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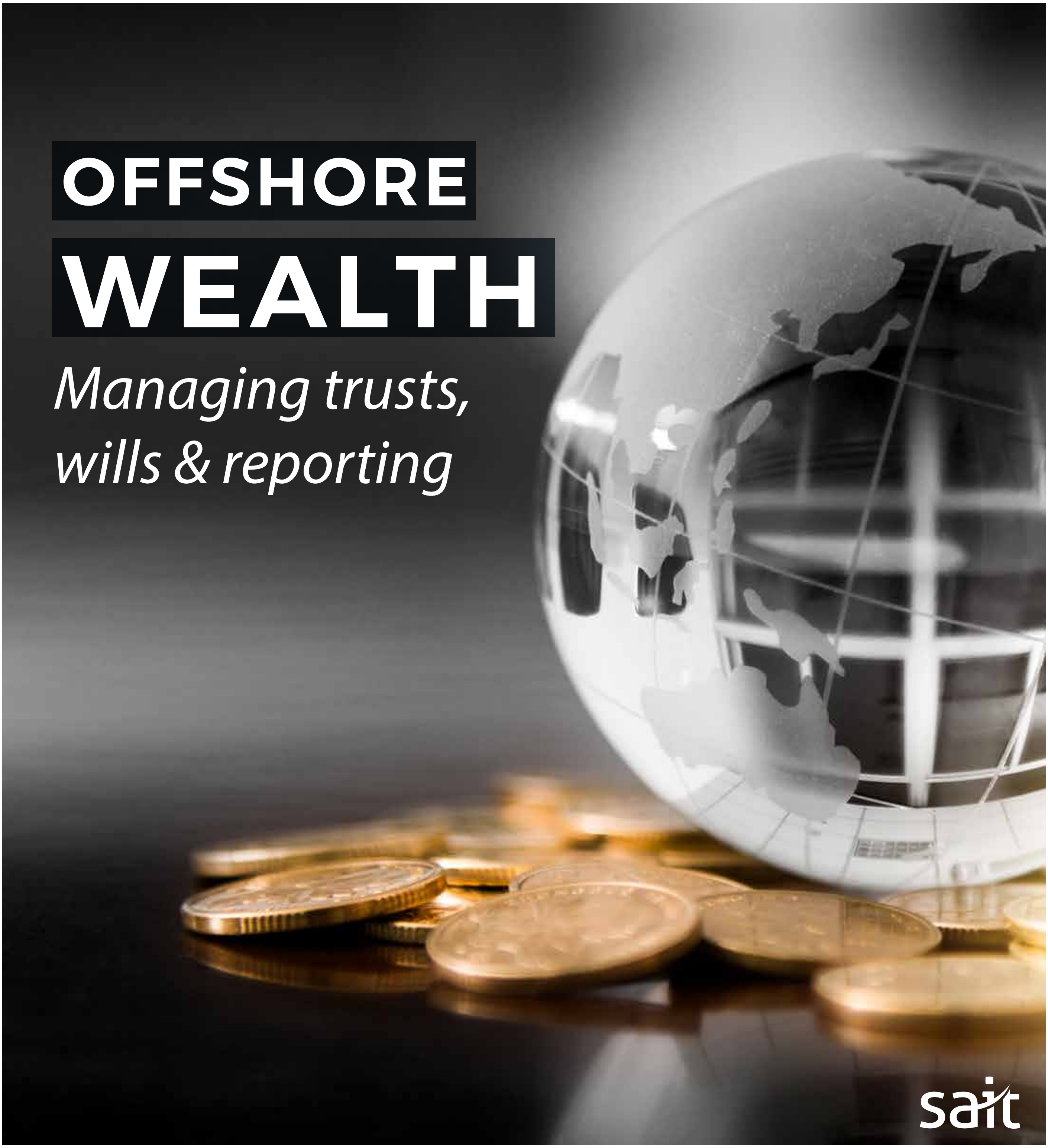

OFFSHORE WEALTH

Managing trusts, wills & reporting

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15 minutes CPD

BASIC OPTIONS FOR OFFSHORE INVESTING

▶ **GARETH COLLIER,** gareth@crue.co.za

Keeping in mind that most people who want to diversify their domestic portfolios by investing offshore also want to keep things simple, our article explores the basic options for investing offshore with the least hassle.

"Many countries have strict inheritance rules in place, which could impact your ability to bequeath your foreign assets as you would like."

Offshore investing has experienced a rapid rise in interest and implementation in the recent past. Arguably, this rise in popularity can be attributed to the poor performance of and the rampant corruption within national government, combined with the stagnation of the South African economy. Naturally, when local outlooks are negative and bad news abounds, investors tend to look elsewhere for investment opportunities in pastures that appear more fruitful. That said, it is always advisable for investors to carefully consider the reasons for wanting to invest offshore, and to ensure that their decision is not merely a knee-jerk reaction to local bad news. Some investors seek offshore investment opportunities to improve diversification, provide for future liabilities or to seek alternative market conditions that are not locally available. On the other hand, some investors make an emotional decision to externalise their rands, believing that they will sleep better knowing that their funds are invested offshore.

The case for investing offshore

For the sake of context, it is important to keep in mind that South Africa currently makes up only around 0.4% of the global GDP. As such, diversifying one's investments across international markets and economies can create a distribution of risk and volatility in one's portfolio that is less concentrated than a pure South African allocation. In this regard, keep in mind that the South African stock exchange is dominated by the major commodity producers together with a combination of Naspers and Prosus, and this makes our investment market quite sensitive to economic conditions which affect these businesses.

In circumstances where investors are likely to incur expenses in foreign currency, it may make sense for those investors to build an offshore portfolio in the jurisdiction in which they intend to live and spend. Primarily, this would involve hedging against a volatile currency exchange. Where an investor is contemplating a retirement abroad, a future emigration or has children who will likely study abroad, setting up an offshore portfolio in that region would make sound investment sense.

The global offshore investment landscape is vast in comparison to the local South African investment market. Funds can be given exposure to selected regional opportunities in economies which are stable and therefore more certain. Alternatively, they can be directed to emerging economies in pursuit of more potential growth. Also, keep in mind that many large-scale industries, such as information technology, have minimal diverse exposure in South Africa in comparison to the options available internationally.

Direct or indirect?

Once investors have made the decision to invest offshore, they can effectively choose between direct offshore investing or indirect offshore investing.

The direct option

Investing directly offshore involves the physical transfer of one's rands out of the South African jurisdiction and onto an investment platform listed abroad, with the funds being invested into underlying funds which are domiciled in foreign currency. Investors are able to achieve this using either their single discretionary allowance (SDA), colloquially known as the 'travel allowance', or their foreign investment allowance (FIA), or a combination of both. The SDA is limited to R1 million per calendar year and may be used at the investor's discretion without the need for a tax clearance certificate or other supporting documents. The FIA enables investors to transfer a further R10 million offshore over and above the SDA, although to do so they will need to obtain a tax clearance certificate which, once issued, is valid for a period of 12 months.

It is important to note that the SDA and FIA allowances are not sequential, which means that investors do not need to first exhaust their SDA before making use of their FIA. The FIA can be applied for and used without any of an investor's SDA being accessed, bearing in mind that the SDA is very useful when it comes to travel, covering emigration costs, making international purchases or moving smaller amounts of money offshore when exchange rates are favourable.

Once an investor's funds have been externalised and invested in an offshore account, withdrawals can generally be paid into any international account in the name of the investor, provided the account can accept transfers in the domiciled currency of the investment. The funds do not need to move back into or through a South African account.

There are a number of reputable service providers who can assist investors to move funds abroad. While almost all banks in South Africa offer the facility to make such transfers, there are also a number of companies that specialise in forex transfers. Due to their specialist nature, these companies are able to offer more preferential rates on exchange as well as other value-added services such as enabling the application for tax clearance which is included in their pricing. In addition, more and more asset manager platforms provide for the exchange and transfer of monies to their own offshore platforms, provided this transfer is within investors' remaining SDA capacity for the year. In such circumstances, investors will deposit the rand amount in their local account and the asset manager platform will then complete the exchange and transfer the funds to the offshore platform on the investors' behalf. A significant advantage of this method is that the fees on these transfers can be significantly more cost-effective due to the asset manager's bulk purchasing power.

It is important for investors to consider the most appropriate structure for a direct offshore investment, with options including direct shares, discretionary unit trust funds, or an endowment wrapper. Depending on the investor's tax status and objectives, an endowment wrapper can be a highly useful structure as the taxes are both defined within the wrapper and paid on behalf of the investor to the relevant revenue authorities. In addition, beneficiaries may be nominated on such investments, which opens the options for beneficiaries as to how such an inheritance is received, and the tax consequences of such.

The indirect option

The other option for externalising funds offshore is to utilise the indirect option through rand-denominated funds. Indirect offshore investing means that no rands are physically transferred by investors, and their investments remain domiciled in South Africa. As there is no transfer of funds abroad, investors will not use any of their SDA nor will they need to apply for a FIA in order to make such an investment. There are a myriad of available global feeder funds offered by various asset managers who then invest funds abroad on an asset swap basis in various markets determined by each fund's particular investment mandate. These indirect investments can be implemented and allocated relatively quickly and efficiently as the investor is making use of the asset manager's capacity to externalise funds. These feeder funds allow an investor to build offshore exposure into their portfolios while also providing an exchange hedge against a depreciating rand. Note, however, that withdrawals and disinvestments from such accounts will need to be paid into a South African bank account that is held in the name of an investor.

Estate planning

Finally, an often overlooked but very important feature of offshore investing is the impact that it has on one's estate planning and the potential need for a foreign will. When making a decision to externalise your funds, be sure to establish whether the administrative platform recognises your South African will for probate purposes, or whether a foreign will in that jurisdiction is required. While South Africa enjoys freedom of testation, this is not necessarily the case in other countries, especially those with civil law jurisdiction. Many countries have strict inheritance rules in place, also known as forced heirship or mandatory succession rights, which impact your ability to bequeath your foreign assets as you would like. That said, it is important to be clear on your reason for wanting to invest offshore and to seek professional advice on how best to externalise your funds in the best interests of both your investment plan and your estate plan.

DISAPPEARING EXCHANGE CONTROL

▶ **REABETSWE MOLOI,** rea@taxconsulting.co.za

After 15 years of reducing exchange control for individuals sending money abroad, our article looks at where we stand now and where we are headed.

We have seen significant changes and adjustments to exchange control policies, with National Treasury steadily reducing exchange controls for individuals seeking to send money abroad, particularly in the last 15 odd years. The most dramatic changes were implemented early this year where we saw National Treasury follow through with their proposed plans as per the 2020 Budget Review to phase out longstanding exchange controls. Among others, the exchange control component of financial emigration was eliminated, with effect from 1 March 2021.

The purpose of this article is to describe the overall state of play as of 1 March 2021 and to briefly outline the direction in which South Africa is headed insofar as exchange control for individuals is concerned.

The history of exchange control

To appreciate the degree of diminishing exchange controls, it is important to understand the history of exchange control and the many faces it has adopted since its introduction.

South Africa introduced exchange control in 1985 in response to the significant outflow of capital from the Republic due to debt defaults as well as economic sanctions. During that time, exchange controls were implemented through a dual rand system which meant that there was one exchange rate for current account payments for residents and another rate for capital account payments for non-residents. Consequently, this resulted in foreign investments in South Africa only being able to be sold for rand.

The purpose of exchange control was to ensure a number of things, including that foreign currency that was acquired by residents of South Africa would be repatriated into the South African banking system, to prevent the loss of foreign currency resources through the transfer of real or capital assets abroad from South Africa, to effectively control the movement of real and financial assets in and out of South Africa, whilst keeping the South African economy operating efficiently and preventing unnecessary pressure on the country's gold and foreign exchange reserves.

In 1994, following South Africa's first democratic elections, it was decided by the South African Government that it would adopt a gradual approach to the elimination of exchange control in South Africa. This gradual elimination would entail the following:

- The lifting of exchange control on the import and export of goods and services
- The lifting of exchange control on non-residents
- More leniency on granting approvals for the application of direct foreign investments by South African corporates
- Allowing institutional investors to acquire foreign assets in order to diversify their portfolios
- Releasing emigrant "blocked accounts"

As it stands, some of these initiatives have been completed, while others are still a work in progress.

Of particular relevance for current purposes is the releasing of emigrant blocked accounts, which took effect on 1 March 2021 and which further drives the objective of eliminating exchange control altogether.

Going, going, gone!

A circular published by the South African Reserve Bank earlier this year confirmed National Treasury's announced plans to phase out the concept of emigration from an exchange control point of view.

In the past few years there has been a rise in the number of South Africans working abroad who cease their tax residency with SARS and subsequently become emigrants for exchange control purposes through the financial emigration process. We saw Government taking this as an opportunity to remove the exchange control treatment of individuals. This was to be seen as Government making efforts to make it easier for South Africans abroad to take out and, most importantly, encourage them to bring in foreign investments into South Africa.

The term "emigrant" specifically related to South Africans who had left or were set to leave South Africa and had taken up permanent residency or would have taken up permanent residency in a country outside of the Common Monetary Area. The transition from a resident to a non-resident involved a long-winded, antiquated and cumbersome process requiring an application to the Reserve Bank using the previously known MP336(b) form which had to be attested to by an Authorised Dealer and backed by an emigration tax clearance certificate issued by SARS, prior to any authorisation by the Reserve Bank.

The whole purpose of one becoming an emigrant for exchange control was for individuals abroad to be able to initially transfer greater sums of funds abroad without the restrictions and controls by the Reserve Bank. However, subsequent to the initial transfer the administrative burden began, where South Africans permanently living abroad could only transfer funds as administered and allowed by their respective Authorised Dealers.

In terms of the new dispensation, all residents and emigrants will be treated identically, and the concept of an "emigrant" has completely fallen away insofar as exchange control is concerned. This means that the process of controlling or blocking an emigrant's remaining assets in South Africa in a special "blocked account" will fall away and all transfers from these accounts will be handled and treated as normal fund transfers. The transfers would need to comply with the same requirements as any other foreign capital allowance transfer applicable to residents.

We have seen that the new regime specifically acknowledges individuals who have formalised their tax non-residency status with SARS. The income transfers for South Africans permanently residing abroad are no longer subject to authority of and are no longer required to report to the Financial Surveillance Department. This includes the transfer of income from trusts, interest and rentals (to name but a few) subject to certain conditions and protocols.

More for all

As a result of the removal of the exchange control restrictions on individuals, National Treasury also advised in the 2020 Budget Review that natural person residents and natural person emigrants would be treated identically.

In terms of the new regime, natural persons, whether resident in South Africa or residing abroad, enjoy the same single discretionary allowance of R1 million without the need for a tax clearance status (TCS) PIN from SARS. Authorised Dealers may also allow all individuals to transfer funds of up to R10 million subject to submission of a TCS PIN.

It is worth noting, however, that any funds in excess of R10 million will now be subject to a more stringent verification process and subsequent approval by the Financial Surveillance Department, which is yet to be seen in practice.

Where to from here?

With the South African Government scrambling to encourage foreign investment, but also moving in line with its gradual plans to eliminate exchange control, we can anticipate further relaxation of exchange control measures, although the extent thereof is not yet known.

What we do know is that a number of initially confirmed plans to do away with exchange control have since been implemented, the newest being the elimination of the emigrant blocked account. However, we still see exchange controls predominantly existing in respect of direct foreign investments by South African corporates and the acquisition of foreign assets by institutional investors.

It remains to be seen if we will reach a point where exchange control is abolished altogether.

15 minutes CPD

BITCOIN AS AN ALTERNATIVE INVESTMENT

▶ **THOMAS LOBBAN,** thomas@taxconsulting.co.za

Our article takes readers through the basics of Bitcoin, its tax impact and its upside potential and risk when used as an alternative investment in a foreign asset portfolio.

Cryptocurrency is a topic that, for many, brings to mind images of a pale individual in a dark room lit only by the monitor of their computer, working their magic on the internet like few others can. However, this is not the real profile of a cryptocurrency investor – which could be a colleague, parent, Aunt Margaret from across the street or your plumber.

The original and most popular cryptocurrency, Bitcoin, has seen a massive rise in popularity and use in recent years, spurred on further by celebrity endorsement and adoption by service providers, such as PayPal for example. As a result, Bitcoin has seen a rise in value from approximately R163 000 to R853 000 from 1 March 2020 to 28 February 2021 alone.

This increase in attention shows that more and more people are seeing the immense potential for profit in Bitcoin as an investment. However, this does not necessarily mean that people are aware of how it works or its associated risks.

What is Bitcoin and what is it used for?

A cryptocurrency is a virtual or digital currency that is secured by cryptography to prevent theft and/or fraud and without the need for bank or government backing.

Bitcoin, arguably the first cryptocurrency, was established in 2009 as a public instant payment system. It uses a distributed ledger, or blockchain, to record transactions immutably. Bitcoin in particular is most often used as a means of payment for goods or services, cost-effective money transfer, active trading or short- and long-term investment. While Bitcoin has indeed shown impressive potential for profit it also presents massive risks for an investor.

"Its use as an alternative asset class in view of the tax implications and compliance requirements should give a taxpayer pause."

The volatility of Bitcoin over the years is more than enough cause for concern – suffice to say that no reasonable person should invest more in this asset class than they can afford to lose. A more pertinent concern, and certainly the issue of the day, is the treatment of cryptocurrency and related transactions for tax purposes.

The tax problem

For South African tax purposes, Bitcoin and other cryptocurrencies are treated as financial instruments. Thus, these are seen as assets which have a monetary value and that may be traded.

When considering Bitcoin or other cryptocurrencies as part of a larger asset portfolio, their decentralised nature means that they are not generally "connected" to any specific country (albeit with a few exceptions). This means that Bitcoin is highly flexible in its use-case and with minimal red tape from a regulatory perspective. However, an investor must take their tax obligations into account.

As a rule, transactions of cryptocurrency (including Bitcoin) have always been taxable in South Africa. For a non-resident in South Africa, amounts derived from a source in South Africa are subject to tax. Therefore, consideration should be given to, *inter alia,* whether the taxpayer carried out the relevant transactions in South Africa (in line with judgments such as those in *CIR v Lever Bros, CIR v Epstein* and countless others as given by our courts over time). For a resident, all transactions are taxable, no matter where they are carried out.

Whether Bitcoin, as an asset, should be treated as capital or revenue in nature depends on the intention of the taxpayer in view of the surrounding facts and circumstances in each case. In SARS' view, Bitcoin-related amounts will most often be of a revenue nature and thus subject to tax at the relevant taxpayer's marginal tax rate (i.e., up to 45%). Going further, cryptocurrency losses are subject to the ring-fencing provisions in section 20A of the Income Tax Act.

In every case, it is the disposal of cryptocurrency that constitutes a taxable event. This means that it is not only the sale of cryptocurrency for money that results in tax implications for taxpayers, but also exchanges of one type of cryptocurrency for another. In the latter case, a taxpayer may often find themselves in a situation where they have a consequent tax liability without sufficient liquidity to meet their obligations in this regard.

Maintaining records

A further issue faced by taxpayers is settling the onus of proof placed upon them. It is crucial for the taxpayer to ensure that they maintain full records of their expenditure and proceeds from disposals made throughout the year of assessment. This must also be borne in mind when taking the position that the proceeds from the disposal of Bitcoin ought to be taxed as capital gains, as opposed to revenue. This would be in the form of CSV reports drawn from the relevant cryptocurrency exchange or platform, bank statements, and reconciliations to allow SARS to parse the relevant data.

The applicable tax treatment will necessarily follow the specific activities of the taxpayer concerned and, in most cases, correct disclosure will require the assistance of a competent hand. For example, where a taxpayer is engaged in arbitrage trading (purchasing cryptocurrency abroad, transferring to another exchange and selling it at a higher price), not only do the expenditure and proceeds of the transactions need to be taken into account but also the foreign currency conversion rules in the Income Tax Act as well as possible foreign exchange limitations.

As an investment opportunity

In short, Bitcoin presents an exciting opportunity for investment and application. However, its use as an alternative asset class in view of the tax implications and compliance requirements should give a taxpayer pause. The decision to include Bitcoin in one's foreign asset portfolio must, therefore, be well considered and with the proper advice first obtained in each case.

