Taxation implications arising from South African residents investing abroad

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As the candidate's supervisor, I have approved this dissertation for submission.

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Abstract

South African investors who have invested or plan to invest their funds offshore have to comply with various legislations, more particularly, the Income Tax Act and the Exchange Control Act.

The change-over process from a source basis to a world-wide basis has left many resident investors confused. The need for clarity is exacerbated by the amnesty granted to residents of South Africa, in terms of exchange control and income tax contraventions relating to offshore assets. Resident investors put together complex structures using trusts and companies to 'conceal' their assets. This amnesty provided investors with an opportunity to declare their investments and to legalise their foreign investment tax affairs without the fear of criminal prosecution.

The practical application of the various tax provisions is complex and the consequences of non-compliance are severe. Many resident investors are unaware that they could apply to them.

There are two crucial questions that are the cornerstone of this study and they have a significant impact on the future planning opportunities that may exist:

- First, is the use of an offshore trust or foreign company beneficial?
- Secondly, what is the most tax-efficient offshore investment vehicle?

The aim of this dissertation is to investigate and identify the various forms of tax legislation as it relates to these foreign structures and investment vehicles, and then to provide a focused analysis of the relevant legislation.

A case study is provided to facilitate the understanding and research of this topic.

Declaration

I, Linda Ann Stonier, certify that the whole dissertation, unless specifically indicated to the contrary in the text, is my own work. It is submitted as the dissertation component in partial fulfilment of the requirements for the degree of Masters of Law in the Faculty of Law, KwaZulu-Natal.

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Chapter 1

INTRODUCTION

The amnesty granted to residents of South Africa, in terms of exchange control and income tax contraventions relating to offshore assets, resulted in a need for more knowledge on the tax implications of offshore assets, more particularly offshore investments. In many instances pre-amnesty, funds were taken abroad illegally, never declared and accordingly, tax planning in this regard was meaningless. Over 43 000 applications for amnesty were submitted. Investors are now paying much closer attention to the tax implications of their investments offshore. It is therefore imperative that financial advisers, lawyers, accountants, tax advisers and most importantly, the investors themselves, understand how the various offshore investments are taxed. They also need to know which of the various investment vehicles are the most tax efficient.

The importance of acquiring this knowledge is further amplified by the fact that from March 2006, the exchange control investment allowance was increased from R750 000 to R2 000 000.[1]

Investors have over the years, put together complex and elaborate structures using companies and trusts in an attempt to 'hide' their assets. In light of the fact that some of these South African residents applied for amnesty, a need exits for clarity on the future taxation of the assets held in these structures.

This dissertation provides guidance as to the suitability of using offshore trusts and companies for investment-planning.

The specific aim of this dissertation is to examine the current tax legislation as it relates to these foreign structures in an attempt to ascertain whether planning

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[1] Old Mutual *Premiums and Problems* 93 ed (2006) in F3.

techniques still exist. It aims to guide investors, already invested in existing structures, in their decision as to whether to dissolve these structures and rearrange their affairs in their individual capacities.

In addition this research aims, to not only provide a discussion on the taxation of the underlying assets held individually or in these structures, but also to provide a practical opinion on the most suitable investment vehicle from a tax perspective in light of recent developments.

A further aim of this dissertation is to briefly compare the various investment options or vehicles to determine which is the most tax efficient in terms of the overall objective of the dissertation.

It is submitted that an effective way to understand and examine the issues at hand is through a case study. This dissertation therefore centres its discussion around the issues raised in the following case study. It would be prudent to begin this investigation with

- an understanding of investment-planning,
- the basic building blocks making up an investment,
- the types of income generated by various asset classes, and
- the definition of an investment 'vehicle'.

Thereafter, this research establishes who is regarded as a South African resident.

Having established that a natural person, company or trust is a resident in South Africa, the next question to determine is the type of income subject to tax. In this regard s 1, s 7(8), s 7(9), 7(10), s 25B, s 31, s 9D, s 10(1)(*k*), s 6*quat* and s 25B of the Income Tax Act (the Act) are relevant.

Income tax is not the only tax that affects offshore assets. To make a finding on the most tax-efficient investment vehicle, a detailed study includes capital gains tax, specifically when use is made of offshore trusts and companies. This issue requires

an in-depth discussion that could form the topic for a future research. For the sake of clarity, capital gains tax is only briefly dealt with.

This dissertation examines the various investment vehicles, namely,

- endowments,
- open-ended investment companies,
- roll-up funds,
- unit trusts, and
- retirement funds.

Ultimately a finding in terms of the most suitable vehicle to the South African investor from a tax perspective may need to be made in further research.

As pointed out earlier, and in an effort to facilitate the understanding and research of this topic, a case study has been provided. Reference is made continuously throughout this dissertation to this case study.

Case study

A client, Clive, seeks advice on offshore tax and investment-planning. His friend, Rupert, claims to have carried out successful tax planning. Clive wishes to use the same structures that Rupert used, but needs an opinion before he does so.

Rupert is concerned about the political stability of South Africa. He fears that he could lose all his assets. He is not confident with regards to his assets invested offshore as he believes that they could be confiscated and redistributed to the poor.

Rupert moved many of his assets offshore. Both he and his wife used their full R750 000 (then) offshore allowance. In addition, both Rupert and his wife used their offshore travel allowances. They deposited this amount into Rupert's offshore bank

account in the United Kingdom. Rupert also used others to help him move funds offshore. He paid them a fee to move funds offshore on the unused portions of their travel allowances. These funds were deposited into his offshore bank account. Over the years he has accumulated in excess of a million pounds offshore.

He is nervous of the South African authorities discovering these assets. He feels that he already pays too much tax on his South African income. He therefore believes that it would not be fair to be taxed on his offshore assets. In any event, he cannot disclose the amounts earned on his offshore assets as the authorities will then know that he has illegally taken funds out of South Africa. He claims that he has established several 'highly sophisticated' structures in an attempt to conceal his offshore assets.

He formed a foreign company and a foreign trust. The foreign trust is the sole shareholder in the company. He lent this company £1 000 000.

Rupert did not accept the amnesty. He believed that it was a ploy on the part of the government to uncover assets that would then be expropriated.

His company has now transferred its assets to a tax-haven jurisdiction. He is confident that the tax-haven authorities will not tax him on his assets. He believes that he has successfully divested himself of these assets. He has managed to convert what would have been taxable income into non-taxable income. He believes that Clive should adopt a similar structure for himself.

Clive's wife, Sarah, inherited £2 000 000 from her late aunt. This amount was bequeathed to a trust on the Isle of Man. The trust is a discretionary trust. Sarah and her children are its beneficiaries.

Clive's father, who lived in Scotland recently passed away and left him £5 000 000. For estate planning purposes he is considering transferring this £5 000 000 to a trust. In an attempt to save trustees fees he would like to transfer it to his wife's established trust. Since he is a simple man he would like to minimise the administration of the funds.

This dissertation examines all the issues raised in the above case study, reference is therefore continuously made to this case study throughout the dissertation. The conclusion attempts to provide solutions and recommendations.

Investor and the process

The above case study gives an insight as to who an investor is.

More in-depth discussion is necessary on the concept of offshore investing. It is first necessary to seek, define and understand who the investor is, and then how an investor invests offshore. Once this has been explored, the investment process that should be followed before a client invests offshore must be examined.

Alternatively, the investment process to be followed if the funds are already invested offshore must also be examined.

This is important as it establishes how and why an investor arrives at the decision to invest

- first offshore, and
- secondly, the asset classes selected.

This ultimately impacts on the taxation of the investment return.

A decision to invest in an asset should not simply be arrived at arbitrarily. The decision an investor makes should not hinge solely on the taxation of the investment return. The return itself is also critical. And then, the appropriateness of the investment needs to be taken into account. In this regard, an understanding of asset classes is necessary.

Defining an 'investor' is important as investment asset classes and vehicles are determined by the phase the investor is in. Broadly speaking, there are two categories of investors:

- First, those investors who are still in the process of accumulating funds or wealth and require advice on how best to save.
- Secondly, those who already hold the assets and need advice as to how best to invest them.

The tax status of the vehicles used varies according to which phase the investor is in. For example,

- an investor acquiring assets and saving may use a retirement annuity fund for this purpose, but
- an investor already retired may use a living annuity which has separate tax rules.

It is for this reason that an understanding and appreciation of who the investor is, is needed. These basic investment principles flow through to an investment no matter where geographically the assets are held.

The process usually begins when an investor approaches a financial planner for investment advice.

A financial planner or adviser then sets about formulating an investment strategy for the investor. Financial plans and philosophies vary from one financial planner to another. There is no one right answer. Having investigated various investment models, theories and philosophies it is submitted that the appropriate investment-planning process to be followed is the one discussed below.

