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South Africa's exchange control regulations and 'loop structures': The income tax implications on the removal of the restrictions with effect from 1 January 2021

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Abstract

This article analyses the implications of the income tax provisions introduced to address the potential tax avoidance that could arise from the lifting of the exchange control restrictions on 'loop structures' which were effected from 1 January 2021. Most South Africans and foreign investors do not quite understand the operation and implications of exchange controls due to the complexity of these regulations, and the perception that it is difficult to move money in and out of South Africa. Since the removal of exchange control restrictions on loop structures does not apply to existing unauthorised loop structures, this paper also provides a broader understanding of the operation of exchange controls regarding loop structures. The article first explains the administration of exchange controls and how the restrictions of exchange controls on loop structures have been relaxed over the years, and then it explains the 2021 removal of the restriction on loop structures as well as the amendments to the Income Tax Act to curtail tax avoidance risks.

Keywords: Exchange controls, loop structures, tax avoidance, controlled foreign companies, participation exemption, capital gains on the disposal of shares

I Introduction

Exchange controls are implemented by some countries, particularly developing countries (such as South Africa, Zimbabwe, Nigeria, Morocco, Ghana, Libya, Namibia, Russia and Venezuela) to limit and

control the outflow and inflow of capital. [1] In South Africa, the relationship between capital flows and exchange control regulations has been of concern to fiscal policymakers for decades. Exchange controls were first introduced in South Africa in the form of Emergency Finance Regulations at the outbreak of the Second World War in 1939, [2] with the intention of protecting South Africa's foreign exchange reserves. However, from 1939 until the late 1950s, exchange controls restrictions on capital transfers were minimal. [3] This changed during the apartheid era (the period from 1961 to 1993) when South Africa had a negative political reputation which impacted the price of gold mined from the country in the international market, which necessitated restrictive exchange controls to protect the currency from devaluation. [4] The apartheid era was thus characterised by a comprehensive system of exchange controls on current and capital account transactions over residents and non-residents. [5] For residents, exchange controls were tightened in response to the large-scale capital outflows. For non-residents, the repatriation of the proceeds of sales of South African securities was prohibited. [6] At the end of apartheid, which ushered in the democratic election of a government of national unity in April 1994, South Africa was reintegrated into the global economy. This provided opportunities for the gradual liberalising or relaxing of exchange controls, and it has been the stated intention of National Treasury that the liberalisation and deregulation of exchange controls would continue. [7]

Nevertheless, exchange controls continue to complement the anti-tax avoidance legislation since they prevent the outflow of capital from the country which could deplete the tax base. [8] Essentially, the term 'tax avoidance' refers to the use of legal methods to arrange one's affairs by utilising loopholes in the tax laws so as to pay less tax. [9] Exchange control regulations have been used to prohibit engaging in so-called 'loop

structures' (explained in paragraph 4 below), except with permission of the Treasury, as they have the effect of reducing South Africa's tax base. However, the last decade has seen increasing relaxation of the exchange control provisions regarding loop structures. Finally, from 1 January 2021, the exchange control restriction on loop structures was lifted to encourage inward investments into South Africa. [10] This decision by the South African government appears to indicate that instead of trying to combat tax avoidance through exchange controls, the focus will be placed on using anti-tax avoidance legislation. Consequently, lifting restrictions on loop structures necessitated amendments to some provisions in the Income Tax Act in order to guard against tax avoidance.

Most South Africans and foreign investors do not quite understand the operation and implications of exchange controls due to the complexity of these regulations and the perception that it is difficult to move money in and out of South Africa. [11] The purpose of this paper is to provide an analysis of the income tax implications of the provisions that were introduced to address the potential tax avoidance that could arise from lifting the exchange control restriction on loop structures. The analysis will help tax advisers and investors who intend to invest in loop structures to understand the tax and exchange control considerations that will apply to their investments. Since the removal of the exchange control restriction on loop structures does not apply to existing unauthorised loop structures (those created prior to 1 January 2021), this paper provides a broader understanding of the operation of exchange controls on loop structures. The paper first explains the administration of exchange controls, and how the restrictions of exchange controls on loop structures have been relaxed over the years, and then it explains the 2021 removal of the exchange control restrictions on loop structures as well as the amendments to the Income Tax Act to curtail the risks of tax avoidance.

II The administration of exchange controls

In terms of section 9 of the Currency and Exchanges Act 9 of 1933, the President of the Republic of South Africa is empowered to make regulations that directly or indirectly relate to or affect currency,

banking or exchanges. Exchange control regulations were promulgated by Government Notices R1111 and R1112 of 1 December 1961 and have been amended and updated on several occasions since then. [12] The regulations aim to control capital movements in and out of the Common Monetary Area (CMA) which consists of South Africa, Lesotho, Namibia and Swaziland. [13] There are no exchange control restrictions among the members of the CMA as they form a single exchange control territory and their monetary agreement provides for the free flow of funds and access to capital markets between the countries. However, Lesotho, Namibia and Swaziland have their own exchange control authorities as well as their own regulations and rulings. But in terms of the CMA Agreement, the application of their regulations and rulings must at least be as strict as those of South Africa. [14]

In South Africa, the main purposes of exchange controls are twofold. First, they seek to ensure the timeous repatriation into the South African banking system of certain foreign currency acquired by residents of South Africa, whether through transactions of a current or of a

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capital nature. Secondly, they seek to prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa. [15] The exchange control regulations are administered by the Minister of Finance in terms of regulation 22E, who delegates his powers, functions and obligations to the South African Reserve Bank ('the SARB') in the Financial Surveillance Department. [16] However, certain powers, functions and duties have been assigned to and imposed by National Treasury which in turn, has the power to appoint as 'authorised dealers' certain banks (such as selected commercial and merchant banks) to administer certain categories of transactions on its behalf. [17] All applications to the SARB must be made through an authorised dealer. However, applications for the approval of certain transactions have to be made to the SARB and not to the