PLANNING FOR EXIT

45 minutes CPD

▸ **JEAN DU TOIT,** jean@taxconsulting.co.za &
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Planning to relocate yourself and your finances abroad? Our article looks at the hows and tax pitfalls that may hamper liquidity in your new life.

With the world's recent and continuing lockdowns in view of the ever-present COVID-19 pandemic, more and more South Africans are considering moving abroad (or having their children move abroad). "Work from anywhere" is the theme of the day and, while this seems a simple enough endeavour in theory, in reality there are many concerns which must be taken into account and most of which arise from a tax perspective.

One critical aspect of emigration is having sufficient available funds on hand. It is not uncommon for employment to not yet be forthcoming and, most often, there are significant set-up costs that will need to be incurred by an expatriate, to set up not only themselves, but their key support system such as family. Either way, liquidity is key – if improperly handled, one could face an untimely return trip to South Africa.

Special visa programmes

Many countries the world over, including Portugal and Mauritius (as often recurring examples), offer immigration programmes which are wholly or partly based on in-country investments, with a view to providing an economic boost for the respective countries. This is intended to incentivise inbound foreign investment into the country and generally offers an ideal vehicle to secure long-term residence and financial stability.

This is typically a popular vehicle for higher net worth individuals to enter a country. However, this must also be considered from a tax perspective. Capital gains or profits which are made from these investments may be subject to tax in South Africa, if a taxpayer is seen as a South African resident for tax purposes.

This means that, if improperly handled, profits made from a foreign investment may remain subject to tax in South Africa and this could substantially erode any progress made in the other country, regardless of whether the said profit is taxed in the other country.

Direct foreign investment

A steady option available to emigrants from South Africa is also direct foreign investment. For example, the direct purchase of immovable property, shares, opening of a savings or other bank account or even acquiring and transferring cryptocurrency are all seemingly viable options.

Provided that there is enough latitude given to expatriates on investments they are permitted to make, the only limiting factor would be the liquidity of the taxpayer and whether they can draw on sufficient cash to meet their in-country financial needs and obligations. It should be kept in mind that there may also be limitations and controls on the amounts that a person is permitted to transfer out of South Africa each year.

However, in most cases, a taxpayer may not have the cash resources at the ready and available to finance their relocation to another country without first disposing of assets which are held by them in South Africa and abroad. Where this is the case, capital gains tax (CGT) becomes a relevant concern and is worth considering well beforehand.

Furthermore, regardless of whether the taxpayer disposes of their assets prior to their departure from South Africa and/or investment in the other country, this may also result in complexity and unforeseen costs from a tax perspective, regardless of whether tax is imposed by one's new home country, due to that taxpayer's residency status in South Africa.

Cessation of residency status

Upon emigration, one of the most pertinent issues to be addressed is whether a taxpayer will still be considered a "resident" for tax purposes in South Africa. A resident is liable to tax on their income as derived from worldwide sources (subject to certain exemptions) and a non-resident is only subject to tax on their income derived from a source within South Africa.

Equally important is a taxpayer's residency status in their new home country, which could predicate that they are also considered to be liable to tax on income from worldwide sources in that country. If the taxpayer is considered a resident in both countries for tax purposes, the provisions of the double tax agreement (DTA) between the two countries should be considered to cconfirm in which country the taxpayer will be exclusively tax resident.

The distillation of one's tax residency is an absolutely crucial matter when emigrating, as the absence of this determination may result in double taxation between South Africa and the other country. Knowing which country may rightfully impose tax liability for income generated from worldwide sources will go a long way in informing where and how to approach foreign investment.

> *"While National Treasury is yet to provide a concrete timeline for the introduction of the deemed retirement fund withdrawal, it should be noted that this would foreseeably constitute circumvention of certain treaties, and may further complicate the financing of one's new life abroad."*

Deemed CGT liability or "exit tax"

When ceasing to be a resident in South Africa for tax purposes, this results in the so-called "exit tax". The exit tax is, in reality, a deemed disposal of one's worldwide assets, at their market value (on the day prior to residency cessation) and a deemed reacquisition of those assets on the day that residency ceased. In effect, this creates a potential CGT liability in the hands of the taxpayer concerned.

While CGT is levied at a maximum effective rate of 18% in South Africa, it is well noted that this would go a long way in disincentivising the cessation of residency in many cases, depending on the nature of the assets held by the individual – the exit tax does not apply to immovable property situated within South Africa. There is no escaping this liability in respect of applicable assets upon the cessation of one's residency and, for this reason, it is important to tread carefully in each case.

Proposed law changes

It is no secret that there are changes which have been and are being made to the laws around expatriates. As from 1 March 2020, the foreign employment income exemption provided for under section 10(1)(o)(ii) of the Income Tax Act has been limited to R1.25 million per annum. Notwithstanding this, there may be further incoming changes for an emigrating taxpayer to consider.

Of these prospective law changes, one that stands out in relation to an expatriate ceasing their South African tax residency is the proposed deemed retirement fund withdrawal as outlined in Annexure C of the 2021 Budget Review document. This contemplates that South Africa does not have an opportunity to tax the retirement interests of emigrant South Africans upon withdrawal, where a DTA allocates the exclusive taxing right over the amount to the other country concerned.

While at this stage National Treasury is yet to provide a concrete timeline for the introduction of the deemed retirement fund withdrawal, it should be noted that this would foreseeably constitute circumvention of certain treaties, and may further complicate the financing of one's new life abroad.

Financing emigration

Given all of the less-than-ideal financial considerations when emigrating, if one plans to relocate from South Africa then it is important to ensure sufficient liquidity to meet their needs and settle their obligations not only upon departure but also for some time thereafter as well.

This means that tax planning is necessary to ensure that a person does not get caught in the pitfalls on moving abroad, whether this is from the perspective of possible double taxation, a too-high tax burden or as a consequence of the exit tax.

In most cases, an individual who is emigrating will reasonably acquaint themselves with the pertinent tax considerations when transferring funds abroad to fund their lives outside of South Africa, and it is prudent to ensure the correct advice is sought beforehand in every case.

MOVING RETIREMENT FUNDS OFFSHORE

HUGO VAN ZYL, hugo@taxforum.co.za

For many South African expats and emigrants, financial emigration through the South African Reserve Bank was a quick solution to access their retirement funds in order to settle their exit tax and finance their restart abroad. Our article covers the situation now that route is no longer available.

> *"The fact that the risk management function now rests on the fund is likely to create its own complications: Will the fund managers now be required to understand the intricacies of every DTA signed?"*

Background

As a result of the ceasing of exchange control, effective 1 March 2021, the Reserve Bank concept of emigration (aka formal emigrations), be it financial or formal emigration, no longer exists. Since exchange control is no longer relevant, neither is financial emigration.

The financial emigration process previously resulted in the South African Reserve Bank controlling or blocking an emigrant's remaining assets in a special capital or "blocked funds" account. The Reserve Bank has announced that blocked accounts will revert to local bank accounts. Henceforth, all transfers from previously blocked assets (be it cash or listed and unlisted securities) will be handled as regular FIA fund transfers, subject to SARS tax compliance or tax clearance certificates. In short, natural person emigrants and natural person residents are treated identically.

In respect of the withdrawal of retirement funds, the key is now cessation of South African tax residence status or the emigrant becoming a "person other than a [tax] resident," referred to in the definition of "gross income" in the Income Tax Act.

The new rules

The new rules for early withdrawal of retirement annuities and certain preservation funds (RAs or encashment of RA on emigration) stem from the definitions in the Income Tax Act. The new Income Tax Act wording only refers to three or more years, driven and based on the tax principle "to cease tax residency" (aka cessation of residency or tax emigration).

As with all new legislation, SARS' interpretation and application processes have to play catch-up, withdrawing (now) irrelevant processes and implementing new requirements.

Since the Reserve Bank is no longer involved in the decision-making process, SARS amended the SARS Tax Compliance Status (TCS) process to remove the requirement to upload a Reserve Bank form MP336(b). SARB circular 6 of 2021 (C6-2021) explains the new verification process.

The tax law does not define emigration and, even though the Reserve Bank concept of emigration was terminated, we continue to use the word emigrant in everyday parlance. In this article, the word emigrant is used to indicate an individual who ceased to be a South African tax resident for whatever reason. It will typically include immigrant workers whose work visa expired, despite not all of them becoming South African tax residents.

A person other than a tax resident is not subject to local income tax on income not from a South Africa source. However, any proceeds from a local retirement fund are deemed to be from a South African (local) source. Therefore, SARS should collect tax before the net amount is remitted abroad, unless a double tax agreement (DTA) or treaty restricts this obligation.

The new processes

Emigrating fund members now need to place on record:

- Their new foreign address, within 21 days of the date of their physical departure from South Africa (section 23 of the Tax Administration Act). This date may not be the tax exit date in terms of the Income Tax Act, read with the relevant DTA.
- Their deemed date of tax emigration at SARS:
  - At the time of tax filing, using the ITR12 and eFiling
  - When filing the TCR01 to obtain a Tax Emigration Clearance (TEC) or TCS PIN.
- In tax year four, the date they qualify to encash their remaining retirement funds, this time via the fund manager, who will file the tax directive and supporting documents with SARS.

SARS has not yet issued any draft guides for industry players' comment, be it bankers, Authorised Dealers, fund managers or tax practitioners.

The trade testing of the interface between SARS and the various funds dealing with the TCS process was completed on 22 April 2021. Effectively, the new process, albeit legislated as of January 2021, was only implemented from that point onwards. Unfortunately, the delay in issuing new draft guides, and implementing new processes, has had (and will continue to have) an impact on all affected.

How did we get here?

During 2019 and early 2020, it became evident that the financial emigration process was abused and outdated (or just not suitable) to place cessation of tax residency on record. Expats could complete the financial emigration process without breaking South African

> *"It can only be hoped that SARS will seriously consider the industry's comments and make the early withdrawal not only easier but quicker."*

tax residency. The new complexity is that the cessation of tax residency is an absolute requirement.

There are several factors causing uncertainty and complexity, including:

- The at least or more than three years' non-SA tax residence test (three-year test).
- The 2021 Budget tax policy announcement that Government intends to immediately raise a section 9H-like exit tax on remaining retirement funds.
- The e-Filing system being inadequate when it comes to dealing with the cessation of tax residency.
- The e-Filing system and ITR12 annual tax return's failure (to date) to ask the fundamental questions regarding tax residence status and DTA application.
- A dated interpretation note dealing with the concept of an ordinarily resident. Perhaps it is time to codify the breaking of ordinary residence based on a number of days or tax year test. Should National Treasury stick to their guns on the three-year test, why not treat all expats as deemed non-SA tax residents as on the first day of the fourth tax year?
- The SARS guide IT-AE-33-G01: TAX DIRECTIVE for emigration and cessation of VISA was updated on 26 April 2021, leaving no time for practitioners to prepare for its introduction.
- The introduction of "expat tax" or the capping of the foreign-earned income exemption, announced in 2018/2018 and implemented 1 March 2020 (February 2021 tax year). Interpretation note 16 (Issue 3) was finalised a few months before the introduction of the capped exemption. The frequently asked questions (FAQs) document was published in September 2019. To date, no formal SARS guide or interpretation note has been issued on the taxable value of typical expat benefits not currently defined in either the Fourth or Seventh Schedule to the Income Tax Act.

In addition to the above, the uncertainty around the foreign-earned employment income exemption and expat tax has caused a stampede to complete cessation of tax residency (and some even incorrectly abusing the terminated financial emigration bank emigration concept) to escape worldwide taxation.

Way forward

Effective as of 1 March 2021, taxpayers will be able to access their applicable retirement benefits if they can prove to the fund that they have been non-resident for tax purposes for an uninterrupted period of three years. Taxpayers will no longer need to file an MP336(b) at their bankers. This article does not deal with the transitional rules applicable to the incomplete financial emigration process.

The RA fund manager (and no longer the banker) is now obliged to ensure the departure, verify the tax exit and collate the supporting documents before filing. A Tax Directive is issued to the fund by SARS. The fact that the risk management function now rests on the fund is likely to create its own complications: Will the fund managers now be required to understand the intricacies of every DTA signed?

Taxpayers must provide to their fund managers a TCS with a verification PIN, the application to encash, proof of foreign tax residency and a "cessation of residence document". Once the fund is confident the taxpayer qualifies, a tax directive request is submitted to SARS, which may be declined or issued. If the directive is issued, the fund withholds the tax and pays the balance to the local bank account. Taxpayers may no longer require the fund to pay into a foreign account and the blocked account system has been abolished.

This means that the taxpayer will have to approach their banker to transfer the net after-tax amounts to a foreign bank account. The Authorised Dealers cannot do the transfer until the fund manager has filed the required documentation confirming the final amount paid to the taxpayer.

Effectively, the eventual transfer of the RA may have to be communicated and processed four or five times. The cessation of residency application (TCR01) and the FIA (Foreign Investment Process) no longer contain any monetary limit. The actual R10 million FIA allowance is a glass ceiling dictating the level of complexity.

If a request to remit funds of more than R10 million per calendar year is submitted to an Authorised Dealer, the Dealer or bank has to submit the application to the Financial Surveillance Department (FinSurv) of the Reserve Bank.

Due to the ongoing trade tests by SARS, the actual process to cash out an emigrant's retirement annuities before retirement age only actually commenced at the beginning of May 2021. (Refer to IBIR-006 Tax Directive's Interface Specification version 6.104.)

What are the uncertainties and changed rules that increase the complexity of moving funds offshore?

- The supporting documents for emigration withdrawal (Directive Code 29 on Form Band C) were previously evaluated by the Reserve Bank's FinSurv (as part of the MP336(b) process). The retirement fund administrator now considers the new Cessation of Residence Reason Code 29 or 57 (Form B and C).
- The fund notifies SARS, using an online directive containing simple Yes or No answers. Where either the date of accrual or the date of cessation of residence is after 1 March 2021, SARS requires two additional documents: a TRC (Certificate of Tax Residency or Tax Domicile Certificate in a new country) and a "document confirming cessation of residence".
- SARS has not designated the document confirming cessation of residence. For now, we assume it to be a Tax Emigration Clearance (TCS with PIN) following the successful processing of the TCR01 application to place cessation of residency on record.
- For most funds, the SARS validity test suggestions to the cessation of residency dated before 1 March 2021 do not require a +three-year test verification or document confirming the deemed exit date as problematic. It is anticipated that the TCS application by the fund could be declined without the taxpayer being given the opportunity to intervene or argue their case.
- Fund payroll administrators are not tax assessors and cannot stress test the provided documents or judge the adequacy of the uploaded TRC. Added to this, many countries do not issue or have a process to issue a TRC.
- There is no indication on the validation period of a tax emigration clearance certificate (TEC). For example, if the TEC was dated in 2018 but the retirement annuity is cashed out in the 2021 tax year, will a new TCG (FIA based) approval be required? Even more complex is the situation where the RA encashment and other remittable funds exceed R10 million. The tax non-resident will now be required (C6-2021 rules) to ask their bankers to follow the new Reserve Bank verification process. Many commentators assume that once the TEC is issued, the +R10 million Reserve Bank verification process will not be required. C6-2021 reads: "All transfer of assets by private individuals that have ceased to be SA tax residents will be transferable subject to tax compliance … The tax residency status will determine how FinSurv treats the resident's domestic assets, taking into account that the sale proceeds and assets of non-residents are freely transferable offshore."
- The writer suggests the +R10 million FinSurv process will be required because of the monetary value. The source of funds may ease the process but the early withdrawal of a lump sum by a tax non-resident will not result in the Reserve Bank process being waived. Dividing massive RA transfers over two calendar years may be the preferred solution. We are mindful that very few individuals will have a net after-tax RA withdrawal benefit in excess of R10 million.
- Because the R10 million per calendar year limit will trigger FinSurv verification, non-residents are encouraged to remit liquid cash and equities in the first three years after ceasing tax residency. This will ensure the transfer in tax year four does not aggregate to the R10 million per calendar year.
- There is no FinSurv guidance on a wealthy spouse donating or transferring the amounts in excess of R10 million to the other spouse. The local Income Tax Act anti-avoidance will not be triggered, but tax non-residents should consider the new country's tax rules and the matrimonial regime rules.
- The C6-2021 states that the new TCS and TEC process or procedure "will apply regardless of whether such a private individual would be transferring funds abroad at the time he/she ceased to be a resident for tax purposes". Should this be the SARS guidance in the updated tax emigration guide, one can foresee a bottleneck of old informal tax and bank emigrants now required to update their e-Filing and SARS profiles.

Conclusion

The most critical interpretation awaited by the industry is the three-year rule. Is it three periods of 12 months, three tax years, or three calendar years?

It can only be hoped that SARS will seriously consider the industry's comments and make the early withdrawal not only easier but quicker. Waiting for +three years to cash out the amount SARS wishes to tax immediately as a deemed "disposal" of an asset (refer to section 9H of the Income Tax Act) in the year of tax emigration cannot be fair tax treatment.

Only once the draft Taxation Laws Amendment Bill is issued will the industry know how the "exit tax" will impact the retirement funds left behind.

THE IMPLICATIONS OF OFFSHORE ASSETS FOR YOUR WILL

15 minutes CPD

▶ **CHANEL KEMPFF**, Chanel.Kempff@fnb.co.za

What happens when a South African passes away while directly holding assets offshore? Are the foreign assets covered by a local South African will? Our article looks at ways of ensuring that your assets are treated in the way you intended.

We live in an era where more and more people are considered "global citizens". Diversifying across jurisdictions has become somewhat of a norm. Given the fact that most people understand the importance of having a valid will in place as part of the effective execution of their estate planning wishes after their death, understanding the statutory requirements of other jurisdictions might prove to be more of a challenge when deliberating on whether multiple wills are necessary in order to cover all bases. The question can consequently be posed: Do I require more than one will to deal with my worldwide estate or should I have a separate will for each jurisdiction where assets are held?

The complexity stems from the fact that we live in a world where, for the most part, borders have become little more than grey lines separating countries on a map. As such, it can be tempting to believe that the freedom of testation, which comes with your South African citizenship, affords you the right to leave your assets to whomever you please. However, not all countries have the same rules as South Africa when it comes to dealing with the distribution of assets after death. It is therefore important to obtain advice in each specific jurisdiction in order to ensure that your assets are distributed in line with your wishes, taking into account the rules – and possible limitations – that apply in each jurisdiction. This will ensure that you have a clear understanding of the possible limitations involved, while keeping in mind how the global mobility of heirs and legatees might affect the transfer, as well as what is legally required to ensure the smooth transition of assets to these individuals or entities.

"The first consideration is to make sure you have a clear understanding of whether each of the countries in which you hold assets offer the same level of freedom of testation as South Africa."

Administering an offshore deceased estate

When considering the administration of an offshore estate, it is important to understand what the process is after death. At death, your family will engage with your South African estate's executor to finalise the deceased estate reporting documents for submission to the Master of the High Court. During this process, your executor would probably be made aware of the fact that you own foreign assets. The executor will consequently establish whether you have an offshore will or whether your local will covers all assets situated worldwide. In the event where there is no offshore will, your executor will ensure that all your formal death documents (e.g. will and death certificate) are formalised and apostilled by the Master, as well as possibly translated (if required) in order to be sent to the foreign authorities for reporting purposes. Depending on the assets and jurisdictions involved, this might result in a lengthy and possibly costly process.

Basic principles

Given that there is no one-size-fits-all solution to these complexities, personal advice specific to your circumstances is the best course of action. Nonetheless, there are a few basic principles that, generally, underpin successful multi-jurisdiction estate plans.

The first consideration is to make sure you have a clear understanding of whether each of the countries in which you hold assets offer the same level of freedom of testation as South Africa. If that is the case, a single will, drawn up in this country, should be sufficient to ensure that your wishes regarding all your assets, in every jurisdiction, are carried out.