Why this investment process is important to this dissertation is because it impacts on the choice that the investor has when investing in asset classes. The asset class, in turn, then impacts on the tax status of the investment which forms the core focus of this dissertation.

Financial planning process

Financial planning entails an examination of all aspects of an investor's personal circumstances and wealth management. The financial-planning process, therefore, takes a holistic view of the investor's financial well-being, as opposed to a piecemeal approach. The problem with a piecemeal approach is that it deals with issues independently, and ignores the interrelated consequences of those decisions that have been made in isolation.

The objective of the process is to produce a financial plan based upon clearly-defined financial goals. This provides a framework for decision making by developing an appropriate investment strategy.

It is possible to produce asset allocation models that combine different asset classes in an investment portfolio to meet specific investment requirements.

Once the adviser has determined the asset allocation required, he then recommends portfolios. The decision of what portion of the investors assets will be invested offshore and what portion will be invested locally will then be made.

As can be seen from the above, the financial planning process dictates

- where an investor's funds should be invested, and
- in what asset classes they should be invested.

Once this has been determined, factors including the taxation of the various asset classes and investment vehicles or instruments must be considered.

Often investors are impressed by the investment that has the highest yield. Yet these investments are not necessarily the best investments. Tax implications will vary depending on the investment chosen by an investor. Accordingly, the after-tax return of an investor plays a vital role in selecting the most suitable investment.

Taxation is a key driver of net returns.[2] An investment return can be almost halved by the effects of tax. It follows that investors may not achieve their financial goals because of tax. The compounding effect of this tax can be staggering. By simply choosing the correct structure and asset classes, investing the same amount of funds could make the difference between an investor achieving, or not achieving, his financial goals. This is discussed in greater detail in the chapters that follow.

Traditionally little emphasis has been placed on the tax status of investors. Most products have been designed to maximise pre-tax returns. This is not an economic reality. It is for this reason that this dissertation discovers investment solutions and structures that maximise after-tax returns.

[2] Old Mutual *Premiums and Problems* 93 ed (2006) in B6.

Chapter 2

INVESTING OFFSHORE

For some years South Africans were prohibited from investing offshore. Then exchange controls were relaxed and South Africans were gradually allowed to invest offshore.

Diversification

Diversification is the antidote to uncertainty. It is the cornerstone of an investment philosophy. Nowhere is the expression 'putting all your eggs in one basket' more applicable than in the area of investments. Logic dictates that if an investor invests across countries that bear no correlation to one another, the risks will reduce. This is especially relevant when the risk associated with investing solely in South Africa is examined. It should be noted that South Africa is classified as an emerging market.

Emerging markets constitute less than 7% of the overall stock market capitalisation. South Africa represents less than 1% of the stock market capitalisation.[3] No matter how strong an economy, by virtue of it being labelled an 'emerging market', another emerging market crisis will have a rippling effect for that county's economy. South Africa's currency is thus affected.

It follows, that to reduce risk, an investor should spread his South African investments across various

- geographic areas,
- currencies, and
- asset classes.

[3] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 1 - 3.

As mentioned above, South Africa represents an insignificant percentage of the world's economy. By diversifying into more mature markets, an investor will have access to stocks that he would not have had in South Africa. By not investing offshore an investor will be restricting his portfolio. This could deprive him of an extensive investment opportunity including investing in equities and currencies in developed countries.

It is held that by investing abroad, an investor can improve his return while significantly reducing his risk.[4]

Rand hedging

A further motivation for the South African investor to invest offshore is the continued depreciation of the rand over long periods. Although the rand did recover considerably a few years ago, a number of economists and investment houses hold the view that the rand will continue to depreciate over the long term. In this regard De Kock, Kruger and Roper point out the following: [5]

> 'A South African investor can protect him or herself from becoming poorer in global terms by investing in funds and assets, which are denominated in hard currencies.'

Moving funds offshore

South African investors were not always permitted to invest offshore. De Kock, Kruger and Roper state the following: [6]

> '[E]xchange control was first introduced in South Africa at the outbreak of the Second World War in 1939.'

Goodall states further that[7]

> 'exchange control was introduced to monitor and protect the countries foreign reserves'.

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[4] B B Goodall *Investment Planning* 14 ed in § 6.9.2.
[5] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 8.
[6] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 92.
[7] B B Goodall *Investment Planning* 14 ed in § 6.4.

In 1996 the government introduced the concept of an asset swap as a relaxation of exchange control.

An asset swap is an exchange of investment assets between two parties in different countries. Essentially, this meant that certain types of local institutions were allowed to take a percentage of the value of assets under management offshore, provided they were able to secure a reciprocal investment into South Africa. No capital outflows actually took place and hence there was no negative impact on the exchange rate. Consequently, this allowed investors to benefit from diversification offshore without placing a drain on the country's foreign reserves.

Certain South African institutions, including long-term insurers and pension funds, were permitted to swap a percentage of their total assets under management. This resulted in the introduction of asset swap international portfolios and unit trusts.

With the new exchange control regulations Collective Investment Scheme manager company's can invest up to 30% of retail assets under management in foreign assets.[8]

Practically, what this means is that ordinary investors could use investment institutions to invest their funds offshore through vehicles including collective investment schemes (so-called unit trusts), retirement annuities and endowments. This is discussed in more detail in Chapter 4.

An alternative is to invest directly offshore. Authorised dealers (banks) may approve the transfer of up to R2 000 000 by a private individual resident in South Africa over the age of eighteen years who holds a tax-clearance certificate. This means that the funds would have to obtain tax and Reserve Bank approval before they can be transferred and invested offshore.

In summary, an investor has two options when it comes to investing offshore:

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[8] *Profile's Unit Trusts and Collective Investment* (2009) at 30.

- The first is via institutions, and
- the second, is direct offshore investments.

Institutional investments

The advantage of the institutional option is currency hedging.

But the disadvantage is that the investor has no political hedging. In other words, when the proceeds from the investment are paid out, they are paid in rands. This could cause complications depending on the political regime at the time.

Another disadvantage is the 'capping' when an institution has exceeded its limit. Some of these 'offshore funds' are diluted when the institutions are forced to sell off some of their foreign securities.[9]

A further disadvantage is that these investments are reported to the client in rands. It is therefore difficult to monitor the underlying performance of the investment. The investor is often confused by the performance.

If the funds are invested in a dollar-denominated investment and reported in rands, the value will reduce if the rand strengthens against the dollar. Practically, some investors have liquidated out of these funds when they perceive that their investment is going 'backwards', even when the underlying funds have actually performed well. This is merely a perceived loss and can be dangerous to an investor's 'strategy' as defined in Chapter 1.

If this is compared to funds invested directly offshore and monitored and reported in a foreign currency, investors are less inclined to liquidate out, even if the net result in monetary terms monitored in rands, is the same.

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[9] *Premiums and Problems* 93 ed (2006) in B48.

In 2001 the Minister of Finance terminated the asset swap mechanism.[10] This resulted in many rand-denominated unit trusts and insurance funds closing.[11] This is discussed in more detail in Chapter 3.

Direct investing

The second option of investing offshore, namely, directly has the advantage of currency hedging and political hedging.[12]

Government committed itself to relaxing exchange controls with effect from 1 July 1997 when private individuals were permitted to invest R200 000 offshore or hold foreign currency at local banks. The current remittable amount of R2 000 000 was announced in 2006.[13]

Other methods

Not all investors choose the above methods of investing offshore. Some investors, such as Rupert (in the case study), transferred funds abroad illegally. These investors therefore contravened the exchange control regulations. In addition, as these funds were not disclosed, the investor also contravened the Income Tax Act by not disclosing the amounts earned from these funds.

In 2003, the Minister of Finance announced an exchange control and tax amnesty for foreign funds and assets.[14] There are two distinct issues covered by this amnesty:

- Exchange control, and
- tax.

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[10] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 92.
[11] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 92.
[12] *Premiums and Problems* 93 ed (2006) in B49.
[13] *Premiums and Problems* 93 ed (2006) in F3.
[14] *Premiums and Problems* 93 ed (2006) in F3.

The amnesty extended to trusts and companies. It was clear that the tax amnesty was for offences under the Income Tax Act[15] and the Estate Duty Act[16]. This included donations tax and capital gains tax, but excluded value-added tax, general sales tax and customs and excise offences.[17]

Michael Katz used the following interesting quote when speaking at a seminar in Johannesburg in 2003:[18]

> 'When a lawyer begs amnesty for his client, he is actually asking the judge to have an attack of amnesia. The first person in history to grant amnesty was reported to have been a Greek general who said that he would forgive his enemies and "not remember" (Greek a-"not" mnasthia, "to remember") their misdeeds. And from this we inherited our two English words amnesia ("loss of memory") and amnesty ("a pardon for offences").'