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authorised dealers. [18] For example, applications for the relaxation of any restrictions or requests require special consideration in terms of the wide discretion given to the Exchange Control in the regulations. [19] Each case is considered on its own merits. Where an application is unsuccessful, the Exchange Control is obliged to give reasons in terms of section 33 of the Constitution and section 5 of the Promotion of Administrative Justice Act 3 of 2002. Authorised dealers are not permitted to enter into foreign currency transactions with customers of banks in other CMA countries. If such applications are received, customers are referred back to their banks in the CMA country concerned. [20]

An Exchange Control Manual [21] was issued in 2005 and was effective until 1 August 2016. It has been used to guide authorised dealers, their clients, and other interested parties on the operation of the exchange control system in the Republic of South Africa and the CMA. The Manual itself however has no special legal status. [22] However, in 2016 the SARB streamlined the Exchange Control Manual [23] and replaced it with the 'Currency and Exchanges Manual for Authorised Dealers' and the 'Currency and Exchanges Manual for Authorised Dealers in Foreign Exchange with Limited Authority', which came into effect on 1 August 2016. [24] The 'Currency and Exchanges Manual for Authorised Dealers' ('Manual for Authorised Dealers'), which is focused on in this paper, contains the permissions and conditions applicable to transactions in foreign exchange that may be undertaken by authorised dealers and/or on behalf of their clients, which are regularly updated. [25] Exchange control circulars issued by the Financial Surveillance Department to authorised dealers, set out the conditions, permissions and limitations that apply to foreign exchange transactions undertaken by authorised dealers and their administrative responsibilities. [26]

In terms of exchange control regulation 2, the general policy approach to exchange controls is that except with permission granted by the Treasury, and in accordance with such conditions as the Treasury may impose, no person other than an authorised dealer shall buy or borrow any foreign currency or any gold from or sell or lend any foreign currency or any gold to any person who is not an authorised dealer. Moreover, an authorised dealer shall not buy, borrow or receive or sell, lend or deliver any foreign currency or gold except for such purposes or on such conditions as the Treasury may determine. From the above, it is clear that the legal framework of exchange controls is one of total prohibition on dealing in foreign exchange except with the permission of and on the conditions set by the Treasury. In *S v Immelman*, [27] the court made it clear that contravention of the regulations is a serious offence since it prejudices the economic interest of the state and the general body of its citizens. The economic policy underlying exchange control is, however, not totally prohibitive, since such an approach would not be conducive to international trade and investment. [28]

In terms of regulation 2, the exchange control regulations apply to a 'person'. However, there is no definition of 'person' in the Currency and Exchanges Act or in the regulations. Section 1 of the exchange control regulations defines an 'affected person' to mean:

> 'a body corporate, foundation, trust or partnership operating in the Republic, or an estate, in respect of which (i) 75 per cent or more of the capital, assets or earnings thereof may be utilised for payment to, or to the benefit in any manner of, any person who is not resident in the Republic; or (ii) 75 per cent or more of the voting securities, voting power, power of control, capital, assets or earnings thereof, are directly or indirectly vested in, or controlled by or on behalf of, any person who is not resident in the Republic.' [29]

According to the Currency and Exchanges Manual for Authorised Dealers, the term 'person' refers to a natural person or legal entity. [30] Some of the exchange control regulations refer to a 'person resident in the Republic', while some regulations refer to a person who is 'resident outside the Republic'. It should be noted that the definition of the term 'resident' in the Income Tax Act [31] is not necessarily the same for

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exchange control purposes. The term 'resident' is not defined in the Currency and Exchanges Act or the Exchange Control Regulations. However, the Currency and Exchanges Manual for Authorised Dealers defines a resident as 'any person (ie a natural person or legal entity) who has taken up permanent residence, is domiciled or registered in South Africa. For the purpose of the Authorised Dealer Manual, this excludes any approved offshore investments held by South African residents outside the CMA. However, such entities are still subject to exchange control rules and the Regulations.' [32] A 'South African resident is in turn defined as a person, whether of South African or any other nationality, who has taken up residence or is domiciled or registered in the Republic.' [33] Note that for income tax purposes, a natural person is considered resident in the Republic if they are an ordinary resident or physically present in the Republic, while a person other than a natural person (eg a company or a trust) is resident in South Africa if it is incorporated, established or formed in South Africa, or if it has its place of effective management in South Africa. [34]

III Gradual relaxation of exchange controls

Over the past 22 years, there has been ongoing liberalisation of exchange controls, whereby South Africans are afforded the opportunity to invest outside of the country's borders. Cross-border investment can take the form of establishing branches and offices, as well as acquiring equity stakes in new or existing foreign enterprises. [35] The liberalised exchange control regime has seen the establishment of a Bond Exchange and a South African Futures Exchange along with foreign ownership of stockbrokers, which enables South Africans to freely participate in global financial markets and opportunities. [36]

In terms of the Currency and Exchanges Manual for Authorised Dealers, South African private individuals who are exchange control residents (in terms of the SARB policy), which differs from tax residency as explained above, are permitted to invest up to R10 million per calendar year outside of South Africa provided that they are taxpayers in

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good standing, they hold a South African identity document and are at least 18 years old. [37] South African private companies, public companies and listed companies that wish to make new offshore direct investments outside the CMA may do so without prior approval of the Exchange Control, if the total cost of such new investments does not exceed R1 billion per company per calendar year. [38] To qualify as a foreign direct investment, the rules previously provided that a South African company must obtain a minimum of at least 10 per cent of the voting rights in the foreign offshore entity. Authorised dealers have the responsibility of ensuring that the foreign investment is undertaken by *bona fide* South African companies for foreign direct investment purposes. All further investments must be reported annually to the Exchange Control, accompanied by audited financial statements of the offshore entity and holding companies. Where the total cost of the foreign direct investments exceeds the R1 billion limit, an application has to be submitted to the Exchange Control before the investment is made. In general, companies wishing to invest outside the CMA should demonstrate a long-term monetary benefit to the Republic, for example, enhanced earnings derived from the export of goods and services. [39]