If, however, you hold assets in a country with forced heirship rules, these will provide specific guidelines on precisely how your assets must be distributed. In such instances, having a separate will dealing specifically with the assets held in each such country may be the most appropriate approach. This is particularly important if you want to avoid lengthy estate administration delays and even the need for possible legal battles by your heirs. Further, where no separate offshore will is available and the South African Letters of Executorship are not deemed acceptable in terms of dealing with a foreign asset, the South African will would need to go through an onerous and often costly validation process before it could be accepted as enforceable in that country. Having a separate offshore will that aligns with the forced heirship rules of the country concerned in place would streamline the entire estate planning process and allow all the offshore assets to be dealt with at the same time as the administration of the South African estate.

Separate wills

That said, simply having separate wills covering assets in various jurisdictions is not a guarantee of a smooth and simple estate administration process. It is imperative that the separate offshore wills and the South African wills are aligned, otherwise the process can still become incredibly complex and frustrating. At their most basic level, these wills should never be seen to contradict, supersede or replace one another. In other words, the wills should not refer to the same assets and care should be taken that they do not unintentionally revoke each other. This might result in another will accidentally "cancelling" all or some of the other wills, which might result in an unintended sequence of events on all other assets.

Take care to establish that there is a clause in the offshore wills that clearly indicates exactly which offshore assets or jurisdictions are dealt with in that specific will. This will ensure that none of the other wills are accidentally replaced or revoked. This also creates certainty surrounding the jurisdiction to which the offshore will refers, so that there is no doubt as to the application of your wishes versus the jurisdiction involved.

The value of seeking the assistance of a professional fiduciary expert or adviser cannot be over-emphasised in this regard as each of the wills has to be properly worded, so as not to create any confusion. It is essential that multiple wills are thoroughly assessed to ensure they are not contradictory and align with the rules and regulations of each jurisdiction.

Points to ponder

When drawing up a will, or wills, for assets held in multiple jurisdictions, it is a good starting point to be able to check off the following five considerations:

The types of assets should be considered

Where the offshore assets only consist of movable assets, the general rule is that a single (worldwide) will can be drafted. For this purpose, the will should be drafted in the jurisdiction where the testator is domiciled. However, depending on the above-mentioned factors, a separate will may also be required in the jurisdiction where the assets are located.

Gathering all relevant information on the offshore asset types and values

These aspects may determine whether or not a separate will is required within the jurisdiction where assets are located, even if they are movable. An example would be where the only asset is a bank account to a value under a specified amount, for example £10 000. The foreign bank, and subsequent foreign rules, might allow the release of the funds on presentation of the South African formal documents. This should be confirmed with an expert within the specific jurisdiction.

Confirmation of ownership of an asset

Consider how your marital regime, as an example, impacts your ownership of an asset. This impact should be weighed upon any transfers made to any other heirs in terms of your will. Also take into account whether there are any limitations on the ownership you enjoy on the property, which might negate any of the wishes in your will.

Are there any forced heirship laws in the countries where you hold assets?

It is important to understand whether freedom of testation applies in the specific jurisdiction. If not, can you include a clause in your offshore will where you can perhaps rely on private international law or international regulations to apply South African law when executing your offshore will?

Are there any other potential challenges to the execution of your will/s?

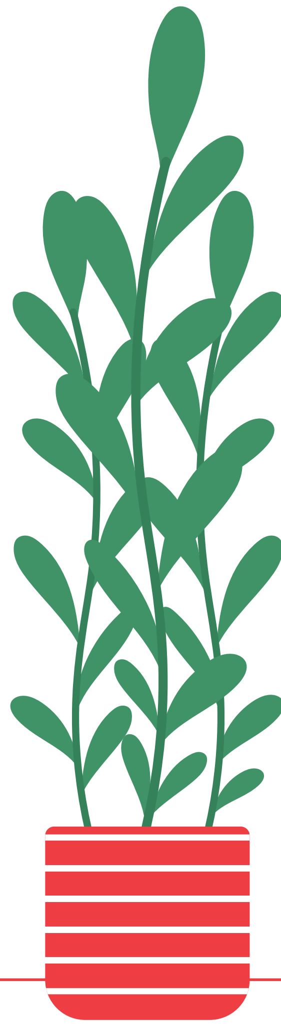
The impact of language barriers and the potential for instructions to be "lost in translation" is something that should be considered. If you rely on one worldwide will to address your worldwide estate and if you hold assets in, for example, Germany, this will result in the worldwide will having to be translated to German. This will result in extra costs, delays and possibly other barriers: a poor translation might cause unintended consequences after your death.

Concluding thoughts

Ultimately, it is important to understand the full implications of assets in other jurisdictions and to ensure that the laws of those jurisdictions are complied with when setting up one or more wills. Failure to do so could result in significant challenges, delays and possible unintended consequences for those whom you want to take ownership of your assets in those countries after you have passed away.

As such, the advantages of seeking professional advice and assistance from an advisor who is well versed in foreign succession laws cannot be too strongly recommended.

"The impact of language barriers and the potential for instructions to be 'lost in translation' is something that should be considered."



15 minutes CPD

LOANS TO OFFSHORE TRUSTS

▶ **ROXANNA NYIRI,** roxanna@transferpricingsolutions.co.za

The most common way of funding offshore trusts is via loans. These loans must carry a transfer pricing rate of interest versus the section 7C rate. Our article covers the considerations of determining an appropriate interest rate.

Certain tax anti-avoidance measures are aimed at curbing the transfer of wealth to offshore trusts by way of loans, where such loans bear interest which is below market-related rates.

In summary, the aforesaid measures include the donor attribution rules in section 7, read with paragraph 72 of the Eighth Schedule to the Income Tax Act, and the transfer pricing principles contained in section 31 of the Act in the case of an individual who is a connected person in relation to the offshore trust (such as a beneficiary of such trust or a relative of such beneficiary).

Donor attribution rules

With effect from 1 March 2017, section 7C of the Income Tax Act deems that where a natural person makes a loan to an onshore or offshore trust, that person is deemed to have made an ongoing donation to that trust of interest not charged. The amount of donation is calculated based on interest to be charged on loans to offshore trusts by South African natural persons at a rate not lower than the official rate of interest, which is defined as the South African repurchase rate (rate at which the central bank advances loans to commercial banks) plus 100 basis points.

An interest free loan that is granted by a South African resident to a foreign discretionary trust will trigger the attribution rules contained in section 7(8) of the Income Tax Act if income generated by the funds that were lent was retained in the trust for the year of assessment or distributed to a non-resident beneficiary. The lender is taxed on the income to the extent that the trust has benefited by not having to pay interest on the loan, at a market-related rate (rate at which the trust could borrow from an independent third party) for the currency in which the loan is denominated.

> *"Key considerations would be whether the borrower could obtain this level of financing from a third party lender under current market conditions and whether there are similar indicative transactions within the market that would evidence this."*

Section 31

The transfer pricing provisions contained in section 31(1) will apply to transactions between a resident trust and any non-resident person who is a connected person in relation to such trust, as well as between a non-resident trust and any person who is a resident connected person in relation to such non-resident trust. In this regard, the most common issue that arises is funding provided by a South African resident to an offshore trust or to a wholly-owned offshore subsidiary of the offshore trust by means of an interest free loan. This funding will be subject to the provisions of section 31(2), which requires that the interest charged be market related.

So in a nutshell, in addition to the attribution rules, section 31 would apply to deem the South African resident to have earned interest on the loan at a market-related rate. If section 31 applies to a cross border transaction between related parties, e.g. a South African beneficiary of an offshore trust, then the donations tax provisions contained in section 7C do not apply.

In circumstances where an offshore trust structure is being funded by an interest-free loan, a continuous donation is being made so that section 7(8) will apply. To the extent that section 7(8) applies, section 31(2) cannot also apply as this will lead to double tax. However, even in circumstance where section 7(8) applies, income tax could still be avoided, so that section 31(2) could apply simultaneously with section 7(8), depending on the circumstances.

In terms of section 31 and in terms of outbound interest free loans, the rate of interest must be market related and should be commensurate with what the lender would earn in the open market.

The rate of interest on an interest free loan granted to an offshore trust by a South African connected party, calculated in terms of section 31, is somewhere between the rate that a lender would earn in the open market and the rate a borrower would pay if monies were borrowed from an independent third party.

The currency of the loan and credit rating of the borrower would be relevant in determining the market rate of interest. The basic economic principle is: the higher the risk profile of the borrower, the higher the rate of interest. There would be different rates of interest for different currencies of loan, usually the base rate of the country of currency would be a starting point.

One way of determining an arm's length rate of interest would be to obtain independent bank confirmations of the rate of interest they would charge on the same quantum of loan based on comparable terms and conditions, which include currency of the loan.

In the alternative a debt capacity analysis may be performed which determines an adequate level of borrowing for the trust with reference to comparable data transactions within the market.

Key considerations would be whether the borrower could obtain this level of financing from a third party lender under current market conditions and whether there are similar indicative transactions within the market that would evidence this. Another key consideration would be how the borrower will meet its liabilities. Can the borrower be expected to service its obligations, including repayment of the principal amount of the loan plus interest, which should be reflected in the credit rating of the borrower.

Market analysis

In the market analysis, databases can be used, such as Bloomberg (which contains integrated information on bonds, equities, commodities, currencies and funds) or DealScan (which is a source of information on global loan markets and provides access to multiple bond and loan transactions from around the world).

Loan stat publications can also be used. These help investors to benchmark the structure and risk and return on loans. These reports present financial ratios by company size and industry.

In the market analysis, Step 1 would be to search in Bloomberg and DealScan for loans corresponding to the terms and conditions of the intercompany loan, using region, industry, loan currency and loan start date. Step 2 would be to calculate interquartile ranges and Step 3 would be to determine, based on debt-to-EBITDA ratios, whether the trust could reasonably have been able to borrow the same quantum of loan.

The OECD Transfer Pricing Guidelines, upon which the transfer pricing legislation in section 31 is modelled, are clear that transfer pricing is not an exact science and does require the exercise of judgement by both the taxpayer and tax administrator.

30 minutes CPD

MANAGING OFFSHORE TRUSTS

▶ **NEIL RIEKERT**, neil@thomsonwilks.co.za

A look at the proper governance of an offshore trust that is respected and is "effectively managed" in the desired location, as well as the choosing of an in-country trustee.

Introduction

The establishment of an international trust has become increasingly attractive to many South Africans. These offshore trusts are primarily based in low (or zero) tax jurisdictions. They are instrumental in holding offshore wealth and hedging against political and economic uncertainty. In previous times many offshore trusts fell largely undetected under the veil of secrecy of the many so-called offshore tax havens. Offshore trusts were easy to establish as long as one had the available funds. Growing global awareness and transparency have led to an increased level of scrutiny, and indeed regulation, of the entities and trusts established in these previously somewhat obscure tax havens. Enter the offshore compliance age of many new sophisticated acronyms, policies and a wave of greatly increased compliance and regulation: the Base Erosion and Profit Shifting (BEPS) policies of the Organisation of Economic Co-operation and Development (OECD), Inter-Governmental Agreements (IGAs), Red-Listings, the Foreign Account Tax Compliance Act (FATCA) and, very importantly for the South African tax resident settlor, the Common Reporting Standard (CRS), which allows for the mandatory exchange of certain tax residents' information between signatory offshore and onshore countries' tax authorities. What is clear is that the days of running "fast and light" offshore trusts are over.

Let us take a quick look at some of the key role players in a typical discretionary offshore trust structure. The founder or settlor donates the initial trust fund to the trustee for further holding, control and management of the fund for the benefit of the named beneficiaries, or class of beneficiaries, subject to the terms of the trust deed. The settlor, also known as the beneficial owner, may request that a protector be appointed. The protector may have positive and negative vetting powers over certain actions of the trustees. Examples of a protector's powers may include the power to appoint and remove trustees, the approval of any distributions and required consent to any change in the trust's jurisdiction. Caution should be exercised in appointing a protector with wide powers as these may impinge on the control and discretion of the trustee and place the trust at risk not only of being regarded as a sham trust but also of weighting the move of the effective management of the trust towards the place of tax residency of the protector rather than that of the trustee. This will be expanded upon below.

Management or trust companies

For an offshore trust to enjoy the preferential tax rate of the relevant offshore jurisdiction it must be a tax-resident of that country. This requires that, at the least, the trustee should be tax-resident of that country. A South African settlor would need to identify and appoint such an in-country person as a critical initial step in establishing an offshore trust. It is common for these offshore service providers to establish specific fiduciary services businesses, usually referred to simply as management companies. The trustee itself is typically a corporate trustee, meaning a company registered in and with resident directors in the trust's home jurisdiction. The trustee company is usually a subsidiary or entity controlled by the relevant management company.

In most reputable offshore jurisdictions management and trustee companies not only have to be registered specifically as such with the local company registration office but also licensed by the local financial services authority. In Mauritius and Jersey this authority is known as the Financial Services Commission or simply the FSC and the JFSC, respectively. Such licensed management companies are required to report to the relevant FSC. In the instance of Jersey the key function is to:

"maintain Jersey's position as a leading international finance centre, with high regulatory standards, and to adhere to our guiding principles which are:

- *reduce risk to the public of financial loss due to dishonesty, incompetence, malpractice or the financial unsoundness of financial service providers;*
- *protect and enhance the reputation and integrity of Jersey in commercial and financial matters;*
- *safeguarding the best economic interests of Jersey;*
- *countering financial crime both in Jersey and elsewhere"*

[Extract from the official website of the JFSC Commission.]

When looking for a suitable offshore management company it is therefore critical to ensure that it is registered with the relevant financial services authority. These registration details are usually public records and accessible through the relevant authority's website. An absence of access to such records should raise a red flag.

With the increased level of global offshore compliance, and the pivotal role that the trustee plays, it is imperative that a professional service provider that has the requisite level of skill and infrastructure is appointed. This may come at an increased cost but one that is perhaps well justified, bearing in mind that the settlor would be divesting itself of the entire trust fund to this person for purposes of the trust. It would certainly be worth a prospective settlor's time and money to travel to the relevant country to meet with the senior management and decision makers of the identified management company. In the current times, this may be prohibitive but at least one or more electronic meetings would be strongly advisable. Before committing, one should be entirely comfortable and conversant with the decision makers of your offshore service provider. The level of seniority, qualifications and experience of the trustee's representative should all be considered and be commensurate to the size and complexity of the trust fund. The corporate trustee should also carry proportionate trustee liability insurance cover and produce proof of this on request. Choosing a trustee that has knowledge of South African tax laws and exchange control regulations is important. There are a number of management companies that focus specifically on the South African market and who have tailored their documents and procedures to match the need.

"During interactions between the settlor (and protector if applicable) and the trustee they should always remain vigilant and cognisant of their respective roles and responsibilities."

Jurisdiction

When choosing an offshore jurisdiction it may be best discussed with the management company who usually have offices in several jurisdictions. Some considerations are the locality and ease of travel, political stability, double taxation agreements, the degree of financial services authority oversight and accountability, local legal framework, accessibility to the local courts and the level of banking support. Offshore jurisdictions are monitored continuously by the OECD and a list of "non-cooperative" non-EU jurisdictions is published regularly. The significance of this, purely from a banking perspective, is that a trustee may find it very difficult, if not impossible, to perform a banking or investment transaction from within such a red-listed location. As of 22 February 2021 the list includes Seychelles, Panama and the US Virgin Islands.

If travelling to the relevant jurisdiction, the initial trust fund may be paid to the trustee at this time. Alternatively, this amount may be paid by electronic means whilst on your visit. Similarly, the settlor and the trustee would sign the relevant trust deed establishing the new trust at this time. Whilst it is certainly not fatal to the formation of an offshore trust not to do so, this action leaves no doubt at all when and where the trust was established. Regardless of where the initial trust fund is to be paid from, the donated funds should be reported to SARS as a donation by the settlor. The corporate trustee should be named as the donee and should sign the relevant declaration form and name the place where the donation is accepted. For instance, if in the Isle of Man – accepted by ACME Trustees Ltd, Douglas, Isle of Man. If the initial donation is made by the settlor electronically from within South Africa the purpose of the payment should be made explicit when completing the relevant foreign exchange control documents provided by a bank.

Effective management

While a settlor or a protector of a trust may request a trustee to consider performing certain actions in relation to the trust, it is ultimately the trustee who is required to exercise its discretion to initiate such actions or not, after exercising its independent judgment. This is not unique to offshore trusts but within the offshore context the risk of not doing so carries the additional potential of the offshore trust being regarded as being effectively managed and controlled by the South African resident settlor and taxed as a resident trust in South Africa.

The Court in *Oceanic Trust Co Ltd v CSARS (2012)74 SATC 127* when considering the place of effective management (POEM) of a trust registered under the laws of Mauritius looked beyond the contents of the trust deed. It sounded the caution that, notwithstanding the usual provisions of a trust deed stating where the affairs of the trust are to be managed from, the prevailing facts and circumstances of each case should be examined. It further emphasised that the POEM is the place where key management and commercial decisions that are necessary for the conduct of business are made. This ruling is reflected and expanded upon in the SARS Practice Note 6 (Issue 2) 3 November 2015, relating to companies in which it states, “The place of effective management test is one of substance over form. It therefore requires the identification of those persons in a company who actually call the shots and exercise realistic positive management”.

This excludes reference to special investment trusts or any jurisdiction that may have a double taxation agreement with South Africa that automatically vests POEM in that location.

As mentioned previously, care should be exercised in reviewing the standard form trust deed supplied by a management company. It is certainly not a “one-size-fits-all” scenario – bearing in mind that most management companies deal with clients from all over the world. Some offshore jurisdictions have liberal trust laws to make their destination a more attractive offering to onshore investors. One example of this is the degree of control of the settlor and clauses in the trust deed that contain reserved settlor’s powers. Whilst these may be appealing from the settlor’s perspective, they may inadvertently shift the POEM to the settlor’s location, or at least place it in question. The trust deed should match the conduct and purpose of the trust. These can change, so whilst on his annual trip to his favourite island a settlor would do well to call in on the trustee and review the state of the trust, and the trust deed.

Who calls the shots?

During interactions between the settlor (and protector if applicable) and trustee, all parties should remain vigilant and cognisant of their respective roles and responsibilities. This applies not only to the administration of the trust but also, very importantly, to the management of the trust fund (including all trust property). Activities pertaining to trust administration would include the preparation and execution of all trustee resolutions, the preparation of accounts and financial statements, bank account opening and maintenance, and the maintenance of all books and records. Asset management and business activities are broad and may include key decision making, exercising shareholder voting rights, providing instructions to fund managers or brokers, negotiations, signing of agreements and providing investment mandates. All of these activities should be conducted from the trust’s home location and by the trustee.