At this seminar, Michael Katz announced that the amnesty exposed the fiction of trusts, particularly, offshore trusts.

Offshore trusts have for some years been used by South African residents to hide assets. Some were used for estate planning purposes.

When the assets of a foreign trust had not yet vested in a beneficiary, the amnesty allowed the donor to the trust to elect that the assets were deemed to be held by him.

- For the purposes of the amnesty the assets were deemed to have been held by the donor from the date of their acquisition by the trust.
- For the purposes of the Income Tax Act, the assets were deemed to have been held as from 28 February 2003.

This meant that future income tax or capital gains tax will be calculated from that date. A deemed tax from an accrual to the trust is also amnestied.[19]

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[15] Income Tax Act 58 of 1962.
[16] Estate Duty Act 45 of 1955.
[17] *Premiums and Problems* 93 ed (2006) in B52.
[18] Michael Katz quoting from *Word Origins – An Exploration and History of Words and Language.*
[19] *Premiums and Problems* 93 ed (2006) in B52.

A further interesting factor that came out of the 2003 Budget speech was the fact that emigrants could take out further blocked assets subject to an exit charge of 10%.[20]

Unfortunately, Rupert did not take advantage of the amnesty. If his assets are discovered, Rupert could face severe penalties with a possible prison sentence. Technology has resulted in 'global shrinking' with information between countries being shared more readily. Most of the offshore financial centres have procedures in place for cooperation with foreign investigations. In addition, most of the offshore financial centres require disclosure of the beneficial owners of an offshore company.

In addition, Rupert will not be in a position to obtain professional advice on the underlying assets as his financial adviser is under a duty to report these activities to the authorities.

The amnesty granted pointed out a need for investors and financial advisers to take stock of the future taxation and other implications of having applied for amnesty and to plan accordingly.

Many investors have not yet given sufficient thought to the future tax implications resulting from being granted amnesty.

[20] *Premiums and Problems* 93 ed (2006) in F3.

Chapter 3

VARIOUS ASSET CLASSES

The financial plan dictates what asset classes the investments should be exposed to. But what is meant by 'asset classes'? This chapter explains and lists the different asset classes (or building blocks) of an investment. It also describes their tax consequences.

In its simplistic form, there are five basic building blocks or components (asset classes) that could be included in a client's portfolio. Each asset class carries its own risk rating, with

- cash being the most conservative, and
- ending in equities.

Alternative investment strategies can be the most aggressive.

An interesting factor when looking at risk is that it is common to assess risk only taking a short term. Yet some investors who accumulate wealth and then invest their funds in their retirement are looking at long periods of investing. Over the long term, cash and money market investments often become the more riskier investments as generally they under-perform inflation.

All investments incorporated into an investor's strategy should benchmark themselves against inflation. Inflation is a major threat to retired investors. Yet some investment plans are structured in a conservative manner, with tax compounding the issue.

For the purpose of this dissertation the more common approach will be adopted, namely,

- cash being conservative, and
- equities and certain hedge funds being the riskiest.

It is also important to note that there are other asset classes but they fall outside of the scope of this particular dissertation. Each asset class has its own unique distinguishing features and each has its own tax implications.

An investor can invest directly into some of these asset classes. An investor would invest directly in

- cash, and
- in some properties.

Yet some investors, either through a lack of skill or expertise or through a lack of inclination, may choose not to invest directly. They would then have the option of accessing these asset classes through investment vehicles including,

- endowments,
- collective investment schemes (unit trusts),
- retirement annuities,
- provident funds,
- pension funds,
- preservation funds,
- open-ended investment vehicles, and
- roll-up funds.

To simplify, an analogy of empty glasses is used to describe these vehicles. The main difference between the various glasses is tax and term. The liquid being poured into the glass is made up of the asset classes. If the same quantity of liquid is poured into each glass, the same level would not be maintained in each glass as the net return on the investments would be different. The reason being the impact of tax on the returns. This is best illustrated by the following example:

Example

An individual owns an endowment. The underlying funds in the endowment are invested in a money market portfolio. Money market portfolios generate interest that is taxable. As this investment is housed in an endowment, the interest will be taxed at 30%.

In terms of a proposal made in the 2007 Budget speech and implemented from 28 February 2007, the assets invested in a retirement annuity fund are taxed at 0%. In this example, had this individual invested his funds in a retirement annuity fund instead of an endowment, the return from the assets invested in the retirement annuity fund would not have attracted tax, as would have been the situation if invested in the endowment. The return from the assets is taxed at 0%. If this investment were invested for a long period of time, the 30% savings of not paying tax in the retirement annuity fund, compounded, will be significant.

Thus, the way in which the various building blocks (liquid) are taxed depends on the investment (glass) chosen. As this is so pivotal to the choice an investor makes, Chapter 4 of this dissertation is devoted to investment vehicles.

Thus the effect of tax cannot be under estimated when deciding on asset classes and investment vehicles.

Asset classes

The various asset classes are described below commencing with the asset class of least risk in the short term, namely, cash or money market.

Cash or money-market

Most investors are familiar with the word 'cash' as most of them will have money in a bank. Money-market instruments, however, also include

- call deposits,
- notice deposits,
- bank acceptances,
- promissory notes,
- negotiable certificates of deposit,
- treasury bills,
- trade bills,
- bridging bonds,
- capital project bills, and
- Land Bank bills.

The access to these money-market instruments is normally through money-market funds that are regulated by the Collective Investment Schemes Act (which is dealt with in more detail in the chapters that follow). But in essence, by investing in a money-market fund an investor can have immediate access to his funds. [21]

Bonds

Put quite simply, a bond is a promissory (IOU) note issued by

- the central government,
- municipalities, and
- other large organisations including Eskom and Telkom.

The bond issuer borrows money from the holder of the bond and promises to

- pay interest periodically, and
- to repay the capital borrowed at some later stage (even up to twenty years later).

[21] B B Goodall *Investment Planning* 14 ed in § 1 at 2.2.

When interest rates change there is a simultaneous change in the price of a bond and *vice versa*.[22]

Property

Property as an asset class is generally regarded as medium risk, but factors including

- location,
- price range,
- supply and demand, and
- commercial or residential status,

will affect its rating. The growth received from a property is derived from a combination of

- rentals earned, and
- capital appreciation.

Property prices are greatly affected by factors including inflation and interest rates.

Equities

De Kock, Kruger and Roper state the following in regard to equities: [23]

> 'Owning equity, also called stocks or shares, is nothing more than owning a stake in a publicly traded company. Most companies that list on a major stock exchange across the world do it mainly to access enough capital to expand their businesses. When one owns such a stake in a company, one also has the right to share in the success and profits achieved by the company. The ongoing payments paid to investors to compensate them for their stock investments are called dividends.'

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[22] M Botha, C du Plessis, W Geach, B Goodall, Z Nel, L Rossini & G van der Linde *The South African Financial Handbook* (2008) in § 9 at 478.
[23] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 213.

Equities are generally regarded as the asset class producing the highest level of return over the long term. As mentioned earlier, over 100 years of investment history has shown that equities have produced an average return of 7% a year above inflation. Over the short term, however, there can be much variation around this return. This points out the need for a disciplined long-term approach to investing.

Alternative investment strategies

De Kock, Kruger and Roper state the following in regard to alternative investment strategies (hedge funds):[24]

> 'Investments in hard assets, private equity, commodities and hedge funds. . . are recognised as a separate asset class, since performance correlation with equity and bond markets is greatly reduced.'

To narrow the scope of this dissertation, hedge funds and the taxation of their returns has not been discussed. (It could form the topic of further research.)

Once again it is important to note that although an asset class may provide a high yield, it does not necessarily mean that it is the most-favourable investment. It is the after-tax return of an investment that is important. Each asset class has its own tax implications. The chapters that follow deal with the returns generated from each asset class and hence their tax status.

An investor has the freedom to manage his financial affairs in such a way so as to pay the least amount of tax. As long as he does so within the prescribed parameters of the Income Tax Act he may plan his tax affairs to his advantage.

As mentioned earlier, tax has the ability to reduce an investor's return. It is therefore necessary to examine the provisions of the Income Tax Act that effect these returns so as to allow the investor to plan his affairs to his advantage.

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[24] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 213.

