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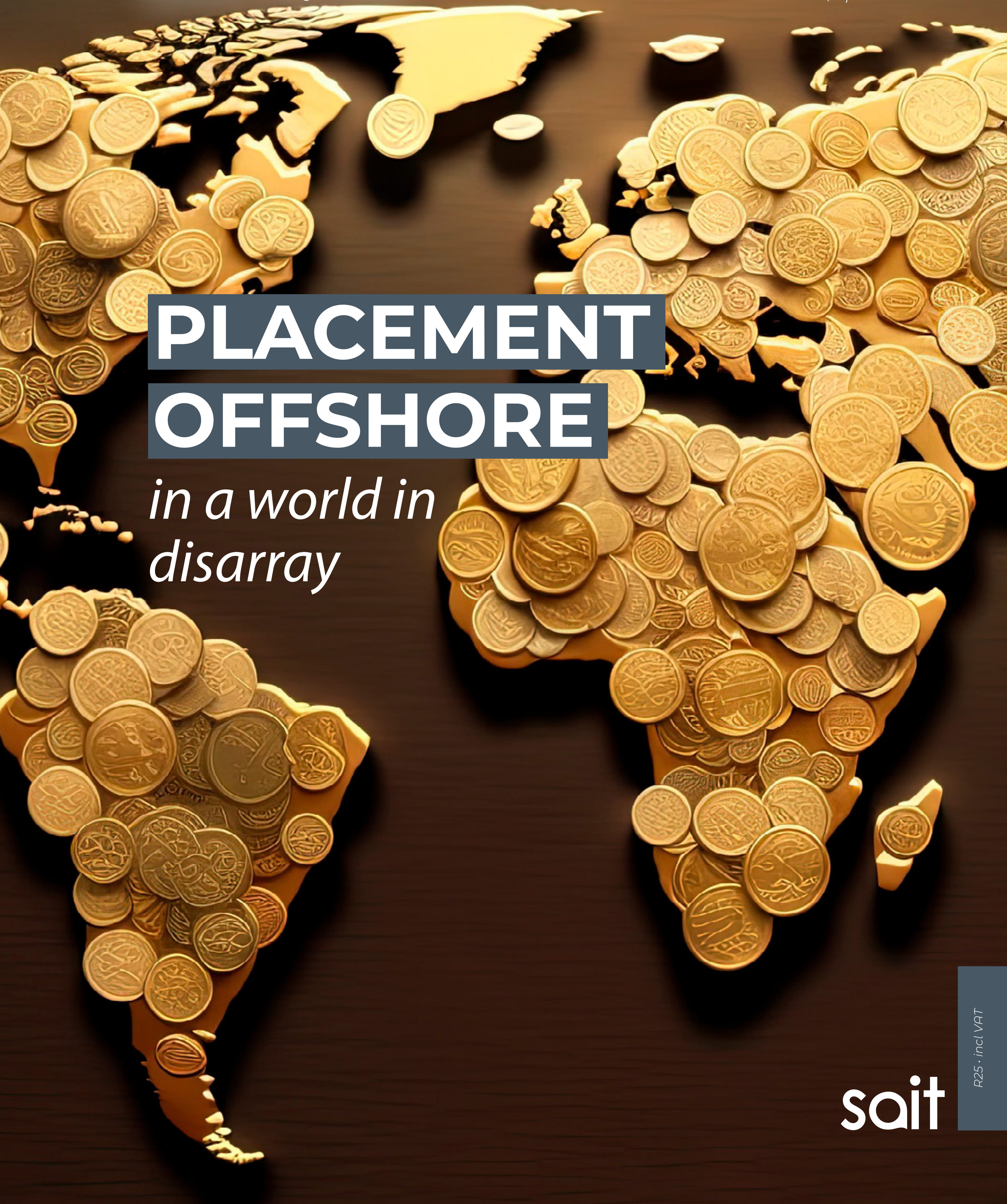

PLACEMENT OFFSHORE
in a world in disarray

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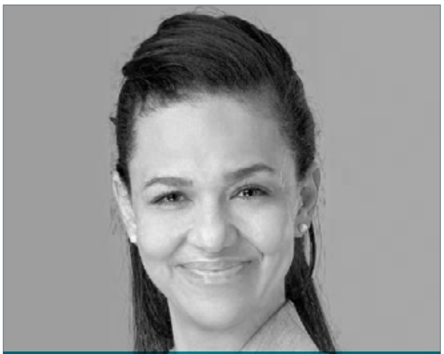

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15 minutes CPD

VOLATILITY IN THE SOUTH AFRICAN TRUST WORLD

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South African trusts have been used for decades by South African individuals as a vehicle to manage wealth, hold and administer assets into perpetuity, conduct both operational and passive business activity and as a strategic financial planning tool. In addition, trusts have been used to achieve philanthropic objectives of servicing the socio-economic needs of specified beneficiaries and protecting individuals with varying degrees of vulnerability.

Despite the benefits that trusts offer as a juristic vehicle, our regulators, including the South African Revenue Service (SARS), the South African Reserve Bank and, more recently, the Financial Action Tax Force, have been increasing measures to clamp down on this legal entity. These increased measures are due to regulators' general perception, exacerbated by international pressure, of (1) the secrecy of trusts (2) the ability of trusts to manipulate ownership rights and shield assets due to their seeming multifaceted control structures and (3) the use of trusts to circumvent fiscal policy, such as tax and exchange controls.

In the ongoing escapade to tighten the agility of the vehicle that remains on the front burner, several legislative changes and proposals have been introduced by the South African legislature over the past few months. These are listed below.

Changes leading up to greylisting

Following the government's evaluation of the Anti-Money System and the Combating the Financing of Terrorism System (AM/CFT), the National Treasury announced the enactment of The General Laws (Anti-Money Laundering and Combating Terrorism Financing) Amendment Act (i.e., the General Laws Amendment Act) in January this year to address the deficiencies said to have been identified.

The trigger for the government's review was the report issued by the Financial Action Tax Force (FATF), which is the international organisation established to combat money laundering and of which South Africa is also a member state. This report was issued in October 2021; it reported that South Africa's technical compliance for AM/ CFT is very low. The General Laws Amendment Act introduced amendments to, among other legislation, the Trust Property Control Act. The published objective of the amendments to the Trust Property Control Act is to "*strengthen the ability of investigators and other authorities to pierce the corporate veil and determine who the natural persons that deal with financial and other institutions at arm's length through trusts and companies are*".

The changes to South African trusts, most of which are effective from 1 April 2023, include:

- Specifications of matters that would disqualify a person from acting as a trustee;
- A requirement that a foreign person may only act as a trustee with the authority of the Master of the High Court;
- A requirement that a trustee discloses their position as trustee to any accountable institution with which the trustee engages in that capacity and to make it known to that accountable institution;
- Trustees are to provide details of accountable institutions which trustees use as agents to perform trustee functions and who provide any services to trustees;
- Prescribed information to be kept by the trustees in relation to direct or indirect beneficiaries. This includes a requirement to keep a register and lodge certain information with the Master in relation to the beneficial owners; and
- If the trustee fails to comply with these obligations, they will commit an offence and on conviction, will be liable to a fine not exceeding ZAR10 million or imprisonment not exceeding five years or both.

Note that where trusts are non-profit organisations in terms of the Non-profit Organisations Act, the General Laws Amendment Act has also introduced changes to the Non-profit Organisations Act, which ensures that non-profit organisations transferring funds overseas abide by standards of good governance and financial management.

Notwithstanding the legislative amendments, South Africa was put on the FATF's greylist for still falling short of its recommendations. A greylisting denotes that South Africa is a country which is "*under increased monitoring*" by the FATF. In response to this listing, the government has said that it will ramp up its action plan.

Budget speech proposals

The annual national budget speech was delivered by the Minister of Finance on 22 February 2023. As in many of the past budget speeches, proposals have been made to tighten legislation in relation to local trusts. In particular:

"Where loans are advanced in a foreign currency, section 7C does not provide clarity on how the amount should be converted, which impacts the computation of the deemed donation"

- National Treasury has contended that the flow-through of amounts from South African tax resident trusts to non-resident beneficiaries makes it difficult for SARS to collect income tax from those non-resident beneficiaries, given that it is more complicated for SARS to enforce recovery actions against non-residents. To address this, the Budget proposes that changes be made to section 25B of the Income Tax Act to ensure that, where beneficiaries of a local trust are South African tax non-resident, there is no flow through of income receipts and that the trust is rather subject to income tax.

- National Treasury has also proposed amendments to the anti-avoidance provision, targeting interest-free or low-interest loans, contained in section 7C of the Income Tax Act. In particular, the proposed amendment to the section is intended to deal with the following:

    - The provision of section 7C excludes from the ambit of the provision loans advanced to purchase a primary residence. The Budget has stated that it is not clear what a primary residence constitutes and it is proposed that an amendment be introduced to provide clarity.

    - Where loans are advanced in a foreign currency, section 7C does not provide clarity on how the amount should be converted, which impacts the computation of the deemed donation. The Budget, therefore, proposes that amendments be made to section 7C to deal with this.

With this number of legislative changes on local trusts, one tends to understand why South Africans are more inclined to establish foreign trusts. Whereas certain jurisdictions carry their own sets of compliance and fiscal hurdles, foreign trusts tend to be more appealable in the flexibility that they afford to house local and foreign investments.

THE TAX RISK IMPACT OF MOVING OFFSHORE ECONOMY

HANNEKE FARRAND, Director & **JARRED VAN DER WESTHUIZEN,** Senior Associate at Farrand Global

South Africans relocating abroad can trigger multiple tax events before departure.

This article looks at the deemed sales rules, the impact of change of effective management for their trusts / companies, pension withdrawals and other notable impacts.

The Exit Tax and procedure for ceasing to be a tax resident

The South African Income Tax Act, 1962 (Act No. 58 of 1962, as amended, the 'ITA') provides for a deemed disposal of a tax resident's assets at market value to a resident on the day immediately before ceasing to be a tax resident with the concomitant capital gains tax consequences (the 'Exit Tax'). The resident is deemed to reacquire the assets on the day that the person ceases to be tax resident.

The maximum effective rate of taxation of capital gains of an individual is currently 18%.

Generally, the resident individual's worldwide assets would be the subject of the Exit Tax. Some assets which are excluded from the Exit Tax are:

- the resident's immovable property in South Africa;
- assets attributable to a permanent establishment of the individual in South Africa;
- certain shares (to which sections 8A, 8B and 8C of the ITA would apply); and
- personal-use assets (assets used mainly for purposes other than the carrying on of a trade, subject to exclusions).

The declaration to the South African Revenue Service (SARS) of ceasing to be a tax resident in South Africa may be done via eFiling and the RAV01 Form, alternatively, by recording the date of ceasing to be tax resident in the individual's tax return. In addition, the emigrating individual would need to apply to SARS for a Tax Compliance Status (TCS) PIN for 'emigration' purposes. This TCS PIN (broadly, a confirmation to third parties of the emigrating individual's tax compliance) is critical for submission to the individual's bank in order to allow the export of the person's capital from South Africa.

Whichever route one chooses to inform SARS of ceasing to be a South African tax resident, one will be required to demonstrate the source of one's wealth. High-net-worth individuals may generally expect an audit from SARS.

The bases for individuals ceasing to be South African tax residents

The tax residency tests for individuals are the 'ordinarily resident' test and the 'physical presence' test. An individual may also cease to be a South African tax resident by means of the application of the residency provisions in the agreement for the avoidance of double taxation (DTA), if any, between South Africa and the jurisdiction to which the individual will be moving permanently.

The DTA should apply where the individual is a tax resident in both jurisdictions by virtue of the respective domestic laws. In these circumstances, the DTA should provide tie-breaker tests to determine the individual's exclusive tax residency.

An analysis of the tax residency tests is beyond the scope of this article. However, it should be noted that the 'physical presence' test cannot apply in the same year of assessment as the 'ordinarily resident' test.

Tax residency risks for emigrating directors and trustees

Companies incorporated in South Africa are generally subject to tax in South Africa on a worldwide basis by virtue of such incorporation.

An important consideration for emigrating directors should be to obtain tax advice in the jurisdiction to which they emigrate in order to ensure that the company for which they are responsible would maintain its tax residency in South Africa.

Similar to the Exit Tax, a company ceasing to be a tax resident in South Africa should also be a capital gains tax event: there should be a deemed disposal of the company's assets at market value to a resident on the day immediately before ceasing to be a tax resident and the company is deemed to reacquire the assets on the day that it ceases to be tax resident.

If the jurisdiction to which the director emigrates and South Africa both claim tax residency of the company under the respective domestic laws, the DTA between South Africa and that jurisdiction, if any, would generally resolve the company's exclusive tax residency with reference to the 'place of effective management' (POEM) test. This test generally involves the determination of the place where the *"key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made".*

"When a beneficiary's tax residence changes, the trustees need to be informed well in advance, particularly when the new jurisdiction is a civil law jurisdiction, as these jurisdictions may not recognise trusts or may look through trusts"

- Practitioners and emigrants should take into account any amendments made to the relevant DTAs by the 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' (sometimes referred to as the 'MLI'). In addition, the Commentary on Article 4 of the Organisation for Economic Cooperation and Development's Model Tax Convention should be consulted in interpreting the POEM test, where applicable.

Withdrawal of South African preservation fund and retirement annuities before retirement on emigration

Members of a 'pension preservation fund' or a 'provident preservation fund' who have ceased to be South African tax residents for an uninterrupted period of three years or longer, may withdraw the full benefit before they choose to retire from that fund.

Members of a 'retirement annuity fund' who have ceased to be a resident for an uninterrupted period of three years or longer and who have stopped contributing to a 'retirement annuity fund' may withdraw the full benefit before they choose to retire from that fund.

Before a lump sum benefit can be paid out, a fund administrator, trustees or insurers must apply for a tax directive from SARS to determine the taxable portion of the lump sum payable to the member.

The timing of the withdrawals should be considered with respect to anticipated cash flows.

Conclusion

Holistic and multi-jurisdictional planning is the key to a successful emigration with the expected tax consequences.

Some of the rules of thumb which should be considered by potential emigrants and their advisors are to prepare a detailed timeline with important dates and action steps, to obtain advice in both South Africa and in the jurisdiction to which the individual will be emigrating and to consider tax planning which may be required with respect to the individual's estate (particularly when the individual has varied interests in multiple jurisdictions and when the new jurisdiction has forced heirship rules).