A settlor or protector who may be tempted to hold transactional capability over the trust’s bank account or stock portfolio, or generally exert undue influence or control over the trustee, should revisit the issue of POEM. When establishing a new offshore trust, perhaps the poignant question would be “which trustee do you want calling the shots?”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GOING NEXT DOOR? MAURITIAN TRUSTS

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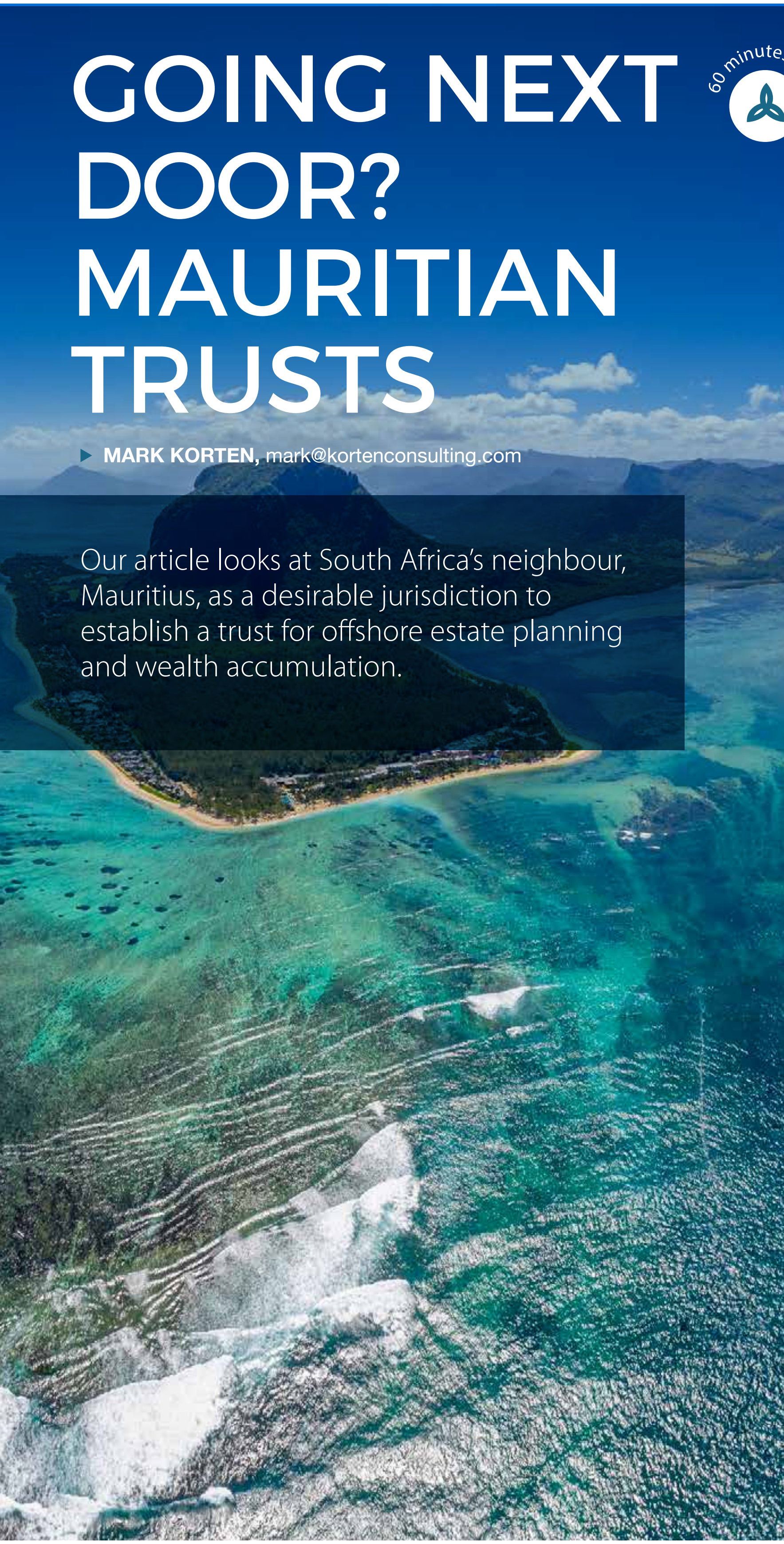


Our article looks at South Africa's neighbour, Mauritius, as a desirable jurisdiction to establish a trust for offshore estate planning and wealth accumulation.

Considering Mauritius as a suitable wealth planning jurisdiction

By virtue of its close proximity to South Africa – as well as its favourable low tax environment and a healthy network of investment, trade and tax agreements with South Africa's neighbours in Sub-Saharan Africa, as well as India, Asia and parts of Europe – Mauritius has for many years been a popular jurisdiction for South Africans to use for active or passive companies. However, Mauritius has also been adding modern and flexible legislation in areas of financial services and estate planning in order to attract foreigners to use Mauritius as an offshore wealth planning jurisdiction. Mauritius also boasts fiscal advantages of having no exchange controls, a sound banking system, no capital gains tax, a fairly extensive network of double taxation agreements and a relatively simple tax regime. This article considers Mauritius as a location for establishing a Mauritian trust for general offshore estate planning and wealth accumulation purposes.

The Mauritian government has created various incentives to attract international financial services providers to have a meaningful presence in Mauritius. Investment advisors and fund managers are carefully regulated by modern enabling legislation and a strict financial services licensing system through the Mauritian Financial Services Commission (FSC) in order to protect the interests of investors. In particular, there has been a significant increase in the establishment of various investment advisory, fund management, asset management, venture capital and other financial services concerns. Certain benefits associated with listing on the Stock Exchange of Mauritius has resulted in many South African fund management corporates establishing branches in Mauritius, as well as individual skilled financial advisors moving their residency to Mauritius. Whilst South Africa has for years suffered from a "brain drain", the opposite has happened in Mauritius.

Notwithstanding the positive reputation that Mauritius has been building as an international financial centre, it would be remiss not to mention the regrettable "blacklisting" of Mauritius by the European Union (EU) with effect from 1 October 2020, which remains in force to date. Whilst this is certainly a setback for the reputation of Mauritius as a credible wealth planning jurisdiction, this blacklisting is transient in nature and must be put into its proper perspective. Firstly, it should be noted that the blacklisting of Mauritius by the EU was not on account of a breach of international taxation practices or any inadequacy with the calibre of its laws. Mauritius was placed on the EU High Risk Jurisdiction List on account of certain strategic deficiencies in its regime to counter money-laundering and financing of terrorism. The Mauritian government has acted quickly and with great priority in order to address this with a view to being de-listed by the EU as soon as possible, and hopefully before the end of 2021. In the meantime, in my experience, the blacklisting has had little to no practical implications for South Africans who have established Mauritian trusts.

Trust law differences between Mauritian and South African trusts

The trust laws in South Africa are based on a mixture of Roman Dutch and common law rules, which in fact creates a fair degree of uncertainty, and South African trust law experts have often pronounced that the vast majority of South African trusts would most likely be successfully challenged as being invalid by the South African courts for various different reasons. It should be noted that in South Africa there is no enabling legislation that gives clarity as to the laws that govern the validity of a trust and the rights and obligations of the parties involved in a trust. The only specific legislation that deals with trusts is the Trust Property Control Act, which does not in fact address the legal validity of trusts at all, but rather prescribes various largely administrative rules relating to the property held by a trust. The mere fact that a trust is registered by the Master of a High Court does not mean that it is a valid trust, as it is not the Master's responsibility to determine whether the trust complies with South African trust law, but only that it complies with the Trust Property Control Act.

In contrast, in Mauritius trusts have been given legal effect and very clear rules as to validity, existence and the rights of various parties that have an interest in, control or otherwise transact with a trust in terms of the Trusts Act. Comparing South African and Mauritian trust laws, the following distinctions are noteworthy:

- The Trusts Act in Mauritius deems a trust to exist where a person (the trustee) holds or has vested in him property of which the person is not the owner in their own right, but with the fiduciary obligation to hold, use, deal or otherwise dispose of such property for the benefit of any person (beneficiaries) whether or not already ascertained or in existence, alternatively for a defined purpose (including a charitable purpose), and provided that such trust arrangement has been reduced to writing. This means that a simple "declaration" of trust in terms of a deed of declaration by the trustees signed solely by the trustees is sufficient evidence to recognise the creation and existence of a Mauritian trust. In contrast, although South African trust law acknowledges the existence of a verbal trust, for a trust to come into being there must be the intention, agreement and action on the part of its founder to create a trust by way of gifting an initial asset to be held by trustees in a fiduciary capacity for the benefit of its beneficiaries. A mere declaration of trust by the trustee will not be technically sufficient to evidence the creation of a trust (unlike in Mauritius) and accordingly the founder must evidence a donation of an asset to trustees, and generally it is recommended that this is reduced to writing and signed by both the founder (also known as the first settlor) and the trustees.
- The Trusts Act does not recognise a Mauritian trust if the founder is the sole beneficiary, even if the founder is not a trustee. In contrast, South African trust law will recognise a valid trust where the founder is the sole beneficiary provided that the founder is not the sole trustee.
- The Trusts Act provides for a maximum of four trustees to be permissible for a Mauritian trust, where at all times one of the trustees must be a "qualified" trustee. This is defined as a licensed Mauritian management company or such other person resident in Mauritius as may be authorised by the FSC to provide trusteeship services. In contrast, in South Africa common law and the Trust Property Control Act do not prescribe a minimum or maximum number of trustees, although in recent years the Master of the High Court generally prefers a minimum of three trustees with one of them being an independent third party.
- The Trusts Act provides for a maximum period of 99 years for the existence of most trusts, except for a "purpose" trust of a non-charitable nature where the maximum prescribed period is 25 years. In addition, any Mauritian trust that owns immovable property located in Mauritius may not accumulate income for a period of more than 25 years. In contrast, South African trust law has no prescribed maximum duration for the existence of a trust.

Unique features of a trust under Mauritian law

In addition to the abovementioned distinctions, unique features of a Mauritian trust include the following:

- The Trusts Act places on trustees a duty of care and prudence and utmost good faith. They are accountable for any breach of trust and cannot avoid liability in the event of fraud, dishonesty or gross negligence. Nonetheless, trustees are permitted to apply or otherwise invest trust property without restrictions and without a strict obligation to preserve the trust capital and be accountable for any diminution in its value. This therefore permits trustees to apply trust property into alternative or slightly more aggressive investments, such as applying the trust property to fund and own a private trading enterprise (usually by way of shareholding in a company) and to hold wasting assets such as yachts and motor vehicles that depreciate. Trustees are specifically entitled to delegate investment decisions to qualified third parties such as financial advisors and other investment professionals. This is somewhat different to the trust laws applicable in jurisdictions such as Guernsey and Jersey where, due to their stricter fiduciary obligations, trustees will be hesitant to place the majority of trust property in what may traditionally be considered to be speculative or otherwise not strictly conservative investments.
- The Trusts Act makes provision for a "purpose trust" that exists for a specified objective or purpose and not necessarily to benefit beneficiaries. In fact there is no necessity to have any beneficiaries of a purpose trust, although this is often necessary if it is appropriate for a Mauritian purpose trust to qualify as a valid trust in accordance with South African law. The position of an "enforcer" is compulsory, whose responsibility it is to ensure that the purpose of the trust is carried out. Purpose trusts may be appropriate as special purpose vehicles where the arrangement between the parties concerned, as well as tax planning considerations, favour that participants do not receive beneficial distributions.
- Similar to the trust laws in many tax haven jurisdictions, the Trusts Act provides for the position of a "protector" who may also be the founder and the trustee, whose powers general include the power to remove and appoint trustees, determine the law applicable to the trust and withhold consent (effectively a negative veto) with respect to specified actions of the trustees, such as amendments to the trust deed and any decision by the trustees to make distributions to beneficiaries. Given that the position of a protector is likely to be viewed by the South African courts as effectively controlling the trust, care should be taken that a South African tax resident person or entity is not a protector of a Mauritian trust, alternatively not the sole protector, failing which the Mauritian trust concerned may well be considered to be a South African tax resident.
- Section 11 of the Trusts Act makes provision for various powerful asset and credit protection provisions. A Mauritian trust shall not be void, voidable or otherwise invalidated in the event of or by reason of the settlor's bankruptcy or liquidation or any action against the settlor at the instance of its creditors, provided that the settlor of the trust at any time that he settles property on the trust did not intend to defraud persons who were creditors of the settlor at that time. In addition, even if a creditor has a claim on the grounds of the actions of the founder being of a fraudulent nature to avoid creditors, the creditor has a period of only two years from the date of transfer or disposal of assets to the trust in order to have a valid claim against the trustees. Also, notwithstanding any rule of law relating to the enforcement of judgements in Mauritius given by the courts of another jurisdiction, the Mauritian courts are obliged not to recognise the validity of any claim against Mauritian trust property pursuant to the laws or court order of another jurisdiction that relate to the proprietary consequence of marriage or the dissolution of a marriage, succession rights of the founder after death, as well as claims by creditors in the case of the insolvency of the founder.
- An important peculiarity in the Trusts Act is the right given to beneficiaries, including beneficiaries that may be completely discretionary with no vested rights, to force the trustees to terminate a trust at any time where all of the beneficiaries concerned are in existence, all are of full age and legal capacity and have unanimously agreed to do so. In such a situation the beneficiaries may force the trustees to terminate the trust and the trustees are required to distribute the trust property as the beneficiaries may direct by unanimous agreement. It is therefore very important for the estate planner (usually the founder) to ensure that during her lifetime she is one of the named beneficiaries, and provision is made to appoint an alternative discretionary beneficiary in the event of the mental or legal incapacity of the founder during her lifetime. Also, where the founder has specific wishes regarding the distribution policy after her death, enforceable arrangements need to be provided for to ensure that this is achieved.

"Choose this service provider carefully by understanding what you require and what the service provider is able to offer, and whether the fees they charge are appropriate in the circumstances."

Practical considerations to bear in mind

From a practical perspective, a few points are worth taking into account in the course of the founder's decision-making process to establish a Mauritian trust, namely:

- The Trusts Act and South African tax laws require a leap of faith for the founder to vest control over the trust assets with a licensed Mauritian management company. Choose this service provider carefully by understanding what you require and what the service provider is able to offer, and whether the fees they charge are appropriate in the circumstances. Also ensure that the objectives of the estate plan are considered by an independent lawyer with sufficient Mauritian trust law experience, as well as a review of the trust deed by an advisor proficient in the trust and tax laws of South Africa, as this expertise is seldom offered by the Mauritian management company.
- Determine whether it is initially appropriate to apply the Trusts Act as the governing law of the trust. Depending on the requirements of the founder the opportunity exists to apply the trust laws of another jurisdiction that may be more appropriate for their needs, whilst still having the administration and trustees based in Mauritius, taking advantage of the Mauritian tax benefits and local financial service provider skills that may be necessary to use to show commercial substance in Mauritius when making investment decisions.
- Consider the future plans of the founder and family members who will be beneficiaries of the trust in terms of the place of ultimate residency. If the founder or certain of the beneficiaries intend to move their tax residency to Mauritius, a Mauritian trust will invariably be an excellent choice in terms of the application of the Trusts Act. However, if it is the intention of the beneficiaries to eventually move their tax residency to, say, Portugal, then Mauritius is not going to be an appropriate jurisdiction for various reasons.
- Take care to ensure that where possible the trust is formed outside of South Africa. This means that ideally the founder should not be within the borders of South Africa at the time that the trustees communicate to the founder their acceptance of the initial donation into trust. If this is not possible (particularly in current times with travel restrictions), then not doing so is not fatal provided that great care is taken to ensure that all aspects of the administration and decision making of the trust happen strictly in Mauritius and not in South Africa. Also ensure the trust is recognised as a trust according to South African law by using a Settlement of Trust deed rather than a Declaration of Trust.
- If the future needs of the founder and family members are to receive beneficial distributions whilst being South African tax residents, ensure that South African tax advice is obtained from the outset so that the trustees are aware of how to account for the growth of the trust fund and make distributions tax efficiently.

OFFSHORE FINANCIAL CENTRES: The benefits and considerations

30 minutes CPD

▶ **HANNEKE FARRAND,** Hanneke@farrandconsulting.co.uk

South African businesses planning to expand into bigger markets increasingly make use of offshore financial centres as a hub into which to move their businesses' and personal wealth. Our article looks at points to consider when deciding where, when and how to make a move.

In a world of constant change and turmoil, what are the benefits to South Africans of moving their wealth and businesses offshore, using offshore financial centres as a hub?

In my experience, I have found that South African clients require advisors with a specific focus on South African companies looking for both expansion and full or partial relocation of existing business into offshore jurisdictions. Specifically, they require advice and assistance with the expansion of South African entrepreneurial businesses into Europe and the US, while providing management skills to assist clients with economic substance requirements.

The commercial rationale(s) and business substance, or economic substance, are critical issues for investors in offshore structures. An offshore base provides a better entry point for foreign investors and ease of operations in international jurisdictions, while creating the possibility to retain profits offshore. (For South Africans, retaining profits in a jurisdiction or jurisdictions without exchange controls remains an important strategic objective.)

What are the hurdles?

Some of the more common hurdles in growing a business from an offshore jurisdiction, including from an offshore financial centre, are:

- Understanding the impact on the commercial rationale for the business of holding investments (including operating companies) from the financial centre.
- Maintaining the proper, required economic substance for each of the entities in the group in the jurisdictions from which they operate.
- Managing the effective management of each of the entities such that the entities are tax resident in the relevant jurisdiction and do not incur an unplanned tax liability in an unintended jurisdiction.
- Understanding the transfer pricing implications for the business of an offshore expansion, including ensuring that profits are taxed where the profits are generated.

Once you have a (successful) business

Many investors with successful businesses require advice on the best jurisdiction from which to hold their structures, which hubs are often offshore financial centres because of their proximity to the world's most developed markets and infrastructure. More than this, the offshore financial centres tend to create a presence for growing businesses in the markets into which the businesses are to expand (e.g., the UK and the EU).

The strategic choice of the jurisdiction (hub) for the business is one of many considerations for people looking to expand their businesses globally. Another key consideration is the structure of the group, including the use of trusts for wealth preservation for future generations or differing levels of holding companies for businesses to control the equity interests in different operations of the group.

The proper implementation of any offshore expansion of a business includes the following considerations:

- A thorough and detailed paper trail of the expansion, including detailed notes and documents, taken by the right people in the right jurisdictions, considering the available options and the formalised commercial rationale for the business decisions made in pursuit of the expansion, to support the economic substance and tax residency requirements.
- The correct (especially consistent) disclosures to the relevant authorities (including the revenue authorities or exchange control authorities) to record the expansion, including the substance of the arrangements.
- The common reporting standard and the Automatic Exchange of Information between jurisdictions, including understanding the disclosures made and whether these are consistent with the substance of the business, group, or individual to which they relate.

Economic substance requirements

The economic substance requirements were, in the main, initiated by the Organisation for Economic Co-operation and Development (OECD) and the G20's Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

The economic substance requirements mean that international, and specifically South African-connected, businesses wishing to take advantage of the fiscal and business benefits of expanding their businesses via a financial centre, will now need an element of physical presence in the financial centre. This is a complex requirement and is a function of the business activities in the jurisdiction.

The economic substance requirements could vary from jurisdiction to jurisdiction, with differing requirements applicable to different "relevant sector" companies, but these requirements generally require that the company have "adequate substance" in the jurisdiction, with reference to the following:

- The company is directed and managed in the jurisdiction.
- The company has adequate employees in the jurisdiction proportionate to the level of activity in the jurisdiction.
- The company has adequate expenditure proportionate to the level of activity carried on in the jurisdiction.
- The company has an adequate physical presence in the jurisdiction.
- The company must conduct core income-generating activities (CIGA) in the jurisdiction. (The CIGA are determined with reference to the "relevant sector" company's activities and its functions in the group.)

The penalties for non-compliance with economic substance requirements vary by jurisdiction but generally include:

- Financial penalties for first offences
- The company being deregistered for serial offences
- Non-compliance may result in the jurisdiction exchanging information concerning the offending entity, with the risk that the holding entity (or ultimate beneficial owner) would be assessed by the relevant revenue authorities

No or minimal tax jurisdictions without the required economic substance legislation and requirements typically face reprisals from the EU or other organisations with the result that the offending jurisdictions become more difficult to do business in for international investors.

Tax residency

Tax residency of incorporated entities is generally determined (whether under domestic law or in terms of the application of an agreement for the avoidance of double taxation entered into between Contracting States) by the place where the entity is effectively managed. (Some jurisdictions refer to the test by different names but the substance of the test is usually similar although there is no universally accepted meaning.)

For example, in South African tax law, the test is referred to as the place of effective management (POEM) test. Under South African domestic law, the POEM test determines an incorporated entity to be a South African tax resident if South Africa is the place where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. The South African POEM test is consistent with the OECD's commentary on effective management.

Transfer pricing

Transfer pricing is a set of (usually) domestic rules and international rules that attempt to ensure that profits are taxed where the economic activity bringing about those profits is conducted (i.e., where the value is created). To align transfer pricing with value creation, the internationally recognised standard for determining transfer prices for tax purposes is the arm's length principle. This principle requires entities within a group to deal and transact as though each entity were not a group member (the separate entity approach). The authoritative recital of the arm's length principle appears in the OECD's Model Tax Convention as follows:

> *"conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

"As part of the landing process, it is critical that the regulatory requirements that could potentially apply to a client's business must, as a first step, be considered."

A robust transfer pricing policy (and, possibly, transfer pricing documentation) is vital to defend the group structure in possible audits from domestic and offshore revenue authorities.

Funding the offshore business – general SA exchange control comments

The most commonly applied South African exchange control dispensations to externalise funding for the offshore business are:

- The foreign capital allowance, which allows individuals to externalise up to R10 million per calendar year without being referred to the Financial Surveillance Department (FSD) of the South African Reserve Bank.
- Foreign direct investments allowance, which allows companies to externalise up to R1 billion per calendar year without being referred to the FSD.