Capital distributions from local testamentary trusts [40] due to non-residents may be remitted abroad, provided that the trustees' resolution confirms the capital distribution and the last will and testament confirms that the beneficiary is entitled to such capital distribution. [41] This does not apply to *inter vivos* trusts which are created by a contract during a person's lifetime. [42] Although *inter vivos* trusts are normally established for legitimate purposes in estate planning, they operate like a conduit through which assets pass to the beneficiaries during the lifetime and/or after the death of the donor, and they are sometimes used to export capital from the Republic. [43] Consequently, the Exchange Control requires that all requests for the transfer of income and capital distributions to beneficiaries resident outside the CMA must be referred to the Exchange

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Control for consideration. The purpose is first to ensure that a non-resident is entitled to such a distribution, and secondly to

prevent the export of capital disguised as income distributions through the trust. [44]

IV Exchange control regulations and 'loop structures'

Despite the fact that exchange control regulations have been relaxed over the years, regulation 10(1)*(c)* of the exchange control regulations, 1961, provides that 'no person shall, except with permission granted by the Treasury, enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic'. This regulation has been applied to prohibit South African exchange control residents from engaging in 'loop structures'. These structures can broadly be defined as arrangements by which a South African resident individual, trust or company transfers/invests authorised or unauthorised funds from South Africa to an offshore structure (for example, a foreign company or a foreign trust) which, in turn, directly or indirectly invests the funds in South Africa (creating a loop) by, for instance, acquiring shares, loans or some other interest in a South African resident company or a South African asset. [45] The South African resident would thereafter export returns made on the South African investment, for example, through sharing profits, granting loans or paying dividends or interest to the foreign structure. [46] The result of the loop structure is that the investment of funds from the offshore structure into the Republic and the sharing of profits or the payment of dividends and interest offshore result in the accumulation offshore of value over and above the nominal foreign investment that was initially made. [47] Essentially, loop structures have the effect of reducing South Africa's tax base and the taxes that the offshore structure would have to pay in South Africa.

An example of a loop structure that was commonly used is the so-called 74/26 structure which was used as a tax-avoidance scheme by South African residents who used their foreign investment allowance to invest in offshore trusts which, in turn, reinvested funds in South African businesses in which the original investor had a stake. [48] In terms

of this structure, only a 74 per cent interest in the South African company would be taken up, but the balance would be held by the South African settlor of the offshore trust. The reason for the 74 per cent limit was that local borrowing restrictions applied only where the foreign shareholding was 75 per cent and higher (in terms of section 1 of the exchange control regulations as explained above). [49] The South African company would then use the proceeds from the trust (which was originally the foreign investment allowance), together with the local borrowings from the settlor or a bank, to purchase capital assets in South Africa. If those capital assets included shares, dividends would be remitted overseas. [50] On realisation of the capital assets, the company would be liquidated and the capital gain would be remitted to the offshore trust. [51] Investments in such loop structures were popular in the Jersey Islands and many financial institutions in South Africa offered them. [52]

Although regulation 10(1)*(c)* does not specifically refer to the word 'loop structure', the interpretation of the regulation is that it prohibits South African residents from engaging in such structures without exchange control approval. [53] Such loop structures have therefore been considered to be in breach of exchange control regulations and they have always been frowned upon by the SARB. [54] In *Abreu v Campos* [55] the court cited the general rule in regulation 10(1)*(c)* and noted that:

> 'Here the purpose of the legislature is to conserve the country's foreign exchange and, to that end, to prohibit dealings in foreign currency without permission. It cannot have been the intention to allow enforcement of contracts involving dealings in foreign currency without permission for that would encourage the very mischief which the legislature seeks to avoid.'

Although regulation 10(1)*(c)* only refers to the export of capital from the 'Republic', the prohibition against creating loop structures applied to the reinvestment into all countries that form part of the CMA. Since regulation 10(1)*(c)* prohibits South African residents from engaging in

loop structures without exchange control approval, [56] this implies that not all loop structures were unlawful. The Manual for Authorised Dealers sets out some circumstances under which a loop structure may be approved. Section B.2(B)*(l)* of the 2019 version of Manual stated that 'unintentional ''loop structures'' created with authorised foreign capital invested with non-resident asset or fund managers, who invest in foreign companies that have CMA assets/interests and/or offshore global investment funds that directly or indirectly hold CMA investments over which the South African investor has no control, are permitted.' [57] It is important to note though that such approval applied if the South African investor made the investment after legally taking the invested funds abroad. Section B.2(F) of the Manual also states that South African technology, media, telecommunications, exploration and other research and development companies may establish an offshore company to raise foreign funding for their operations, subject to certain conditions. These conditions include registering with the SARB and ensuring that the established offshore company is a tax resident in South Africa. [58] Such companies may hold investments and/or make loans into South Africa, even though the investment or loan would create a loop structure.

In the case of *S v De Castro* [59] it was held that the consequence of entering into unapproved loop structures that created a 'channel' for the future export of capital out of the Republic was that such structures were deemed null and void. However, the Appellate Division in *Barclays National Bank Ltd v Thompson* [60] held that a contravention of the regulations could not result in any agreement being void; rather, it prevents performance in terms of the agreement. The court pointed out that the legislature prescribes criminal sanctions to enforce compliance with the regulations in such cases. Exchange control regulation 22 sets out certain penalties for contravening the regulations. Where a person is convicted of an offence, a maximum fine of R250 000 may be imposed.

A person could also be imprisoned for a period not exceeding five years. In certain cases, both a fine and imprisonment may be imposed. Money or goods relating to the contravention may also be attached or forfeited.