Chapter 4

PROVISIONS OF THE INCOME TAX ACT

The aim of this chapter is not to give a detailed analysis of the Income Tax Act but to illustrate how tax affects the investor. A summary of a tax calculation is also provided. In this regard Goodall points out that[25]

> 'for the investor it is important to know not only the total amount of tax paid, but also the amount that goes in tax for every additional rand earned, namely, the marginal rate of return. The investor should also be able to calculate the return he or she receives on an investment before tax and after tax.
>
> 'For example, if an investor receives an income of 9% on an investment and his or her marginal rate is 40%, (i.e. 40 cents of each rand earned is paid as tax) the after tax return received is calculated using the following formula:
>
> 'After tax return = Gross return x (1 – marginal rate of tax)
> = 9% x (1 – less 0,4)
> = 9% x 0,6
> = 5,4%.'

It is necessary to look at the provisions of the Income Tax Act dealing with

- first, who should be taxed,
- secondly, what receipts or accruals should be taxed, and
- thirdly, how they should be taxed.

The Income Tax Act deals with four different types of tax, namely,

- normal tax (on income and on capital gains),
- donations tax,
- the secondary tax on companies, and

[25] B B Goodall *Investment Planning* 14 ed in §16.3.

- various withholding taxes.

From 1 October 2001 capital gains tax was introduced into the Income Tax Act.[26] This is a tax on a capital gain made on an asset.

Normal tax applies to the taxable income of all persons. It is levied by applying rates set out in the tax tables. Different tax rates apply to natural persons, non-natural persons and trusts. The basic calculation, provided in the Income Tax Act, is as follows:

Gross income	XXX XXX
Less exemptions	XX XXX
Income	XXX XXX
Less deductions and allowances	XX XXX
	XXX XXX
Add taxable capital gains and certain allowances	XX XXX
Taxable income	XXX XXX
Normal tax payable (schedule tax)	XX XXX
Less rebates	XX XXX
Normal tax liability	XX XXX

Gross income

The definition of 'gross income' in section 1 of the Income Tax Act reads as follows:

> '"Gross income", in relation to any year or period of assessment, means . . . in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident . . . during such year or period of assessment, excluding receipts or accruals of a capital nature . . ..'

[26] The Taxation Laws Amendment Act 5 of 2001.

Prior to 1 January 2001, South Africa had a source-based tax regime. This meant that amounts that were not received or accrued or deemed to accrue from a South African source were not subject to South African tax.

By its very nature this source-based system gave rise to a situation where South Africa could be viewed as a tax haven for individuals who became residents of South Africa but who earned amounts from a source outside the country. In this way they avoided taxation on their world-wide receipts or accruals.

Prior to the South African exchange controls being relaxed, there was no danger to the South African tax base as there were no offshore passive receipts or accruals that could be taxed, as investor's were not permitted to invest offshore.

Once exchange control was relaxed in 1997, and investors were permitted to invest offshore, the Income Tax Act was amended. Two deeming provisions were introduced into the Income Tax Act to include world-wide passive amounts including interest and rentals in an investor's South African taxable income.

The first deeming provision was section 9C. It provided that irrespective of where an amount accrued, it would be deemed to have accrued from a South African source if it was received by a South African resident.

In an attempt to stop South African residents from transferring assets to non-resident entities and thereby avoiding tax, section 9D was also introduced into the Income Tax Act. It deals with controlled foreign companies (CFCs) earning passive amounts. It also initially dealt with a situation where a South African resident donated assets to a foreigner and income accrued to that foreigner by virtue of the donation. In this instance the income was taxed in the hands of the donor resident. This particular provision has now been 'moved' into section 7(8) of the Income Tax Act.

In addition to the above, section 9E was introduced into the Income Tax Act in February 2000 deeming certain foreign dividends to be from a South African source.

These provisions were introduced as an interim measure to safeguard the tax base until such time as the process for moving from a source-base to a residence-base tax system was finalised.

For years of assessment commencing on or after 1 January 2001, South African residents are subject to tax on their world-wide receipts and accruals. It should be noted, however, that in certain instances, when a double taxation agreement with another country exists, certain tax relief is granted. This is dealt with in a later chapter.

Non-South African residents are taxed on amounts received or accrued on a source basis. This is in line with other international residence-based tax systems.

A brief explanation of the development of the provisions dealing with offshore assets is provided below. Most of these changes occurred between 2000 and 2002.

In 2001 there were various amendments to the Income Tax Act, and more specifically to the capital gains tax provisions. At the end of 2001 some of the provisions contained in the Taxation Laws Amendment Act 5 of 2001 were replaced by provisions introduced by the Second Revenue Laws Amendment Act 60 of 2001. These amendments were incorporated into the Income Tax Act.

In contrast with 2000 and 2001, which resulted in a major restructuring of the South African tax system, the 2002 amendments could be regarded as a consolidation year because a number of minor amendments were introduced by the Taxation Laws Amendment Act 30 of 2002 and the Revenue Laws Amendment Act 74 of 2002.

The Commissioner also issued a number of interpretation notes in an attempt to clarify certain uncertainties. During 2003 the Commissioner issued Practice Note 18 to clarify the section 6*quat* rebate for foreign taxes relating to resident natural persons.

The Revenue Laws Amendment Act 45 of 2003 introduced a number of significant changes, including the repeal of section 9E. These amendments came into effect on the 1 June 2004 and applied to years of assessment commencing on or after 2004.[27]

Chapters 5, 7 and 8 are devoted to explaining how these amendments have affected offshore investments.

Amounts to be taxed

The amount to be included as gross income is the total amount, in cash or otherwise received by or accrued to a resident from anywhere in the world. This means that it must first be established whether a person or entity is a resident before determining whether his receipts and accruals are to be taxed in South Africa. Once it has been established that a natural person is a resident or the entity is a resident, his or its world-wide receipts or accruals may be taxed.

This dissertation focuses on the South African taxpayer and thus assumes that the investor is a South African resident.

It is important to determine who qualifies as a resident in so far as it relates to foreign entities. This is because many elaborate schemes were put in place to conceal assets. Residents divested or continue to divest themselves of their assets by transferring them to a non-resident entity.

Residents

A resident can be either a natural person or a juristic person or trust. A juristic person or trust is a resident if it has its place of effective management in South Africa. This is discussed further in Chapter 8 of this dissertation.

Different criteria apply to legal entities who are not natural persons.

[27] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 53.

Natural persons

As mentioned, it is assumed that the South African natural person is a resident. A detailed examination is therefore not necessary. For the sake of clarity, it is briefly mentioned, that there are two alternative tests to determine whether a natural person is a resident of South Africa: [28]

- The first test determines whether a person is ordinarily resident, and
- the second requires a person to be physically present in South Africa for a certain period of time (in days) to be regarded as a South African resident.

Legal entities

Anti-avoidance provisions were introduced into the Income Tax Act to circumvent the methods used by investors to conceal their assets. An examination of these provisions is detailed below. The provisions relating to trusts are section 7(8) and section 25B of the Income Tax Act. A provision relating to companies is section 9D.

Trusts

De Kock, Kruger and Roper point out the following: [29]

> 'Approximately a quarter of the worlds assets are in offshore trusts.'

It is for this reason that an entire chapter is dedicated to this topic. A thorough understanding of the mechanics of offshore trusts and their relationship with the Income Tax Act is essential.

Offshore companies

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[28] Definition of a 'resident' in section 1 of the Income Tax Act 58 of 1962 read with Interpretation Note 4.

[29] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 154.

Transfer pricing

Many investors attempt to maximise concessions when it comes to planning their tax affairs to their advantage. As will be evident from the chapters that follow, some individuals, in an attempt to avoid paying tax on their offshore investments, transfer their investments to other entities. They create complicated structures to hide their assets from the tax authorities. To this end they use offshore companies and trusts, or a combination of both.

In an attempt to control the flow of capital between South Africa and other offshore entities, section 31 of the Income Tax Act was introduced. It deals with the determination of the taxable income of certain persons who have international or similar transactions. This provision was recently amended by Revenue Laws Amendment Act 35 of 2007. Most of the amendments addressed the concerns around intellectual property which falls beyond the scope of this particular dissertation. Insofar as it relates to this dissertation the scope of the rules remain the same.

Section 31(1) reads as follows:

> '"**goods**" includes any corporeal movable thing, fixed property and any real right in any such thing or fixed property;'
>
> '"**services**" includes anything done or to be done, including, without limiting the generality of the foregoing-. . . .the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee.'

Section 31(2) reads as follows:

> '(2) Where any supply of goods or services has been effected–
>
> (*a*) between–
>
> (i) (*aa*) a resident; and
>
> (*bb*) any other person who is not a resident;
>
> (ii) (*aa*) a person who is not a resident; and

(*bb*) a permanent establishment in the Republic of any other person who is not a resident; or

(iii) (*aa*) a person who is a resident; and

(*bb*) a permanent establishment outside the Republic of any other person who is a resident;

(*b*) between those persons who are connected persons in relation to one another; and

(*c*) at a price which is either–

(i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or

ii) greater than the arm's length price,

the Commissioner may, for the purposes of this Act in relation to either the acquiror or supplier, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.'