The South African exchange control regime has recently been reformed to lift the prohibition on loop structures, which reform can be a boon to South African and international investors alike. Loop structures are broadly structures through which a South African resident invests back into South Africa through their offshore structure.

Global minimum taxation of multinational enterprises

As per Pillar 2 of the so-called BEPS 2.0, which is receiving much attention in the global press, the international community is in the process of considering the implementation of global minimum taxation for multinational enterprises (MNEs). Recently, the US Secretary of the Treasury announced US support for a global minimum level of taxation of MNEs.

The effect of a global minimum tax for MNEs is, at the time of writing, uncertain as there is currently no international consensus on how such a tax would operate (e.g., the rules to be applied, the nexus for taxation, exemptions or de minimis) nor how such a tax would be implemented (e.g., a multilateral instrument, domestic and international adoption of the standard).

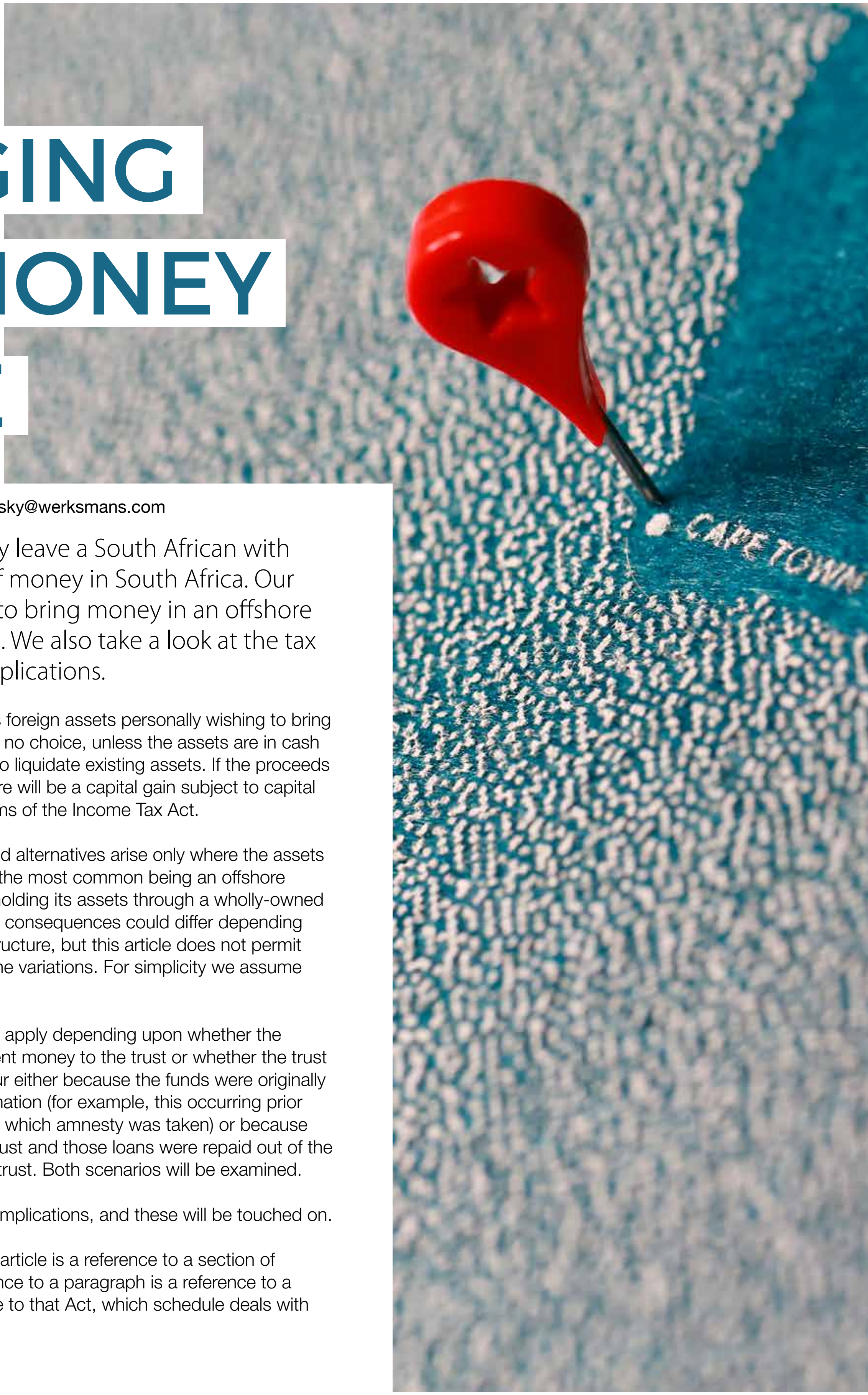
Wealth planning for next generations

A range of factors need to be considered. These vary from launching the business from South Africa and advice on the regulatory tax and exchange control requirements, whilst also managing the landing of clients in the appropriate jurisdiction by having the required skills and a credible presence to grow the businesses from the offshore financial centre. As part of the landing process, it is critical that the regulatory requirements that could potentially apply to a client's business must, as a first step, be considered.

The client's commercial (not tax) strategy should drive the decision-making process. The benefits of having an offshore base are enormous – not only from a business perspective but also as a different means of preserving wealth for the next generations.

30 minutes CPD

BRINGING THE MONEY HOME



▶ **ERNEST MAZANSKY,** emazansky@werksmans.com

Economic conditions may leave a South African with offshore assets in need of money in South Africa. Our article discusses options to bring money in an offshore trust back to South Africa. We also take a look at the tax and exchange control implications.

An individual who holds foreign assets personally wishing to bring funds home really has no choice, unless the assets are in cash balances, other than to liquidate existing assets. If the proceeds exceed base cost there will be a capital gain subject to capital gains tax (CGT) in terms of the Income Tax Act.

It follows that the complexities and alternatives arise only where the assets are held in an offshore structure, the most common being an offshore trust and, sometimes, that trust holding its assets through a wholly-owned offshore company. The actual tax consequences could differ depending upon the precise nature of the structure, but this article does not permit sufficient scope to go into all of the variations. For simplicity we assume that there is only a trust.

Differences in tax treatments also apply depending upon whether the beneficiary concerned has also lent money to the trust or whether the trust is debt free. The latter could occur either because the funds were originally settled on the trust by way of donation (for example, this occurring prior to the amnesty in 2003, following which amnesty was taken) or because funds were originally lent to the trust and those loans were repaid out of the income and capital profits of the trust. Both scenarios will be examined.

There are also exchange control implications, and these will be touched on.

Any reference to a section in this article is a reference to a section of the Income Tax Act, and a reference to a paragraph is a reference to a paragraph of the Eighth Schedule to that Act, which schedule deals with the calculation of capital gains.

The trust is financed by a loan

Should the lender require funds in South Africa, on the face of it, it would seem that the simplest way to effect repatriation is for the trust to repay the loan. Such a repayment has no tax consequences. Even if the loan is denominated in, say, US dollars and the rand has depreciated since the loan was advanced, the currency gain will not be taxed as section 24I does not apply to individuals and currency gains are no longer subject to CGT since Part XIII of the Eighth Schedule was repealed.

But when there is an interest-free loan advanced to a trust the attribution rules under section 7(8) and paragraph 72 apply. In short, and insofar as is relevant here, these provisions state that if by reason of any donation, settlement or other disposition made by a resident to a foreign trust the foreign trust has derived income or a capital gain, that income or capital gain derived by reason or in consequence of the donation, settlement or disposition will be deemed to be derived by the donor. Our courts have held that the failure to charge interest amounts to a continuing donation. Consequently an amount of any such income or capital gains arithmetically equal to the interest not charged is deemed to be earned by the lender. Note it is not interest that is deemed to be earned but an amount of the actual income and actual capital gains that is arithmetically equal to the amount of interest that is deemed to be earned by the lender.

So, if the trust has sufficient liquid funds to repay the loan there will be no problem. But if the trust needs to liquidate an asset in order to repay the loan, then it is possible it will result in a capital gain for the trust, which gain will be attributed to the lender under paragraph 72, which places the lender in a similar position to where he or she would be had they held the asset personally.

The trust was settled by donation

If the trust was settled by donation and the donor or settlor who donated the original funds is the person requiring the funds and he or she took amnesty on the trust, the amnesty legislation deemed the assets of the trust to belong to the amnesty applicant, but only until the trust itself disposed of that asset. Following such disposition the deemed owner or applicant was deemed to have disposed of the asset for proceeds equal to market value. Thereafter section 7(8) and paragraph 72 re-commenced applying.

On the assumption that none of the assets in the trust are the same as those that existed at date of the amnesty, none of those assets are still deemed to be owned by the settlor.

Section 25B(2A) provides, in effect and insofar as is relevant here, that if an offshore trust derives income (which is not attributed under section 7(8)) and that income is retained and added to capital, and that capital is ever distributed to a South African-resident beneficiary in a later year, that beneficiary will be taxable on that income. Effectively the capital retains its identity as income, that is capitalised interest will be taxed as interest, capitalised dividends as dividends, etc. Paragraph 80(3) has the same effect for capital gains.

Because the trust was funded by an out-and-out donation, it means that all of the income and capital gains of the trust would have been attributed to the donor and be taxable in his or her hands, and it would not be limited to an amount arithmetically equal to the interest not charged on a loan. As that income and those gains were deemed to be earned by the settlor, clearly they cannot, if they are distributed to him or her, again be taxable in the settlor's hands (or, for that matter, in any beneficiary's hands in South Africa) under section 25B(2A). After all, if the income/gains were deemed to be earned by the settlor, they could not have been earned by the trust. It is therefore a "nothing" as far as the trust is concerned, at any rate as far as the Income Tax Act applies.

If any authority is required for this, see *Estate Dempers* v *SIR 1977 (3) SA 410 (A), 39 SATC 95 at SATC 110-111.*

It follows that a distribution of income and capital gains to any beneficiary in these circumstances cannot be taxable.

Again, however, if there is insufficient liquidity in the trust and it is necessary to sell an asset to create that liquidity, any capital gain will be attributed to the settlor under paragraph 72.

The settlor was a non-resident

Where the settlor was a non-resident, none of the attribution rules would have applied. It follows that any distribution out of capital, where that capital represents capitalised income or capital gains, will be taxable in the beneficiary's hands under section 25B(2A) or paragraph 80(3), as described above.

But if the distribution is instead made out of the original donated capital it will simply be a tax-free capital receipt in the beneficiary's hands.

In these circumstances if an asset must be liquidated to provide the necessary cash, any capital gain will have no South African tax consequence.

The loan was repaid in full

Under this example the trust was funded by a resident by means of loans and the loans have been repaid.

On the assumption that the attribution rules have been applied in full until date of repayment, it is likely that the capital of the trust falls into two categories, being:

1. That portion that was attributed to the lender
2. The balance, which escaped South African tax as it was in excess of the amount arithmetically equal to the interest not charged

To the extent that the distribution is out of (1), the amount can be received free of tax for the reason explained above, but to the extent that the distribution is out of (2), the amount is fully taxable. Clearly it will have been necessary for the trustees to keep careful accounting of the split between attributed and non-attributed income and gains.

Exchange control considerations

Where authorised or legitimate funds are held abroad it is possible to repatriate them and then, at any time in the future, to send them out again without the requirement to obtain any tax clearance or any exchange control

"Even if the individual already has advanced a loan to the trust, there is no reason why the trust cannot advance a loan to that same individual."

approval. This is under the so-called funds-in-funds-out principle. There are two practical problems, however, with this procedure, when read together with what has been stated above. These are:

Firstly, when funds are repatriated and converted into rand, one is only entitled to send out again the same amount in rand, and not the amount in foreign currency that was repatriated. Therefore the individual takes the exchange risk. So if the rand has depreciated since the time of repatriation, less foreign currency will be sent out again.

Secondly, where a loan has been advanced to a trust and the loan is repaid and brought onshore, there is no real change to the individual's net asset position from an estate duty point of view. And if the monies are sent offshore again and again advanced to the trust, the status quo is more or less restored. But where distributions are made because there is no loan, the individual's estate is increased from an estate duty point of view. And if the money is sent out again, he or she cannot simply donate it back to the trust as this will trigger donations tax – the funds will likely have to be lent to the trust, and the attribution rules will commence applying again. (Note that section 56(2)(g) does effectively allow a distribution from an offshore trust to be donated free of donations tax, but that is only if the donated assets received were at all times outside South Africa. Clearly that will not be the case here.)

A practical solution

With effect from the beginning of this year the concept of a "loop" for exchange control purposes was abolished. This means that the, inter alia, offshore trust can legitimately make a loan to the South African beneficiary. What is more, that loan can be denominated in, say, US dollars, even though it might be interest free.

The effect of this is, firstly, that one does not take the risk of reducing the value of offshore assets under the funds-in-funds-out principle by converting the assets to rand. Secondly, leaving aside the fact that it might be necessary to sell an asset in order to provide the liquidity for the loan, which sale triggers the attribution of a capital gain, the loan itself cannot be construed as a distribution which triggers section 25B(2A) or paragraph 80(3).

Even if the individual already has advanced a loan to the trust, there is no reason why the trust cannot advance a loan to that same individual. It is true that set-off under South African law applies automatically by operation of law where both debts are due and payable but, even assuming that South African law applies to both loans, if the loan advanced by the individual to the trust and the loan made by the trust to the individual in South Africa have different terms and conditions, then set-off would not be triggered, and the funds could still be brought back by way of that separate loan.

IT'S A NEW TAX YEAR – HERE ARE SEVEN THINGS EMPLOYEES AND EMPLOYERS NEED TO KNOW

BY YOLANDI ESTERHUIZEN
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The fiduciary field is a niche area for tax practitioners and lies in the intersection of accounting and law.

A "fiduciary" is an individual or company holding assets for another party, often with the legal authority and duty to make decisions regarding financial matters on behalf of the other party. The word "fiduciary" also denotes a legal duty of the utmost good faith.

Most employers and employees in South Africa greeted the Budget Speech with a sense of relief. Against all odds, government managed to provide for a large-scale COVID-19 vaccination campaign without needing to introduce significant new tax increases. Indeed, the Budget avoids increasing the tax burden by withdrawing the R40 billion tax measures previously announced.

The above-inflation personal tax relief is especially welcome to struggling households. That's not to say we're out of the woods yet – debt levels are high and much depends on whether government can hold the line against public-sector unions' demands for above-inflation wage hikes.

Here are seven things to note as we move into a new tax year:

1. No major developments on National Health Insurance (NHI)

In real terms (considering the effect of inflation), National Treasury has cut the funding allocated to the Department of Health. This is perhaps surprising in the year of a pandemic. In addition, Finance Minister Tito Mboweni didn't mention the migration to NHI in his Budget Speech. Treasury's Budget documents for the year simply state the following recommendation:

"The National Treasury, together with the Department of Health, should ensure that adequate resources are made available to expedite the implementation of NHI to ensure that the implementation of the much needed universal access to healthcare services is achieved for the benefit of the poor and vulnerable, especially during the COVID-19 pandemic."

This indicates that we may still need to wait a while longer to learn more about how the NHI will be funded and how it will work in practice.

2. National Minimum Wage and the BCEA earnings threshold have increased

Separately from the Budget, the government announced increases to the National Minimum Wage earlier this year. Government has needed to walk a fine line between the financial pressures companies are facing during the pandemic and the impact of high food inflation on low-income earners. The National Minimum Wage has increased as follows:

- From R20.76 per hour to R21.69 per hour for most workers.
- Farm workers' minimum wage has been aligned with the National Minimum Wage, up from R18.68.
- For domestic workers, a hike of almost 23% from R15.57 per hour to R19.09 per hour. Government plans to align this with the National Minimum Wage, by next year.
- From R11.42 to R11.93 per hour for workers employed on the expanded public works programme.
- Learners who concluded learnership agreements are entitled to the allowance determined by the national qualifications framework level.

Employers should ensure their payroll systems are up to date. Some sectors have different wage regulating measures (sectoral determinations, bargaining council agreements or collective agreements) which might be more beneficial to the worker – employees who fall under these regulating measures should be paid accordingly.

In addition to the increase in the National Minimum Wage, the BCEA (Basic Conditions of Employment) earnings threshold was increased from R205 433.30 per annum to R211 596.30 with effect from March 2021. Employees earning more than the threshold are excluded from certain provisions of the BCEA and the LRA (Labour Relations Act).

3. Changes to tax treatment of bursaries for employees' relatives

If an employee's remuneration for the previous year (remuneration proxy) was above R600 000, then the full amount of the bursary is taxable, irrespective of the value of the bursary.

If the employee's remuneration proxy was R600 000 or less and the bursary is granted, then:

- The first R20 000 per year (R30 000 if the family member has a disability) of the bursary is exempt if it is for basic education (up to NQF level 4); or
- The the first R60 000 per year (R90 000 if the family member has a disability) of the bursary is exempt if it is for higher education (NQF levels 5-10).

However, from March 2021, if the employee's remuneration package includes bursaries or scholarships as an element of salary sacrifice, the above exemption is not allowed. Employers are advised to let their employees know about the tax implications before their payroll run in March. Some employers may have to review their package structures to accommodate this amendment.

4. No tax increases

In a year in which we braced for the worst, it was welcome to hear that personal income tax brackets and rebates will increase 5%, which is just above the inflation rate of 4%. This means most people will be paying slightly less income tax in real terms, with most of the relief going to low- and middle-income earners.

5. UIF limit increase

I was pleased to see a proposal to increase the UIF earning contribution ceiling to R17 712 per month from R14 872 per month with effect from 1 March 2021. However, although March was mentioned in the Budget Speech, it is important to note that the effective date should still be announced and indicated in a Government Gazette.

The maximum monthly contribution will increase from R148.72 for both the employee and employer to R177.12. Sage had called for this change ahead of the Budget because we believed it would be sensible to align the contribution limit and the benefits limit. It is also wise to raise contributions at a time of rising unemployment claims.

6. Home office tax deductions and travel

It's good news that National Treasury will review the current travel and home office allowances, starting with consultations during 2021/2022. The pandemic has triggered a massive shift to working from home, and we can expect remote work to be a feature of the workforce even when the worst of the COVID-19 crisis is over. We would welcome moves to ensure that travel and home office allowances are adjusted to be more fair and simpler in tax years to come.

7. Retirement funding changes

The compulsory annuitisation of provident fund payouts is effective from 1 March 2021. This means members of a provident fund will be permitted to take up to a third of the retirement benefits as a lump sum and annuitise the remaining two-thirds. However, this is subject to certain conditions and exclusions.

Before 2016, provident fund members were not entitled to a tax deduction on their monthly contributions towards the fund, but now the tax treatment of contributions towards a pension, provident and retirement fund are aligned.

ABANDONING DUSTY TRUST CONSTRUCTIONS for modern foundation structures

30 minutes CPD

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Our article focuses on the trend towards offshore foundations as an alternative to offshore trusts, and compares and contrasts the two.

For centuries high-net-worth individuals, entrepreneurs and their advisors turned towards setting up trusts in various offshore jurisdictions for asset protection, legacy planning and the attendant tax advantages.

Although trusts played – and continue to play – a valuable role, especially in countries with a common law-based framework, stories abound around trustees misusing the power and trust laid upon them. The need for professionals acting as trustees in something that, in a nutshell, is not more than a contractual relationship, whilst giving them access to high-net-worth assets, increasingly intimidates potential settlors. This intimidation in combination with the stories of trustees misusing their power motivate people more and more to look for alternatives.

In recent years, leading financial centres like the United Arab Emirates (UAE) understood this need and introduced and implemented legislation for foundations.

A common staple of many civil-law European jurisdictions, the introduction of foundations across common-law jurisdictions has opened up a variety of previously unknown structuring options. One of the main factors in setting up a foundation, especially for entrepreneurs and their families, is the fact that the foundation independently stands alone, is fully registered with a registrar and does not depend on the cooperation of a third party, like a trustee.

The trend is massively increasing and the demand for foundations is higher than ever, particularly from jurisdictions that combine a trade hub pedigree, a tier 1 financial centre and an attractive residency scheme – like the UAE.

What is a foundation?