The new jurisdiction may have different tax rules that apply to the funding of and distributions from offshore trusts which would need to be understood before a person becomes a tax resident in that new jurisdiction. An example would be that when a beneficiary's tax residence changes, the trustees need to be informed well in advance, particularly when the new jurisdiction is a civil law jurisdiction, as these jurisdictions may not recognise trusts or may look through trusts.

With holistic planning well in advance of the emigration, the emigrant may be properly prepared for their emigration in addition to having realistic expectations of the consequences and costs of emigrating.

15 minutes CPD

USING AN ENDOWMENT POLICY IN THE OFFSHORE WORLD

▶ **HARRY JOFFE,** Head of legal services at Discovery Life and Discovery Life International

Investors all want to be offshore but they often neglect to consider the estate planning issues regarding such investments.

This article will attempt to analyse some of these issues and discuss the benefits of using an offshore endowment policy with a South African Insurer.

The benefits of nominating a beneficiary

An endowment policy is a life policy under the Long-term Insurance Act. As long as the policy has a life assured, a beneficiary can be nominated to receive the policy proceeds on death of the life assured. This allows the proceeds to be paid out without incurring executor's fees. It also ensures that they get paid out to beneficiaries directly, without having to pass through the estate and the whole winding-up process.

This is the major benefit of using an endowment wrapper in the offshore world, as the whole complex process of winding up a South African offshore estate is often underestimated. Let us discuss some of the complications:

- First, if someone dies with assets in Europe, forced heirship will often apply to assets situated in that country. This means that descendants of the deceased inherit in fixed percentages, which generally overrides a will. Although it is possible to set up a special will which opts out of forced heirship provisions for nationals of other countries, this process is fraught with complexity and is still very new.
- Second, doing a will in a foreign jurisdiction is not easy. You need to find an expert in that jurisdiction, which is not always that simple. Where do you find an expert to draft a Croatian will in South Africa (SA)?
- Third, although your South African will can technically be used and be valid offshore, it carries logistical challenges. The SA Master requires an original will. So do the local authorities offshore, which creates delay unless the individual has duplicate originals. In addition, the SA might have concepts that are not always the same in Europe, for example, the concept of a Usufruct might have a different meaning in some parts of Europe.
- Fourth, many countries (the United Kingdom [UK] and the United States [US], for example) apply Situs tax. This means that they apply their death duties

on many assets situated in the country. Their rates are normally higher than the SA rates of estate duty; both the US and UK rates go up to 40%, for example. In addition, the US abatement for non-US Nationals is only $60 000, which is much lower than for US Nationals.

However, because the endowment allows for a nomination of a beneficiary to whom the proceeds are paid directly on the death of the life assured, it avoids the first three problems and even avoids the need for a foreign will or executor for the assets inside the wrapper. In addition, because the endowment itself is normally housed in a tax centre, it avoids the issue of Situs tax, even if the underlying assets are invested in a country that applies Situs tax.

The writer recently had an interesting case. A client had a property in the US. The property was not being privately used and was held for investment purposes. The client did not realise the Situs tax consequences in the US when they died. As a consequence, once they understood the issue, the client sold the US Property, paid some CGT and moved the proceeds into a US Property-linked Exchange Traded Fund (ETF) inside a South African offshore endowment wrapper housed in Guernsey. The client still has exposure to the US property market but because they are in an endowment wrapper housed in Guernsey they do not pay any Situs tax in the US when they die. (They do pay estate duty on the asset in SA; although at the much lower rate of 20/25% and if their spouse is the beneficiary, then no duty would be paid at all).

Tax implications of the investment during the term

With an endowment policy, the tax is paid into the endowment policy fund in terms of the five-fund approach. Assuming the investor is a natural person, income will be taxed in the fund at 30%, with Capital Gains being taxed at 12%. This is potentially lower than the investor's marginal rates of 45% on the income side and 18% on the capital gains tax (CGT) side; however, there are some important caveats to stress here:

- With an endowment policy, because the tax is paid into the fund and not by the investor, the investor cannot use their interest or CGT rebates.
- Tax is paid at 30% on the income side and 12% on the CGT side, irrespective of the investor's actual tax rates. This is again because the fund is the taxpayer and not the individual.
- This means that if the individual has a marginal tax rate of above 30% on the income tax side and above 12% on the CGT side and if they have used up their interest and CGT rebates, then investing in an endowment policy makes tax sense, as they will be bringing their tax rates down to the fund rates. However, if the individual has a marginal rate of 30% or below on the income side and 12% or below on the CGT side, then investing in an endowment policy makes no tax sense, as they will then be increasing their tax rate to the fund rate. The impact of the rebates should also not be ignored.

"The offshore tax world is complex. If investing directly, the investor has to obtain their annual interest earned and capital gains made from the investment company and then convert the foreign gains to rands"

However, to me, the most important issue is tax simplicity. The offshore tax world is complex. If investing directly, the investor has to obtain their annual interest earned and capital gains made from the investment company and then convert the foreign gains to rands. With the rand's volatility, converting dollars to rands for a tax return is not that simple! (SARS does provide a table of average exchange rates for the year, which does help, but it is still not that simple). They very often have to calculate any capital gains made themselves, as many offshore companies only do a very basic calculation. Finally, the foreign dividend calculation is not simple, as the investor has to try work out if the dividend received is net/gross of withholding tax. With an offshore endowment with a SA Insurer, all the tax is paid on the investor's behalf into the fund, which means the investor is spared all the tax calculations.

Protection on insolvency

An endowment policy with a life assured also provides the owner with protection against insolvency. In terms of Section 63(1) of the Long-term Insurance Act, the following conditions are laid down: The policy must be a life, disability, assistance [funeral policy] or health policy; it must have been effected by the insolvent on his own life or that of his spouse 'and it must have been in force for a minimum of three years prior to the date of insolvency'. Because an endowment policy is a life policy, it also qualifies for protection. Policy benefits are protected unless it can be shown that the policy in question was taken out with the intention to defraud creditors. It is important to note that the policy must have a life assured and so a sinking fund would not qualify for protection.

Conclusion

When it comes to estate and tax planning, the offshore endowment wrapper with a SA Insurer offers many unique planning opportunities.

30 minutes CPD

TAXATION CONSIDERATIONS FOR OFFSHORE ENDOWMENT POLICIES

▶ **ERNEST MAZANSKY,** Director in Tax Practice at Werksmans Attorneys

Harry Joffe has written an article on the topic for this publication, dealing mainly with the estate duty aspects. My article touches more on the income tax and capital gains tax (CGT) consequences.

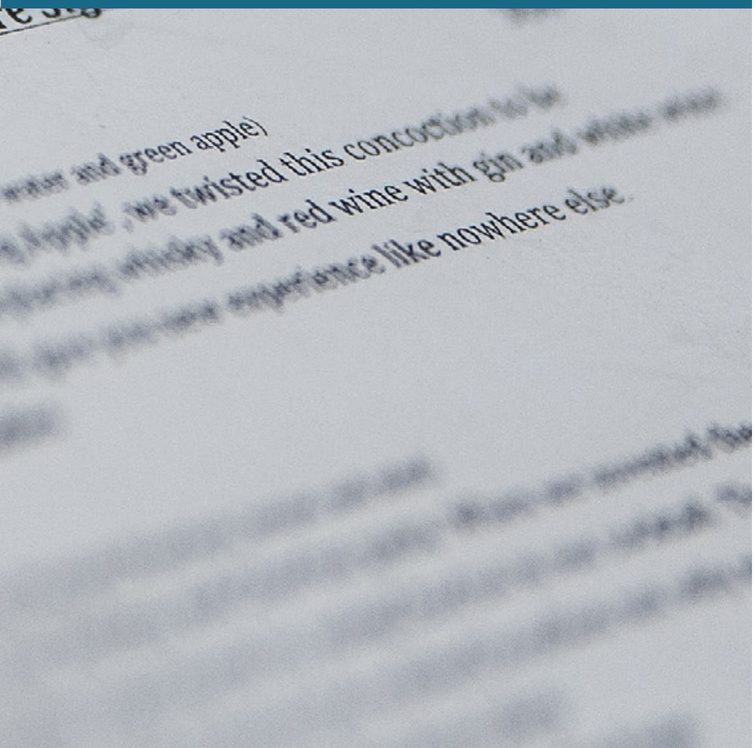
Moreover, Harry's article concentrates on offshore endowment policies issued by South African insurance companies through their offshore branches. For the purpose of this article, however, I focus on endowment policies that are issued by offshore insurance companies.

Nature of the policies

Generally and from a contractual perspective, such policies are not very different from endowment policies issued by South African long-term insurance companies. In fact, in many respects, the South African insurance industry was ahead of the international markets when they introduced policies that took their value from the underlying portfolio of assets, i.e. linked policies, rather than having whole life cover. But the foreign markets have quickly caught up and offer much the same product. What is important, though, is that their policy terms are in all relevant respects, little different from the policy terms one would find when dealing with a local insurer.

In a typical policy of this sort, one would pay periodic premiums to the insurance company, the underlying assets would be invested by them and they would appoint an appropriate asset manager (typically that must be regulated) in order to manage the portfolio. They could choose an asset manager or one nominated by the policyholder (as long as the manager is regulated). Typically, the owner of the policy would have a right to surrender the policy at any time (which right is a valuable right and would, therefore, constitute inter alia property for estate duty purposes).

“Gains made on any disposal of rights in an offshore policy will trigger CGT in the investor's hands”



However, to prevent the policy from terminating on the date of death of the 'investor', the policies often allow for successive lives insured, e.g. the investor, thereafter his or her spouse, then his or her child/ren, and so on, with the result that 'ownership' of the rights in the policy will pass to the next named life insured, who will then continue to hold the policy as an asset; this mechanism does not need to be resorted to locally, owing to different rules.

Income tax and CGT aspects

It is important to distinguish between (a) the rights in the policy and (b) the ownership of the underlying investments. An insurance policy is a contract between the insured and the insurer in which the insured undertakes to pay one or more premiums and the insurer undertakes to perform and make funds available under specific circumstances.

It follows that the sole asset of the insured/investor will be their contractual rights that are held against the insurer. Conversely, the insurer will have obligations in favour of the investor, which obligations have a monetary value, representing in a typical linked policy the value of the underlying assets (net of relevant costs, fees and so on). But what is important to note is that those investments are beneficially owned by the insurance company and not by the investor, so that the income thereof is the income of the insurer and profits on sale are gains made by, and for the benefit of, the insurance company.

However, what does happen is that the growth in the value of the general portfolio by reason of income earned and capital profits made will increase the liability that the insurer has under the policy in favour of the owner of the policy, whereas the asset of the latter increases in value, albeit that it is an unrealised gain.

So, what does this mean from a South African income tax point of view? There are a number of points to note, particularly when compared with similar policies issued by the offshore branches of South African insurance companies:

- The insurance company pays no South African tax on its income and gains. In fact, other than potential withholding taxes suffered by it on dividends and interest, it typically pays no tax at all, given its jurisdiction. What is more, if it is in a jurisdiction that has signed double tax agreements with other countries, the lower withholding rates will apply instead of the normal domestic rate.
- Similarly, no CGT is payable on any capital gain — neither under South African law nor under the insurer's domestic law.
- As stated, what happens is that the unrealised value of the policy increases by the amount of income and capital profits earned by the insurer in respect of the underlying assets linked to the policy (obviously, less any costs and fees that are payable).

- In all but extreme circumstances, the policy held will be a capital asset in the hands of the investor. Unlike policies taken out with South African insurance companies, where the original owner is exempt from CGT on a disposal of the policy, gains made on any disposal of rights in an offshore policy will trigger CGT in the investor's hands. Thus, on the total surrender or termination of the policy, e.g. on the death of the last-dying, the excess of the policy proceeds over the base cost (either the total amount of premiums paid or, where the owner is a successor owner, typically the market value at date of acquisition plus any further premiums paid) will be subject to CGT. But it could also happen that the holder of the policy requires certain funds and undertakes a partial surrender, i.e. where the policy pays out certain amounts without the policy ceasing to exist. This will be treated as a part-disposal for CGT purposes and, using the prescribed rules, the excess of the proceeds over the allocated portion of the base cost will be subject to CGT.

Reading all of the above together, the upshot is as follows:

- Any income derived by the insurance company is not taxed as such, as and when the income is earned. Similarly, any capital profit made by the insurance company is not taxed in South Africa, as and when made.

- Because any surrender or partial surrender triggers CGT, it means that, to the extent that the gain is attributable to income earned, there has effectively been a 'conversion' of income to capital gain. And as everyone knows, in the hands of an individual this means a reduction in the tax rate from 45% to 18%.

- To the extent that the capital gain on disposal or part-disposal is attributable to capital profits made by the insurer, there has effectively been a deferral of the CGT until there is a partial or total surrender of the policy.

It is thus a very tax-effective method of making one's offshore investments. What is more, the extent of effort required every year when preparing one's tax return is significantly reduced. Instead of having to ascertain the various types of income on one's offshore portfolio; determine the extent of capital gains and losses for the purpose of preparing and filing one's tax return; and establish what assets one holds for the purpose of the statement of asset and liabilities in the tax return, here, all that happens is that one's foreign investment simply increases in value every year by the amount of additional premiums paid. In other words, there is a single asset to account for and the only time one has to make any other form of disclosure in the tax return (apart from reporting the asset at cost) is to report a capital gain arising on a partial or total surrender of the policy.

SARS' ruling

In 2014, SARS issued a rather strange binding private ruling, namely BPR 179. This involved a policy very similar to that discussed above. In essence, SARS ruled that the policy was totally transparent so that any income on the investments would be considered to be income of the investor as and when earned and any realisation of the investments on the surrender of the policy would constitute a disposal on the investor's behalf, thereby triggering CGT.

Of course, at the end of the day, each ruling is determined based on the individual facts and circumstances of the applicant; those facts are not always spelled out in detail. For example, if the policy wording was such that, in effect, the insurance company was nothing more than an agent for the insured and administered investments on their behalf, then I could certainly see how such a ruling would be given. But if the policy is of the type that I have described above, I cannot see under what provision of our tax legislation such an approach by SARS is justifiable.