Insofar as the resident or his relative are beneficiaries in a trust, they will be regarded as connected persons and accordingly taxed at a market-related interest rate.

Practice Note 2, gives an indication of what the Commissioner will consider to be an arm's length rate for interest. Generally, the arm's length rate relates to the relevant currency, namely,

- prime,
- interbank rate, or
- libor [30] plus 2%.

When a resident transfers funds via a loan to an offshore company or trust, this loan will fall under the provision of section 31.

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[30]London Interbank Offered Rate is a daily reference rate based on the interest rates at which banks borrow unsecured fund from other banks in the London wholesale money market or (interbank market) http:en.wikipedia.org/wiki/LondonInterbankOfferedRate last accessed on 8 February 2010.

In South Africa this interest-free loan does not give rise to donations tax, when a local trust is used. Yet when dealing with offshore trusts, the provisions of section 31(2) of the Income Tax Act could apply. This could give rise to a harsh situation in that double taxation could result. Accordingly planning in this regard should be made with great care. Some consultants, tax planners, or financial planners tend to neglect or overlook this important provision in the Income Tax Act.

Should Clive (from the case study) lend his inheritance to Sarah's trust (or another trust) it may be regarded as a transaction funded by an interest-free loan and will then fall within the so-called transfer pricing provisions. A result will be that Clive will be taxed at a market-related interest rate.

Chapter 5

FOREIGN DIVIDENDS

Introduction

In its move from a source-based to a residence-based tax system, a new provision was introduced into the Income Tax Act in 2000, which sought to tax dividends declared out of foreign profits. The provisions dealing with the taxation of foreign dividends were contained in section 9E of the Income Tax Act. Section 9E included foreign dividends in the gross income of the resident. This section dealt with credits and exemption of dividends. The problem with section 9E was that resident shareholders, avoided or postponed repatriating the dividends into South Africa. The South African legislature realised that it had the effect of deterring dividend inflows into the country, and thus had to make certain amendments.

The Revenue Laws Amendment Act 45 of 2003 repealed section 9E with effect from the commencement of years of assessment ending on or after 1 January 2004.

Tax

Amounts received or accrued

Distributions representing interest, rental or dividends received or accrued to a local collective investment scheme, fall within the definition of a 'dividend' and are included in the investor's gross income. This applies even when the distribution is interest. A remedy to protect the tax base currently exits within the Income Tax Act. It does not grant an exemption to a dividend funded by interest and distributed by a local collective investment scheme. Thus the dividend is exempt in terms of section 10, but not to the extent it is funded by interest.

What of a foreign collective investment scheme?

The following provisions of the Income Tax Act are relevant in aiding the understanding of the tax treatments of foreign dividends:

- Section 1 – the definition of a 'foreign dividend'.
- Section 1 – paragraph (*k*) of the definition of 'gross income'.
- Section 1 – paragraph (*e*) of the definition of a 'company'.
- Section 10(1)(*k*)(ii) – certain exempt foreign dividends.
- Section 11C.
- Section 6*quat* rebate.

A description of the relevant provisions of the Income Tax Act follows:

Dividends

A dividend is defined as[31]

> 'any amount distributed by a company (not being an institution to which section 10(1)(*d*) applies) to its shareholders, and in this definition the expression '**amount distributed**' includes. . .'.

This definition also contains specific inclusions and specific exclusions.

Foreign dividends

Section 1 defines a 'foreign dividend' as[32]

> 'any dividend received by or which accrues to any person from a foreign company as defined in section 9D'.

Foreign company

[31] Definition of a 'dividend' in section 1 of the Income Tax Act. For the purpose of this dissertation it is the legislation that applies before the new 'dividends tax' comes into operation. (This will occur three months after the Minister of Finance gives notice thereof in the *Gazette* notice.)

[32] Definition of a 'foreign dividend' in section 1 of the Income Tax Act.

Section 9D defines a 'foreign company' as meaning[33]

> 'any association, corporation, company, arrangement or scheme contemplated in paragraph (*a*), (*b*), (*c*), (*e*) or (*f*) of the definition of "company" in section 1, which is not a resident; . .'.

Company

Paragraph (*e*) of the definition of a 'company' deals with any[34]

> 'portfolio comprised in any collective investment in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002 . . . or arrangement or scheme carried on outside the Republic in pursuance of which members of the public (as defined in section 1 of the Collective Investments Scheme Control Act, 2002 (Act No.45 of 2002)), are invited or permitted to invest in a portfolio of a collective investment scheme, where one or more investors contribute to and hold a participatory interest in a portfolio of the scheme through shares; units or any other form of participatory interest . . .'.

Gross income

Paragraph (*k*) of the definition of 'gross income' deals with dividends and with foreign dividends that accrue to collective investment schemes. It includes in gross income

> 'any amount received or accrued by way of a dividend: Provided that where any foreign dividend declared by a foreign company . . . is received by or accrues to a portfolio of a collective investment scheme referred to in paragraph (*e*)(i) of the definition of "company"; and . . . is distributed by that portfolio by way of a dividend, or a portion of a dividend, to any person who is entitled to that dividend by virtue of being a holder of any participatory interest in that portfolio, that foreign dividend shall, to the extent that it is declared to that person as contemplated in subparagraph (ii), be deemed to have been declared by that foreign company directly to that person and to be a foreign dividend which is received by or accrued to that person . . ..'

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[33] Definition of a 'foreign company' in section 9D of the Income Tax Act.
[34] Paragraph (*e*) of the definition of 'company' in section 1 of the Income Tax Act.

Thus a

- local collective investment scheme,
- an open-ended investment company, and
- a foreign collective investment scheme

are all regarded as companies. Dividends include an amount distributed by a company and are to be included in gross income in terms of paragraph (*k*) of the definition of 'gross income'.

Exemption

Some of the exemption provisions relating to foreign dividends previously dealt with in section 9E have been moved to section 10(1)(*k*)(ii). Thus the exemptions and deductions relating to dividends are dealt with in section 10(1)(*i*)(xv), section 10(1)(*k*)(ii) and section 11C.

Section 10(1)(*k*)(ii) provides for the following four exemptions:[35]

- Profits that have already been taxed in South Africa.
- Dual-listed companies.
- Controlled foreign companies.
- The so-called participation exemption.

Profits that have already been taxed in South Africa

Foreign dividends received by or accrued to a person are exempt from normal tax to the extent that the profits from out of which they are distributed relate to an amount that has been or will be subjected to tax in the Republic, or arose directly or indirectly from a dividend declared by a company that is a resident. This exemption does not

[35] Section 10(1)(*k*)(ii) of the Income Tax Act.

apply to amounts taxed in terms of section 9D (the net income of a controlled foreign company (CFC)).

Dual-listed company

All foreign dividends from companies listed both on the JSE and another recognised foreign exchange are exempt from tax. This will apply to dual-listed companies including, for example, Old Mutual, Investec, Liberty, and Anglo American.

Controlled foreign companies

The exemption for a CFC is different from the other exemptions in that it applies only to residents. Profits from a company may have already been taxed in terms of section 9D. These profits may, in turn, be distributed as a 'foreign dividend' to a resident. It is not the intention of the legislature to tax this amount again. These foreign dividends from a CFC are therefore exempted in terms of section 10(1)(*k*)(ii)(*cc*). This applies only to the extent that the foreign dividend does not exceed the amount of the previously taxed income.

Participation exemptions

When a person holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend, that foreign dividend qualifies for the section 10(1)(*k*)(ii)(*dd*) exemption.

This exemption includes anti-avoidance rules to prevent it being used to obtain deductions by transferring taxable funds into a foreign company, and having them paid back into the Republic in the form of foreign dividends that would ordinarily be exempted. The two anti-avoidance provisions are as follows:

- The first proviso, has the effect that shares with debt-like characteristics will not be allowed to produce exempt dividends and therefore do not qualify for this participation exemption.
- The second proviso, does not allow the exemption for dividends that form part of a scheme to produce exempt dividends while a person makes corresponding deductible payments.

Other than redemptions made, the insertion of paragraph (*j*) to the definition of a 'dividend' in section 1 of the Income Tax Act does not affect residents investing in distributing foreign or offshore collective investment schemes. An investor will continue to be taxed on foreign dividends received or accrued from the investment unless he owns

- at least 20% of the shares if it is a foreign private or unlisted company, or
- it is a dual-listed foreign company.

Collective investment schemes

There are various collective investment schemes in securities. They are treated as companies in terms of paragraph (*e*) of the definition of a 'company'.

Generally, each collective investment scheme has three legal entities including

- the fund comprising the pooled contributions of the investors,
- the trustee who is usually a bank and appointed as custodian of its assets (all cash and securities), and
- the management company who administers the fund.