A foundation is an independent legal entity which holds assets separately from the founder's personal wealth. The foundation shares similarities of functions and mechanisms with both a company and a trust, while it is not strictly considered a hybrid of the two. Unlike a trust – a concept derived from common law principles – the foundation originates from civil law jurisdictions. It is similar to a company in that it has its own legal personality. However, it does not issue shares or any other legal title of ownership – it is an "orphan" structure. A foundation must further have one or more objects, which may be a purpose and/or serve for the benefit of beneficiaries, just like a trust.

A foundation is governed by its charter and by-laws, which together reflect the desires of the founder. It is managed by a foundation council and may be supervised by a guardian. The assets of a foundation are owned by the foundation in its own name and may be held directly by the foundation or consist of shares in an underlying company.

A comparison between trusts and foundations

	TRUST	FOUNDATION
IN A NUTSHELL	Obligation whereby the settlor transfers legal title of assets to the trustee to manage and distribute assets pursuant to the trust agreement for the benefit of one or several beneficiaries. No legal title of ownership (e.g., shares) issued to settlor / beneficiaries.	Independent legal entity established by the founder to manage and distribute assets pursuant to the foundation's charter and by-laws for the benefit of one or several beneficiaries. No legal title of ownership (e.g., shares) issued to founder or beneficiaries.
PURPOSE	• Succession planning • Legacy planning (continuity) • Asset protection • Tax planning • Confidentiality • Flexibility	• Succession planning • Legacy planning (continuity) • Asset protection • Tax planning • Confidentiality • Flexibility
PARTIES	• Settlor • Trustee • Beneficiary(ies) • Protector (optional)	• Founder • Foundation council • Beneficiary(ies) • Guardian (optional) • Registered agent (often mandatory if no local office)
IN PRACTICE	Trustee legally owns, holds, and manages assets settled onto the trust by settlor, typically, through an underlying (holding) company. Trustee is bound by the trust agreement. Settlor may convey his wishes by way of (non-binding) letter of wishes.	Foundation legally owns and holds in its own name assets settled onto foundation by founder or third party. Foundation is managed by foundation council pursuant to charter and by-laws.
RESIDUAL CONTROL / MONITORING	Settlor has limited control over assets. Some of trustee's powers may be delegated to third parties including settlor (e.g., investment powers). Protector may be appointed to monitor trustee (prior consent) and granted reserved powers (e.g., distribution of funds, election of beneficiaries, trustee, amend trust deed).	Founder can retain flexible powers, e.g., can be a council member. Some of council's powers may be delegated to third parties including founder (e.g., investment powers). Guardian may be appointed to monitor council (prior consent). Founder (or a guardian) may be granted reserved powers (e.g., amend or revoke by-laws, revoke foundation).
MANAGEMENT / EXECUTIVE POWERS	Trustee, an individual or a company, acts in the interest of beneficiaries according to trust agreement and letter of wishes. A private trust company may be established to manage the trust.	Foundation council acts in the interests of founder and beneficiaries, in accordance with the foundation charter. Foundation council may be composed of founder / beneficiaries (e.g., entrepreneur and/or family members).
DISTINCT LEGAL ENTITY	No, cannot hold assets or enter into contracts in its own name.	Yes, can hold assets and enter into contracts in its own name.
USE FOR COMMERCIAL PURPOSES	Yes.	No, but may hold shares in commercial companies.
CREATION (DURING LIFETIME / UPON DEATH)	Both.	Both.
REGISTRATION	No.	Yes.
MINIMUM SHARE CAPITAL REQUIREMENTS	No.	Yes (amount specific to each jurisdiction).
SEPARATION OF LEGAL AND BENEFICIAL OWNERSHIP	Yes. Trustee is legal owner of assets while beneficiaries are beneficial owners.	No. Foundation is the legal owner of the assets. Beneficiaries benefit from the foundation but do not hold ownership rights in the assets.
BENEFICIARIES	Beneficiaries can be individuals, companies or charities and may include settlor. Distributions made by trustees in accordance with trust deed, considering (but not being bound by) letter(s) of wishes by settlor.	Beneficiaries may be individuals, companies, or charities. Distributions made by foundation in accordance with charter and by-laws, considering (but not being bound by) letter(s) of wishes by settlor.
BENEFICIARIES RIGHTS TO RECEIVE ASSETS	Potentially – subject to discretionary powers of trustee.	No.

	TRUST	FOUNDATION
BENEFICIARIES RIGHTS TO INFORMATION	Potentially – subject to trust agreement.	No – unless expressly mentioned.
BENEFICIARIES RIGHTS TO WIND UP AND DISTRIBUTE ASSETS	Potentially – subject to trust agreement.	No.
PROTECTION AGAINST FORCED HEIRSHIP RULES	Yes.	Yes, depending on jurisdiction.
PROTECTION FROM CREDITOR CLAIMS	Yes, except in cases of fraudulent transfers.	Yes, except in cases of fraudulent transfers.
PROTECTION FOR BENEFICIARIES	Trustee must act in accordance with trust law and precedent and protector may be appointed to monitor trustee's actions.	Councillors do not owe direct fiduciary duty to beneficiaries but must act in accordance with charter and by-laws.
COULD BE CONSIDERED AS A SHAM	Yes, sometimes.	No.
PUBLICITY OF INFORMATION	Not public.	Limited. Charter (with generic information) is public in some jurisdictions.
REVOCABILITY	May be revocable or irrevocable.	May be revoked/discontinued.
TIME PERIOD	Depends on jurisdiction.	None.
PORTABILITY	Can be transferred to another jurisdiction.	Can be transferred to another jurisdiction.
FLEXIBILITY	High – in terms of way the trust operates, over time.	Somewhat limited – due to charter and by-laws.
BODY OF LAW AND PRECEDENT	Case law and precedent developed over many centuries by the common law.	Case law and precedent (in common law jurisdictions). Statutory law, less precedent (in civil law jurisdictions).
TAXATION	Tax issues to be considered on creation depending on jurisdiction, often governed by established tax laws.	Tax issues to be considered on creation depending on jurisdiction; not always governed by established tax laws.

"Generally speaking, foundation regimes provide more flexibility with regard to the powers of the founder and members of their family."

Main differences

The main differences between trusts and foundations are:

- Shares or members: Neither have shares or members.
- Distinct legal entity and ownership of assets: A trust is a contractual agreement; a foundation forms a distinct legal entity. A foundation legally owns assets in its own name and can enter into contracts. In a trust relationship, the trustee legally owns the assets and enters into contracts on behalf of the beneficiaries.
- Use for the benefit of beneficiaries: Optional for foundation, mandatory for trust.
- Use for commercial purposes: Impossible for foundation (may hold shares in a commercial company though), allowed for trust.
- Registration and lifespan: Foundations must be registered (with few exceptions) and have unlimited lifespan. Trusts are not registered; often limited in time.

Foundations in high tax countries

Foundations in high tax countries are often set up for either philanthropic purposes or ensuring business continuity.

Other aspects, such as wealth structuring, asset protection (forced heirship rules, creditors and hostile takeovers) or long-term holding structures for businesses, do not always suit the options available in high tax countries and have to be covered with other structuring options. Foundations in offshore jurisdictions offer more flexibility and in general offer better control mechanisms for their founders.

Choosing the right jurisdiction for a foundation

When setting up a foundation the following key factors should be taken into consideration for choosing the right jurisdiction:

- Reputation of the jurisdiction
- Regulatory framework
- Legal and court system
- Tax regime (applicable tax rate and access to double taxation treaties)
- Confidentiality
- Governance controls
- Firewall provisions (i.e., foreign forced heirship rules and creditor claims)
- Ease of registration

Offshore foundations for South African tax residents

South Africa does not know foundations except as non-profit organisations. As a result, a foundation can, from a tax purpose, be viewed as company or a trust depending on its internal characteristics. If it is viewed as a "normal" trust, then the standard tax treatment applicable to a (foreign) trust will apply.

For South African residents to fully benefit from the possibilities offered by offshore foundations, the "outer appearance" and "internal governance" of a foundation must be modelled to that of a trust, without effectively being one.

To achieve South African tax neutrality, the foundation will also need to be deemed and managed like a trust. Proper planning and reliance on both South African private client tax advice and foreign-based structuring expertise will be required.

Effective management in the foreign country is paramount in that respect. The good news: controllers of the foundation can be members of the entrepreneurs' family, if not permanently resident in South African.

In closing

Generally speaking, foundation regimes provide more flexibility with regard to the powers of the founder and members of their family. Foundations having their own legal personality may offer advantages in the management of the operations, and they are more widely accepted in civil law jurisdictions, where trusts may face ownership restrictions. That being said, there is no one-size-fits-all solution and the answer always depends on the individual circumstances and objectives of each client, which is why comprehensive legal advice should be sought.

15 minutes CPD

OFFSHORE TRUSTS IN FINANCIAL AND ESTATE PLANNING

▸ **CHERYL HOWARD,** cheryl@cherylhoward.co.za

Our article asks questions and provides answers on the use of a foreign trust as a financial and estate planning tool to protect direct foreign investments and accumulate an offshore asset base.

South African resident taxpayers are increasingly making use of the R10 million per calendar year foreign investment allowance (FIA) to gain access to direct offshore investment exposure. This investment strategy raises ownership considerations when planning one's estate during one's lifetime and then succession planning on death.

To this end, investment strategy, tax planning, estate planning, formation and administration of trusts and drafting of wills have become a global consideration for most South African resident taxpayers.

Using a foreign trust

Whether it is protection of direct foreign investments under the FIA, working abroad and accumulating an offshore asset base or the globally mobile family unit, if and when to use a foreign trust should be, and is, part of any financial and estate planning consideration.

With very few exceptions, South African resident taxpayers are liable for South African estate duty on worldwide assets, including those directly held foreign investments. The use of local and foreign trusts as estate planning vehicles becomes relevant.

South African *inter vivos* trusts are currently precluded, in terms of exchange control regulations, from holding direct foreign investments. As a result, the South African estate planning structure is often mirrored offshore, thus doubling the occurrence of professional fees and the consequent administrative requirements when effectively managing such structures.

Cost-to-benefit ratio is the primary factor, with professional fees being foreign denominated on offshore trusts. In most instances, the directly held investment portfolio is accumulated over a period of years utilising the annual R10 million FIA. The initial value of the portfolio might not warrant the cost of an offshore trust. Until such time as the value of the direct foreign investment portfolio justifies the cost, the use of an offshore trust could largely have a negative impact on the investment portfolio yield. Waiting for the accumulation of that optimal "sweet spot" has an additional subsequent capital gains tax cost liability when eventually liquidating the investments and transferring the cash to the trust. Once the cash is transferred into the name of the trust, an estate dutiable asset is created in the form of the loan to the offshore trust. Then there is the matter of the interest charge on the loan to the offshore trust under the section 31 transfer pricing provisions or the section 7C deeming provisions of the Income Tax Act. The actual interest rate is a function of the currency of the loan, i.e., a foreign currency denominated loan versus a rand denominated loan. The latter scenario pegs the estate duty value of the asset in rands, although with a higher interest rate charge and therefore annual tax liability. In the former scenario, the planner will need to consider a long-term view of the rand, with a lesser annual taxable interest accrual on the loan value.

"A South African resident taxpayer, when compiling a sound worldwide financial and estate plan, must consider the use and timing thereof for the implementation of a foreign trust."

The relationship between the independent investment advisor and the independent offshore trustee also needs to be considered. Often, extensive (and expensive) due diligence formalities are performed by the independent offshore trustee on both the independent investment advisor and the underlying investment selections, in line with, firstly, the trust company's own internal risk compliance policies and, secondly, any jurisdictional statutory regulatory requirements.

Seeking a reputable trust company where one can foster a long-term personal relationship could outweigh the selection of the jurisdiction for trust registration. Jurisdiction for the trust registration can also be separated from the trust administration location. Depending on the nature of the assets to be held in the offshore trust, jurisdiction can, however, be an important factor. Foreign held immovable properties or property owning companies are such a case in point, especially where the immovable properties or company registrations are held in the USA or the UK.

Estate planning

The introduction of the "bottom drawer" trust has become a valuable planning tool. In essence, a foreign *inter vivos* trust is formed, lying dormant until the trust is capitalised – usually on the death of the surviving spouse or maybe even on the death of the planner him or herself. In terms of the will, the direct foreign investments are bequeathed to the offshore trust and administered for the heirs accordingly. The timing of the bequest – taking advantage of the rollover relief for estate duty and capital gains tax to the surviving spouse versus paying the estate duty on the death of the first dying spouse – depends on the attendant estate duty and tax costs and cash flow requirements of the surviving spouse. Should the offshore trust inherit the direct foreign investments on the death of the first dying spouse, the assets at that time are subject to estate duty and capital gains tax. Subsequently, these direct foreign investments are excluded from any further South African estates, both for the section 7 deeming provisions of the Income Tax Act and the Estate Duty Act. The surviving spouse can utilise the now fully functioning offshore trust to capitalise further foreign investment allowances or transfer the cash from currently held direct foreign investments into the trust as and when the portfolio is rebalanced, since capital gains tax would be a natural transactional cost.

Independent trustees, protectors and reporting

Jurisdiction of the trust registration is probably of less importance than the selection and appointment of the independent trustee. Trusting the trustee is paramount. Coupled with differences in time zones, places of effective management and sometimes even language barriers, the task of appointing a foreign trustee is daunting. Unlike the less formally regularised South African trustee's appointment – where the planner and spouse are most often co-trustees together with a local independent trustee – the highly regulated formal trustee appointments abroad make the independent trust company the sole custodian and decision maker of the foreign assets held within the offshore trust. Furthermore, the decision to distribute capital and/or income to beneficiaries resides within the trustee's authority.

The appointment of a protector, either at the time of forming the trust or on the death of the planner and or surviving spouse, is a further consideration. Such a protector carries a regulatory (Common Reporting Standard) reporting requirement and potentially an additional professional fee cost. The protector should have no other statutory powers than the hiring and firing of the independent trustee and the nomination or termination of beneficiaries. The appointment of a protector is unique to foreign trusts. South African tax planners tend to appoint a protector as an additional security measure, aiding the relationship between the planner, the family and the independent trustee, especially following the death of the planner.

The Common Reporting Standard reporting requirements extend to the funders of the trust as well as instances where income or capital awards are distributed to beneficiaries. These reporting requirements have a further impact on the cost of foreign trust administration as well as the documentation requirements.

Unique circumstances

Similar to its South African counterpart, the use of a foreign trust provides for a number of benefits such as pegging the estate for estate duty purposes, protection of assets from third-party risk, ease of succession planning and protection of assets for heirs, continuity and flexibility of ownership and investment strategy. However, in each estate plan, the family's unique circumstances need to be considered before settling any structure.

A South African resident taxpayer, when compiling a sound worldwide financial and estate plan, must consider the use and timing thereof for the implementation of a foreign trust. Shying away from the control factor, the laborious initial and ongoing documentation and disclosure requirements or the payment of professional fees are not plausible reasons for not forming that offshore trust. Together with local financial and estate planning tools and techniques, trusting the trustee, professional administration and financial reporting, the offshore trust is a valuable vehicle in any tax and estate planning structure.

OFFSHORE TRUST REPORTING

15 minutes CPD

▶ **DEVON CARD,** devon@crue.co.za

Our article discusses growing efforts to shine a light on offshore structures sometimes used in the past to evade tax. We also detail the reporting currently required on assets and accounts of offshore trusts.

A trust is a three-way fiduciary relationship in the form of an agreement which allows the first party, often referred to as the trust founder or settlor, to transfer assets to a legal entity, the trust, for the benefit of a third party, the trust beneficiary. The agreement, known as the trust deed, is set up and agreed upon between the trust founder and the trust. By setting up the trust, the founder relinquishes control of the assets to the trust, and spells out in the trust deed how the assets are to be used and distributed. The most common use of a trust is to ensure that the trust assets are protected from misuse by the trust beneficiaries and managed according to the intentions of the trust founder.

An offshore trust is one where the trust settlor has created a trust in a jurisdiction that is different from the one where they reside. In the past, this used to provide numerous additional benefits such as hiding assets and business operations away from the local tax revenue services, ultimately allowing for massive tax evasion.

Through the Foreign Account Tax Compliance Act which was passed in March 2010 and became effective in July 2014, the United States has been trying to combat tax avoidance by their own citizens through offshore entities. It was through the Organisation for Economic Co-operation and Development (OECD) that the Common Reporting Standard (CRS) was developed at the request of the G20. The CRS was approved in July 2014 and took effect in March 2016. It calls on jurisdictions to gather information from their respective financial institutions, and to automatically exchange that information on an annual basis. Further, the CRS sets out the financial account information to be exchanged, which financial institutions are required to report, the various types of accounts and taxpayers covered, together with common due diligence procedures to be followed by the financial institutions. The premise of this was to help tax authorities tackle offshore tax evasion by shedding light on their residents' detailed information on assets and wealth held abroad.

That said, the world was not fully aware of the extent to which this standard of reporting would shine a light until the Panama Papers of 2016. The Panama Papers refers to the 11.5 million leaked, encrypted documents that were the property of Panama-based law firm, Mossack Fonseca. These documents were released on 3 April 2016 by *Süddeutsche Zeitung*, a German newspaper, which dubbed them the "Panama Papers". These documents exposed a network of more than 214 000 tax havens involving individuals and entities spread across 200 different countries. *Süddeutsche Zeitung* and the International Consortium of Investigative Journalists embarked on a year-long investigation to decipher the encrypted files, after which their findings were made public.

The Panama Papers include personal financial information of a number of wealthy individuals and public officials who had previously been kept private. Among the names in the leak were a dozen current and former world leaders, 128 public officials, politicians, celebrities, numerous business people and other wealthy individuals. While the majority of the documents showed no inappropriate or illegal behaviour, there were a number of shell corporations and entities set up by Mossack Fonseca that were revealed by reporters to have been used for illegal purposes, including fraud, tax evasion and the avoidance of international sanctions.

So, how exactly does the CRS affect those with offshore trusts and what type of requirements does CRS place on those with offshore trusts? The framework of the CRS is such that an obligation to provide and report account holder information to the various tax administration offices in participating jurisdictions is placed on financial institutions. This includes a number of steps to identify exactly who and what needs to be reported.

While all trusts are considered entities in the eyes of the CRS, bear in mind that a trust may be a financial institution or a non-financial entity. The most likely scenario in which a trust will be a financial institution is where it falls within the definition of "investment entity" as described in Section VIII, paragraph A(6)(b) of the CRS. These would typically include banks, brokers,

"While a South African tax resident might not disclose their assets to SARS, there remains a good chance that through global co-operation their activities will be reported to our tax authorities."

custodian banks, funds, portfolio managers and life insurance companies. For the purposes of this article, we have focused on the reporting requirements and processes where a trust is not a financial institution.

Where a trust is not a financial institution, it will be considered a non-financial entity (NFE). NFEs are either active NFEs or passive NFEs, depending on the nature of their activities. It is possible, although perhaps less common in practice, that a trust could qualify as an active NFE, such as a trust that is a regulated charity or a trading trust carrying on an active business. If a trust is not an active NFE, it will be a passive NFE. In addition, if a trust holds a financial account with a reporting financial institution, such reporting financial institution must treat the trust as a passive NFE if it is an investment entity described in Section VIII, subparagraph A(6)(b) that is not resident or located in a participating jurisdiction.

So, what are the steps required for reporting? When it comes to reporting, the CRS has five steps:

Step 1: Determine who the reporting financial institution is

A reporting financial institution could include depository institutions, custodial institutions, investment entities or specified insurance companies. While the trust might not itself be a reporting financial institution, it is commonly found that the assets held within the trust are themselves held by a financial institution that has an obligation to report, such as where a trust has a bank account held in a financial institution in Guernsey.

Step 2: Review financial accounts

A financial account is an account maintained by a financial institution. Specifically, the term "financial account" includes five categories of accounts, namely depository accounts, custodial accounts, equity and debt interests, cash value insurance contracts and annuity contracts.

Step 3: Identify reportable accounts

The account held by a trust that is an NFE is a reportable account if:

- The trust is a reportable person; or
- The trust is a passive NFE with one or more controlling persons that are reportable persons.

Step 4: Apply due diligence rules

The reporting financial institution must apply the due diligence rules to determine if the account held by the trust is a reportable account.