I might add the following: to the extent that the wording of the offshore policies is, in all relevant respects, the same as one would find when domestic-linked policies are taken out with South African insurance companies, why would this ruling not apply to those policies as well, whether issued by an offshore branch or issued locally? In other words, if SARS' interpretation of the offshore policy is the correct interpretation, then surely this must apply to every single linked policy issued by a South African insurance company.

As this is not the case, except in very special circumstances, I cannot see that BPR 179 is of any relevance to the circumstances described above.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30 minutes CPD

CAN SOUTH AFRICAN TAXPAYERS FREELY CHOOSE THE CURRENCY OF LOANS FUNDING FOREIGN TRUSTS?

PROFESSOR KEITH ENGEL, CEO of SAIT

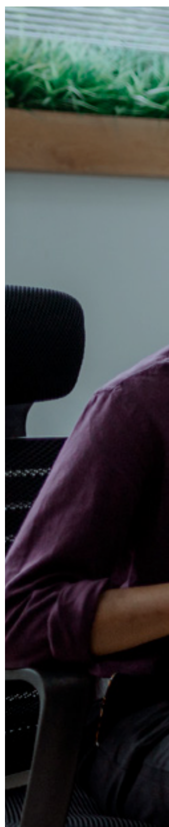
Wealth planners have two general methods of funding domestic and foreign trusts, namely donations and loans. Loan funding is often preferred to avoid Donations Tax implications. Loan funding without interest (i.e. zero interest or discounted interest loans) now triggers an annual Donations Tax equal to the amount of interest annually forgone, as well as the historic rule reallocating potential taxable income from the trust back to the funder under section 7 of the Income Tax Act. In the case of cross-border loans, this Donations Tax may arise either from the transfer pricing rules of section 31 of the Income Tax Act or the deemed donation rules of section 7C of the Income Tax Act.

One key consideration when utilising cross-border loans is the deemed interest charge. This interest charge will depend on whether the loan is dominated in South African Rands or in foreign currency. More notably, a further question exists as to which foreign currency denomination is to be considered if a cross-border trust loan is to be foreign as opposed to Rand denominated. In the case of section 7C, the donation subject to the tax equals the South African repo rate plus 100 basis points when the Rand is utilised or the equivalent of the foreign country repo rate plus 100 basis points when a foreign country's currency is utilised. In the case of section 31, an arm's length interest rate will apply that will vary from currency to currency.

Choosing a foreign currency

Given this reality, some wealth planners seek to rely on a foreign currency of a country with the lowest set of interest rates in order to minimise the deemed interest charge triggering Donations Tax and/or Income Tax. Sometimes, the currency of the loan may be associated with the location of the borrowing foreign trust or certain foreign trust assets. In other cases, the loan currency may have no relationship.

Switzerland is often cited as a planning opportunity, given its history of low-interest rates. According to the Trading Economics website, Switzerland has recently raised its interest rates to 1 per cent as of February 2023. This low-interest rate is to be compared with the South African interest rate of 10.5% as of March 2023, as indicated by SARS. Swiss rates have even fallen below zero as recently as 2022. This differential accordingly appears very extractive to certain tax planners as a way of undercutting the tax hindrance associated with potential Donations Taxes and Income Tax charges in respect of deemed interest.



Will the choice of foreign currency be respected?

The legal tax question that arises is whether the tax law will inhibit the free underlying choice of country currency regarding the trust loan. Upon review of the specific tax sections dealing with foreign currency, there appears to be no outright provision preventing this free choice.

Section 25D, which deals with the taxable income determination for foreign currency, only addresses translation. Foreign currency amounts, e.g. income and expenditure, must generally be translated to Rands at an appropriate spot rate or at the average exchange rate at the election of individual taxpayers. Nowhere within section 25D is there a requirement that the taxpayer chooses a particular currency at the commercial level before tax is applied.

Section 24I imposes mark-to-market annual taxation in respect of foreign currency units, foreign currency debts and certain foreign currency derivatives. Setting aside the fact that section 24I does not apply to individuals and trusts in most contexts, at no point does section 24I require that the taxpayer chooses a particular currency at the commercial level before tax is applied. Section 24I(8) admittedly contains a general anti-avoidance rule that prohibits deductions arising from exchange losses, "*if such transaction was entered into . . . or acquired solely or mainly to enjoy a reduction in tax by way of a deduction from income*". The avoidance of notional donations giving rise to Donations Tax falls far outside this anti-avoidance ambit.

More problematic may be the application of broader anti-avoidance rules. In particular, the key rules at issue are the general anti-avoidance rule (GAAR) of Part IIA, that is, sections 80A to 80L of the Income Tax Act and the transfer pricing rules of section 31.

In terms of the GAAR, section 80A(b) specifically triggers the GAAR if "*in a context other than business, [a transaction] was entered into or carried out by means or in a manner which would not normally be employed for a bona fide purpose other than obtaining a tax benefit*".

The term 'tax' for this purpose means "*tax or penalty imposed in terms of this [Income Tax] Act*", which would include the Donations Tax (See section 1 for 'tax' defined). Hence, one has to question the use of a foreign currency that is wholly unrelated to the nature of the lender and borrower in terms of a trust loan, especially if that foreign currency is wholly unrelated to the assets of the borrowing trust. Under these circumstances, there is a risk that SARS could argue that the loan was not carried out by means or in a manner which would not typically be employed for a bona fide non-tax purpose. A good way for tax planners to counter this SARS argument is to actually remit funds to the lender utilising the stated foreign currency. It should also be noted that the GAAR and substance-over-form have never been used simply to recharacterise a single step of a transaction, especially not in this context.

Whereas the section 31 transfer pricing rules are mainly aimed at pricing, transfer pricing technically applies when any "*term or condition*" of any connected personal loan, such as those found on cross-border loans used by trusts, "*results in or will result in any tax benefit*" (Section 31(2) of the Income Tax Act). This tax benefit would again include Donations Tax. Under these circumstances, section 31(2) indicates that the "*tax payable . . . must be calculated as if that transaction . . . had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length*". The Explanatory Memorandum for the 2010 Tax Amendment Bill associated with section 31 specifically provides that "*SARS . . . has the power to adjust the terms and conditions of a transaction, operation, scheme, arrangement or understanding to reflect the terms and conditions that would have existed at arm's length*". (See also OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, section D2 of Chapter I, "The Arm's Length Principle"). Hence, once again, section 31 could seemingly be applied to recharacterise the

"In many cases, the increase in foreign trust asset value is mainly driven by foreign currency appreciation versus the Rand, especially if the foreign trust assets are passive in nature"

foreign currency 'terms' of the cross-border loan as a South African-denominated loan or other more appropriate foreign currencies. That said, similar to the GAAR, SARS has never asserted transfer pricing in this narrow context.

In view of the GAAR and transfer pricing rules above, the use of foreign currency in respect of a cross-border trust loan that bears no commercial reality to any aspect of the transaction should best be avoided. Even if these anti-avoidance rules do not technically apply, most planners would preferably rely on a foreign currency that has some reasonable non-tax explanation simply for appearances. Therefore, it is suggested that either the underlying currency for the loan be somehow connected to the foreign location of the borrowing trust, the trust's reporting currency, the trust assets funded by the loan or collateralised by trust assets or by payment remittance.

Concluding utility

While the use of foreign currency-denominated loans has its tax advantages in terms of setting the potential notional tax interest charge, one should be mindful of the corresponding tax disadvantages. The volatility of the foreign loan corpus can be particularly problematic.

One should remember that the key to successful estate-trust planning is to freeze asset values for the estate. In the standard case, the funder provides a fixed Rand loan with the trust holding high-growth assets. However, once the funder opts for a foreign currency-denominated loan, the corpus of the foreign currency loan becomes volatile in terms of value. Moreover, based on history, the Rand is likely to continue deteriorating in the long run, meaning that the value of the creditor rights of the foreign loan is also likely to increase. As a result, the size of the funder's estate upon death increases—a result directly adverse to the estate freeze desired. In essence, a good planner needs to make a proper comparison of the loan funding option versus paying the full estate duty without planning by fully taking into account the stated taxes, the time value of money and the various probable economic scenarios.

One must also question the practical investment viability of utilising a foreign-denominated loan to fund foreign trust assets. In many cases, the increase in foreign trust asset value is mainly driven by foreign currency appreciation versus the Rand, especially if the foreign trust assets are passive in nature. Hence, if foreign trust assets are to increase significantly outside the funder's estate, it is important that the funder's estate be limited to Rand-based assets, i.e., to a Rand-based loan.

A final note of warning about tax planning in this area is the continued tinkering by National Treasury which has once again made further announcements relating to section 7C. This tinkering includes changes to the currency translation of foreign trust loans (albeit outside the choice of foreign currency discussed in this article). Therefore, even if an unfettered choice of foreign currency can lead to tax savings in this area, one can expect that there is a good chance that National Treasury may eventually close this space in years to come.

30 minutes CPD

SOUTH AFRICA'S

'STEALTH-WEALTH TAXES'

DEBORAH TICKLE, Adjunct Associate Professor at UCT

A couple of weeks prior to the 2023 National Budget Speech, the Commissioner for the South African Revenue Service (SARS), Edward Kieswetter, was quoted in local media as saying: "*While studies show South Africa's income disparity would make it a good candidate for a wealth tax, authorities are currently not considering the measure and believe growing compliance would reduce the need for additional levies*".

Before going any further, it is important to point out that South Africa already has wealth taxes. These comprise estate duty, levied on the value of a person's assets when they die; donations tax, levied on the value of assets gifted during life; transfer duty, levied on the transfer of immoveable property and securities transfer tax (STT), levied on the transfer of, largely, shares.

On occasion, more than one of these wealth taxes can be levied on the same transaction. For example, if immoveable property or shares are donated to a family member, both transfer duty or securities transfer tax and donations tax would be payable. Capital gains tax (CGT) may also be payable if the market value of the asset exceeds its base cost, but CGT is generally not classified as a 'wealth tax' as it subjects to normal income tax a percentage of the growth in the value of an asset between acquisition and disposal. This argument may be valid in times of low inflation but where the growth in the value of an asset is purely inflationary, the taxation of that growth clearly erodes the asset base (wealth) of the person disposing of the asset.

The 2022 Tax Statistics booklet, issued jointly by SARS and National Treasury on 3 March 2022, indicates that in 2021/2022 collections of the current wealth taxes (termed 'property taxes' in the booklet) amounted to just over R22 billion, a significant increase on the previous four years which each reflected around R15 to R16bn. This could be attributed to a backlog (due to the COVID-19 pandemic disruptions) being dealt with or to the improved compliance referred to by Commissioner Kieswetter; since all categories (estate duty, donations tax, transfer duty and STT) saw significant increases, it could probably be attributed to a combination of both.

Thus, in light of the existence of wealth taxes in South Africa's bouquet of taxes, the Commissioner was clearly referring in his pre budget discussion to a new wealth tax––likely one levied annually on the value of a person's wealth. Such a tax would generally replace inheritance and gift (donations) taxes, being an advanced form of such taxes.

In the 2022 Budget Speech, South Africans were advised that the 2023 tax return for individuals who have assets with a value greater than R50mn, will be required to disclose their assets at market value in order for the viability of an annual wealth tax to be considered. This was recommended by the Davis Tax Committee in its 2018 Wealth Tax Report. However, even though such information may still be requested, it would appear that the debate for new wealth taxes can be taken off the table, at least for the short term.

This approach appears to be eminently sensible as many global studies have shown that an annual wealth tax is generally less effective at raising revenue than hoped for and that the costs of enforcing such taxes are relatively significant.

In its report on 'The Role of Wealth Taxes' issued in 2018, the Organisation for Economic Cooperation and Development (OECD) has gone as far as to suggest that, for many countries, broad-based capital taxes and well-designed inheritance and gift taxes (like those in South Africa) are a more effective mechanism for taxing wealth. In line with this thinking, the OECD issued a report in 2021 on the design of inheritance taxes in OECD countries. Although South Africa is not an OECD member, it is a 'key partner' and largely subscribes to OECD recommendations.

Nevertheless, in a country that is among the countries that have the highest income and wealth inequality levels and, more importantly, significant poverty, it is important to be aware of the fact that a new wealth tax not being proposed, does not let the wealthy 'off the hook'.

In fact, South Africa's approach over the last few years has perhaps been much more effective than the introduction of a new annual wealth tax.

The enforcement of compliance with South Africa's current wealth taxes was poor in the past. However, the rebuilding of SARS under Commissioner Kieswetter's leadership and the reinforcement of the unit dealing with high-net-worth individuals (HNWIs), with the assistance of Judge Dennis Davis, has ensured that these and other taxes on the wealthy are being looked at much more closely to ensure that all taxes are ultimately paid.

It is also important to be aware that the rate at which the value of estates, to the extent that they are over R30mn, has been increased from 20% to 25%—an increase in taxes for HNWIs and the abatement (the tax-free value of the estate), which is R3.5 million per individual (or R7 million per 'married' couple) has not been increased since 2007, meaning that the number of estates which now qualify to pay estate duty has been increased.

In addition, besides the formal wealth taxes mentioned above, Treasury has been slowly increasing the general taxes on 'wealthy' people over the last decade or so. Such taxes could be termed 'stealth-wealth taxes', as the laws introducing them have been enacted without any fanfare as to their targeted 'audience'. Some of these are discussed below.

The introduction of the 'environment tax' only on the purchase of 'luxury cars' can be taken as a starting point to these stealth-wealth taxes. Thus, anyone buying a car that falls within the category of a luxury car is required to pay, in addition to the purchase price and the VAT, R132 (ex VAT) for each gram of carbon dioxide it emits over 95g per km.

Then, clearly targeted at the wealthier individuals of South African society, the amount of any capital gain included in taxable income on disposal of an asset by a natural person was increased from its original 25% to 33.3% in 2012 (a maximum effective rate of 13.3%) and to 40% (maximum effective rate 16.4%) in the 2016 tax year. Owing to the increase in the marginal tax rate to 45% in 2018, this then increased to a maximum effective rate of 18%. Thus, a person disposing of an asset for, say, R11million and a base cost of R1 million would have paid normal tax on 25% of the gain, i.e. on R2.5 million before the 2012 tax year and by 2017, the person would have to include and pay tax on 40% of the same gain, i.e. on R4 million—a significant increase.