As discussed in Chapter 5, foreign investments operate through structures including

- open-ended investment companies (OEICs)(distributing or non-distributing),
- externally domiciled international collective investment schemes (foreign funds),

Non-distributing open-ended investment companies or 'roll-up' funds

As pointed out above, under the residence-based income tax system the investor is liable for income tax on both receipts and accruals generated from his foreign investments. Shares issued to investors in a non-distributing open-ended investment company are issued with no dividend rights attached. A South African shareholder in an OEIC will be taxed only at the time that he redeems his investment. If the redemption amount exceeds the issue price of the shares, the difference will be a capital gain on the disposal of the share.

It is the increase in value of the capital of the roll-up fund that is subject to capital gains tax upon redemption. Amounts (interest, rentals or dividends) re-invested during the duration of the investment are excluded for the purposes of capital gains tax. On redemption, these reinvested amounts are included in the capital gains tax calculation only to the extent that the shares or other asset that they have invested in have increased in value.

Until recently, foreign dividends from a foreign collective investment produced a different tax consequence because of the unintended consequence of paragraph (*c*) of the definition of a 'dividend'. The part of the return that constituted a 'dividend' was the amount received by the shareholder that exceeded the par value of the shares to the extent that it was funded out of reserves (undistributed profits including those of a capital nature) of an OEIC. This resulted in the proceeds from the redemption being a dividend. Upon disinvestment, the full gain was included in gross income.

In its recommendations for changes to the Income Tax Act, the Association of Collective Investments discussed how best to deal with roll-up funds when the income is accumulated in the portfolio and not declared to investors. The Association of Collective Investments recommended that when an investor could not prove, to the satisfaction of the Commissioner, the net income that accrued during the period of

holding the investment, the proceeds of the investment should be deemed to be a dividend.[36]

The Association of Collective Investments proposed the insertion of paragraph (*j*) into the definition of a 'dividend' in the Income Tax Act. The proposed insertion read as follows:[37]

> '[A dividend includes] the redemption or repurchase of shares, units or any other form of participatory interest of a company as defined in paragraph (*e*) of the definition of "company", provided that, where the taxpayer cannot, to the satisfaction of the Commissioner, show the net income accrued to such shares, units or any other form of participatory interest in a company as defined in paragraph(*e*)(ii) of the definition of "company", the difference in market values in the foreign currency of such shares, units or any other participatory interest at the beginning and end of that tax year be deemed to be a dividend.'

The Association of Collective Investments cautioned as to the extent of the problem as a consequence of the collective investments schemes industry not having treated redemptions from foreign collective investment schemes as dividends from 26 February 2000 to the 14 March 2005. The Association of Collective Investment stated further as follows:[38]

> 'The potential affected value of the investments in such schemes is R8,5 bn directly and a further R28,8 bn through institutional investors. It is estimated that 150 000 investors would be affected with an average of account balance of R60 000.'

The Association of Collective Investment advised that investors should be given the assurance that any amendments would not be applied retrospectively as it would have major repercussions for the entire financial sector.

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[36] Association of Collective Investments *Recommendation for Changes to the Income Tax Act No 58 of 1962.* (Received via facsimile from Fairbairn Capital on 3 October 2006).

[37] Association of Collective Investments *Recommendation for changes to the Income Tax Act No 58 of 1962.*

[38] Association of Collective Investments *Recommendation for Changes to the Income Tax Act No 58 of 1962.*

There were amendments in 2006 and 2007 that remedied this situation. The Second Revenue Laws Amendment 2006 amended the definition of a 'dividend' in section 1 of the Income Tax Act. Section 5(*f*) of the Revenue Laws Amendment Act, 2007 deleted paragraph (*c*) of the definition of a 'dividend'.[39]

Section 5(1)(*m*) of the Revenue Laws Amendment Act, 2007 inserted paragraph (*j*) of the definition of a 'dividend'. It excludes from the definition of 'dividend'

> 'any amount distributed by way of the redemption of a participatory interest in a portfolio, arrangement or scheme contemplated in paragraph (*e*) of the definition of "company". . .'.

The Revenue Laws Amendment Act, 2007 inserted a new paragraph (*j*) into the definition of a 'dividend' but did not take up the recommendation as intended by the Association of Collective Investment insofar as it omitted the proviso. This proviso read as follows:

> 'Where the taxpayer cannot, to the satisfaction of the Commissioner, show the net income accrued to such shares, units or any other form of participatory interest in a company as defined in paragraph(*e*)(ii) of the definition of "company", the difference in market values in the foreign currency of such shares, units or any other participatory interest at the beginning and end of that tax year be deemed to be a dividend. . ..'

In light of the amendments, proceeds from the redemption of a foreign collective investment scheme are no longer included as a dividend.

It is submitted that the proviso recommended above would have resulted in an inequitable situation for the investor. This is because in most circumstances, amounts received or accrued in a foreign jurisdiction have been subject to a withholding tax. It is therefore received net of a foreign withholding tax by the investor.

Rebate

[39] It should, however, be noted that it was reinstated a year later in the Taxation Laws Amendment Act 3 of 2008.

Taxpayers may use the section 6*quat* rebate to offset foreign taxes paid. The purpose of these credits is to prevent double taxation.

The rebate is limited to the resident's South African normal tax payable on the foreign dividend that is included in his taxable income.

The Revenue Laws Amendment Act, 2007 made amendments to section 11C to repeal the election to deduct foreign withholding taxes on foreign dividends in light of the more general deduction provisions added to section 6*quat*.

Conclusion

Given the recent changes in legislation discussed above, the proceeds from the redemption of a roll-up funds no longer constitute a 'dividend'.

Residents investing in distributing foreign or offshore collective investment schemes will continue to be taxed on foreign dividends received or accrued from the investment unless they own at least

- 20% of the shares if it is a foreign private unlisted company, or
- shares in a dual-listed foreign company.

Chapter 6

INVESTMENT VEHICLES

As discussed in Chapter 3, each asset class carries its own tax implications.

- Equities produce foreign dividends that may be taxable depending upon the entities owning it and the extent of the holding.
- Property generates a rental that is taxable.
- Cash and bonds generate interest that is also taxable.

Having established that asset classes carry their own tax implications the investor must decide how his investment should be structured to achieve maximum tax efficiency. An objective of the dissertation is to arrive at a decision as to the most appropriate

- investment vehicle, and
- entity.

This chapter deals with the investment vehicle.

Investor's funds can be classified as discretionary or non-discretionary.

- Discretionary funds are not regulated by the Pension Funds Act and are also referred to as voluntary funds.
- Non-discretionary funds are funds regulated by the Pension Funds Act and include retirement annuities, preservation funds, provident funds, and pension funds.

Within these categories (discretionary or non-discretionary) the investors may have more than 54 000 investment funds to choose from. The funds can be accommodated in different investment vehicles. As discussed earlier, each investment is made up of various asset classes. The asset classes are

- cash,
- bonds,
- property,
- equity, and
- alternative strategies.

These can be regarded as the building blocks of an investment.

Before deciding on the appropriate investment vehicle, some preliminary steps to the investment-process is necessary. These steps include

- identifying the investor's goals with regard to his investment,
- calculating the real rate of return required to achieve these goals,
- modelling the asset allocation to produce the calculated return,
- deciding whether to have the portfolio actively or passively managed, and
- choosing the correct vehicle taking his personal tax situation into consideration.

It is important for an investor to select an investment solution (asset allocation, portfolio or fund) that is appropriate to his needs. Once the asset allocation has been decided, the next step is to select the appropriate investment vehicle. It is important to note that there is a fundamental difference between the investment vehicle and the investment solution or fund. Given the importance of this distinction, an examination of the key features of the various investment vehicles is necessary.

As discussed in Chapter 2, it is important to differentiate between rand-dominated offshore portfolio vehicles and direct offshore vehicles. There are many investment vehicles or various permutations of the same investment vehicle, but essentially, the vehicles are dealt with by either

- the Long-Term Insurance Act,[40] or

[40] Long-Term Insurance Act 52 of 1998.

- the Collective Investment Schemes Act.[41]

Rand-denominated vehicles

There is no restriction on the amount that may be invested in these funds. They include

- collective investment schemes (unit trusts),
- endowments,
- sinking funds,
- retirement annuities,
- pension funds,
- provident funds, and
- preservation funds.

Unit trusts can invest 10% of their previous year's cash flow's abroad. The limit for unit trusts is 20 % of each collective investment schemes manager's total assets under management.[42]

The investor transfers a sum of money to the institution. It then deals with the currency conversion and the decisions as to where and how to invest in the various offshore markets. The investment will be rand-denominated and when the investor redeems the investment he will be paid out in rands.