Step 5: Reporting the relevant information

Where a trust is a reportable person, the reporting financial institution will report the account information and the financial activity for the year with respect to the account of the trust. The account information will include the identifying information of the trust – such as the name of the trust, address, residence, taxpayer identification number and account number – and the identifying information of the reporting financial institution, being the name and identifying number.

In the past, offshore trusts had very few reporting requirements and were commonly used to hide assets from local authorities and tax administration services. However, the CRS has resulted in many jurisdictions collaborating to exchange information, which helps to pierce the veil on such entities. From a South African perspective, the CRS means that, while a South African tax resident might not disclose their assets to SARS, there remains a good chance that through global co-operation their activities will be reported to our tax authorities. Naturally, there are still some jurisdictions that do not comply with the CRS, but it is becoming more difficult to transact and do business in jurisdictions where this is the case.

LOOPS: New opportunities or more of the same?

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Our article explores recent exchange control relaxations and amendments to the Income Tax Act aimed at ensuring that loop structures do not provide a tax benefit or planning opportunity for local shareholders. We also ask whether venture capital investments in South Africa are now more or less viable.

More than a year ago, in his February 2020 Budget Speech, the Minister of Finance announced the abolishment of the so-called "loop structure" rule. However, in order to address concerns that loop structures could be used to avoid South African tax, the relevant provisions of the Income Tax Act first had to be amended.

The tax changes were implemented by amending the controlled foreign company (CFC) provisions. These changes and the abolishment of the loop structure prohibition came into effect on 1 January 2021. As the tax changes apply in the CFC context, loop structures where the total shareholding by resident shareholders does not exceed 50% will not be impacted.

Historic loop structure concerns

Loop structures refer to cross-border structures where a South African exchange control resident has an interest in a foreign structure which directly or indirectly invests in South African assets.

For individuals, loop structures often include the use of a foreign trust, while in the venture capital context, it includes an investment in a foreign fund holding shares in a South African company (SACo).

A South African shareholder in such a structure would not receive their returns (for example, dividends or capital gains) directly from SACo but via the foreign structure.

Although National Treasury has never expressly set out their concerns about perceived tax abuse, the use of a loop structure could potentially result in:

- A resident investor avoiding paying capital gains tax (CGT) on the disposal of shares in a non-property owning SACo.
- A natural person avoiding the 20% dividend withholding tax applicable to dividends paid to natural persons, and benefiting from a reduced dividend withholding tax in terms of an applicable double tax agreement (DTA).

Interestingly enough, there are no reported judgments which held loop structures to be illegal. While the case of *Pratt v Firstrand Bank Ltd [2014]* ZASCA 110 involved a loop structure, the Court did not express an opinion on the (il)legality of loop structures.

However, until the end of 2020 loop structures were only permitted in very limited circumstances such as where South African investors (natural person or a company) held 40% or less of the shares in the foreign company. South African employees were also permitted to participate in a foreign share scheme.

Although these exceptions were utilised in the private equity context to allow the participation by South African investors and employees in a foreign investment vehicle, it often remained very difficult for foreign funds with South African investors to invest in South African assets.

Common solutions to this problem included:

- Mirror structures providing for South African and foreign investors to invest via separate structures.
- Co-investment arrangements in terms of which South African and foreign investors invest in the same assets.

While these structures solved the loop structure problem, they often are complex and cumbersome to implement.

CFC rules and SA dividends

In terms of the CFC rules, the "net income" of a CFC must be determined. An amount equal to a pro rata share of such net income must be included in the income of the resident shareholder, subject to the detailed provisions of section 9D of the Income Tax Act.

Briefly summarised, the new changes in respect of dividends declared by a SACo to a CFC are as follows:

- Before the amendments, for purpose of the net income calculation, South African dividends qualified for an exemption from income tax in terms of section 10(1)(k) of the Income Tax Act. The SACo has to withhold dividend withholding tax (subject to a reduced withholding rate in a DTA, if applicable), but the dividend would, for purpose of the net income calculation, be exempt.
- However, these dividends will no longer be fully exempt for purpose of the net income calculation. Instead, a formula will apply to ensure that the dividend is taxed at a rate of 20% where the South African shareholder is a company. This is achieved by providing that the exemption in section 10(1)(k) will not apply in respect of a certain percentage (based on a ratio of 20/28) of the dividend.
- While this will result in an effective 20% tax rate where the South African shareholder is a company, the formula is not adjusted where the resident shareholder is an individual. As a result, the dividend could be taxed at a rate of up to 32.14% where the shareholder is an individual.
- The formula takes into account the impact of dividends tax withheld by the SACo when it paid the dividend to the CFC. The adjustment should ensure that the total tax liability (for a corporate shareholder in the CFC) does not exceed 20%. For example, if the dividend was subject to dividends tax at a reduced rate of 5%, the formula should ensure that the dividend is subject to income tax at a rate of 15%. However, a natural person who is a shareholder in the CFC will pay income tax at a rate of up to 24.11%, plus the 5% dividends tax that was withheld by the SACo declaring the dividend.

CFC rules and capital gains

Before the changes, where a capital gain had to be included in net income, the inclusion rate was 40% where the resident shareholder was a natural person, and 80% where the resident shareholder was a company. This ensured that a natural person benefited from the lower CGT rate (maximum 18%) applicable to natural persons, while a corporate shareholder paid CGT at a rate of 22.4%.

In terms of the amended provisions, an inclusion rate of 80% will apply in all instances. This could result in an effective CGT burden of 36% where the resident shareholder is a natural person. However, if the shareholder held the assets directly, his or her CGT rate would have been maximum 18%.

Paragraph 64B and local assets

Paragraph 64B of the Eighth Schedule to the Income Tax Act provides for a capital gain or loss to be disregarded where a person disposes of shares in a foreign company to another foreign company, where the shareholder held at least 10% of the shares in the foreign company.

This paragraph has now been amended to provide that it will not apply in respect of the sale of shares in a CFC to another foreign company, to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued or registered in South Africa.

Unintended consequences for South Africans with offshore venture capital investments

The new tax rules as set out above apply to all CFCs with South African assets, irrespective of whether this was a permissible loop under the previous regime. This is a very unwelcome development. Where before the dividends declared by a South African target company would have been subject to dividend withholding tax only, the dividend will now be subject to tax (a combination of dividend withholding tax and income tax) at a rate of 20% where the South African shareholder in the CFC is a company. This rate could increase to up to 32.14% where the South African shareholder is a natural person.

However, if the shareholder held the shares in the SACo directly, the rate would have been 0% where the shareholder is a company, or 20% where the shareholder is a natural person.

Also, with respect to capital gains, while a corporate shareholder in the CFC is not impacted by the amendment in this regard, a natural person is penalised as capital gains will be taxed at a rate of 36%, as opposed to 18% if the person held the shares in the SACo directly.

The above significantly increases the tax burden for South African shareholders in a CFC with South African assets.

Are venture capital investments more viable after recent relaxations of exchange control?

In those instances where South African investors hold or will hold 50% or less of the shares in a foreign fund, the abolishment of the loop structure prohibition is welcome news as South African shareholders can now hold up to 50% in the foreign fund.

However, while the abolishment of the loop structure prohibition has been portrayed as a substantial relaxation, an alternative view is that the exchange control prohibition has simply been replaced with punitive tax measures: The fact that the new tax rules apply where shareholding in the offshore fund exceeds 50% could be an effective prohibition against the use of loop structures.

Although the stated intention was for the Income Tax Act to be amended to avoid abuse, the amendments as set out herein go further than just ensuring that loop structures do not provide a tax benefit or planning opportunity for local shareholders. The new punitive measures also apply to existing CFC loop structures which were given special permission to increase the South African shareholding to more than 40%.

Accordingly, while loop structures are now permissible, it is possible that offshore fund structures will still (have to) use mirror structures, co-investment arrangements and also so-called "access shares" which would allow South African shareholders to directly own shares in local companies, instead of holding them via the foreign fund.

Whether the abolishment of the loop structure prohibition will in fact encourage investment in South African assets via a loop structure therefore remains to be seen.

OFFSHORING NEW ENTREPRENEURIAL VENTURES

15 minutes CPD

RALPH WICHTMANN, rwichtmann@sovereigngroup.com

Many entrepreneurs are seeking to move operations offshore. This article explores how these ventures are typically moved offshore and the best time to make this shift.

If you are an entrepreneur looking to open a business in a post-COVID world, the question is whether to launch your business in South Africa first and then expand abroad or create an offshore structure immediately? That is the dilemma facing a growing number of local entrepreneurs and there are various factors to take note of before making a final decision.

Why would a new entrepreneurial venture move its operations offshore?

One of the main points to consider in making a decision is where the company's target market is based as well as where the intellectual property (IP) of the company will be created and registered. Many start-ups register a South African company to engage in business with local clients and an offshore company to focus on all clients outside the country.

The number of clients looking to set up offshore operations in jurisdictions like Mauritius, Gibraltar, the Isle of Man, Guernsey, Malta, Cyprus and the United Arab Emirates is increasing as businesspeople look for new markets to organically create wealth overseas, and even provide future residency and immigration pathways.

On the one hand, South Africa still has great infrastructure and offers the potential to be one of the highest growth markets in the world. On the other, setting up an offshore company facilitates ease of trade, with the ability to pay suppliers and receive funds in foreign currency without having to comply with exchange control regulations each time. It all depends on your objectives.

It is important to look at some of the pros and cons when launching a business in South Africa first versus launching it outside of South Africa from the onset.

Launching a business in South Africa

Pros

- South Africa has a good legal, financial and banking infrastructure, with a vibrant start-up community, including the likes of Snapscan, Luno, Pineapple, Ozow, Ukheshe, Yoco and Sweepsouth.
- There is an increasing amount of venture capital available as well as start-up funding initiatives to assist prospective entrepreneurs, such as Naspers' venture capital arm, Naspers Foundry.
- South Africa has a well-developed IP infrastructure that protects start-ups and small businesses.

Cons

- South Africa-based businesses are subject to the South African tax system and exchange control regulations, which can be stringent, especially for start-ups. Corporate taxes on profits in South Africa are 28%, the dividend withholding tax is 20% and capital gains tax is 22.4%.
- Foreign investment, via a loan or share capital, would require Reserve Bank approval, as would the sale of IP to an offshore company. This can be a tedious and expensive process.

Launching a business abroad from the onset

Pros

- Depending on the jurisdiction, there are various benefits from reduced taxes, no exchange control regulations and even government incentives for certain industry sectors. The lack of exchange control and double taxation agreements with other offshore jurisdictions could make the start-up more attractive for foreign investment.
- Many jurisdictions also have well-developed legal, financial and banking infrastructures.

Cons

- When choosing an offshore jurisdiction, one must ensure that any IP is created within that jurisdiction. If IP is considered to be created in South Africa, this can result in it being considered as South African IP and Reserve Bank approval would be required to sell it to a non-South African resident buyer.
- Navigating the world of offshore structuring can be a daunting task as you might have to deal with institutions, banks and parties based in various jurisdictions, each with their own legal and regulatory framework that needs to be complied with. It is thus always advisable that you partner with an experienced and trusted company that specialises in offshore structuring.

Choosing the best time to make the shift and what to consider

The ideal time for a company to make the decision to either move their operations completely offshore or start a new company offshore depends on various factors both unique to the company itself and criteria unique to the business sector that the company operates in. Factors unique to the company include the potential for good growth in market capitalisation when the company is interested in being listed in one of the major stock exchanges, interest from potential investors and new business ventures offshore. Business sector factors that might make it more ideal for the company to move operations offshore include less stringent industry, product or service regulations.

If the company founders are able to determine from the onset that their company will have an international focus and service clients both in and outside of South Africa, or alternatively exclusively serve clients outside of South Africa, then it might be best suited that the company is incorporated from the onset in a jurisdiction other than South Africa.

What to consider if your company creates intellectual property

A very important factor to take into account is whether the company will hold IP, as it is the most valuable asset of the information age. The largest companies in the world are built on IP and organisations of all sizes are recognising the value of digital and intellectual property. It is thus critical that start-ups take the time to develop a proper IP strategy upfront, as this will play a major role in the way they raise money or sell their business in the future.

Strict exchange control regulations are in place governing the sale or assignment of IP to non-South African residents. Transferring and licensing South African IP to a non-South African resident is subject to South African Reserve Bank approval, which can be a time-consuming and costly process.

If IP has already been created, it is important to determine where the IP was created and what exactly it consists of, as the process of transferring the IP to a non-resident can be simplified if the IP was originally created outside South Africa. In that case, the IP laws of the relevant jurisdictions will govern the transfer of the IP to non-residents.

One way of easing the IP transfer process is to establish an offshore structure that will be efficient in terms of international business expansion, tax and estate planning, as well as prevent exchange control regulations that could hinder the transfer thereof to a potential foreign investor. That is why it is important to get suitable offshore structuring advice before creating the IP and, if possible, determine upfront the target market or buyer of the IP.

A further benefit is that if you hold the IP in an offshore structure which has a business-friendly environment and reasonable tax system, this will make venture capital or similar investing all the more attractive, especially if your IP is in a competitive market segment.

When the offshore structuring is done correctly, this will help avoid unnecessary frustrations in the future should start-up founders wish to sell or transfer the IP or the company to a potential multinational investor or technology giant such as Google or Facebook – and walk in the footsteps of other successful South Africans such as Mark Shuttleworth and Elon Musk.

When choosing an offshore jurisdiction, one should also consider whether the company will be licensing the IP to other users, who will have to pay royalties. The country from which the royalty fee is paid might impose a withholding tax on such payments, so it is important to confirm that the jurisdiction where your company is incorporated has signed double taxation avoidance agreements with those royalty countries. This can significantly reduce the withholding taxes imposed – and in some circumstances even reduce it to 0%.

"There are various elements to consider before commencing the process of offshore structuring and potentially combining it with your South African operation."

Once the IP is owned by an offshore company, it should then be registered to prevent any copying and abuse by potential competitors or disgruntled employees.

Even if the IP is intended solely for the local market, proper structuring is still required to hold the IP and to ensure it does not form part of your estate's assets. This will be especially important when the IP grows in value.

Final note

There are thus various elements to consider before commencing the process of offshore structuring and potentially combining it with your South African operation. A good initiative by the South African government has been the implementation of the necessary legal and regulatory framework to allow for the creation of a South African headquarter company as a vehicle to attract foreign investment to South Africa and into Africa. This can be a good option if a South African company wishes to expand offshore and link its offshore business with the South African headquarter company, as it benefits from relaxed exchange control regulations and reduced taxation. However, there are specific requirements that must be met around equity shares, voting rights and how the costs of the assets are attributed and it is therefore not a suitable vehicle in many circumstances.

In essence South African start-ups and existing businesses intending to venture offshore should surround themselves with experienced tax, legal and offshore structuring experts to assist in aligning their business expansion strategy with the various requirements when taking the step to "go offshore".

15 minutes CPD

AUDITS ON OFFSHORE ASSETS

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With SARS beginning to receive information from 87 different jurisdictions through the Automatic Exchange of Information regime, the likelihood of taxpayers being audited on their offshore assets has increased significantly. Our article provides details.

"Seemingly, these taxpayers were advised that their offshore planning structures would remain undetected. But perhaps with the means now at SARS' disposal, they will be able to untangle these arrangements."

South Africa has a history of taxpayers making use of offshore structures in order to conceal their assets and income. Taxpayers have long believed that these arrangements were beyond SARS' reach, but will they stand the test of time?

While many South Africans previously disclosed their offshore assets under the tax and exchange control amnesty programmes introduced by government, some still chose to take their chances. To a large degree, their decision may have been informed by the perception that SARS did not look beyond our borders or at least did not have the capability to do so effectively.

The OECD's Common Reporting Standard for the Automatic Exchange of Information was introduced on a global scale and the first reporting occurred in 2017. But until recently it appeared that this initiative was not utilised by SARS. In the same vein, SARS reported that 1 700 South Africans were identified in the data leaked under the Panama Papers, but we have not seen any progress in this regard since SARS' undertaking to investigate these individuals.

An unexpected audit

In 2020, for the first time we saw SARS issue notices to taxpayers informing them that SARS is reviewing their offshore holdings.

These notices confirmed that the request for information sent to the relevant taxpayer was prompted by information received by SARS from 87 different jurisdictions through the Automatic Exchange of Information regime, and which was under review by SARS. This was the first indication that SARS is making use of information shared by other countries since this reporting commenced. The notice requests that the taxpayer confirm, first of all, that they do have offshore holdings and then requires details on the nature of the assets, amounts invested, intermediaries that facilitated the investment, source of the funds, and tax obligations discharged with regard to the holdings. Finally, the notice requests an explanation of why the information was not previously disclosed. SARS affords the taxpayer 21 business days to provide the material requested.

As with any information request, the notice is issued under section 46(1) of the Tax Administration Act. Failure to respond fully will constitute a criminal offence under section 234 of the Tax Administration Act. This is a difficult request to navigate, even where you have dutifully observed all of your obligations. Where you have not, it truly presents a quandary and a voluntary disclosure application (VDP) is likely your best bet for a good outcome.

In this regard, from the wording of the notice, it appears SARS will allow the taxpayer to submit a VDP application, even after they have received the request. This is an interesting concession, as by its nature, a VDP application must be "voluntary", otherwise it does not meet the requirements of a valid VDP application under section 227 of the Tax Administration Act. Nevertheless, even where the taxpayer opts to regularise any related default by filing a VDP application, they must still respond to the notice.

No escape from the exit tax

SARS has also sharpened its axe in vetting the affairs of taxpayers who leave the country. Prior to 1 March 2021, emigrating taxpayers who sought to close the book on their fiscal obligations in South Africa completed the emigration process as recognised by the South African Reserve Bank. This process, which has now been phased out, had a tax component, where the individual would apply for an emigration tax clearance certificate.

In practice, taxpayers still apply for an emigration tax clearance certificate when they leave South Africa and the process to review the taxpayer's affairs is now far more sophisticated. Taxpayers who apply for emigration tax clearance certificates now often receive notifications from SARS where they are called to comply with further arduous information requests.

To finalise the process, taxpayers are asked to submit a comprehensive statement of assets and liabilities for the previous three years of assessment, particulars of any trusts in which they have an interest, a complete statement of assets and liabilities, particulars of all shareholdings and an explanation of their exit tax calculation.

SARS' ability to interrogate these declarations has been enhanced by the use of data received from third-party sources such as the deeds office, local financial institutions and the tax authorities of other countries under the Automatic Exchange of Information SARS' refined audit strategy follows a promise from the government that the tax component of the emigration process will be more rigorous, and it aligns with the institution's commitment to bring undisclosed offshore assets within the South African tax net. An important part of utilising this untapped pool of revenue is to ensure that those who leave the tax base have paid their dues.

An interesting point to note here is that it appears that SARS will no longer shut its eyes to offshore trusts. The Davis Tax Committee in its Final Report on Estate Duty noted that it appeared that much of the South African wealth held in foreign trust arrangements was not identified by tax and exchange control amnesty programmes.

Seemingly, these taxpayers were advised that their offshore planning structures would remain undetected. But perhaps with the means now at SARS' disposal, they will be able to untangle these arrangements.

SARS' expanded scope of capabilities

A key part of SARS' vision to rebuild a robust and respected institution, based on integrity and trust, is to modernise its systems and to rely more on data analytics and artificial intelligence to execute its mandate. This, together with the expansion of its global network, will only further enhance its capability to look into the offshore assets of taxpayers.

But all the technology in the world does not mean much if you do not have the resources to wield it. It is widely known that there was a mass exodus of senior SARS officials under the previous administration. Beyond the fact that this caused SARS to be understaffed, it created a problem with skills transfer at the institution. In 2020, the Commissioner told the Standing Committee on Finance that there are 800 critical vacancies at the organisation that need funding.

The government heard the Commissioner's plight and with the 2021 Budget it was confirmed that SARS will be given an additional R3 billion in funding.

It soon became clear that a large chunk of the additional funding will go to recruitment. On 28 March 2021 SARS announced that it is undertaking a massive recruitment drive. The skills that SARS is hoping to attract include 370 highly skilled specialists, as well as 200 finance graduates. Seemingly, this would mean that SARS will not be shying away from complex issues and international financial arrangements.

