Tax Alert
National Tax Technical

Interests in foreign companies held by SA residents via foreign trusts: new anti-avoidance measure

4 March 2019

In brief

Since as far back as 2008, government has been concerned that the controlled foreign company (“CFC”) rules do not cater for situations where South African residents hold shares in foreign companies via foreign trusts.

As part of a set of legislative measures to address this concern, the participation exemption (an exemption available in respect of foreign dividends if at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend are held) is, with effect from 1 March 2019, no longer available to South African resident individuals in certain circumstances.

Broadly, the new rules (which apply to amounts received or accrued on or after 1 March 2019) potentially impact South African tax resident individuals who are settlors and/or beneficiaries in relation to non-resident trusts that hold interests in foreign companies, where the foreign company would have constituted a CFC had the foreign trust been a resident.

In detail

Background

Generally, the concern of government has been that South African residents, in order to circumvent the CFC rules, have been interposing foreign trusts between themselves and foreign companies. This, government has argued, has allowed South African residents to avoid tax or, at a minimum, re-characterise income from foreign companies in order to avoid tax.

Accordingly, in 2017, National Treasury published for public comment a set of draft rules in a proposed section 25BC of the Income Tax Act, 1962 (Act No. 58 of 1962) (“the ITA”). Essentially, the draft rules deemed all distributions of a discretionary foreign trust in such a scenario to be income in the hands of the South African resident.

Following public consultation in 2017, the proposed section 25BC was withdrawn on the basis that the rules were overly broad and complex, and on the understanding that the issue would be dealt with in a more targeted and appropriate manner in the 2018 legislative cycle.

To this end, the Taxation Laws Amendment Act, 2018 (Act No. 23 of 2018), inserts a new paragraph (aA) in section 7(8) with effect from 1 March 2019.

Operation of the new section 7(8)(aA)

Section 7(8)(aA) applies where an amount is received by or accrued to a non-resident due to a donation, settlement or other disposition made by a resident to that non-resident, and would therefore invariably apply in the scenario with which National Treasury is concerned (i.e. the holding of shares by a resident in a foreign company via a non-resident trust). In that scenario, in terms of section 7(8)(a), amounts received by or accrued to the non-resident trust

www.pwc.co.za/tax-alert
(i.e. from the foreign company) must, if that amount would have constituted income had the non-resident trust been a resident, be included in the income of the resident.

This anti-avoidance measure therefore only applies to the extent that the amounts received by or accrued to the non-resident trust would have constituted “income” had the non-resident trust been a resident. This is where the participation exemption, contained in section 10B(2)(a) of the ITA, comes into play. The participation exemption applies to exempt from income foreign dividends received by or accrued to a person if that person holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend. Being exempt, such foreign dividends would not constitute “income”.

Consequently, where a South African resident holds shares in a foreign company via a foreign trust (and the trust holds 10% or more of the shares in a foreign company), the effect of section 10B(2)(a) on the application of section 7(8)(a) is that foreign dividends received by or accrued to the foreign trust from the foreign company are not included in the income of the South African resident.

It is this scenario that the new section 7(8)(aA) is aimed at. The effect of this new provision is that where a South African resident holds shares in a foreign company via a foreign trust, the participation exemption will be disregarded in determining whether an amount must be included in the income of the resident in terms of section 7(8), provided that two additional conditions are met.

These two additional conditions are that (1) more than 50% of the total participation or voting rights in the foreign company are held (directly or indirectly, and whether alone or together with any connected person) by the foreign trust; and (2) there is a connected person relationship between the foreign trust and (a) a South African resident settlor or founder of that trust, or (b) any connected person in relation to a South African resident settlor or founder of that trust.

Section 7(8)(a) also contains provisions that prevent double inclusions in income. Thus, the provision will not apply to the extent that the foreign dividend is derived from (1) amounts that must already be included in the income of the South African resident; or (2) capital gains that must be attributed to the South African resident.

Moreover, section 7(8)(a) has no effect on the “partial dividend exemption” provided for in section 10B(3), which applies to exempt a portion of all foreign dividends received by South African residents so that these dividends are effectively taxed at the same rate as local dividends.

Other affected provisions of the ITA

Together with the insertion of section 7(8)(aA), other provisions of the Act have also been amended (with effect from years of assessment commencing on or after 1 March 2019) to disregard the participation exemption in the same manner as it is disregarded for the purposes of section 7(8)(a).

Thus, the participation exemption is disregarded in respect of foreign dividends for purposes of income inclusion in terms of section 25B of the ITA, as well as in respect of capital gains derived from the sale of foreign shares for purposes of attribution of capital gains in terms of paragraphs 72 and 80 of the Eighth Schedule to the ITA.

The take-away

South African residents who may be impacted by the new section 7(8)(aA) are advised to obtain professional advice on a case-by-case basis on their particular circumstances, more specifically whether foreign dividends received by a foreign trust of which they are a beneficiary, founder, donor or settlor are exempt from normal tax or not. This should be followed by appropriate planning and the quantification of their tax liability (if any) based on the new rules.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

<table>
<thead>
<tr>
<th>Location</th>
<th>Contact Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cape Town</td>
<td>James Whitaker</td>
<td>(021) 529 2638</td>
<td><a href="mailto:james.whitaker@pwc.com">james.whitaker@pwc.com</a></td>
</tr>
<tr>
<td>Cape Town</td>
<td>Louis du Plessis</td>
<td>(021) 529 2229</td>
<td><a href="mailto:louis.du-plessis@pwc.com">louis.du-plessis@pwc.com</a></td>
</tr>
<tr>
<td>Johannesburg</td>
<td>Jan Coetsee</td>
<td>(011) 287 0172</td>
<td><a href="mailto:jan.coetsee@pwc.com">jan.coetsee@pwc.com</a></td>
</tr>
</tbody>
</table>

This Tax Alert is provided by PricewaterhouseCoopers Tax Services (Pty) Ltd for information only, and does not constitute the provision of professional advice of any kind. The information provided herein should not be used as a substitute for consultation with professional advisers. Before making any decision or taking any action, you should consult a professional adviser who has been provided with all the pertinent facts relevant to your particular situation. No responsibility for loss occasioned to any person acting or refraining from acting as a result of using the information in the VAT Alert can be accepted by PricewaterhouseCoopers Tax Services (Pty) Ltd, PricewaterhouseCoopers Inc. or any of the directors, partners, employees, sub-contractors or agents of PricewaterhouseCoopers Tax Services (Pty) Ltd, PricewaterhouseCoopers Inc. or any other PwC entity.

© 2019 PricewaterhouseCoopers (“PwC”), a South African firm, PwC is part of the PricewaterhouseCoopers International Limited (“PwCIL”) network that consists of separate and independent legal entities that do not act as agents of PwCIL or any other member firm, nor is PwCIL or the separate firms responsible or liable for the acts or omissions of each other in any way. No portion of this document may be reproduced by any process without the written permission of PwC.