There are, however, some conflicting views about the applicability of regulation 10(1)*(c)* based on the reasoning that a wider interpretation of the prohibition if brought before the courts, based on the rules of interpretation of statutes, would put into question whether some of the prohibited structures are in fact unlawful. [61] The wide interpretation that loop structures are not in contravention of the regulation revolves around the meaning of the words 'capital' and 'indirectly exported' used in regulation 10(1)*(c)*. Since consent is normally granted before the export of capital from South Africa, any dividends that are remitted comprise revenue profits which cannot be regarded as the export of capital. [62] It is further argued that where a South African company is liquidated, any remittable capital gain, even if regarded as the export of capital, is incidental to the arrangement and cannot be considered to be part of the original transaction. [63] However, others argue that the word 'indirect', as used in the regulation, gives a wide meaning and so any remittance of a capital profit, for example, on liquidation of the South African company, is an indirect export of capital and consequently a contravention of the regulation. [64] In that case, it may be argued that a loop structure can only be considered a contravention of regulation 10(1)*(c)* when the capital gain is remitted from South Africa on liquidation of the South African company. However, in practice, it appears that the Exchange Control's approach is that capital does not have to have been exported before regulation 10(1)*(c)* can apply. [65] Indeed, in the case of *S v De Castro*, [66] where the appellant had arranged for money to be exported, the then Appellate Division held that the appellant had contravened regulation 10(1)*(c)* even though he had been arrested before the money could be exported.

With the increased use of loop structures, [67] Exchange Control Circulars D417 and D405 [68] were issued in 2003 to clarify that the Exchange Control regards loop structures as a contravention of regulation 10(1)*(c)*. The Circulars set out certain administrative concessions

that would apply if South African residents unwound these structures in the manner set out in the circulars and the Exchange Control undertook

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not to take further action against such residents provided the unwinding was done on or before 27 February 2004 and certain levies were paid. These concessions were designed to facilitate the application for exchange control amnesty which was set up in terms of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003, which had a deadline of 29 February 2004. However, Exchange Control Circulars D405 and D417 seemed to have been dealt a blow by the 2004 decision of the court in *Pratt v FirstRand Bank and another*, [69] which seemed to condone the legality of loop structures. The facts were that Ann Pratt controlled the offshore trust (the Fast Track Trust) which acquired 70 per cent of the shares in her South African company (Ann Pratt & Associates). On 8 May 2000, the Fast Track Trust purchased 700 ordinary shares in Ann Pratt & Associates. In December 2001, Ann Pratt borrowed R25 million from FirstRand Bank to capitalise a close corporation (Classy Living CC) which purchased the shares from the Fast Track Trust. The issue was whether the arrangements contravened Exchange Control Regulation 10(1)*(c)*. After a detailed analysis of the Exchange Control Regulations and Rulings that relate to the transfer of shares to non-residents (regulations 3(1)*(e)* and 10(1)*(c)*), the court ruled that transactions in contravention of these regulations were null and void. It, however, found that Exchange Control approval had been granted for the respective transactions since the shares in question had been 'endorsed' by the Authorised Dealer Bank. The court concluded that the endorsement of a share certificate by an Authorised Dealer Bank, following the required procedures (inter alia, ensuring that the market value had been confirmed by an independent valuation), was evidence of compliance with the Exchange Control Regulations. The court ruled that the transference of the purchase price to the non-resident was an authorised export of capital. Although some commentators were of the view that the case was wrongly decided in that the bank's confirmation cannot legalise an otherwise illegal act, [70] the decision was regarded as authority for the establishment of a valid loop structure and it called into question the validity of Exchange Control

Circulars D405 and D417, which indicated that such transactions contravened Exchange Control Regulation 10(1)*(c)*. [71]

V Relaxation of exchange control regulations on loop structures

However, over the last decade, the country saw increasing relaxations of exchange controls with regard to loop structures. Following the Minister of Finance's Medium-Term Budget Policy Statement on 25 October 2011, Exchange Control Circular 19/2011 was issued which relaxed the restrictions on corporate 'loop structures'. Previously the Exchange Control Manual permitted South African companies to make offshore direct investments outside the CMA that did not exceed the prescribed limits in a calendar year, without prior approval of the Exchange Control, on the condition that South African companies investing in a foreign corporate entity acquired a minimum of 10 per cent of the equity/voting rights in the entity concerned, including any investment in a foreign entity which in turn holds South African investments (a loop structure). Exchange Control Circular 19/2011 permitted a South African company to acquire from 10 per cent to 20 per cent equity and/or voting rights (whichever is higher) in a foreign target company which holds investments and/or makes loans into any CMA investment. South African companies could thus make *bona fide* new outward foreign direct investments outside their current line of business, thereby enabling South African companies to diversify their offshore operations from a domestic base. This Exchange Control Circular did not apply to investments where the South African company held an equity interest and/or voting rights in excess of 20 per cent in the foreign corporate, and loop investments by South African individuals remained wholly prohibited. Passive investments were also not permitted in terms of this Circular. [72]

On 13 July 2016, the South African Reserve Bank issued Exchange Control Circular 6/2016 as part of the joint tax and exchange control Special Voluntary Disclosure Programme (SVDP), which the Minister of Finance announced in the 2016 budget speech. The SVDP, which ran for six months (from 1 October 2016 to 31 March 2017), afforded South African residents and former residents the opportunity to disclose their

foreign assets that were held in contravention of the Exchange Control Regulations, 1961, in order to regularise their affairs from an exchange control perspective. [73] On 17 November 2016, the SARB issued a policy document entitled 'Exchange Control Special Voluntary Disclosure Programme Policy dealing with ''loop structures'' (including 74/26 structures)' which set out its policy regarding the regularisation of loop structures in terms of the exchange control special voluntary disclosure programme.