Nevertheless, it is clear that SARS has embarked on a larger project of remedying its internal, operational, cultural and technological deficiencies and one can only hope that the skilled individuals it now attracts will stay the course. Skills take time to develop but SARS is laying the foundation to rebuild the organisation. In the course of time, leaving offshore assets undisclosed may simply no longer be worth the risk.

BINDING RULINGS

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We summarise two recent binding rulings involving corporate reorganisations, a B-BBEE investor, the issuing of preference shares and the sale of shares to a third-party buyer.

BINDING PRIVATE RULING 360

Internal restructure followed by a disposal of shares to a B-BBEE investor

Issue

This ruling determines the tax consequences, in terms of the Income Tax Act, of an internal restructuring of several operating entities within a group, under an ultimate intermediate holding company and the subsequent disposal of the intermediate holding company's shares by the ultimate holding company and to a B-BBEE investor.

Facts

The applicant is a resident company listed on the JSE and is the ultimate holding company of a group of companies (A, B, C, D, E, F and G) that are all resident companies and co-applicants in this ruling. The applicant is the sole shareholder in Companies A, C, D, E and G, while Company A is the sole shareholder in Company B and Company E is the sole shareholder in Company F.

The applicant intends to protect and enhance its commercial position by undertaking a B-BBEE initiative. Prior to undertaking the B-BBEE initiative, the applicant seeks to commence an internal restructuring of its operating companies within the group. The applicant formed Company G as part of this initiative.

The applicant intends to undertake its internal restructuring by consolidating the group operating companies under Company G as the ultimate intermediate holding company, and Company C as the intermediate holding company of the group. To achieve this, the applicant will first subscribe for additional shares in Company C to enable the repayment of outstanding funding used by Company C prior to this initiative.

Secondly, the applicant will implement various intra-group transactions in terms of which the group companies, as its direct or indirect subsidiaries, will sell and transfer shares to each other in terms of section 45(1)(a) of the Income Tax Act.

Thirdly, the applicant will implement an asset-for-share transaction (AFS transaction) in terms of which it will, subject to section 42 of the Income Tax Act, transfer its entire holding of shares in Company C to Company G, in exchange for shares in Company G. The effective date of the AFS transaction will be after all the internal restructuring approvals have been obtained.

Finally, after the implementation of the internal restructuring, the applicant will implement its B-BBEE initiative by selling 25% of the issued shares in Company G to the B-BBEE investor on the basis of specific identification in terms of paragraph 32(3) of the Eighth Schedule to the Income Tax Act. A minority and liquidity discount will be applied to the value of the shares purchased by the B-BBEE investor.

Ruling

This ruling is subject to the following additional conditions or assumptions:

- The intra-group transactions meet the requirement of section 45.
- The transaction steps occur in the order they were outlined.
- On the AFS transaction effective date, the market value of each of the qualifying Company C disposal shares equals or exceeds its base cost.
- On the AFS transaction effective date, the market value of the disqualified Company C existing share does not exceed its base cost.

The ruling issued by SARS is as follows:

- The applicant's subscription of new Company C shares will not have any immediate tax consequences for either the applicant or Company C.
- The disposal of qualifying Company C shares in exchange for Company G consideration shares on a 1:1 basis will constitute an AFS transaction in terms of section 42(1).
- Section 24BA is not applicable to the AFS transaction.
- The transfer of all the Company C shares pursuant to the AFS transaction will be exempt from the securities tax applicable in terms of section 8(1)(a)(i) read with section 8(1)(a)(iv)(B) of the Securities Transfer Act.
- The proceeds from the sale of the Company G disposal shares by the applicant to the B-BBEE investor will not be of a revenue nature and will not fall within the applicant's "gross income".
- The base cost of the Company G disposal shares will be determined in accordance with the specific identification method in terms of paragraph 32(3)(a) of the Eighth Schedule to the Act.
- The purchase price payable by the investor will constitute "proceeds from disposal" in the hands of the applicant, in terms of paragraph 35(1) of the Eighth Schedule.
- The discount applied for the purposes of the determination of the pricing of the B-BBEE transaction will not constitute a "donation" as envisaged in section 55. Under the circumstances, SARS is of the opinion that the pricing of the B-BBEE transaction constitutes an adequate consideration.

BINDING PRIVATE RULING 361

Asset-for-share transaction followed by an unbundling transaction, the issue of capitalisation redeemable preference shares and the sale of shares to a third party

Issue

The ruling determines the tax consequences of an internal restructuring involving corporate rules. Cumulative redeemable preference shares are also issued as a capitalisation issue which is followed by the sale of shares to a third party. In particular, the tax relief under corporate rules for the parties involved is examined and whether the dividend stripping rules will apply.

Facts

The applicant, Company A and Company B are resident companies, and the third-party buyer is a resident natural person. Company A is the holding company of the applicant, Company B will become a subsidiary of Company A and the third-party buyer is the managing director of the applicant. Company B wishes to reduce its involvement in the applicant

to that of a passive limited shareholder, whose interest will be phased out over time, whilst the third-party buyer wishes to obtain an equity interest in the applicant. The third-party buyer will acquire the ordinary shares of the applicant for purposes of holding them as a long-term investment.

The transaction will be implemented in steps, as follows:

- The applicant owns the property from which it operates and has claimed section 13 allowances on the property. This property will be transferred to Company B in exchange for the issue of ordinary shares by Company B and implemented under section 42 of the Income Tax Act. The applicant will simultaneously enter into a five-year lease with Company B in respect of the property. The lease payments will be at an arm's length consideration.
- The applicant will distribute Company B shares acquired in step 1 to Company A in terms of an unbundling transaction as defined in section 46 of the Income Tax Act and issue class A cumulative redeemable preference shares to Company A as a capitalisation share issue.
- Company A will dispose of all the ordinary shares in the applicant to the third-party buyer for an amount which will be the market value of the ordinary shares at that time.
- The third-party buyer will subscribe for additional ordinary shares in the applicant through which he will provide the applicant with a cash injection to fund its operations. The applicant will declare and pay cumulative preference dividends in respect of the class A preference shares. Over time, the applicant will redeem the preference shares.

Ruling

This ruling is subject to the following additional conditions and assumptions:

- The property will be sold at market value and does not secure any debt.
- The parties to the proposed transaction will not elect that the provisions of section 42 do not apply.
- The public officer of Company B will make a sworn affidavit or solemn declaration, required by the Securities Transfer Tax Act, that the acquisition of the property is by way of an AFS transaction under section 42 of the Income Tax Act.
- The applicant and Company B will not jointly elect that the provisions of section 46 do not apply.
- The requirements of section 47 of the Companies Act will be complied with when the applicant makes any payment in respect of the class A preference shares.

The ruling issued by SARS is as follows:

- The applicant will be deemed to have disposed of the property to Company B for an amount equal to its base cost in terms of section 42(2)(a)(i)(aa) of the Income Tax Act.
- The building allowance, previously allowed in respect of the property, must not be recovered by the applicant, or included in its income in the year of that transfer, as contemplated in section 42(3)(a)(i).
- The applicant and Company B will be deemed to be one and the same person for purposes of determining the amount of any allowance previously deducted, as contemplated in section 42(3)(a)(ii).
- Company B will not be entitled to any allowances as the property has been fully claimed for income tax purposes and has

a zero-tax value. The amount of any allowance or deduction previously claimed by the applicant must be recovered by Company B, if Company B disposes of the property in the future.

- The transfer of the property will be deemed not to be a supply made by the applicant for value-added tax purposes under section 8(25)(iii) of the VAT Act.
- The transfer of the property will not be subject to transfer duty under section 9(1)(l)(i) of the Transfer Duty Act.
- The applicant must disregard any income tax implication of the distribution of the Company B shares to Company A under sections 46(2), (5) and (5A).
- Company A must allocate a portion of the base cost of the ordinary shares of the applicant to the ordinary shares of Company B that the applicant will distribute to it, under section 46(3).
- The distribution of the ordinary shares of Company B by the applicant will be exempt from securities transfer tax in terms of section 8(1)(a)(iv) of the Securities Transfer Tax Act.
- The issuing of the class A preference shares of the applicant as capitalisation shares to Company A is not a "dividend" or "gross income" as defined in section 1(1) of the Income Tax Act.
- The class A preference shares have a zero-base cost for Company A, under section 40C. The contributed tax capital of these shares amounts to nil rand.
- No contributed tax capital will be created by the issuing of the class A preference shares.
- On the disposal of the ordinary shares by Company A to the third-party buyer, the difference between the proceeds and the base cost of the ordinary shares, after adjustments made in terms of section 46(3), will be subject to capital gains tax.
- Securities transfer tax will be levied under section 2 of the Securities Transfer Tax Act on the market value of the ordinary shares of the applicant transferred to the third-party buyer. The applicant is liable for the payment of securities transfer tax under section 6 of the Securities Transfer Tax Act which may be recovered under section 7(2) from the third-party buyer.
- Paragraph 43A of the Eighth Schedule to the Income Tax Act will not apply to the distribution of the Company B shares to Company A by the applicant, under section 46.
- The issue of the class A preference shares will not be regarded as a "dividend", as defined in section 1(1), and as a result paragraph 43A will not apply.
- The class A preference shares are not hybrid equity instruments as defined in section 8E(1) of the Income Tax Act and the dividends are not deemed to be income under section 8E(2).
- To the extent that the class A preference share dividends and redemption amounts are received by or accrued to Company A, these amounts will be "dividends" as defined in section 1(1). In the context of the specific facts and circumstances of the transaction, these "dividends" that arise on dividend declaration and redemption dates will be "extraordinary dividends" as defined in paragraph 43A(1). Paragraph 43A(2) of the Eighth Schedule to the Income Tax Act will apply to these "dividends".

Case Law
WRAP-UP

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Our summary of recent cases deals with capital losses, a tariff heading application for customs purposes and the use of a court process rather than the dispute resolution process outlined in the Tax Administration Act.

MASSMART HOLDINGS LIMITED V CSARS (84/2020) [2021] ZASCA 27 (26 MARCH 2021)

Issue

The issue in this matter was whether the taxpayer suffered capital losses for capital gains tax (CGT) purposes, owing to its dealing with the Massmart Holdings Limited Employee Share Trust.

Facts

In 2000, the taxpayer adopted and implemented a share incentive scheme for its key management staff, which was to be conducted through a trust known as the Massmart Holdings Limited Employee Share Trust (the Trust).

Clause 33 of the trust deed, in short, stated that the Trust shall not be entitled to make any profit on the resale of shares acquired by it and it, therefore, ceded to the taxpayer its right to any profit. The trustees at the time sought legal clarity as to whether this clause implied that the taxpayer could account for the Trust's profit or losses in its own books. After receiving legal confirmation that those CGT obligations remained with the Trust, an addendum to the trust deed was, nevertheless, adopted on 1 October 2003.

The taxpayer subsequently claimed capital losses in the Trust as an assessed loss during the period of its 2007 to 2013 years of assessment for the sum of approximately R954 million.

The evidence on appeal demonstrates that key management staff were offered call options in respect of Trust shares which vested over the course of approximately ten years. Of significance, the taxpayer provided interest-free loans to the Trust. However, there was no unconditional obligation on the Trust to repay the funds advanced to it by the taxpayer. Moreover, it appeared that the funds advanced to the Trust were recorded as loans on the books of both the taxpayer and the Trust.

The taxpayer's case

The taxpayer, in its objection, initially claimed capital losses on the basis that it was a vested beneficiary of the Trust.

On appeal, the taxpayer, however, claimed that when it issued instructions to the Trust to offer specific share options to particular employees at specific prices (the strike price), the taxpayer then acquired a right to claim performance against the trustees, which required them to later grant those options to acquire shares to those particular employees at the strike price.

Once the employees exercised the options, the Trust sold the shares to the employees at the strike price. In order to be able to deliver the shares, the Trust was required to, generally, purchase shares in the market. As a consequence, the purchase and disposal of the shares would result in a loss. For that reason, the taxpayer argued that it actually incurred expenditure equal to such losses incurred by the Trust because of it instructing the Trust to issue the options to the employees.

This right, so the taxpayer argued, should be recognised as an "asset" for CGT purposes and, when discharged, it constituted a disposal in terms of paragraph 11(1) of the Eighth Schedule to the Income Tax Act. It is this disposal which gave rise to the capital loss.

SARS' case

SARS simply disagreed and argued that what has been claimed as an "asset" by the taxpayer is not an asset as defined in paragraph 1 of the Eighth Schedule. Furthermore, SARS argued that no expenditure was actually incurred by the taxpayer in acquiring the right.

Outcome

The appeal was dismissed with costs, which include the costs of two counsels.

Core reasoning

The evidence of the three witnesses presented by the taxpayer, in fact, supported SARS' contention that the right did not constitute an asset. The taxpayer merely purported to account for the Trust's losses in its books.

Takeaway

Taxpayers should be careful when planning their share incentive schemes so as to ensure that no arrangements are concluded whereby the ultimate intention is to avoid the incidence of CGT.

SAMSUNG ELECTRONICS SA (PTY) LTD V CSARS
(2018/68900) (18 MARCH 2021)

Issue

The issue in this matter was whether the tariff heading as determined under the Customs and Excise Act, No. 91 of 1964 and the schedules thereto that were applied by Samsung Electronics SA (Pty) Ltd (the taxpayer) for the importation of Samsung Galaxy S7 devices (the product) was correctly withdrawn by SARS and replaced with another tariff heading.

Facts

In July 2017, the taxpayer applied for a tariff determination in respect of the product that it imported, whereby the product had multifunctional features which could be classified under a specific tariff heading in the taxpayer's view. The tariff heading applied by the taxpayer aligned with a tariff heading determination that the taxpayer's attorneys previously applied in the importation of Apple iPhones.

However, on 6 September 2017 SARS declined the taxpayer's refund applications in respect of the products imported on the basis that, after considering the technical specifications of the product, SARS determined that the taxpayer's tariff heading was incorrect and that the products should be classified under another tariff heading. SARS, therefore, withdrew the tariff heading determination that the taxpayer's attorneys obtained with retrospective effect from 4 August 2017 and made a new tariff determination.

As a result, the effect of the withdrawal is that the previous determination was void and any entitlement that the taxpayer had with respect to the previous imports rendered the taxpayer liable for duties in respect of the imported goods.

The taxpayer brought an application to the High Court to set aside the decision of SARS to withdraw the tariff heading determination and classify the products under a new tariff heading.

The taxpayer's case

The taxpayer argued that the principal function of the product relates to its connection to the internet, social media, games, etc. and not the making of telephone calls. Therefore, the previous tariff heading determination obtained and relied on by the taxpayer was correct. The taxpayer did, however, concede that the product can be used with cellular networks and not only has a telephony function, but can also perform image and data functions.

The argument of the taxpayer was that the correct classification of its product by considering the characteristic of the product and, therefore, the primary step in determining the correct tariff heading should be to consider the description of the word "telephone" as envisaged under the tariff headings.

The taxpayer further relied on a number of market survey reports which indicated that the principal function of smartphones (products) like the Samsung S7 are mainly not used for telephony, but for internet connection, social media, music and games and not for traditional voice calls. Accordingly, SARS' contention that the product should be classified as a telephone is not reconcilable with the tariff heading description that SARS determined after reviewing the specifications of the product.

SARS' case

SARS, in arguing the juxtaposition submitted that it is inexplicable why the taxpayer would choose to seek the meaning of the word "telephone" in order to explain its position rather than the meaning of "telephones for cellular networks" as indicated in the tariff heading in light of the development in telephone technology.

It was further argued by SARS that the use of the product using the wireless network to make calls on WhatsApp, Skype, etc. falls under operating as a telephone as per the tariff heading under which SARS declared the goods.

Outcome

The Court ruled in favour of SARS.

Core reasoning

The Court found that that it is common cause that the product is a composite device which can be used, inter alia, as a telephone and can also perform functions of data processing, video calling, messaging, a camera, and a music player.

In determining the classification under the respective tariff headings of imported goods, the decisive criteria are premised on the objective characteristics and properties of the goods as determined at the time of presentation for customs clearance. Thus, it was held that the intention of the manufacture or the use of the goods after importation is not determinative of their classification under the Act as found in previous cases that dealt with tariff heading determinations.

In considering the taxpayer's assertion that the product is not a telephone for cellular networks but a machine akin to a laptop or desktop is disingenuous, taking into account that the taxpayer has conceded that its product has telephony functions. The Court further elaborated on this aspect and held that the product having functions found in laptops and desktops does not detract from its principal function of being a telephone for cellular networks.

Takeaway

Tariff heading determinations have always been a contentious issue due to the interpretational element associated therewith and considering the evolution of technology which has a direct bearing on whether a certain tariff heading may be suitable or not. Taxpayers are required to apply the six General Interpretive Rules when determining a tariff heading whereby the characteristics of the goods remain the determining factor

ABSA BANK LIMITED AND ANOTHER V CSARS (2019/21825) [P]) *[2021] ZAGPPHC (11 MARCH 2021)*

Issue

The issue in this matter was whether a taxpayer is obliged to pursue a remedy in respect of a dispute over a tax liability in terms of the procedures set out in tax legislation only, or whether the taxpayer may apply directly to a court of law for relief in exceptional circumstances as opposed to following SARS' lengthy dispute resolution procedures.

Facts

The origin of this case lies in a controversy about whether an impermissible tax avoidance arrangement was conceived to evade a tax liability.

SARS was of the view that Absa Bank Limited (the taxpayer) had participated in an impermissible tax avoidance arrangement and proceeded to issue notices in terms of section 80J of the Income Tax Act, informing the taxpayer of the reasons for its belief.

In reply, the taxpayer submitted reasons to SARS as to why the general anti-avoidance rules (GAAR) should not apply and requested that SARS withdraw its section 80J notices.

While considering the request by the taxpayer and prior to its refusal to withdraw the notices, SARS issued letters of assessment in respect of a tax liability imposed in terms of section 80B of the Income Tax Act.

As a result, the taxpayer, seeking to review SARS' decision not to withdraw the notices and to issue letters of assessment, approached the High Court.

The taxpayer's case

The taxpayer's argument was founded on two bases. Firstly, that the dispute is based on a pure point of law, allowing a broader consideration than the stance taken by SARS. Secondly, that the guarantee by section 34 of the Constitution of access by a person to a court to resolve a dispute is not compromised by the provision of a system of internal remedies leading to the Special Tax Court.

The taxpayer further argued that, in so far as a court has a discretion to deal with a tax dispute or insist that the internal remedies be exhausted, a court would regard a pure point of law dispute as an appropriate rationale to hear and dispose of the controversy.

SARS' case

SARS argued that the dispute resolution provisions, as provided for in South Africa's tax legislation, are extensive and provide adequate channels for taxpayers to resolve their grievances and disputes with SARS and that approaching a court of law at the inception of tax proceedings would therefore be inappropriate.

Outcome

The Court ruled in favour of the taxpayer.

Core reasoning

In determining whether the decisions taken by SARS were reviewable by the High Court, the court considered the following provisions of the Tax Administration Act.

The court considered section 9 of the Tax Administration Act, which allows for a decision or notice by SARS to be withdrawn, at the request of the person affected by the decision, by a SARS official. Although section 9 expressly excludes a decision given effect to in an assessment or notice of assessment that is subject to objection and appeal, the court held that section 9 excluded cases where tax is paid and the objections and appeals process is pending, which was not the case in this matter. SARS was of the view that section 9 did not include section 80B assessments.

In considering section 105 of the Tax Administration Act which provides that "a taxpayer may only dispute an assessment or 'decision' as described in section 104 in proceedings under this Chapter, unless a High Court otherwise directs" and section 104 which states that a taxpayer may object to and appeal against "any other decision that may be objected to or appealed against under a tax Act", the Court held that the words "unless a High Court otherwise directs" under section 105 indicated that there is more than one process and that the court has the discretion to deviate from the default route.

Takeaway

Taxpayers need to be aware of their rights regarding tax dispute resolution and that they are not necessarily always obliged to proceed with the various lengthy procedures as set out in tax legislation, but may, in exceptional circumstances, apply directly to a court of law for the necessary relief.

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