"The pool of 'wealthy' people currently in South Africa, is clearly very small. That wealth is being taxed on an ever-increasing basis, be it overtly through increasing estate duty and donations tax rates and not increasing the abatement or covertly through the stealth-wealth taxes. A new wealth tax at this juncture would undoubtedly be unwise"

In 2016, the top rate at which transfer duty is levied was increased to 13% for properties sold with a value of R10 million or more. The level at which this rate is levied has only now been adjusted to R12 100 000 for the first time since then.

In 2017, the rate of tax levied when a company pays dividends to an individual was increased from 15% to 20%. Thus, before the change, where a company had declared a dividend of, say, R1 000 000 to an individual, the individual would have received R850 000. After the change, they would receive R750 000, the balance representing an increase in tax paid.

Also, in 2017, section 7C was introduced. Prior to its introduction, individuals who lent funds to trusts interest-free (later on, this included preference shares and loans via companies) had to pay tax on any income that the trust derived due to the non-charging of the interest. Following its introduction, individuals also have to pay donations tax (20%/25%) on the extent to which interest is not charged by them up to the 'official rate' of interest (repo rate plus 1%). If they charge interest, then they will be taxed on the interest in any event and their estate will grow by that interest such that, on their death, estate duty will be payable. Thus, the ability of the wealthy to avoid estate duty or donations tax (wealth taxes) has been significantly inhibited.

- In 2018, VAT increased from 14% to 15%. Whereas everyone pays Value-added Tax (VAT), it has to be recognised that those who have more money tend to spend more money and thus pay more VAT overall. Also, in 2018, the marginal income tax rate was increased to 45%. This not only taxed high earners at a higher rate but, as mentioned above, simultaneously effectively increased the marginal effective rate applied to capital gains.

Many HNWIs have funds offshore and embark on estate planning strategies. Consequently, it was often hard for SARS to identify income or capital that should be taxed in South Africa. However, in 2017 the 'common reporting standard' became effective for South Africa, providing SARS with significantly more information on what South African tax residents have outside South Africa. This, together with the reinforced HNWI unit and improved tax returns for trusts, has provided SARS with the ability to ensure much-improved compliance by all taxpayers, even more so for HNWIs.

SARS' increased interrogation of wealthy taxpayers' tax returns, including the performance of so-called 'Lifestyle' audits, has also ensured that the wealthy in South Africa pay much more tax during their lifetime and on their death than they might have done in the past. And all this without having to introduce a complicated, new annual wealth tax that might have had little, if any, benefit from a fiscal income perspective but undoubtedly would have given rise to significant administrative problems and costs.

On this basis, it is clear that the Commissioner's comment preceding the Budget was well founded. Not only is the increased compliance which he referred to ensuring the collection of the taxes due, but the stealth-wealth taxes are making sure that the more affluent members of South Africa's population are continually footing an even bigger portion of the overall tax bill.

Bear in mind that the 2022 Tax Statistics booklet provides details of taxes paid by individuals for the 2021 tax year; it indicates that 846 654 people (less than 1.5% of the South African population) had taxable income of more than R500 000. Those people paid R254bn of the total tax assessed for individuals of R328 billion (i.e. 77.4% of the total individual tax assessed). Also, bear in mind that R500 000 represents approximately US$27 000, the equivalent of US$2 250 a month—hardly a 'wealthy' person in global terms. Wealth is, of course, relative and to many in South Africa, such a person would be considered to be 'wealthy'.

Nevertheless, the pool of 'wealthy' people currently in South Africa, is clearly very small. That wealth is being taxed on an ever-increasing basis, be it overtly through increasing estate duty and donations tax rates and not increasing the abatement or covertly through the stealth-wealth taxes. A new wealth tax at this juncture would undoubtedly be unwise.

TWO-POT RETIREMENT SYSTEM IN SOUTH AFRICA

15 minutes CPD

ALEXANDRA BURGER, Managing Director at Lyra Consulting

On 29 July 2022, National Treasury released the 2022 draft Revenue Laws Amendment Bill for public comment until 29 August to introduce the Two-pot System for retirement savings which had been flagged in the national budget. In short, the Two-pot System would allow members of retirement funds to access a third of their pension savings once a year in the event of an emergency, while preserving the other two-thirds for retirement. The planned implementation date for the Two-pot System is 1 March 2023; although it will probably take a bit longer to implement the necessary changes to the funds' rules and systems, we would expect a period of education for members of retirement funds.

The Two-pot System enables the restructuring of retirement contributions into two 'pots' or accounts. One account can be accessed at any time; the other account will not be accessible before retirement and must therefore be preserved until retirement. The proposal is that one-third of any future contributions should go into the first accessible retirement fund account (which is accessible once a year); the other two-thirds should go into the second account that must be preserved until retirement.

The rationale for the new system is that allowing access to one-third of future contributions at any time and removing the ability to withdraw the full amount upon resignation, will eliminate the incentive of employees to resign from their employment to gain access to retirement funds. The current thinking is that greater access and flexibility could also encourage more savings into retirement funds. The Two-pot System spreads the availability of the lump sum that would usually only become available upon retirement over the lifespan of the member so that it is accessible when it is most needed.

Importantly, the withdrawing member would incur the cost of withdrawal so that non-withdrawing members do not subsidise the cost of those drawing. By combining a greater level of access with the restriction that two-thirds of contributions must remain invested in the preservation account until retirement, a larger amount could thus be preserved in the retirement system compared to the current situation. This system should increase the amount of assets available for the individual when they retire and increase replacement rates in retirement.

In practice, there are three parts to this system:

(1) The Vested Pot (includes amounts accumulated before the implementation date);

(2) The Savings Pot (which is accessible before retirement); and

(3) The Retirement Pot (where two-thirds of contributions after 1 March 2023 are to be preserved until members' retirement date).

The existing retirement funds will be adapted to accommodate the Two-pots System, i.e. existing members of funds will not have to re-enrol to gain access. Each retirement fund will have to amend its rules to incorporate the system. Note that the system is not retrospective; thus, the new rules will not affect the existing savings and contributions made prior to the implementation date.

Importantly, all contributions to the new system will benefit from the tax deduction subject to the existing limits.

Contributions will remain deductible up to the specified caps, but any contributions that are more than 27.5% of taxable income or R350 000 a year can only flow into the Retirement Pot.

"It is possible for a member to withdraw funds from the Vested Pot, which will be taxed according to the retirement lump sum tables that are more favourable to tax rates"

All contributions and growth accumulated before the presumed implementation date of 1 March 2023 will have to be valued at that date immediately prior to the implementation to enable vesting of rights. The conditions that were attached to these contributions will remain in place.

The accumulation of the Savings Pot together with the Retirement Pot will start from 1 March 2023. It is important to note that any amount withdrawn from the Savings Pot will be included in the member's taxable income for that year and be taxed at the member's relevant marginal rate. Only one withdrawal from the Savings Pot can be made per year and the minimum withdrawal amount is R2 000. Each year the member may withdraw all or part of the amount accumulated in their Savings Pot.

Before retirement, it is possible for a member to withdraw funds from the Vested Pot, which will be taxed according to the retirement lump sum tables that are more favourable to tax rates (a maximum of 36%) compared to marginal tax rates (a maximum of 45%).

Although no amounts can be transferred from the Retirement Pot before retirement, transfers can be made into it from other pots (i.e., from the Vested Pot or the Savings Pot). Amounts from Savings Pots can only be transferred to other Savings Pots. The Retirement Pot and the Savings Pot must be held in the same retirement fund (for example, a member cannot hold the Savings Pot in one employer's fund and the Retirement Pot in another employer's fund.)

Upon having reached retirement age, the member can add the Savings Pot to the Retirement Pot to purchase an annuity, or can withdraw the full amount in the Savings Pot as cash which would be taxed according to the retirement lump sum tables. Fortunately, as noted, the lump sum tables have more favourable tax rates compared to marginal tax rates that apply before the member retires. Upon retirement, the total amount in the Retirement Party must be used to purchase an annuity, and various options are available. The minimum amount that can be used to purchase an annuity is R165 000; amounts less than R165 000 in the Retirement Pot can be withdrawn as a lump sum.

Naturally, there are concerns about unintended consequences such as potentially large numbers of members withdrawing annually, which could create an additional burden on administrators and potential delays in paying out. Again, the concern has been raised that this system will reopen the door to the practice of pension-backed lending.

Conclusion

It seems like the Two-pot System for retirement will provide greater flexibility and access to retirement savings for individuals, while still preserving a significant portion of their savings until retirement. The system will require some changes to existing retirement funds and it will be important to educate members on how to use the system effectively. It will also be important to monitor potential unintended consequences, such as a potential increase in the number of withdrawals and delays in payouts. Overall, this system has the potential to increase retirement savings and improve replacement rates in retirement for individuals in South Africa.

45 minutes CPD

South Africans relocating offshore: What you should know

▶ **SUZANNE SMIT,** Fiduciary and Tax Consultant at Fidelis Vox

Moving is emotive, moving to another country even more so. Add tax consequences to the equation and you may just reconsider it.

This article guides those seeking to move offshore through the maze of exiting South Africa with a specific focus on tax considerations in order to be proactive instead of facing a myriad of questions after the fact.

Residency status

Residency status could be regarded as an entry into the maze. Several tax risks and considerations hinge on this aspect, including placement of tax residency on record with SARS, declaration of income to SARS going forward (including foreign employment income), as well as deemed sales rules, pension withdrawals and more. These are discussed in more detail below.

Generally, a taxpayer's liability in South Africa is based on whether or not they fall within the definition of resident in section 1 of the Income Tax Act 58 of 1962. A 'resident' is a natural person who firstly is 'ordinarily resident' in South Africa or secondly has been physically present in South Africa for the minimum amount of days over a five-year period as set out in section 1 of the Act.

Tax residency is important to consider when moving abroad because South African tax residents ('tax residents' or 'tax resident' in singular form) are taxed on a worldwide basis. Non-tax residents at a source or deemed source are subject to the application of a tax treaty for the avoidance of double taxation. This means that a tax resident in South Africa and abroad with multiple income streams, including capital gains for purposes of this article, should declare all of it in their South African tax returns, claiming foreign tax credits where applicable. Non-tax residents are only taxed on income sourced in South Africa or deemed to be sourced in South Africa.

All too often, taxpayers would only consider the physical presence test as the predominant or only test and, based on what friends have said or a friend's adviser, determine their tax status accordingly.

This is not the correct way to go about it, especially when it carries several related risk factors. Taxpayers should first consider the 'ordinarily residence' test. The term 'ordinarily residence' is not defined in the Act but it has been interpreted by the South African courts over time. In addition, SARS has issued an interpretation note, i.e. Interpretation Note 3 (version 2 issued by SARS on 20 June 2018), for taxpayers to consider.

▶

At this point, it is important to mention that although SARS' interpretation notes are not legally binding on SARS and / or taxpayers, the Constitutional Court has ruled in *Marshall and Others v Commissioner, South African Revenue Service* 2019 (6) 246 (CC) that a consistent interpretation is required by "*those responsible for the administration of Tax Acts*" (See paragraph 21 of the Marshall case); that is, SARS is responsible.

Factors such as intent, centre of vital interest, access to a permanent home and habitual abode are considered. There is no 'copy-paste'-recipe to apply and each tax resident's subjective factual matrix should be applied according to objective factors set out in case law and in the interpretation note; also, foreign counsel may be required in some instances. Planning in advance is always a good idea and moving to another country with your eyes open is even better. It is recommended to know when tax residency would be triggered abroad, especially to avoid double taxation where possible. If a family or other trust is registered and resident in South Africa, there may be adverse consequences on a deeming basis to consider in that specific country.

When moving abroad, taxpayers should therefore first seek to determine whether or not they would be ceasing tax residency or not, as this will have an impact on the next step in the domestic maze, with the first step being to place any changes of registered details on record with SARS via the RAV01 form within 21 days of the said change.

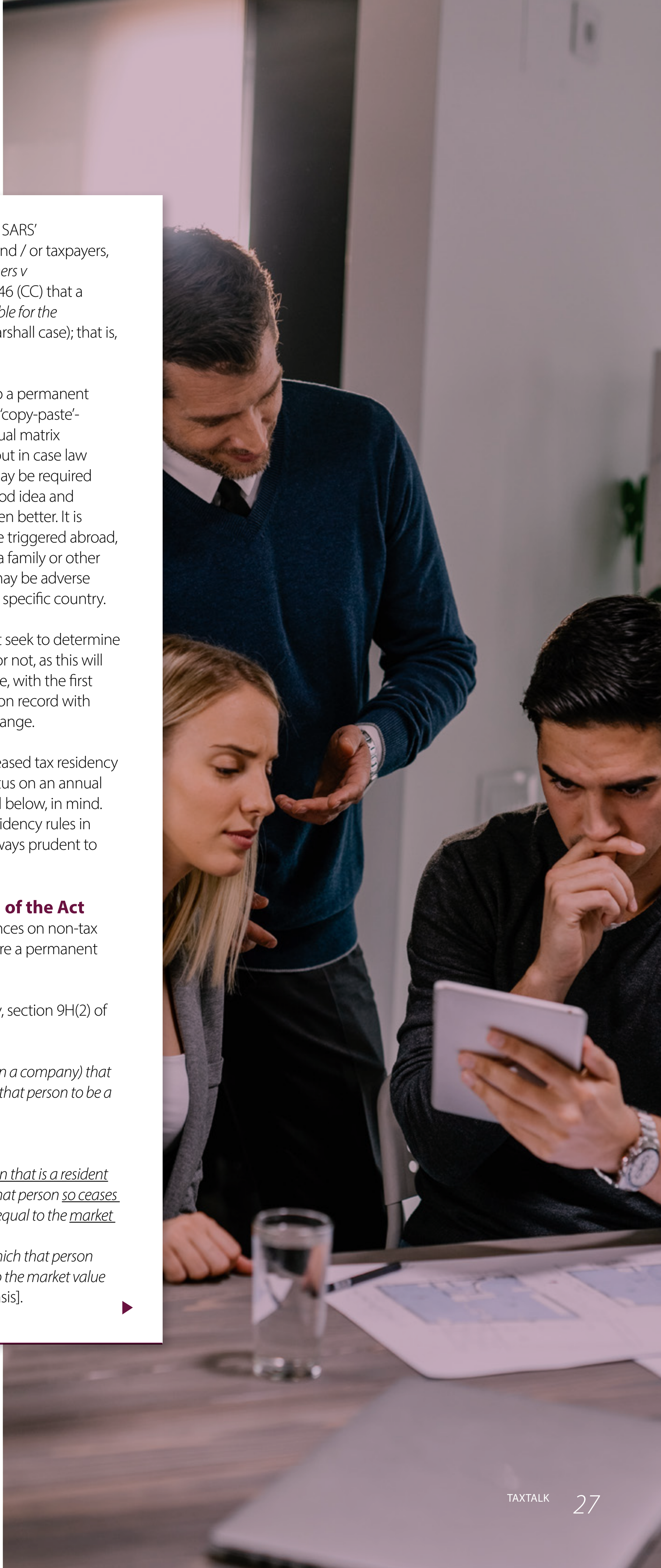
Should it be determined that a tax resident has not ceased tax residency in South Africa, it would be prudent to review this status on an annual basis, keeping the same tax risks, as discussed in detail below, in mind. It is also important for taxpayers to understand tax residency rules in the new country to navigate the maze abroad; it is always prudent to consider professional advice.