Direct offshore portfolios

Individuals over the age of eighteen years can invest R2 000 000 offshore. Some offshore entities market their funds to South African investors. They will in most instances emulate a collective investment scheme. Foreign collective investment schemes have different structures. They are regulated in the country in which they are

[41]The Collective Investment Schemes Act 45 of 2002.
[42] *Profile's Unit Trusts and Collective Investment* (2008) at 47.

domiciled. Some of these funds use a trust structure and others a company structure. Collective investment schemes that operate within a corporate structure include open-ended investment companies. They are discussed below.

Jurisdiction and double taxation agreements

To narrow the scope of this vast topic, the subject of jurisdiction and double taxation agreements is not examined in detail in this dissertation. Yet a brief discussion is necessary.

Jurisdiction

The country where the fund is registered is important because the manner in which it is regulated and taxed could differ from another country. Offshore funds are domiciled in offshore financial centres or tax havens. De Kock, Kruger and Roper point out in *Practical Guide to Offshore Planning* the following:[43]

> 'In 1992, the noted author Walter Diamond, reported that half of the worlds transactions take place offshore . . .. It is now conservatively estimated at 70% – 80%.'

These centres are often referred to as tax havens as the taxes levied in these jurisdictions are either low or non-existent.

Double taxation agreements

Double tax agreements are entered into by the Governments of the contracting countries. They are designed to prevent and remedy the effects of the double taxation of amounts received or accrued from assets located across international borders.

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[43] A De Kock, N Kruger & P Roper *The Practical Guide to Offshore Investments* (2004) at 110.

Financial Services Board

South African individuals may invest their investment allowance in a foreign fund or foreign investment collective scheme. It should be noted, however, that schemes that have not been registered with the Financial Services Board cannot be marketed in South Africa and advisers are prevented from assisting investors to invest in them.

Collective investment scheme

The rationale behind a collective investment scheme is to allow individual investors to pool their money so as to have access to managed investments. The Collective Investment Schemes Control Act 45 of 2002 makes provision for various types of collective investments schemes, including (but not limited to)

- so-called unit trusts,
- companies,
- hedge funds,
- open-ended investment schemes,
- participatory bonds,
- collective investment schemes in property (so-called property unit trusts).

The most common of these schemes is the unit trust. The Collective Investment Schemes Control Act has introduced new terminology. An example is the use of the word 'portfolio' to describe what has always been called a 'fund'.[44] A further example is the word 'unit'. It is now called a 'participatory interest'.[45]

Local funds investing offshore

[44] Definition of a 'portfolio' in section 1 of the Collective Investment Scheme Control Act.
[45] Definition of a 'participatory interest' in section 1 of the Collective Investment Scheme Control Act.

There are three categories of local unit trust funds that invest in offshore markets, namely,

- domestic funds,
- foreign funds, or
- world-wide funds.

World-wide funds are portfolios that invest in both domestic and foreign markets and have complete flexibility in that they can be invested 100% in foreign markets or 100% in local markets. Foreign funds invest at least 85% of their assets offshore at all times.

Foreign funds

The Collective Investment Schemes Control Act defines offshore collective investment schemes as 'foreign investment schemes'. This scheme is not domiciled in South Africa but in an offshore jurisdiction. It is usually denominated in euros, pounds or United States dollars. The base currency of these funds is not rands. This definition causes confusion as a common term for rand-denominated offshore funds is 'foreign funds' as defined in the Association of Collective Investments classification system. The term 'foreign funds' is used throughout this dissertation to avoid confusion. Thus foreign funds are domiciled offshore and denominated in other currencies. Local foreign funds are rand-denominated funds invested abroad.

Linked-products

Linked-product managers invest funds on behalf of investors in various collective investment schemes that they do not manage. The linked-product concept involves the creation of conventional investment products or vehicles including, but not limited to,

- retirement annuities,
- pension funds,
- provident funds,

- preservation funds,
- living annuities, and
- endowments.

The performance of the vehicle is linked to the underlying collective investment schemes.

Endowments

Endowments are dealt with in terms of the Long-Term Insurance Act.[46] An endowment can be a pure investment vehicle and can be rand denominated or foreign denominated.

Section 7 of the Long-Term Insurance Act requires that to carry on a long-term insurance business a person has to be registered as a long-term insurer. Section 16 of the same Act requires that a long-term insurer has to have its head office in South Africa. The only way to meet this requirement is to have either

- a locally issued policy denominated in a foreign currency, or
- a policy underwritten and issued by an offshore branch.

Some investors are under the mistaken belief that an endowment is the investment solution itself. In reality, an endowment is simply a vehicle that is used to house an investment. There are three key features to an endowment. These features relate to how

- contributions,
- the investment accumulation within, and
- the proceeds of an endowment

are treated.

[46] Long-Term Insurance Act 52 of 1998.

Contributions

Contributions paid to an endowment policy are not tax deductible. They are treated as items of a capital nature. They are also considered to be of a domestic nature.

Investment accumulation

Section 29A of the Income Tax Act deals with the taxation of life polices. This provision contains what has become known as the 'four-fund approach' to normal taxation. In short, this means that the life office is a representative taxpayer on behalf of its policyholders.

One of the four funds that a life office must account for normal tax purposes is a fund for individual policyholders. The life office pays normal tax on this fund on the investment amount received or accrued on polices owned by individual policyholders. An endowment is a policy owned by an individual policyholder. The tax rate applied is 30% being the assumed average rate of tax of all individual policyholders.

Capital gains are taxed at an effective rate of 7,5% (25% x 30%).

Maturity or surrender proceeds

Given that contributions to an endowment are not tax deductible, and the investment accumulation within the endowment is taxed, the proceeds of the endowment policies are tax-free in the hands of the policyholder. Correctly speaking the proceeds are not tax-free but represent the after-tax proceeds of the investment portfolio (capital in nature) in which the policy was invested.

The real planning opportunities in using endowments lie in tax arbitrage, that is, the ability to have income or capital taxed at a lower rate than that applicable to the investor. If the investor's tax rate exceeds 30%, for example, a natural person with a

marginal rate of tax of 35%, 38% or 40%, there is a benefit of having an investment in an insurer's individual policyholders fund, allowing for the concession (as discussed above).

If an investor has taxable income that results in a marginal rate of 40%, using an endowment when he secures a 30% rate of tax on his investment income represents a 25% reduction (10% / 40% x 100%) in the effective rate of tax.

Conversely, if a retired investor has a marginal rate of tax of 20%, using an endowment as the investment vehicle will not be tax effective because the investment income will be taxed at the higher rate of 30%, resulting in a 33% increase (-10% / 30% x 100%) in his effective rate of tax.

A similar calculation can be done for capital gains tax purposes.

Trusts are taxed at a flat rate of 40% on their taxable incomes and an effective 20% (50% of 40%) on their capital gains.

Using an endowment to house investments owned by a trust offers a savings in tax. Policies owned by trusts, the beneficiaries of which are natural persons, are held within the individual policyholders fund by the life office. This secures a 30% tax rate and an effective 7,5% (25% of 30%) capital gains tax rate, representing a significant tax arbitrage opportunity.

The underlying investments are generally in collective investment schemes and the investor has a wide range of portfolios. If the endowment is local, an investor may invest in a local foreign fund.

Other benefits of using an endowment include

- no administrative load on the policyholder as the tax is paid by the insurer,
- apart from the disclosure requirement, the policyholder need do nothing further in terms of income or capital gains, and

- avoiding probate through the nomination of beneficiaries for proceeds or ownership.

Retirement annuities

An investor who invests in a linked-investment retirement annuity has the option of using various collective investments schemes including local foreign portfolios. Taxpayers have the right to deduct the greatest of

- 15% of their non-retirement funding employment as a contribution to the retirement annuity,
- the amount, if any, by which R3 500 exceeds the amount of a deduction to which the taxpayer is entitled under section 11(*k*)(i) (pension fund contributions), or
- R1 750.

When the investor retires he has the option to take one-third as a lump sum. At least two-thirds must be used to purchase an annuity. (More than two-thirds could be used to purchase an annuity, for example, the investor could use all his benefits (three-thirds or 100%) to purchase an annuity.)

The tax rate for these non-discretionary funds on gross interest, foreign dividends, net rentals and capital gains is 0%.

Living annuities

A member who retires from an approved pension fund, provident fund or retirement annuity has the option of purchasing either

- a conventionally annuity policy, or
- a linked-annuity policy (a living annuity).

This dissertation focuses on the living annuity.

