore investment is made, they comply with these rules. One of the biggest pitfalls to avoid, is creating a loop structure, which is considered to be a serious contravention of South Africa's exchange control rules.

What is a loop structure and why is it unlawful?

A good description of a loop structure is set out in a policy document that was released by the South African Reserve Bank's Financial Surveillance Department (FinSurv) on 17 November 2016 entitled "Exchange Control Special Voluntary Disclosure Programme policy dealing with 'loop structures' (including 74/26 structures)" (Policy Document). This document sets out FinSurv's policy regarding the regularisation of loop structures in terms of the exchange control special voluntary disclosure programme that was in place between 1 October 2016 and 31 August 2017.

According to the Policy Document, loop structures entail the formation by a South African resident of an offshore structure which, by reinvestment into the Republic, acquires shares, loan accounts or some other interest in a South African resident company or a South African asset. The Policy Document adds that transactions creating loop structures contravene, amongst other provisions, Regulation 10(1)(c) of the Exchange Control Regulations, 1961 (Regulations). Regulation 10(1)(c) states that no person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose, enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic.

The Policy Document sets out how a loop structure can be created and its potential consequences, as follows:

- A South African resident individual, trust or corporate entity transfers authorised or unauthorised funds (could also be existing offshore funds or a combination thereof) from the Republic to set up, for example, a foreign trust or foreign entity. (Authorised funds are those foreign funds held in a manner that does not contravene the Regulations.);

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A loop structure has the effect of reducing South Africa's tax base and could reduce any taxes that the offshore structure would have to pay in South Africa.

- The foreign trust or entity involved would then directly or indirectly (via another offshore entity) reinvest its authorised or unauthorised funds in the Republic, thereby creating a loop structure. The reinvestment could be in the form of South African shares, assets or loan accounts being acquired or created;
- The South African resident would in some instances thereafter export returns made on the South African investment by way of, amongst other things, the payment of dividends, profits, interest and/or loans to the foreign structure; and
- The result of the loop structure is that the investment of funds from the offshore structure into the Republic and the payment of dividends, profits or interest offshore results in the accumulation of value over and above the nominal foreign investment that was initially made.

From the above example, one can also see that a loop structure has the effect of reducing South Africa's tax base and could reduce any taxes that the offshore structure would have to pay in South Africa.

South African residents must keep in mind that although the Regulations and Policy Document only refer to the "Republic", the prohibition against creating loop structures applies to the reinvestment into all countries forming part of the Common Monetary Area (CMA). The CMA consists of South Africa, Swaziland, Lesotho and Namibia. This is stated in the Currency and Exchanges Manual for Authorised Dealers (Manual), which must be read with the Regulations.

Are loop structures unlawful under all circumstances?

As stated above, Regulation 10(1)(c) states that transactions which result in the export of capital from the Republic may only be entered into with the permission of the Treasury and on such conditions as the Treasury may impose. According to the Manual, the word "Treasury" refers to the Minister of Finance or National Treasury, including the persons to which the Minister of Finance has delegated this authority, including the Governor and Deputy-Governor of the South African Reserve Bank. Loop structures may therefore only be created where Treasury has given its permission for this to take place.

In terms of the Manual, some of the circumstances under which a loop structure may be created, are the following:

- Section B.2(B) of the Manual states that it is permitted 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. It is important to keep in mind that the South African investor must have made the investment after taking the invested funds abroad legally.

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FinSurv has broad powers in terms of the Regulations and at worst, could declare that foreign assets held in contravention of the Regulations, such as through an unlawful loop structure, must be forfeited to the State.

- In terms of sB.2(F) of the Manual, South African technology, media, telecommunications, exploration, and other research and development companies may establish an offshore company to raise foreign funding for their operations, subject to certain conditions. These conditions include registering with FinSurv and ensuring that the established offshore company is a tax resident in South Africa. Such companies may hold investments and/ or make loans into South Africa, even though the investment or loan would create a loop structure; and
- In terms of sB.2(A) of the Manual, a South African company is now permitted to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign market entity, which may in turn hold investments and/ or make loans into any CMA country. This dispensation does not apply to foreign direct investments where the South African company on its own or where several South African companies collectively hold an equity interest and/or voting rights in the foreign target entity that exceed 40% in total. Loop structures that exceed the 40% threshold require FinSurv approval with due consideration to transparency, tax, equivalent audit standards and governance. Previously, a South African company could not hold an interest in the foreign entity exceeding 20%. The increase to a maximum 40% interest that may be held was announced in the 2018 Budget and was set out in Exchange Control Circular No. 5/2018, which was released on 21 February 2018.

Conclusion

When considering investing abroad or setting-up offshore structures through which to invest or do business, South African residents must ensure that they comply with not only South Africa's tax laws, but also with South Africa's exchange control laws. FinSurv has broad powers in terms of the Regulations and at worst, could declare that foreign assets held in contravention of the Regulations, such as through an unlawful loop structure, must be forfeited to the State. It is therefore important that before investing or doing business abroad, South African residents ensure that they receive correct and accurate tax and exchange control advice, especially where large sums of money are involved.

Louis Botha

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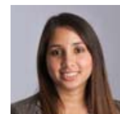

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