Deemed sales rule or 'exit tax': section 9H of the Act

Capital gains tax is imposed in very limited circumstances on non-tax residents, e.g. disposal of immovable property or where a permanent establishment is created in South Africa.

As a last bite at the cherry when ceasing tax residency, section 9H(2) of the Act states as follows:

> *"Subject to subsection (4) where a person (other than a company) that is a resident cease during any year of assessment of that person to be a resident—*
> *(a) that person <u>must be treated as having</u>—*
>
> *(i) <u>disposed</u> of each of <u>that person's assets to a person that is a resident</u> on the <u>date immediately before the day</u> on which that person <u>so ceases to be a resident</u> for an amount received or accrued equal to the <u>market value</u> of the asset on that date; and*
> *(ii) <u>reacquired</u> each of those assets on the day on which that person so ceases to be a resident at an expenditure equal to the market value contemplated in subparagraph (i)…"* [own emphasis].



- Therefore, the liability for capital gains tax arises due to a legal fiction created in the Act on a deeming basis with the effect that the taxpayer must be treated as having disposed of his or her worldwide assets for an amount equal to the market value of such assets on the date immediately before the day on which residency is ceased with reacquisition at the same market value on the same date as a non-tax resident. This means that the taxpayer would only be liable for capital gains tax in very limited circumstances going forward.

Capital assets excluded from the deemed sales rules are immovable property in South Africa, which is owned in the taxpayer's personal capacity, unvested share options and assets which are not typically subject to capital gains tax, e.g. cash and some retirement funds.

A specific tax risk to be weary of is liquidity with the commensurate budget planning to settle the capital gains tax liability in the applicable tax year in which tax residency is ceased where no actual disposal of capital assets has taken place.

The deeming sales rules only apply to the taxpayer as natural person when ceasing tax residency and it does not apply to trusts connected to the taxpayer as they are separate taxpaying entities.

Foreign employment income exemption

When moving abroad, tax residency is also important to consider in light of the foreign employment exemption pursuant to section 10(1)(o)(ii) of the Act (in effect from 1 March 2020 onwards).

Prior to 1 March 2020, if an employee moved, for instance, to Dubai without ceasing tax residency in South Africa, no personal income tax was levied in South Africa as a result of rendering employment services in Dubai. The employee would have had the duty to declare their worldwide income as a tax resident, but personal income tax was exempt.

Owing to the fact that Dubai does not levy personal income tax, the employee would not have paid tax in either Dubai or South Africa based on the respective domestic laws applicable.

As of 1 March 2020 onwards, however, the foreign employment income exemption has been limited to a maximum of R1,25 million per year; this means that, in the same example, the employee would only be 'tax-free' up to R1,25 million and then be taxed on the difference in the remuneration received as a result of rendering employment services in Dubai.

In addition, to qualify for exemption, employment services have to be rendered by the tax resident outside South Africa for:

- more than 183 full days in any 12-month period; and
- for a continuous period exceeding 60 full days outside South Africa in the same 12 months.

The exemption does not apply to non-residents.

This means that should a taxpayer move to a country to render employment services abroad while maintaining his tax residency in South Africa and should there be no tax treaty between South Africa and that country, a tax risk for double taxation and disallowance of foreign tax credits exists.

This is another important factor to consider tax residency status prior to moving offshore, especially in light of tax-treaty protection should the taxpayer remain a tax resident in South Africa.

"Planning in advance is always a good idea and moving to another country with your eyes open is even better. It is recommended to know when tax residency would be triggered abroad, especially to avoid double taxation where possible"

The place of effective management is where key commercial decisions are taken and day-to-day management of an entity is executed 'in substance' (with reference to Interpretation Note 6, version 2 issued by SARS) and is a vital consideration when a taxpayer moves abroad.

This would apply where the taxpayer is a trustee of a domestic trust with underlying investments or a shareholder with voting rights in a South African company. Should such interests and specifically decision-making powers continue when a taxpayer moves abroad, it is vital that the taxpayer travels to South Africa when decisions on behalf of the trust / company are made to ensure that the relevant entity is not pulled into the tax net of the new country.

In this day and age of digital communication, channels via online platforms exist for meetings, key decisions and the day-to-day management of such entities should in substance be made and executed in South Africa so as not to risk imputing the said entity into the tax net of the taxpayer's new home. This means, inter alia, that in-person meetings should be held in South Africa for strategic discussions (such as annual general meetings), where key decisions are made such as visionary direction, mandates of management staff and distributions to beneficiaries in the instance of a trust, to name but a few.

Should the taxpayer who is moving abroad have a managerial role in a domestic company, then this means that the company cannot be managed from abroad. It ultimately boils down to very practical considerations such as not sending instructions per email, having calls impacting decisions or management over Skype or signing of a contract abroad. Passport stamps and flight tickets would serve as supporting documents, as well as an itinerary of meetings attended, meeting minutes and a roster of attendees.

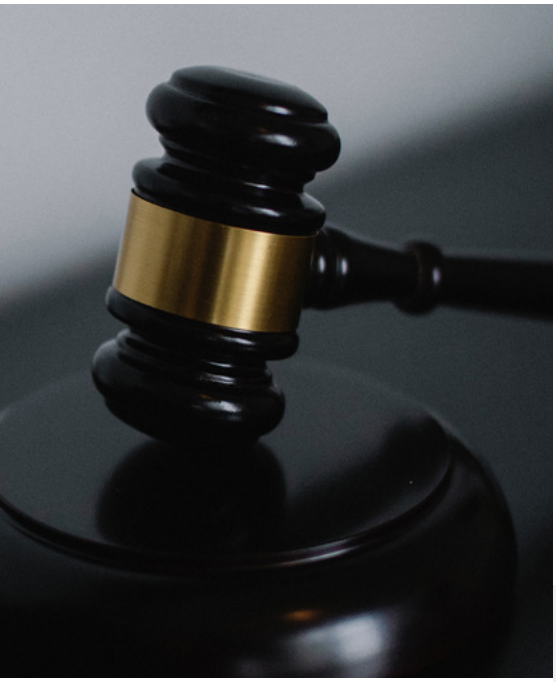
When a taxpayer considers the place of effective management as a factor when moving abroad, a purposive approach should be adopted with the ordinary meaning of words as guidance. *Wensleydale's Settlement Trustees v Inland Revenue Commissioner* [1996] STC (SCD) 241 at 25 held as follows:
"*I emphasise the adjective* 'effective'. *In my opinion it is not sufficient that some sort of management was carried on in the Republic of Ireland such as operating a bank account in the name of the trustees. 'Effective' implies realistic, positive management. The place of effective management is where the shots are called, to adopt a vivid transatlantic colloquialism.*"
[own emphasis].

One should therefore apply common sense to know where the place of effective management would be under specific circumstances.

Other notable impacts

Other notable impacts to consider, include exchange control limits, for example, where the taxpayer has sizable domestic investment portfolios, especially if the taxpayer wants to completely divest from South Africa; immigration status in the other country; specific considerations prior to naturalising as a citizen of that country if you want to retain your South African citizenship; as well as the effect of being a trustee and / or beneficiary of a trust as it relates to the new country to which you are moving.

Some countries could impute a trust into its tax net even if the beneficiary is only named in the trust deed on a discretionary basis, whereas others allow sufficient time to revisit estate planning even after moving.



THE CORONATION JUDGMENT

AND ITS IMPACT ON CONTROLLED FOREIGN COMPANIES

15 minutes CPD

DR ALBERTUS MARAIS, Advocate of the High Court of South Africa, Adjunct Senior Lecturer (UCT), and Director at AJM Tax

The recent Supreme Court of Appeal (SCA) judgment in the Coronation case[1] drew widespread attention. The case involved the well-known asset management group Coronation.

A South African company in that group (Coronation SA) indirectly, through an Isle of Man subsidiary, held all the shares of an Irish subsidiary (Coronation Ireland). Because a South African resident (Coronation SA) directly or indirectly held the shares in Coronation Ireland, it was uncontested that Coronation Ireland was a controlled foreign company (CFC) for South African tax purposes.

The dispute turned on whether Coronation Ireland's income was exempt from being taxed in South Africa for Coronation SA because it had a foreign business establishment (FBE) in Ireland. Under South Africa's CFC rules, foreign companies that are majority-held by South Africans are subject to the CFC rules, which means that their income is taxed in the South African shareholders' hands as though directly earned by the shareholders. An exception to this rule is where the CFC has business substance (read real infrastructure) in the foreign country, provided that that substance is also responsible for the income generated there.

For a foreign company such as Coronation Ireland to have sufficient substance offshore, it is required to have an FBE in that country. Whether such an FBE existed was the central question.

Coronation Ireland was a company registered as a so-called 'Undertakings for Collective Investment and Transferable Securities' (UCITS) in Ireland. As such, it was responsible for managing assets held by that company on behalf of clients, for which it charged a fee. SARS alleged that Coronation's Irish subsidiary did not have sufficient substance (or an FBE) in Ireland and that its income was due to be taxed in Coronation SA's hands under the CFC rules. Coronation denied this, claiming that its income was attributable to an FBE that it had in Ireland.

The FBE definition in section 9D of the Income Tax Act requires the foreign company to have a fixed place of business which is conducted through one or more physical structures like an office. It also requires that the fixed place of business be suitably staffed, equipped and has suitable facilities—all to such a degree that it allows the foreign company to conduct the primary operations of its business. The fixed place of business must not be located outside of South Africa for tax-related reasons.[2]

The question for the SCA to decide upon was whether the premises of Coronation Ireland had facilities and was suitably staffed and equipped to allow it to carry on its primary business operations and that it was used to this end. The Court was therefore required to identify the primary business operations of Coronation Ireland.

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[1] *South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (7 February 2023).
[2] SARS alleged in the Tax Court that this requirement was also not met in Coronation's case. That point was, however, not pursued in the SCA.

"Under South Africa's CFC rules, foreign companies that are majority-held by South Africans are subject to the CFC rules, which means that their income is taxed in the South African shareholders' hands as though directly earned by the shareholders"

In the lower Tax Court, the Taxpayer won the case, there the Court held that the primary business operations of Coronation Ireland involved the maintenance of its business licence in Ireland and fulfilling the role of a fund manager as distinct from an investment manager. That such a distinction was drawn was important because the investment management functions of Coronation Ireland were subcontracted to third parties and, therefore, not performed through the infrastructure which Coronation Ireland had established for itself in Ireland. If the Court had found differently and had held that investment management formed an integral part of Coronation Ireland's business operations, the result in that court would have been quite different. It would have amounted thereto that Coronation Ireland's primary business operations were conducted by others and not through its infrastructure ostensibly comprising its FBE.

A significant finding upon which the Tax Court relied to arrive at its conclusion was that Coronation Ireland's fees charged to clients were calculated based on assets under management, not on the returns that investments would make. The Tax Court also considered what practical functions are required of a fund manager; it found that those functions were not subcontracted by Coronation Ireland but performed by its employees from its premises.

The SCA came to a different conclusion. Because the primary source of income of Coronation Ireland was made from investments, it believed its primary business operations to involve investment management as a key component of fund management. It concluded that those functions accordingly need not only have been capable of being performed by the Irish infrastructure of Coronation Ireland but also that that infrastructure exercised it. Because, factually, this was not the case (the investment management functions were subcontracted), the SCA found that this requirement of the FBE definition was not met. That finding had the effect that the income derived in Ireland by Coronation Ireland was not attributable to an FBE, meaning that its income was required to be imputed by Coronation SA under South Africa's CFC rules.

Whereas the Tax Court and the SCA differed in their approaches based on a question of fact, the judgments both shine a sharp light on the requirement for an FBE not only to involve having substance abroad but also that the relevant CFC's primary operations need to be exercised through that infrastructure.

Coronation is important for another reason. It is also important because it confirms how SARS should approach levying understatement penalties under the Tax Administration Act and penalties for underestimating taxable income for provisional tax purposes. The case confirmed the SCA's recent judgment in *CSARS v The Thistle Trust*[3] that a taxpayer relying on a tax opinion acts in good faith and does not deliberately file its returns based on an incorrect tax position. This finding has the effect that, if the opinion proves to be wrong, the taxpayer made a bona fide inadvertent error in relying on it, which makes an understatement penalty incapable of being levied in such instances[4] and which also has the effect that the underestimation of provisional tax was seriously calculated and not deliberately or negligently underestimated.[5]

The result is that obtaining a tax opinion from an appropriately skilled advisor and relying thereon in good faith puts a consequent understatement coming about due to reliance on that opinion beyond penalties both insofar as they relate to provisional tax penalties and to understatement penalties.