In 2018, exchange control provisions were further relaxed in terms of Exchange Control Circular 5/2018 with regard to loop structures set up by companies into the CMA. The permission granted to South African companies to use their foreign investment allowance to invest in a loop structure if they acquired a minimum of 20 per cent of the equity/voting rights in the foreign entity was increased to a maximum of 40 per cent for *bona fide* investment purposes. South African resident companies were allowed to use their foreign investment allowance to invest in up to 40 per cent of shares (equity) and/or voting rights, whichever is higher in a foreign company that invested back into South Africa and/or made loans into the CMA. Loop structures where the 40 per cent shareholding was exceeded require approval from the Financial Surveillance Department of the SARB with due consideration to transparency, tax, equivalent audit standards and governance. [74]

In 2019, exchange control provisions were further relaxed in terms of Exchange Control Circular 18/2019, for loop structures formed by private individuals after 30 October 2019. [75] Previously, section B.2(B)*(i)* of the 2018 version of the Manual for Authorised Dealers provided that private individuals may not utilise funds or any other authorised foreign assets to enter into a transaction or a series of transactions, directly or indirectly through any structure or scheme of arrangement, to acquire shares or any other assets/interests in a CMA country (loop structures). However, in terms of the circular, section B.2(B)*(j)* was added to the 2019 version of the Manual for Authorised Dealers to provide that 'as an exception to the above, private individuals are permitted individually or collectively to acquire up to 40 per cent equity and/or voting rights, whichever is the higher, in a foreign target entity, which may in turn hold

investments and/or make loans into any CMA country'. The section clarified that the dispensation would only apply in respect of loop structures formed after 30 October 2019. Existing loop structures (created by individuals prior to 30 October 2019) and/or loop structures where the 40 per cent shareholding was exceeded still had to be regularised with the Financial Surveillance Department. [76] This relaxation did not permit offshore trusts with South African beneficiaries to invest into South Africa. [77]

VI Lifting the exchange control restrictions

In the October 2020 Medium Term Budget Policy Statement, the Minister of Finance stated: 'Work is well advanced to modernise the cross-border flows management regime to support South Africa's growth as an investment and financial hub for Africa.' [78] National Treasury stated in the 2020 Explanatory Note on Medium Term Budget Speech: 'The full ''loop structure'' restriction has been lifted to encourage inward investments into South Africa, subject to reporting to Financial Surveillance Department of the SARB as and when the transaction is finalised.' [79]

On 4 January 2021, the SARB issued Exchange Control Circular 1/2021, which stated that 'in order to support South Africa's growth as an investment and financial hub for Africa, it is advised that the full ''loop structure'' restriction has been lifted to encourage inward investments into South Africa; subject to the normal criteria applying to inward investments into South Africa and the reporting to the Financial Surveillance Department.' [80] Exchange Control Circular 1/2021 noted that the above reforms would be effective from 1 January 2021 and they apply to private individuals and companies, including private equity funds that are tax resident in South Africa. [81] In terms of the reforms, section B.2(B) of the Manual for Authorised Dealers (dealing with capital transfers of private individuals resident in South Africa),

section B.2(C) (dealing with capital transfers of South African companies), and section B.2(G) (dealing with capital transfers by South African private equity funds), which previously placed restrictions on loop structures, were amended. [82] These provisions now provide that private individuals resident in South Africa, South African companies and South African private equity funds with authorised foreign assets may invest in South Africa, provided that where South African assets are acquired through an offshore structure (loop structure), the investment is reported

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to an authorised dealer as and when the transaction is finalised. [83] They are however expected to submit an annual progress report to the Financial Surveillance Department via an authorised dealer. An independent auditor's written confirmation or suitable documentary evidence is also supposed to be submitted and reviewed by the authorised dealer, to verify that transactions are concluded on an arm's length basis, for a fair and market-related price. [84] Upon completion of the transaction, the authorised dealer must submit a report to the SARS' Financial Surveillance Department which should, inter alia, 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. [85]

Exchange Control Circular 1/2021 also provides that all inward loans (to private individuals resident in South Africa, South African companies and South African private equity funds) from South African affiliated foreign investors must comply with the directives issued in section I.3(B) of the Manual for Authorised Dealers, subject to some changes the Circular effected on this section. [86]

- Previously, section 1.3(B)*(iii)(a)(mm)* of the Manual for Authorised Dealers provided that authorised dealers may approve applications by residents to avail inward foreign loans and foreign trade finance

facilities from any non-resident, provided that the applicant confirmed that there was no direct/indirect South African interest in the foreign lender. [87] However, Exchange Control Circular 1/2021 deleted section I.3(B)*(iii)(a)(mm),* which implies that inward foreign loans received from foreign lenders are no longer subject to the restriction that there may not be any direct/indirect South African interest in the foreign lender.
- Previously, section I.3(B)*(iv)(a)(ee)* of the Manual for Authorised Dealers provided that when adjudicating applications for inward foreign loans and foreign trade finance, authorised dealers must ensure that the 'loan funds to be introduced may not represent or be sourced from a South African resident's foreign capital allowance, legitimate foreign assets, legitimate foreign earnings retained abroad, funds for which amnesty had been granted in terms of the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003 (Act No. 12 of 2003) and/or foreign inheritances.' [88] In terms of Exchange Control Circular 1/2021, this provision has been deleted.
- Previously, section I.3(B)*(iv)(a)(ff)* of the Currency and Exchanges Manual for Authorised Dealers provided that when adjudicating applications for inward foreign loans and foreign trade finance, authorised dealers must ensure that 'there may not be any direct/indirect South African interest whatsoever in the foreign lender.' [89] In terms of Exchange Control Circular 1/2021, this provision has been deleted.

Exchange Control Circular 1/2021 also indicates loop structures that were unauthorised prior to 1 January 2021 where the 40 per cent shareholding threshold was exceeded will not be automatically regularised as a result of the changes. These structures must still be regularised with the SARB. [90] In addition, where assets are contributed by a South African corporate to an offshore structure, the SARB's approval will still be required as this would constitute an externalisation of South African assets. [91] This aspect is of particular relevance to the private equity industry where 'dual structures' have become the industry norm to comply with the historic loop structure prohibitions. [92]

Exchange Control Circular 1/2021 also amended section B.17(D) of the Manual for Authorised Dealers, which deals with 'Foreign inheritance and legacies from South African estates with foreign assets'. [93] Previously:

