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Loop structures: Tax and Exchange Control developments

Let's talk

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

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In brief

The 2020 Budget announced the modernisation of the Exchange Control rules by putting in place a new capital flow management framework to promote investment, reduce unnecessary burdensome approvals by the South African Reserve Bank ('SARB') and provide a modern, transparent and risk-based approvals framework for cross-border flows.

One of the changes to the Exchange Control rules envisaged was a relaxation of the rules relating to 'loop structures'. In this regard, the Budget also announced that there would be appropriate tax amendments. Such amendments have now been enacted by the Taxation Laws Amendment Bill, 2020, which was promulgated on 20 January 2021. In addition, on 4 January, SARB released a Circular that effects the necessary changes to the Exchange Control Rules.

The purpose of this Alert is to provide an overview of the above developments.

In detail

What is a 'loop structure'?

Generally, the formation of a 'loop structure' involves the export of funds from South Africa by a South African resident (whether in terms of Exchange Control rules or otherwise) and the formation of an offshore structure (for example a company or trust in which the South African resident holds an interest). The 'loop' arises where the offshore company or trust then reinvests into the Common Monetary Area ('CMA') through, for example, the acquisition (whether directly or via another entity) of shares in a company resident in the CMA (the investment could also take place, for example, by way of a loan to an entity within the CMA).

Applicable Exchange Control rules

In terms of regulation 10(1)(c) of the Exchange Control Regulations of 1961, residents of

the CMA may not enter into any transaction (or series of transactions) with the purpose or effect of directly or indirectly exporting capital from South Africa. Generally, the effect of regulation 10(1)(c) is that it prohibits, with certain exceptions, the formation of loop structures (which can be used to indirectly export capital from the CMA as contemplated in the regulation, on the basis that the result of the loop structure could be that profits from investments by the offshore entity into the CMA could be accumulated offshore for the benefit of the CMA resident).

One of the exceptions to the prohibition of loop structures is that resident private individuals and companies who transfer funds offshore (within the parameters allowed by the Exchange Control rules) are permitted to acquire up to 40% of the equity shares or voting rights in a foreign company, which may in turn hold investments (including loans) into the CMA. (Loop structures where the 40% limit shareholding is exceeded require approval from the Financial Surveillance Department ('FSD') of the SARB with due consideration to transparency, tax, equivalent audit standards and governance).

Tax amendments

As stated above, the 2020 Budget also announced that the relaxation of the Exchange Control rules relating to loop structures would take place once tax amendments had been enacted to limit tax planning opportunities that could arise as a result of the proposed relaxation of the Exchange Control rules.

Generally, the tax planning opportunities of concern related to certain exemptions applicable in respect of (1) dividends derived from non-resident companies that hold investments into the CMA; and (2) capital gains derived from the disposal, to non-residents, of shares in non-resident companies that hold investments into the CMA.

Accordingly, the Taxation Laws Amendment Act, 2020 (promulgated on 20 January 2021), has made certain amendments to the Act.

Firstly, a non-resident company that is a controlled foreign company ('CFC') in relation to a South African resident is required to include a portion of any dividend that is received or accrued from a resident company in its net income (previously, such dividends generally qualified for exemption from inclusion in the net income of the CFC). Generally, the quantum of the portion that is to be so included is equal to the amount of the dividend multiplied by the ratio of 20 to 28, reduced on a sliding scale depending on the extent to which the dividend was subject to South African dividends tax (for example, where the dividend was subject to tax at the rate of 20%, the amount of the dividend that must be included is reduced to zero; and where the dividend was subject to dividends tax at the rate of 5%, the amount of the dividend that must be included is reduced to 25% of the amount of the dividend multiplied by the ratio of 20 to 28).

Secondly, the participation exemption (provided for in paragraph 64B of the Eighth Schedule) will not apply in respect of the disposal of shares in a CFC to the extent the value of the assets of the CFC are derived from South African assets (this will effectively create equal tax treatment of residents holding South African assets directly versus South African assets held indirectly via a CFC).

The above amendments came into effect on 1 January 2021 and apply in respect of dividends received or accrued to a CFC, and disposals of shares in CFCs, on or after that date.

The Exchange Control relaxation

On 4 January 2021, the SARB released Exchange Control Circular 1/2021 ('the Circular'), which amends various sections of the Currency and Exchanges Manual for Authorised Dealers ('the Manual') that deal with the loop structure prohibition insofar as the prohibition is applicable to South African individuals, companies and private equity funds.

As discussed above, before the amendment brought about by the Circular, South African-resident individuals, companies and private equity funds were, whether alone or together with any other South African resident(s), only permitted to hold up to a 40% interest in an entity that is a non-resident.

Generally, the effect of the Circular is to remove the 40% limit on holdings of South African residents in entities that are non-resident. More specifically, the rules that now apply in respect of loop structures are as follows:

- Resident individuals, companies and private equity funds with authorised foreign assets may invest in South Africa, provided that where South African assets are acquired through a loop structure, the investment must be reported to an Authorised Dealer ('AD') as and when the relevant transaction(s) is finalised. In addition, an annual progress report must be submitted to the FSD of the SARB via an AD. The AD must be provided with an independent auditor's written confirmation (or suitable documentary evidence) verifying that the relevant transaction(s) is concluded on an arm's length basis for a fair and market-related price.

- Once the relevant transaction(s) are completed, the AD must submit a report to the FSD of the SARB, which should include:
  - the name(s) of the South African affiliated foreign investor(s);
  - a description of the assets to be acquired (including inward foreign loans, the acquisition of shares and the acquisition of property);
  - the name of the South African target investment company, if applicable; and
  - the date of the acquisition as well as the actual foreign currency amount introduced (including a transaction reference number).

It should be noted that all inward loans from South African affiliated foreign investors must comply with existing directives in the Manual.

Existing unauthorised loop structures (i.e. created prior to 1 January 2021) and/or unauthorised loop structures where the 40% shareholding threshold has been exceeded (and that were created prior to 1 January 2021) must still be regularised with the FSD of the SARB.

Takeaway

Investment into an offshore company or entity, particularly structures that involve loops, have significant tax and exchange control implications, all of which should be considered in advance.