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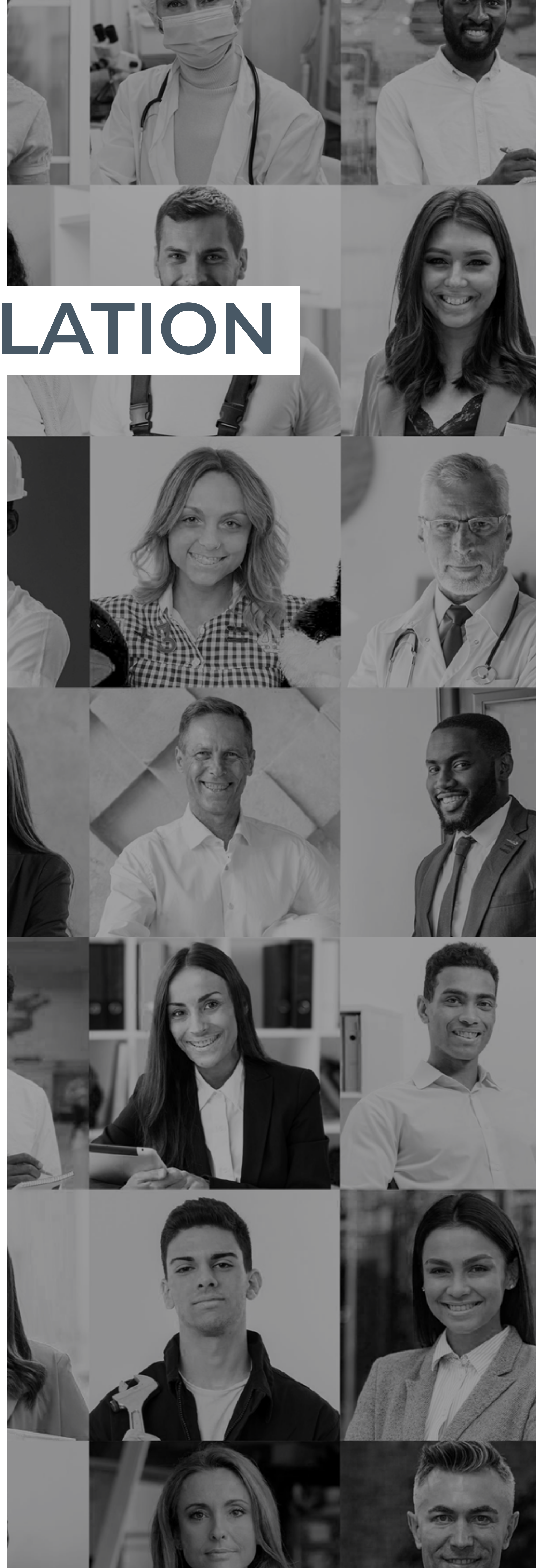
[3] [2022] ZASCA 153 (SCA).
[4] Section 222(1) of the Tax Administration Act.
[5] Paragraph 20(2) of the Fourth Schedule to the Income Tax Act.

30 minutes CPD

CHANGES IN TRUST LEGISLATION IN SOUTH AFRICA



PHIA VAN DER SPUY, CEO and Co-founder of Trusteeze

Overnight, the life of a trustee has dramatically changed. Traditionally, the accountant prepared (sometimes infrequently) the financial statements for the trust, which was considered 'trust administration' by the estate planner and their family.

Also, the current Trust Property Control Act (the legislation governing trusts in South Africa) is considered inadequate when it comes to providing guidance to trustees in terms of what is expected of them. Given the changes in trust legislation in South Africa, not only have trustees as the custodians of trust assets (not the accountants or trust service providers) become third-party data providers to SARS, similar to banks, but for the first time, they also face potential punitive fines of up to R10 million or five years imprisonment or both, if they do not keep up-to-date information about 'beneficial owners' of the trust as well as the 'accountable institutions' with which they are dealing.

'Beneficial owner' of a trust—is this the correct label in South Africa?

Unlike popular belief that 'beneficial ownership' is a term recently introduced into South African law, the concept of 'beneficial ownership' was introduced in South Africa when SARS introduced the concept of 'beneficial ownership' in relation to dividends. The 'beneficial owner' in respect of dividends has since then been regarded as the person entitled to the benefit of the dividends attached to a share. In 2015, Government committed to the high-level principles of beneficial ownership transparency set by G20 and in 2017, the Financial Intelligence Centre Amendment Act introduced a legal definition of 'beneficial owner' as *"in respect of a legal person, means a natural person who, independently or together with another person, directly or indirectly (a) owns the legal person; or (b) exercises effective control of the legal person"*. It also added additional due diligence measures relating to legal persons, trusts and partnerships separately.

In an attempt to avoid being greylisted after the Financial Action Task Force (FATF) mutual evaluation report published in 2021 had required South Africa to address certain areas of technical compliance, the beneficial ownership of legal persons and reporting of and transparency regarding suspicious transactions, National Treasury tabled the General Laws (Anti-Money Laundering and Combating Terrorism Financing) Amendment Bill in Parliament on 22 August 2022. Little time was afforded to the fiduciary industry to provide input on the proposed measures. Most of the proposals were ignored; consequently, on 22 December 2022 Government promulgated the General Laws (Anti-Money Laundering and Combating Terrorism Financing) Amendment Act 22 of 2022.

The resultant amendments to the Trust Property Control Act include a new definition of a beneficial owner of a trust, which includes the founder, trustee and beneficiary of a trust. This definition aligns with the definition of beneficial owner in the Financial Intelligence Centre Act. The definition covers "*anyone who directly or indirectly ultimately owns the relevant trust property or exercises effective control of the administration of the trust*". However, the definition in the latter Act is clearly confined to *"a legal (or juristic) person"*, which a trust is not. The fiduciary industry was of the view that the fundamental principle of a South African trust has been bastardised as our courts have defined a trust as merely an accumulation of assets (*Land and Agricultural Development Bank of SA v Parker and Others* (186/2003) [2004] ZASCA 56; [2004] 4 All SA 261 (SCA) [23 September 2004]), and due to the fact that it was held in *Trustees of the Rae Family Trust* (T2031-2000) *v Ledger and Others* (11895/19) [2020] ZAWCHC 150 [6 November 2020]) that *"although [it] is a separate legal entity, it does not have legal personality, such legal personality vests in the trustees who administers the rights and obligations of the trust"*.

It does seem, however, if the FATF has recognised this fact, as they have broadly referred to 'legal persons' meaning any entities, other than natural persons, that can establish a permanent customer relationship with a financial institution or otherwise own property specifically under Recommendation 24 of a guidance document on Transparency and Beneficial Ownership issued by them in October 2014. However, recommendation 25 deals with "*Enhancing Transparency of Legal Arrangements*", which includes trusts. It recognises that *"trusts usually do not possess a separate legal personality and so cannot conduct transactions or own assets in their own right, but only through their trustees"*.

Many argue that a founder, trustee and discretionary- or vested beneficiary cannot be classified as a beneficial owner in the South African context. However, as South Africa is a member of the FATF, we have to play by the FATF's international standard rules for the purpose of combatting money laundering and the financing of terrorism, regardless of how we view a trust and its parties in South Africa. We could just as well give it a different label, but the FATF requires transparency on these parties as defined by them as beneficial owners.

The new IT3(t)—low-hanging fruit for SARS!

After SARS has discovered a gap of R58 billion between distributions made by trustees and distributions declared by beneficiaries in their tax returns, all boards of trustees (approximately 950 000, it is estimated) are being made third-party data providers to SARS, similar to a much smaller number of banks, medical schemes and fund administrators. For some, this is a thought too hard to contemplate.

Despite pushback from the banking, accounting, tax and fiduciary industries, SARS is pushing ahead with the implementation of IT3(t) trust distribution submissions, with which they have been toying for a while. With it being treated as third-party data provision, it was logically grouped under the 'IT3' banner at SARS. However, SARS made a fatal error in assuming it would be the banks who would submit the data, similar to the other IT3s that they are currently issuing.

With this exercise, SARS is mainly after the traditional family trusts, which are (from a tax perspective at least) taken care of by the accountant or other trust service provider. These accountants mainly use e-filing as their means of submitting tax information to SARS. Unfortunately, only twenty records can be submitted on e-filing at a time, so it will be labour-intensive and not cost-effective to expect the accountants to submit hundreds of trusts'

"For a trustee to be held liable for another trustee's actions, there has to be a fault such as negligence"

information in such a manner to SARS. Another alternative provided by SARS is data submission through Hypertext Transfer Protocol Secure (HTTPS), which is a free, web-based service, IBM® Sterling File Gateway® technology for secure file transfer; with a maximum size of 10 MG for a single file, although multiple files can be submitted. The data submitter, such as an independent software vendor (ISV), who facilitates data submission for their clients on a bulk basis will be the submitting entity (the registered tax practitioner), which is clearly incorrect. The only other alternative provided is the IBM Sterling IBM®Connect:Direct®, which is a web-based interface for customer self-service, to which entities gain access by obtaining a digital certificate and the link from SARS. This is a traditional system used by banks to submit bulk data of up to 10 GB, which is quite expensive to use. This leaves the majority of accountants and trust service providers in South Africa who need to report trust data in bulk in a hugely compromised position, which will have to be addressed by SARS.

SARS asked for volunteers on the SARS website on 28 November 2022 to assist them in their testing phase originally scheduled for March to April 2023. This date has already been postponed to July 2023. It was indicated on the SARS website that the IT3(t) would follow an end-September submission date. It is also stated on the website that this information will still be gazetted in due course. There seems to be confusion at SARS regarding the first compulsory submission date (September 2023), even though that was the date stated on their website.

A trustee is a trustee. . .

Traditionally, the estate planner and his wife, another family member or friend served as trustees. Often, the family trustees have never even read the trust deed and are oblivious to their responsibilities as trustees in terms of South African law. In addition, the layperson trustees relied on their accountants and assumed that their accountants took care of 'their' trusts, even though the accountants may only have taken care of the financial statements and tax returns (if at all). Understandably, this resulted in the majority of trusts being non-compliant, with only 20% of trusts considered compliant in South Africa.

Only in March 2017, the Chief Master issued a directive requiring the appointment of an independent trustee for all new 'family business trusts', as defined. Although the requirement is to appoint only an independent trustee for all new family business trusts, if there is any change to the trustees of any existing trust, the Master now, in some instances, also requires the appointment of at least one independent trustee. The Directive requires an independent trustee to be an independent outsider who accepts office in order to ensure that the trust functions properly and that the provisions of the trust instrument are observed.

The layperson trustees seem to have shifted their reliance from the accountants to the independent trustees and even to trust service providers. This is clearly not allowed in our law. Active participation is required from each trustee. The Courts have, in many cases, confirmed the 'Joint Action Rule', whereby trustees are required to act jointly in dealing with trust assets. The Court also held that a 'silent', 'sleeping', 'absent', or 'puppet' trustee would not be tolerated (*Slip Knot Investments 777 (Pty) Ltd v du Toit case of 2011*). Generally speaking, trustees may be jointly and severally held liable for any wrongdoing. For a trustee to be held liable for another trustee's actions, there has to be a fault such as negligence. SARS may hold the appointed 'Representative Trustee' responsible for tax compliance but may hold all trustees liable for non-compliance. The Trust Property Control Act does not distinguish between different types of trustees or even regard the board of trustees as a unit and defines a trustee as "*any person. . . who acts as trustee*". Each trustee is therefore required to meet the requirements of the Act (including the new requirements discussed above) and may be held personally liable for a fine of up to R10 million and/or be imprisoned for up to five years in terms of Section 19(2) of the Act.

The amendments discussed above, therefore, apply to each and every trustee. More than ever should every trustee ensure that the trust's affairs are in order. The trustees, as a board, will have to tighten their arrangements dealing with which trustee can act on their behalf, as such a person may get the others in trouble. Sloppy arrangements and dealing with trust assets are something of the past.

15 minutes CPD

CHASING INTEREST RATES

MADELEINE SCHUBERT, Independent International and Domestic Tax Attorney at Boshoffinc Attorneys

There is a saying that what goes up must come down; the same can be said for interest rates, which are never constant. This constant movement in interest rate directly affects financial assistance transactions where a South African tax resident lends funds to a non-resident foreign trust to which the resident is connected.

From a tax compliance point of view, the monitoring of where the prevailing interest rates are in comparison with the actual interest rate, which the South African tax resident lender and Trust have negotiated on an outbound loan, must be monitored. This is not only to ensure that the initially agreed-upon interest rate between these parties can be justified as a market-related interest rate concerning the nature of the loan, the currency of the loan and risk associated with the loan, but also concerning other tax-induced benchmarks such as the 'official interest rate' as defined in section 1 of the Income Tax Act 58 of 1962 (the ITA).
The latter refers to section 7C of the ITA.

A constant push-and-pull relationship exists between section 7C (deemed donation) and section 31 (transfer pricing) of the ITA. In addition, if one had to add section 7(8) and paragraph 72 of the Eighth Schedule to the ITA, the attribution rules, one requires technical wisdom to stay on the right track.

At least we know that in terms of the SARS interpretation, Note 114 that if there is no interest or interest rate below a market-related interest rate on a loan, then the attribution rules must be applied first; only if there is still a tax benefit, then section 31 becomes applicable. Also, bearing in mind that if this is the case, section 7C must be applied with the attribution rules as this balances out the combined tax adjustment imposed by section 31 of the ITA. But is this the case?

The attribution rules impose an income tax liability for the lender of interest-free or low-interest rate loans (below market-related interest rates), where the taxable income that arose in the foreign trust must be attributed back to the donor limited to the amount of the 'donation'. The donation is the difference between a market-related interest rate and actual or no interest charged as a percentage of the capital amount of the loan account.

"Although section 25D does not provide a solution, it highlights the concern, particularly if one considers that the mischief tax avoidance legislation addresses wish to stop, that is, non arm`s length commercial transactions"

Section 7C imposes a deemed donation tax liability determined according to the 'official interest rate' as a percentage of the capital amount.

These two rates do not automatically equate to each other.

Suppose there is still a tax benefit for section 31 after an adjustment for attribution. Will section 7C also apply?

In this case, there will be an additional adjustment to the lender's taxable income, which should be the tax on interest after taking the effect of the attribution rules into account. This adjusted amount will be deemed a donation for donation tax purposes in section 31(2) as read with 31(4).

In terms of section 7C(5), there is an exemption that excludes the application of section 7C, which states that:

> *"loan, advance or credit constitutes an affected transaction as defined in section 31 (1) that is subject to the provisions of that section."* [my underlining].

An 'affected transaction' is defined in section 31 of the ITA and means

> *"any transaction, operation, scheme, agreement or understanding between (amongst others) a person that is a resident and any other person that is not a resident and those persons are connected persons or associated enterprises about one another and any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length."*

The term 'connected person' is defined in section 1 of the ITA. In the case of a trust, any person who is a beneficiary of the trust is connected to the trust or any connected person to that beneficiary (among others).

Concerning the direct application of this exemption, section 7C will not apply to the facts disclosed above and the donation tax liability arising from the application of section 31 is technically limited to the adjusted amount (section 31(3) of the ITA).