- Section B.17(D)*(ii)* provided that foreign assets inherited by South Africans may, on application to the SARB, be retained aboard provided that the assets were held abroad by the deceased in compliance with the Regulations (in that they were externalised legally by the deceased and no loop structure was created). [94]
- Section B.17(D)*(iii)* provided that approval to retain such foreign assets abroad would be granted subject to the condition that the foreign assets may not be placed at the disposal of other residents or used to create loop structures. [95]
- Section B.17(D)*(iv)* provided that where it was disclosed to the SARB that the foreign assets inherited were held by the deceased in a manner contrary to the Regulations, including 'loop structures', an application for the regularisation of such assets had to be submitted via an authorised dealer and, if approved, those assets could be retained abroad on condition that the assets would not be placed at the disposal of other residents or used to create 'loop structures'. [96]
- Section B.17(D)*(v)* provided that foreign assets inherited that were held abroad by the resident beneficiary, which were not in compliance with the provisions of the regulations (the resident beneficiary created a loop structure after receiving the inheritance from the deceased's estate) must apply for regularisation via an authorised dealer to the Reserve Bank. [97]

Exchange Control Circular 1/2021 amended the above provisions by removing the condition that approval to retain the assets offshore would be subject to the condition that the assets may not be used to invest in a loop structure. The 2021 Manual for Authorised Dealers deleted the previous section B.17(D)*(v)* and amended section B.17(D)*(ii), (iii)* and *(iv)* as follows:

- The foreign assets inherited may, on application, to the Financial Surveillance Department normally be retained abroad provided that

the assets were held abroad by the deceased in compliance with the provisions of the regulations. [98] The approval of the Reserve Bank to retain such foreign assets abroad will be granted subject to the condition that the foreign assets may not be placed at the disposal of other residents. [99]
- Where it is disclosed to the Reserve Bank that the foreign assets inherited were held by the deceased in a manner contrary to the provisions of the Regulations, an application for regularisation of such assets must be submitted via an authorised dealer to the Reserve Bank. If approved, the retention of such assets abroad is subject to the conditions that the assets will not be placed at the disposal of other residents. [100]

VII Income tax implications of lifting exchange control on loop structures

The end of the exchange control restrictions on loop structures does not imply that South African residents can increase offshore planning opportunities since there is now investment flexibility.

The 2020 Budget Review stated that the relaxation of exchange control rules in respect of loop structures would take effect after tax amendments to address the effect of reducing South Africa's tax base by an offshore company in a loop structure are implemented. [101] This was followed by the release of the Taxation Laws Amendment Bill, 2020, which proposed amendments to the Income Tax Act, to address potential tax leakage arising as a result of the relaxation. The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' indicated that the government proposed to review the exchange control rules and move towards a new capital flow management framework. The proposed aim of this move is to: promote investment; reduce unnecessary, burdensome approvals by SARB; and provide a modern, transparent and risk-based approval framework for cross-border flows. One of the changes to the current exchange control rules envisaged above is the 'relaxation of the approval that is required for loop

structures where the 40 per cent shareholding is exceeded'. [102] The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' further stated that although the Income Tax Act contains some rules that may reduce the revenue risk of loop structures, increased tax planning opportunities may arise as a result of the relaxation of the exchange control approval for loop structures where the 40 per cent shareholding is exceeded. Furthermore, these tax planning opportunities may arise from the current participation exemptions available for foreign dividends and capital gains derived from the disposal of shares in foreign companies to non-residents. [103] Thus, on 20 January 2021, the Taxation Laws Amendment Act, 2020 was promulgated, which effected the following amendments to the Income Tax Act to reduce the above-

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mentioned tax planning opportunities.

(a) Tax amendments to address the impact of the relaxation of exchange control on loop structures on CFCs and foreign dividends exemptions

The effectiveness of Controlled Foreign Company (CFC) rules would be potentially impacted by the lifting of the exchange control restrictions on loop structures. To understand how this could happen, it is important to briefly explain how CFC rules operate. When South African residents invest in foreign companies, South Africa cannot levy tax on those foreign companies since they are separate legal entities in the countries in which they are based. [104] The income that accrues to South African residents would only be taxed in South Africa when it is distributed as dividends. If dividends are not distributed, taxation of that income can be deferred indefinitely and the income reinvested offshore. [105] CFC rules are anti-avoidance rules that prevent tax deferral by ensuring that South African shareholders of foreign companies are taxed on the income earned by those foreign companies, as if it had been repatriated as soon as it was earned. [106] In terms of section 9D(1) of the Act, a CFC is defined, inter alia, to mean any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign

company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies. The term 'participation rights' as used in the section refers to the right to participate in the share capital, share premium, current or accumulated profits or reserves of the foreign company. Voting rights, as referred to in the section, will only be taken into account where a company has no shares and has only voting rights. [107] The definition of a CFC excludes residents who are connected persons who, in aggregate, hold more than 50 per cent of the participation rights or voting rights in a foreign listed company or a foreign collective investment scheme or arrangement, but individually hold less than 5 per cent of the participation rights or voting rights in the listed company or 'foreign collective investment scheme'. In terms of section 9D(2A), the net income of the CFC is attributed to the affected South African resident and taxed on a current basis. 'Net income' is defined in section 9D(2A) in relation to a CFC to mean an amount equal to the taxable income of the company, determined in accordance with the provisions of the South African Act as if the company had been a South African resident taxpayer. Thus, the definition of 'gross income' in section 1 of the Income Tax Act would require the CFC to include its worldwide receipts and accruals in its gross income.

A loop structure would be created when a South African resident individual invests cash and acquires shares in a CFC that then acquires shares in a resident company. Before the 2021 amendments to the Act, the application of the CFC's rules would require that the dividends received by the CFC would be included in the gross income of South African shareholders. Paragraph *(k)* of the definition of 'gross income' includes 'any amount received or accrued by way of a dividend or a foreign dividend'. However, certain exemptions to the taxation of dividends could apply and could potentially create tax planning opportunities. Section 10(1)*(k)(i)* exempts from tax dividends (other than dividends paid or declared by a headquarter company) which are received by or accrued to any person. In addition, although foreign dividends from non-resident companies must be included in a person's gross income, they may be exempt from normal tax in terms of the participation exemption in section 10B(2)*(a)*, 'if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the total

equity shares and voting rights in the company declaring the foreign dividend'. From the above, it is clear that the lifting of the exchange control restrictions on loop structures could create tax planning opportunities, as the dividends would not be included in the net income of the CFC. [108]

It should be noted that sections 64D to 64N of the Income Tax Act also levy a dividend withholding tax at a rate of 20 per cent on shareholders in respect of dividends paid by any company (other than a headquarter company). The dividends tax is payable by South African resident companies or by non-resident companies listed on a South African exchange. Section 64K provides that the beneficial owner is liable for the dividends tax but the tax must be withheld by the company declaring the dividend and the company must pay it over to SARS (unless a reduced rate in a relevant double taxation treaty applies). [109] However, section 64F1*(a)* provides an exemption from the dividends tax (if it does not comprise a distribution of an asset *in specie)* if the beneficial owner is a company which is a resident. In effect, dividends generally qualify for exemption from inclusion in the net income of the CFC to the extent to which the dividend was subject to South African dividends tax. Due to the above exemptions, the 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' stated that the existence of a non-resident company (CFC) in the loop structure may provide tax planning opportunities for South African individuals with respect to dividends tax as the dividend flowing through the structure may not be taxed at the current dividends tax rate of 20 per cent, but at a reduced rate or in some instances at a zero rate depending on the relevant double taxation treaties. [110]

The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' noted that it was therefore necessary to make changes in the CFC legislation so that a non-resident company that is a CFC includes a portion of a dividend that is received or accrued from a resident company in net income. [111] To determine the portion of a dividend that is not exempt, it was proposed that the non-resident CFC include in its net income an amount equal to the ratio of the number 20 to 28 of the

dividend that is received or accrued from a resident company. The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' explained 'This aggregate of dividends received or accrued to the CFC in a loop structure will be reduced by 100 per cent of dividends where dividends tax has been paid at 20 per cent; 50 per cent of dividends where dividends tax has been paid at 10 per cent; 40 per cent of dividends where dividends tax has been paid at per cent; 37.5 per cent of dividends where dividends tax has been paid at 7.5 per cent or 25 per cent of dividends where dividends tax has been paid at 5 per cent.' [112]

With effect from 1 January 2021, section 9D(2A)*(d)* was added to the Income Tax Act, to provide that in determining the net income of a CFC:

> 'any exemption from normal tax in respect of dividends received or accrued as contemplated in section 10(1)(*k*) must not apply in respect of the portion of an amount of the aggregate amount of dividends received by or accrued to a controlled foreign company during any foreign tax year, determined in accordance with the formula: $A = B \times (C - D)$, in which formula:
>
> (i) "A" represents the amount to be determined;
>
> (ii) "B" represents the ratio of the number 20 to the number 28;
>
> (iii) "C" represents the aggregate of dividends received by or accrued to the controlled foreign company during the foreign tax year of that controlled foreign company; and
>
> (iv) "D" represents an amount equal to the amount deducted in respect of any dividend paid by that controlled foreign company for the purposes of the dividends tax contemplated in Part VIII of this chapter, which amount constitutes:
>
> *(aa)* 100 per cent of the amount of any dividend in respect of which dividends tax was paid at a rate of 20 per cent;
>
> *(bb)* 50 per cent of the amount of any dividend in respect of which dividends tax was paid at a rate of 10 per cent;
>
> *(cc)* 40 per cent of the amount of any dividend in respect of which dividends tax was paid at a rate of 8 per cent;
>
> *(dd)* 37.5 per cent of the amount of any dividend in respect of which dividends tax was paid at a rate of 7.5 per cent; or
>
> *(ee)* 25 per cent of the amount of any dividend in respect of which dividends tax was paid at a rate of 5 per cent.' [113]

In summary, section 9D(2A)*(d)* provides that in determining the net

income of a CFC, the exemption from normal tax in respect of dividends in terms of section 10(1)*(k)* no longer applies. The dividends will be

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included in the net income of the CFC to the extent that such dividend has not been subject to dividends tax at the full dividends tax rate of 20 per cent. The quantum of the dividend to be included in the net income of the CFC would be based on a formula. The portion 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. [114] The amendment ensures that, taking into account any dividends tax suffered upon the distribution of such a dividend by the South African company, the dividend is effectively taxed at 20 per cent where the foreign target company constitutes a CFC.

The amendment does not have an impact on loop structures which were permitted in terms of previous restrictions whereby African resident companies were allowed to use their foreign investment allowance to invest in up to 40 per cent of share or voting rights in a foreign company that invested back into South Africa. This is because South African residents that collectively hold 40 per cent of shares or voting rights in the foreign company would not constitute a CFC as defined in section 9D. [115]

(b) Tax amendments to address the impact of the relaxation of exchange control on loop structures on the disposal of shares in a CFC

Section 26A of the Income Tax Act and the Eighth Schedule to the Act provide that a taxable capital gain must be included in a taxpayer's taxable income. In terms of paragraph 3 of the Eighth Schedule, capital gains tax is payable upon the disposal of the asset during the year of assessment. With regards to the disposal of shares in a CFC, paragraph 64B of the Eighth Schedule (which sets out a participation exemption) provides that a person other than a headquarter company must disregard any capital gain or capital loss determined in respect of the disposal of any equity share in any foreign company, if that person (whether alone or together with any other person forming part of the same group

of companies as that person) immediately before that disposal held an interest of at least 10 per cent of the equity shares and voting rights in that foreign company, and held the interest for a period of at least 18 months prior to that disposal. Effectively, gains on the disposal of shares in a non-resident company to a non-resident are not taxed because of the participation exemption in paragraph 64B of the Eighth Schedule, which creates tax planning opportunities. [116] The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' proposed that the participation exemption should not apply to the disposal of shares in a CFC to the extent that the value of the assets of the CFC is derived from South African assets. [117] Consequently, with effect from 1 January 2021, paragraph 64B(6) was added to the Eight Schedule to provide that paragraph 64B 'must not apply in respect of any capital gain or capital loss determined in respect of the disposal of any share in a controlled foreign company to the extent that the value of the assets of that controlled foreign company is attributable to assets directly or indirectly located, issued or registered in the Republic'. [118] This amendment is only applicable where the shares in a CFC are disposed of, and should not have an impact on current loop structures established within the parameters of the current policy. [119] National Treasury is of the view that this amendment will create equal tax treatment for residents holding South African assets directly versus South African assets held indirectly via a CFC. [120]