Another scenario that could apply, could be where there is a market-related interest rate on an outbound loan; in such a case, the attribution rules are not applicable nor is section 31, as there is no affected transaction. It was not subject to the provisions of section 31 (no adjustments required for tax), which means, on the face of it, that section 7C of the ITA will apply.

Concerning foreign-denominated loans, the official interest rate means *"in the case of a debt denominated in any other currency, a rate of interest equivalent to the South African repurchase rate applicable in that currency plus 100 basis points."*

But could one consider the application of section 25D in this instance? Section 25D deals with the conversion rule that applies where a person accrued or received taxable income or incurred any expenditure or loss in a foreign currency.

A natural person or a trust (other than a trust which carries on trade) can convert such income or expense to determine their taxable income into South African Rand using the spot or average exchange rates.

Let us test this possibility.

Let us assume that our natural person has made a loan denominated in USD 1 million as of the year ending 28 February 2023 to a non-resident trust to which this person is a beneficiary. The parties agree that a market-related interest rate is 3% based on a no-risk of default view, which they can commercially support.

According to the SARS-published average exchange rate (Table A), the Rand US conversion is 1 USD: 17,7116 as of 28 February 2023.

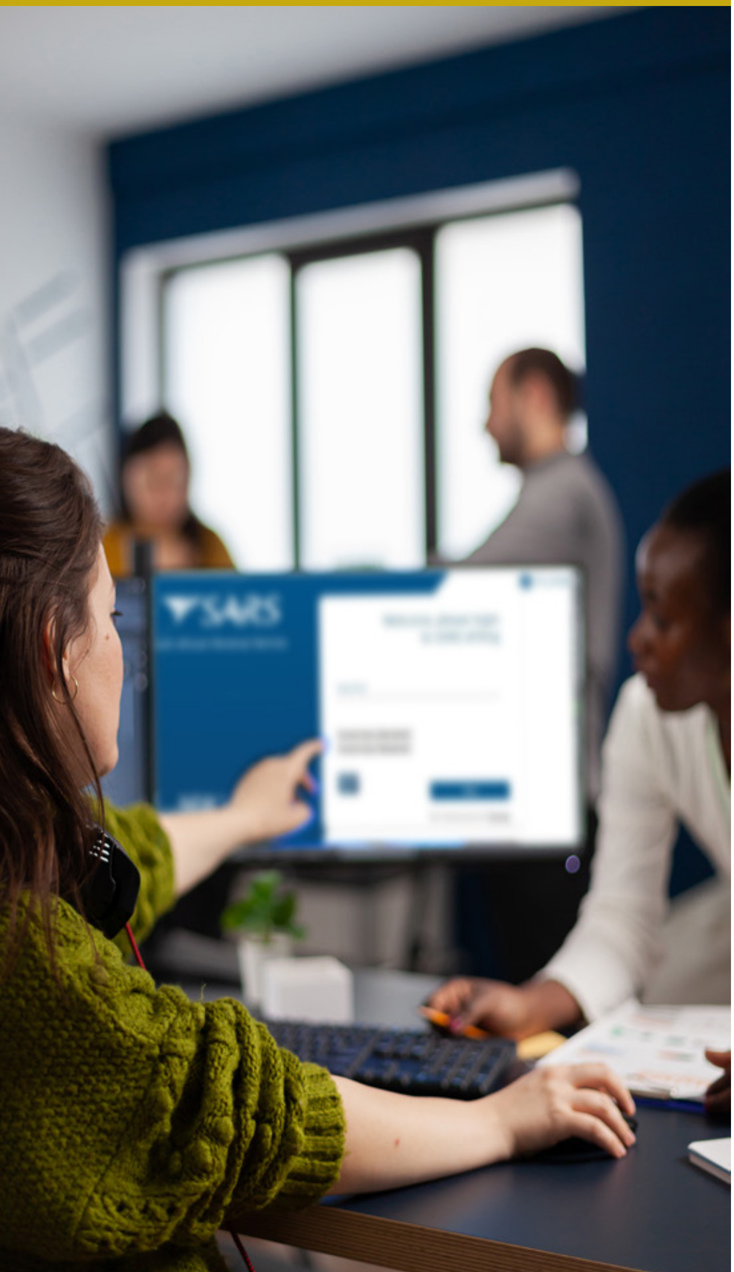
This means applying the conversion rule in section 25D, our interest rate of 3% of USD 1 000 000 equals USD 30 000 and is converted to Rand; it will be R321 348 by applying the average exchange rate.

Now let us assume the SARS official interest rate; we use a US equivalent of the SA repo rate set at 4,9% plus one basis point, resulting in 5,9%. This will equate to the interest of USD 59 000, translated to Rand; it will be R1044 984,4 when applying the official interest rate.

Based on my interpretation of the law, there is now an additional tax liability of 20% for the client (R1044 984,4 - R321 348) R144 727,28.

Although section 25D does not provide a solution, it highlights the concern, particularly if one considers that the mischief tax avoidance legislation addresses wish to stop, that is, non arm`s length commercial transactions that are not reflecting market-related terms.

If a taxpayer entered such an arm`s length market-related agreement, why would he be penalised because of a mismatch of interest rate benchmarks? Or is SARS indicating that the official interest rate is a market-related interest rate despite the transfer pricing determination methodologies they set out in following the OECD model?



60 minutes CPD

CALMING WATERS IN MAURITIUS

MARK KORTEN, Managing Director of Korten Consulting Limited

Mauritius has recently been removed from the Financial Action Task Force (FATF) greylist after having materially revised its tax legislation and global business rules over the last five years to comply with the Organization for Economic Co-operation and Development (OECD) international tax guidelines to stamp out Base Erosion and Profit Shifting (BEPS).

This article identifies the main changes to the taxation landscape in Mauritius and will hopefully illustrate that Mauritius is most certainly "open for business" as an attractive, credible and competitive jurisdiction for various types of international business and wealth management activities.

The FATF greylisting experience in Mauritius

The FATF placed Mauritius on its greylist in February 2020; this greylisting was not on account of any deficiencies, irregularities or contraventions of European Union (EU) policies in its BEPS initiatives, so Mauritius has never been "listed" on account of its taxation laws, policies and enforcement. The reaction of Mauritius to the FATF greylisting was swift and demonstrated political commitment to re-instating the credibility of Mauritius in the international arena as a matter of urgency. The result was that Mauritius was officially removed on 21 October 2021—a period of less than two years when most countries take approximately five years to be removed from the FATF greylist. In my view, little damage was done to Mauritius, including the offshore sector, in the long term; instead, Mauritius has shown its ability to adapt quickly to the world and has demonstrated its commitment to remaining a respected and compliant jurisdiction upon which the tax residency of international businesses and wealth preservation structures can be based.

Changes in company taxation

Since approximately 2016, the EU has placed Mauritius under pressure to address various aspects of its taxation regime that were not aligned with their strategies to combat BEPS. In mid-2018, significant changes were announced following the annual Budget Speech. These changes included material revisions to the Mauritian Income Tax Act (MITA), the Financial Services Act and the Companies Act. The most fundamental change was to remove a tax system of treating foreign-owned or foreign income-generating legal entities resident in Mauritius with tax preferences that were not available to Mauritian entities, which were owned by Mauritian residents. Commencing 1 January 2019, it was no longer possible to form a Global Business Company (GBC) under the existing system of category 1 and category 2 GBC licensing; a category 1 GBC enjoyed a blanket effective 3% tax rate based on a fiction of a deemed 80% foreign tax credit. A category 2 GBC, notwithstanding its tax residency in Mauritius, enjoyed a blanket exemption from taxation provided that the majority of its beneficial owners were not Mauritian tax residents or nationals. Existing category 1 and category 2 GBCs had a three-year 'grandfathering' concession whereby they could continue to enjoy the pre-existing tax rules up to 30 June 2021.

Under the new rules, a new GBC would be subject to exactly the same tax treatment as any other domestic company owned by Mauritian tax residents or nationals that primarily derive their revenue from within the Mauritian economy. All Mauritian companies (domestic and GBC) are subject to the same company tax rate being 15%, subject to certain exceptions mentioned below. Note that there is no tax on dividends declared by a Mauritian company. The only material distinction in terms of tax treatment of a domestic Mauritian company and a GBC is an additional 2% Corporate Social Responsibility Levy (CSRL) that applies to a domestic company and not to a GBC. To clarify:

- A domestic Mauritian company may be used where the tax residency of the company takes place in Mauritius through the concept of 'central management and control', provided that at least 50% of its ultimate beneficial ownership is held by Mauritian citizens or if more than half of its revenue is generated from Mauritian tax resident persons.

- A GBC is required to be used where more than half of its beneficial ownership is held by non-citizens of Mauritius and more than half of its revenue is generated from non-Mauritian tax resident persons. This is essentially a way in which Mauritius has protected its offshore sector by obliging foreigners to apply for a GBC licensing of a Mauritian incorporated and tax resident company, which would require services of a licensed Mauritian management company, an annual audit by a Mauritian auditor and various other enhanced compliance aspects that support the accounting, administration and government licensing revenue of the Mauritian offshore sector.

- An Authorised Company is simply a company that is incorporated in Mauritius but which is not allowed to have its tax residency in Mauritius. Nevertheless, an Authorised Company still needs to register as a Mauritian taxpayer and needs to submit an annual tax return in order to declare any Mauritian-sourced income that would be subject to the same tax as a GBC. This company also needs to confirm that its 'central management and control' does not take place in Mauritius.

The taxation of Mauritian trusts

According to the MITA, a trust is a tax resident of Mauritius if both the majority of its trustees and its administration take place in and from Mauritius. This is a specific definition of tax residency for trusts which differs from that of a company. However, the MITA also provides that it includes a trust within the definition of a 'company' Therefore, this also seems to give the Mauritian Revenue Authority (MRA) scope to apply company rules in the MITA to trusts when it is suitable for policy purposes. Until 30 June 2021, the MITA (to protect the offshore sector but clearly in breach of BEPS) provided that a Mauritian tax resident trust could obtain a tax exemption on all foreign-sourced income each year by filing a 'declaration of non-residence' on the basis that the original settlor of the trust was not a Mauritian tax resident at the date of the establishment of the trust and all of the beneficiaries of the trust were not tax residents of Mauritius during the tax year concerned. Again, EU pressure required that this rule which applied to both foundations and trusts, be removed; this took effect from 1 July 2021.

> *"The MRA will only consider them as tax residents of Mauritius provided that, in addition to having its administration and the majority of trustees based in Mauritius, the first settlor of the trust has been a Mauritian resident at the time when the trust was created"*

The natural conclusion would be that all trusts would become Mauritian taxpayers and be subject to Mauritian tax on worldwide income like a domestic company if it has Mauritian trustees and local administration. However, again to protect the offshore sector in Mauritius, the MRA came out with an interesting Statement of Practice published on 24 August 2021 (SP24/21). It has taken the official view about trusts and foundations that the MRA will only consider them as tax residents of Mauritius provided that, in addition to having its administration and the majority of trustees based in Mauritius, the first settlor of the trust has been a Mauritian resident at the time when the trust was created and a majority of the beneficiaries are not Mauritian tax residents. Whereas SP24/21 has contravened the clear provisions of the MITA, the official position of the MRA may be relied upon. Accordingly, from a tax perspective, the status quo for trusts and foundations has effectively been maintained.

Various partial exemptions and tax holidays

It was important for Mauritius to maintain its attractiveness to foreigners as a place to incorporate and manage company- and trust structures in support of the Mauritian offshore sector. To do so and at the same time comply with EU requirements that do not contravene BEPS, Mauritius took the brave step of introducing a number of '80% partial exemptions' (being an effective 3% tax rate as applied before) and an actual 3% tax rate for a particular business activity as well as a number of tax holidays. These tax exemptions are available to any Mauritian tax resident legal entity but have a requirement that a requisite amount of 'WWe' takes place within Mauritius. A complete list of 80% partial exemptions and tax holidays is too detailed to include in this article. Some of the more relevant include:

- 80% exemption on foreign dividends received by a Mauritian company (which includes a trust and foundation);
- 80% exemption on interest (local and foreign) received by any company (again including a trust and a foundation) other than banks and various financial service providers involved in money lending, leasing and insurance;
- 80% exemption of income derived by a collective investment scheme (CIS), closed-end fund, CIS manager, CIS administrator, investment advisor, investment dealer or asset manager as licensed by the Financial Services Commission; and
- 80% exemption of income derived by a company from re-insurance and re-insurance brokering activities.

A limited period full exemptions (or tax holidays) are numerous and include the following:

- An 8-year full exemption for certain approved bio-farming projects;
- An 8-year full exemption on the income of a company issued with a global headquarters administration license;
- A 5-year full exemption on the income derived by a company issued with either a global treasury activity license or a global legal advisory services license; and
- A 10-year full exemption with respect to the income derived by a company holding a family office license.

- An actual 3% tax rate (as opposed to a 15% corporate tax rate) applies to taxable income derived from 'export activities' which are specifically defined as the purchase of tangible movable products or assets outside of Mauritius and their re-sale to customers outside Mauritius without such products ever having been imported into Mauritius.

Encouraging Mauritian residency with a premium visa

Given the travel restrictions that were still lingering in 2021, a special renewable one-year permit was introduced for foreigners who wished to live and work in Mauritius on the basis that they would conduct their service obligations in and from Mauritius remotely in favour of a non-Mauritian resident employer or as an independent service provider. The premium visa comes with certain attractive Mauritian taxation benefits. The premium visa is easy to obtain through an online process and can be issued prior to arriving in Mauritius for the first time. From a Mauritian tax perspective, a foreign tax resident is usually subject to tax in Mauritius if the source of their income is in Mauritius, which in this case would be the skill, effort and labour that was exerted in Mauritius and that gave rise to the income earned. However, a premium visa exception to this general rule is that such remuneration can only be deemed to have been derived by the foreign tax resident when, if and to the extent that it is remitted into Mauritius. The premium visa tax incentives then continue by saying that the spending of money in Mauritius by the premium visa holder through their foreign debit or credit card, applying such income for Mauritian expenses, shall be deemed not to be a remittance into Mauritius. The MITA has also provided for the tax risk of the employer of a premium visa holder to make it clear that such an employee's presence and activities in Mauritius would not constitute a 'permanent establishment' of the employer as contemplated in Double Taxation Agreements.