The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' also notes that certain provisos to determining the net income of a CFC may pose tax planning opportunities when determining the capital gain for a natural person, special trust or insurer in terms of paragraph 10. This is particularly so with the 'look-through' provision in section 9D(2A)*(f)*, which stated (before the 2021 amendments) that 'where the resident is a natural person, special trust or an insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC shall, for the purposes of paragraph 10 of the Eighth Schedule, be 40 per cent of that company's net capital gain for the relevant foreign tax

year.' [121] To prevent tax planning opportunities, the 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' proposed that the 'look-through' rule for capital gains in section 9D(2A)*(f)* of the Income Tax Act be removed for natural persons and special trusts, because the attribution of an amount of net income of a CFC to residents does not retain the character or nature of the underlying elements of net income for the residents. However, section 9D(2A)*(f)* would be retained only for long-term insurers to cater for the impact on the individual policyholder fund as a higher effective tax rate on the gains of CFCs may have an adverse impact on savings by South African individual policyholders. [122] With effect from 1 January 2021, section 9D(2A)*(f)* was amended to provide that in determining the 'net income of a CFC where the resident is an insurer in respect of its individual policyholder fund, the taxable capital gain of the controlled foreign company shall, for the purposes of paragraph 10 of the Eighth Schedule, be 40 per cent of that company's net capital gain for the relevant foreign tax year'. [123]

VIII Whether the relaxation of exchange controls on loop structures applies to offshore trusts

Over the years of the continued relaxation of exchange controls, there has been uncertainty as to whether the relaxations applied to trusts. Some commentators argue that since Exchange Control Circular 1/2021 permits investments in South Africa through 'offshore structures', the phrase 'offshore structure' could be interpreted to indicate that an offshore trust investing back into South Africa, either directly or indirectly through an offshore company, is no longer prohibited, as long as the transaction is reported. [124] However, the Exchange Control Circular 1/2021 makes it categorically clear that the lift on exchange control restrictions on loop structures applies to private individuals, companies and private equity funds that are tax residents in South Africa, subject to reporting of the transactions through an authorised dealer. [125] The 'Explanatory Memorandum on the Taxation Laws

Amendment Bill, 2020' stated that amendments would be effected to the Income Tax Act to address tax planning opportunities that may arise from the participation exemption available for foreign dividends and capital gains derived from the disposal of shares in foreign companies to non-residents. [126] There have been no amendments to the Income Tax Act regarding South African resident individuals investing cash in a non-resident trust that is part of the loop structure. The 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020' notes that where a South African resident individual invests cash in a non-resident trust that is part of the loop structure, the following tax rules would apply:

- Section 25B(2A) and (2B) of the Act which taxes a resident beneficiary on vesting of the capital of the trust in the resident. [127] Section 25B(2A) provides that where during any year of assessment, any resident acquires any vested right to an amount that represents the capital of a non-resident trust, that amount must be included in the income of that resident, if that capital arose from any receipt and accruals of that non-resident trust which would have constituted income if that trust had been a resident, in any previous year of assessment during which that resident had a contingent right to that income, as long as that amount has not been subject to tax in the Republic.
- Under paragraph 80 of the Eighth Schedule to the Income Tax Act, when a non-resident trust vests an asset or an amount derived from a gain in a resident beneficiary, a capital gain that would have been determined had the trust been a resident is taken into account in the tax calculation of that resident. [128] If there is any donation, settlement or other disposition by a resident to an entity in a loop structure resulting in amounts accruing to that entity that would have been income if that entity had been a resident, the application of section 7(8) of the Act would ensure that the resident is taxed on that income. [129] Section 7(8) states that where by reason of or in consequence of any donation, settlement or other disposition made by any resident, an amount is received by or

accrued to a non-resident (other than a CFC), which would have constituted income had that person been a resident, that amount shall be included in the income of such resident.

The above shows that trusts will continue to be prohibited from establishing 'loop structures'. [130]

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IX Conclusion

Exchange controls have historically been instrumental in complementing anti-avoidance provisions, by, for example, ensuring that 'loop structures' are not used to transfer capital out of South Africa. For decades, the SARB prohibited loop structures to protect the tax base. [131] With the 2021 lifting of the exchange control restrictions on loop structures, it appears that the South African government has taken the decision to stop trying to combat tax avoidance through the use of exchange controls rather than tax avoidance legislation. Indeed, some have argued that the prohibition on loop structures so as to protect the tax base was no longer necessary, as an investment into a CMA country is simply a foreign investment for tax purposes, which is no different from any other investment. It is a requirement that investments into South Africa via an offshore structure have to be reported to the SARB and the information has to be shared with SARS.

Whilst the removal of the prohibition on loop structures is a progressive development and a step in the right direction, it should be noted that the lift on the exchange control restrictions on loop structures does not apply to existing unauthorised loop structures created by private individuals, companies and private equity funds prior to 1 January 2021 and/or unauthorised loop structures where the 40 per cent shareholding threshold was exceeded. [132] These structures must still be regularised with the SARB. Even though the prohibition on loop structures has been lifted, South African residents will still be required to verify that the transactions are entered into on an arm's length basis and for market value consideration. It will be interesting to see how this will be implemented in practice.

With the lifting of the exchange control restrictions on loop structures, amendments have been effected to the Income Tax Act to limit any tax leakage resulting from the lifting of the restrictions on loop structures. It is important for investors to consider the implications of the tax amendments. [133] Unlike the exchange control restrictions which were prohibitive, the tax amendments may pose negative tax consequences for South African tax residents that hold existing loop structures or for those who are considering implementing new loop structures. [134] This article has explained the tax and exchange control considerations that investors should bear in mind if they intend to invest in loop structures.

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