Economic substance rules

As part of its agenda to combat BEPS, the EU requires low tax jurisdictions to have local economic substance rules (ESR) to ensure that revenue-generating companies, trusts and other juristic vehicles locally have the requisite substance of activity in order to meet transfer pricing obligations and discourage tax treaty shopping. Certain jurisdictions have enacted quite elaborate and sophisticated legislation dealing with its ESR. Mauritius has not enacted such legislation and likely will not until it is obliged to. Instead, the ESR in Mauritius are fairly opaque and the standards are quite minimal. These are only really obligatory from a Mauritian tax perspective to qualify for the 80% partial exemptions.

Mauritian ESR is contained in an MRA Statement of Practice (SP22/21) published on 27 January 2021 which, depending on the nature of the activities of the taxpayer concerned, requires three general conditions to be met:

- Its core income-generating activities (CIGA) are carried out in and from Mauritius;
- It has employed locally, directly or indirectly, an adequate number of suitably qualified persons to conduct its CIGA; and
- It incurs a minimum expenditure proportionate to its level of activities.

Significant increases in personal income tax and payroll taxes in Mauritius

With the above-outlined tax exemptions, the tax position of many activities in Mauritius has not changed in the offshore sector. However, this has come at a cost to the Mauritian fiscus as all domestic Mauritian companies may now enjoy the same benefits as GBCs. In addition, the COVID-19 pandemic created massive hardship to the Mauritian fiscus. This has required Mauritius to impose an additional tax on high income earning individuals and to introduce socialist measures by imposing high social security contributions that have no correlation to any return on retirement. Mauritius has always held itself out as having a maximum 15% personal income tax rate. Well, this is simply no longer accurate for a Mauritian tax resident person who is working as an employee of a Mauritian employer. To illustrate, for a person earning approximately USD 8 000 per month (taking note that the cost of living is probably 50% higher in Mauritius compared to South Africa), the effective tax rate on that salary is almost a 38% flat rate of tax, which may be broken down as follows:

- Pay as you earn (PAYE) or personal income tax would be approximately 12% (given a certain degree of progressive tax rates);
- A 9% contribution to social security (known as Contributions Social Généralisée) is a 3% contribution by the employee and a 6% contribution by the employer. Note that even if one qualifies for benefits after decades of living in Mauritius, the 'government pension' bears zero correlation to the contributions made, so this is simply a tax that never comes back;
- A 3.5% contribution to the National Savings Fund;
- A 1% contribution to the National Training Levy;
- A 4% contribution to a portable retirement gratuity (being a compulsory contribution by the employer) where possibly some or all of these contributions may one day come back to the employee, although one would not provide for any growth given the high cost of most gratuity funds; and

"Mauritius has accordingly weathered the storm well in order to preserve the attractiveness of its offshore sector. This is supported by the fact that over the last two years, thousands of South African and European residents have physically moved their tax residency to Mauritius"

- 8% as a personal wealth tax on high income individuals known as the Individual Solidary Levy (ISL). No ISL applies to the first three million Mauritian Rupee (MUR), which amounts to about ZAR 1.2 million; thereafter, it kicks in at a rate of 25% with a rider that the total ISL on all taxable remuneration (including local dividends) shall not exceed 10%.

In summary

The Mauritian government has had a difficult mandate to appease the EU and to align itself to combatting BEPS, yet at the same time wishing to preserve the historical tax benefits associated with Mauritius, thereby retaining and growing its offshore sector as well as encouraging the investment of foreign skills and foreign money into Mauritius. Other than the big increase in personal income tax rates and the fact that any intellectual property and digital-driven activities, non-financial services and agency activities would now be exposed to a 15% tax rate compared to a previous 3% tax rate, many other important industries, particularly in the area of financial services and trading in tangibles continue to enjoy the same tax benefits as before.

In the case of wealth management and the use of Mauritian-based offshore trusts, the tax benefits have not changed. In my view, Mauritius has accordingly weathered the storm well in order to preserve the attractiveness of its offshore sector. This is supported by the fact that over the last two years, thousands of South African and European residents have physically moved their tax residency to Mauritius not only to enjoy acceptable tax laws, but also to enjoy a country far away from war, with an improving and working infrastructure, a booming property market, social stability and a sound system of law and order.

STRUCTURING OFFSHORE INVESTMENTS FROM KENYA:

WHAT ARE THE OPTIONS?

30 minutes CPD

ALLAN WANG'ANG'A, LLM Candidate in Commercial Law, University of Johannesburg

Investing offshore is a key component in holistic wealth planning. It allows one to spread one's investment risk across different economies, regions, sectors and securities in addition to finding more opportunities for wealth creation.

Kenya has generally seen trends towards offshore investments which may be attributed to various factors. Firstly, over the past three years, the Kenya shilling has lost approximately 25% of its value against the US dollar, falling from Sh99 to Sh132[1] and its annual inflation rate is now at 9.23%.[2] Moreover, Kenya has a limited number of growth industries; companies in Kenya account for less than 1% of global listed companies by value. Therefore, diversifying investment portfolios mitigates against currency and other risks and caters to emerging political uncertainties. Finally, it also provides for more liquidity considering the breadth of offshore portfolios such as the New York Stock Exchange or the Nasdaq stock market.

While offshore investments may offer optimal investment alternatives, it is important to bear in mind that various tax and legal considerations would apply to and affect each context.

Structuring offshore investments

1. General tax considerations

Kenya operates a territorial tax system. Income accrued in or derived from Kenya would be taxable in Kenya, with two exceptions: (a) the individual/employment income of Kenyan residents earned from services rendered is taxed on a worldwide basis, that is, regardless of whether the income is derived from or accrued within or outside Kenya; and (b) resident companies that conduct business partly within and partly outside Kenya are taxed on their total income accrued in and derived from both within and outside Kenya. In addition, non-residents who source specific incomes such as dividends or interest from Kenya may also be deemed to be subject to tax in Kenya through the withholding tax mechanism, even where they do not have a permanent establishment in Kenya.

On the one hand, individuals would be tax-resident in Kenya if they have a permanent home in Kenya and if they have been resident in Kenya for at least 183, days or were resident in Kenya in that year of income and more than 122 days in each of two preceding years. On the other hand, companies are resident if they are incorporated in Kenya or if they have their place of effective management in Kenya in a year of income or if so declared, under a legal notice by the Cabinet Secretary for the National Treasury.

These considerations would apply differently based on the set-up of each investment vehicle.

2. Investment vehicles

Broadly, the choice of investment vehicles and platforms would hinge on the feasibility of the option from a commercial perspective. Investors would select a particular vehicle and jurisdiction based on the strength of the regulatory regime and the level of political and economic risk. An offshore portfolio would then be invested in one or more of the following ways:

(a) Offshore equity markets

Concerning portfolio balance, stock market equities were reported to constitute about 18% of high-net-worth Kenyan individual holdings relative to property and bonds reported to account for 66% and venture capital reported to account for 5%.[3]

Kenyans can access global equity markets through various platforms. For instance, non-dealing forex brokers may provide access. Non-dealing forex brokers operate electronic platforms that act as a link between the online foreign exchange market and a client in return for a commission or markup in spreads. They do not engage in market-making activities (buying and selling of foreign currencies). They will provide their clients with access to trading platforms, enabling them trade from anywhere and at any time using their electronic devices. Online foreign exchange trading platforms give access to global markets and an opportunity for clients to educate themselves on the global financial markets. Non-dealing online forex brokers do not offer client advice or trade on behalf of their clients. Examples of non-dealing desk forex brokers currently licensed in Kenya include GM Securities Limited (trading as 'FXPesa'), SCFM Limited (trading as 'Scope Markets'), Pepperstone Markets Kenya Limited and Exinity East Africa Limited.

In addition, access to global markets may be provided by collective investment vehicles, including mutual funds, unit trusts or investment companies. They pool investors' funds and may provide direct access to stocks and bonds in offshore markets or connect customers to global asset managers. Financial institutions in Kenya may provide such services through equity funds that provide access to offshore listed companies denominated in the Euro, Sterling Pound or US Dollar. Examples include the Old Mutual Equity Fund, the Britam Equity Fund and the CIC Equity Fund.

In addition, the Capital Markets Authority (CMA) recently granted a 'No Objection' to Waanzilishi Capital Limited to roll out a robo-advisory solution to the mass market upon the successful completion of the product test in the CMA Regulatory Sandbox. The company is licensed as a fund manager and investment adviser. Using the Ndovu App, an investor creates a profile to assist in determining a risk profile (risk appetite) and investment goals. The robo-advisor will then use the information provided by the investor and inbuilt algorithms to recommend a portfolio of suitable investments, both local and international, to the investor.

Kenyans can also trade offshore through Eurobonds as part of the exposure to offshore fixed-income securities. A Eurobond is a debt instrument denominated in a currency other than the home currency of the country or market in which it is issued. They help spread out investment risk and serve as an additional diversification strategy. In Kenya, various financial institutions now provide access to the Eurobond market. For instance, the Standard Investment Bank provides Eurobond brokerage and advisory services which enable clients to tap into global Eurobonds. Standard Chartered Bank also provides similar services to local investors.

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[1]See Central Bank of Kenya statistics on the US dollar-Kenya shilling exchange rate, https://www.centralbank.go.ke/rates/forex-exchange-rates/

[2]See Central Bank of Kenya statistics on the rate of inflation, https://www.centralbank.go.ke/inflation-rates/

[3]See the https://hapakenya.com/2023/03/04/report-private-investors-in-kenya-turn-their-focus-on-rented-residential-retail-properties/ the Frank Knight 2023 Wealth Report.

Dealers in offshore securities, trading participants and collective investment schemes must be registered and licensed by the Capital Markets Authority before operating as such under the Capital Markets Act Cap 485A. In addition, pension schemes can invest a maximum of 15% in offshore investments, in bank deposits, government securities, listed equities and rated corporate bonds and offshore collective investment schemes reflecting these assets.[4]

Under the Income Tax Act unit trusts, collective investment schemes and investment banks registered by the Commissioner-general to the Kenya Revenue Authority would be exempt from tax on their incomes except for payment of withholding tax on dividends or interest paid to unit holders who are not tax exempt. This flow-through approach may be convenient for the operation of such entities in providing access to offshore equity markets.

Conversely, the Finance Act 2022 introduced a provision by which non-residents would be taxed on the gains they make through derivative transactions with Kenyan residents. Given the likely extra cost of hedging or investing in derivatives, access by Kenyans to the global derivatives market may be reduced.

(b) Offshore real estate

Kenyan investors are reported to have held a greater proportion of their investment portfolios in property and bonds than the global norm. In 2022, when energy prices and inflation were rocking markets worldwide, many moved to increase those positions that were not immediately impacted through reduced profits from the surges in energy prices and input inflation. The proportion of high-net-worth individuals (HNWIs) in Kenya owning privately rented property is reported to have risen from 44% to 70%. The proportion owning retail properties has risen from 41% in 2021 to 70% in 2022.[5] There was also a sharp shift towards domestic markets which were considered to offer more stability in light of global turmoil.

Offshore real estate investments may be made through Real Estate Investment Trusts (REIT). Through Kenyan REITs, promoters source funds to build or acquire real estate assets such as residential, commercial, retail and mixed-use developments, which they sell or rent to generate income. REITs may invest in offshore properties as this cushions the sector from market shocks or political risks. Examples of active REITs in Kenya are ILAM Fahari REIT, Acorn D-REIT and Acorn I-REIT. Financial institutions also operate balanced funds that may invest in diversified asset classes, including fixed-income assets and offshore property and equity. Examples include the Britam Balanced Fund or the Old Mutual Balanced Fund.

The above investment vehicles also benefit from an exemption from income tax except for payment of withholding tax on dividends or interest paid to unit holders who are not tax-exempt. Additionally, the transfer of properties to a REIT is exempt from stamp duty as per the terms of Section 96A (1) (b) of the Stamp Duty Act. However, it is noteworthy that the rate of capital gains tax on the transfer of property was increased from 5% to 15% which applies from 1 January 2023. For Kenyans, this may have the effect of increasing the cost of disposal in real estate property investments by 10%.

(c) Offshore bank accounts

Divestment through offshore bank accounts typically allows Kenyans to transfer money offshore and convert it into a currency of their choice. There may not be any precise legal limitations on the amounts that can be divested into offshore bank accounts by ordinary citizens. However, public officials may come under considerable scrutiny and are required to obtain the consent of the Ethics and Anti-corruption Commission (EACC) before operating an offshore bank account. They are also required to submit annual bank statements to the EACC for their verification. This was due to the concern that public officials were operating secret offshore accounts for tax evasion.

(d) Offshore trusts

Offshore trusts would be an increasingly handy method for asset protection and succession planning in Kenya. Offshore trusts would enjoy preferential tax treatment if they were tax-resident outside Kenya. Where income is generated outside Kenya, it may be settled into an offshore

"Offshore investments provide access to a wide array of opportunities. However, they might, in turn, create exposure to market, currency and regulatory risk"

trust, considering that the settlor may not be taxed in Kenya while they remain Kenyan resident. However, it will be important that the effective management of the trust takes place offshore to avoid the risk of the trust being considered to be effectively resident in Kenya. To this end, the trust may establish trust/management companies offshore to manage the investment portfolios of the trust.[6]

Kenya has recently introduced new tax rules applying to registered trusts. The following payments on behalf of a beneficiary are tax exempt: payments made out of a registered trust used exclusively for the purpose of education; medical treatment or early adulthood housing; and income paid to a beneficiary which is below Ksh 10 million. In addition, the principal sum of a registered family trust is exempt from tax and transfers of property into a registered family trust are exempt from capital gains tax and stamp duty. These incentives encourage investment and succession through registered trusts.

Conclusion

Offshore investments provide access to a wide array of opportunities. However, they might, in turn, create exposure to market, currency and regulatory risk. Offshore investments might perform better at times than Kenyan investments and vice versa, depending on various factors such as global economic conditions and exchange rates. Investors will therefore need to be wary of local and global economic and regulatory environments.
economic and regulatory environment.

[4]Retirement Benefits Authority, 'Investment Regulation and Policies', https://www.rba.go.ke/investment-regulations-policies/.
[5]See https://hapakenya.com/2023/03/04/report-private-investors-in-kenya-turn-their-focus-on-rented-residential-retail-properties/ referring to the Frank Knight 2023 Wealth Report.
[6]https://allafrica.com/stories/202110070346.html

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