Botha, du Preez, Geach, Goodall and Rossini point out in *The South African Financial Planning Handbook* that[47]

> '[a] compulsory linked annuity policy (living annuity) is a compulsory annuity policy which
>
> - the liability of the insurer is limited to the value of the investment account which is credited with an initial amount, net of initial expense, and subsequent net-investment return earned, and which is debited with annuity payments and on-going expenses, and
> - the annuitant may vary the size of the annuity payments within limits determined by SARS Practice Note RF1/96'.

In response to uncertainty regarding whether a living annuity constituted a drawdown of capital or income, the Taxation Laws Amendment Act, 2008 has introduced into the Income Tax Act the definition of a 'living annuity' as part of gross income.

The underlying investments are generally in collective investment schemes. The investor has a wide range of portfolios to choose from including local foreign funds. The fund itself is not subject to income tax. The annuity is, however, fully taxable in the hands of the annuitant.

Pension funds, provident funds and preservation funds

There needs to be an employer-employee relationship for a pension or provident fund to exist. There are two types of pension and provident funds, namely, a

- defined benefit, and
- defined contribution.

This dissertation focuses on the defined contribution. Some pension, provident and preservation funds have evolved over the years to allow individual members the choice of underlying portfolios or unit trusts.

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[47] M Botha, L du Preez, W Geach, B Goodall and L Rossini *The South African Financial Planning Handbook* (2008) at 824.

It is assumed that on retirement the member applies the full fund value towards purchasing a living annuity. This is a tax-neutral transfer. Accordingly the taxation of lump sums is not dealt with in this dissertation.

The tax implications of the provident and pension fund are tabulated below for simplicity:

	Provident fund	***Pension fund***
	Employer	***Employer***
Deductible contribution	10% of approved remuneration for pension, provident funds and medical-aid schemes. In practice up to 20% is allowed. Section 11(*l*).	10% of approved remuneration for pension, provident funds and medical-aid schemes. In practice up to 20% is allowed. Section 11(*l*).
	Employee	***Employee***
	Not tax deductible	Deductible with a maximum of the greater of R1 750, or 7,5% of pensionable remuneration. Section 11(*k*)(i).

A preservation fund is sometimes referred to as a 'parking bay'. It is used when a member of a pension or provident fund resigns or is retrenched. A preservation fund is either a pension fund or provident fund and is defined as such from a tax perspective. There are differences but this is beyond the ambit of this dissertation. Yet it should be noted the major difference is that for a preservation fund there is no employer-employee relationship.

Some of the linked-investment preservation funds allow the members to invest in local foreign funds.

The tax rate for pension, provident and preservation funds on gross interest, foreign dividends, net rental income and capital gains is 0%. They are exempt from normal tax (including capital gains tax) and there is no other 'special' tax that applies to them.

Foreign collective investment schemes

Foreign collective investment schemes were discussed briefly in the chapter on dividends.

Foreign collective investment schemes have different structures.

Trust structure

Foreign unit trust funds are similar to South African local unit trusts. They operate within a trust structure. The investors funds, and the assets bought with these funds are held in trust. The fund or scheme appoints a trustee to look after the assets in the trust.

Corporate structure

Collective investments schemes that operate within a corporate structure include open-ended investment companies (OEICs). OEICs operate in similar way to unit trusts except that an OEIC is legally constituted as a company. OEICs have a depositary that holds the securities. These depositaries have similar duties to unit trust trustees.

OEICs are open-ended. This means that the fund can be larger or smaller, depending on the number of investors who wish to buy or sell shares. An OEIC can set up sub-funds with each sub-fund having different investment objectives.

Roll-up funds

Roll-up funds are non-distributing funds. Most offshore roll-up funds are established as OEICs in tax-haven jurisdictions including

- Guernsey,
- Jersey, and
- the Isle of Man.

Some of these funds are established as an umbrella fund with a number of sub-funds.

Investors in the fund receive shares. These funds do not distribute amounts during the term of the investment. Neither do they produce capital gains subject to capital gains tax in the hands of the investor. Instead the amount arising from the underlying portfolio is accumulated. This increases the value of the shares in the fund. As discussed in the previous chapter upon redemption, paragraph (*j*) of the definition of a 'dividend' removes the earnings of these funds from the ambit of normal tax by providing that a distribution from one of these funds is not a dividend.

But the capital gain arising on the redemption or disposal of the investment is subject to capital gains tax in the hands of the investor.

Withholding tax

As previously discussed, portfolios are made up of building blocks or asset classes.

A collective investment scheme may invest in an asset, for example, shares in a company (equities). When a foreign company declares a dividend to a unit trust portfolio and this dividend is distributed (on-distributed) by it (the unit trust portfolio) to its unit-holders, the dividend is deemed to have been declared directly to the unit-holders by the foreign company (in terms of paragraph (*k*) of the definition of 'gross income').

This foreign dividend will generally be subject to normal tax in South Africa in the hands of the unit-holder.

A collective investment scheme may invest in an asset, for example, shares in a company (equities) situated in a foreign country that imposes a withholding tax. This withholding tax would have been withheld by the company declaring the dividend and paid across to its government.

Double taxation agreements may exist between countries. Each agreement will state who has the right to impose the tax on a particular receipt or accrual. These agreements may provide relief to an investor who has been subject to double taxation. South African residents would then be in a position to apply for a tax credit.

As discussed in Chapter 5, section 6*quat* potentially provides relief to an investor who has been taxed by a foreign country but who has not obtained credit relief in terms of a double taxation agreement.

If an investor held a direct share portfolio in a jurisdiction that imposes a withholding tax, the investor should ensure that this jurisdiction had a right to impose this tax. When a foreign dividend is taxable within South Africa, a credit will then be granted in terms of this double taxation agreement by the local government for the foreign taxes proved to be payable on this foreign dividend.

Many portfolios are diversified geographically with some portfolio's mirroring the geographic allocation of the Morgan Stanley Capital International (MSCI) world index. This MSCI world index is a stock market index of world stocks and is maintained by it. This index includes a selection of stocks of the developed markets in the world. It is a common benchmark for 'world' or global stock funds.[48]

[48] http://en.wikipedia.org/wiki/msci_world. Last accessed 8 February 2010.

Although the structure of the funds are formed and administered in tax havens, the underlying assets in which they invest are spread across the world. Many of these portfolios are not designed for residents of a particular country. Investors who invest in these funds are scattered all over the world. The questions that need to be asked include the following:

- How is the withholding tax levied?
- Over what duration is it levied?
- When should it be paid?
- What happens when the fund switches out of portfolios or equities over different periods of time?
- How does the management company account to the individual investors for a withholding tax that has been paid?

This practical problem is further exacerbated by foreign funds or OEICs who invest in other OEICs or foreign funds (fund of funds).

It is submitted that is not possible for a resident investor to establish within a portfolio made up of over 100 shares spread across the world, what withholding tax has been imposed on what shares.

It is therefore submitted that, in reality, an investor may be taxed twice, namely,

- first, the withholding tax in the country where the assets are located, and
- secondly, on the foreign dividends to be included in his taxable income in South Africa.

It follows that endowments and distributing OEICs may in fact be subject to a double taxation with no corresponding relief.

A similar argument can be made for foreign funds or rand-denominated portfolios accommodated within an endowment.

Retirement funds that do not attract tax on the amounts received and accrued from the assets invested may have had a withholding tax levied against the returns from these assets.

Conclusion

From the above it would seem that all vehicles can have exposure abroad, either directly or through a rand-denominated institution. In most jurisdictions withholding tax is levied. In theory, it may be more tax efficient for the investor to invest directly in the asset. This may afford him the opportunity of using the section 6*quat* rebate.

For many reasons, an investor may not choose to invest directly in the asset class. If the assumption is made that withholding tax is levied against the return from the asset, the choice of vehicle becomes important to minimise or reduce a second level of tax.

An investor, depending on the circumstances, may wish to contribute to a retirement fund. Contributions made to a retirement fund, within the limits described above, are tax deductible. In addition, the returns from the assets within a retirement fund are taxed at 0%. The annuity that the investor draws on retirement will be taxed. Portion of the lump-sum benefit is also likely to be taxed.

In some instances a retired investor's marginal tax rate reduces after his retirement because his taxable income has decreased. A planning opportunity may exist for investors who have both living annuities and voluntary capital. Investors who have living annuities may elect to draw at income levels of between a 2,5% to a maximum of 17,5% simple interest rate of return. The investor could elect to drop his income level from his living annuity to the minimum of a 2,5% simple interest rate of return. He may in turn elect to increase the draw down on his voluntary capital resulting in a reduction of his normal tax liability.

In terms of current legislation, a roll-up fund is tax efficient as it is only the capital gain on its redemption that is subject to capital gains tax.

Assuming an investor is taxed at the maximum marginal rate of 40%, there may be a tax-planning opportunity for using an endowment to accommodate the portfolio. The same arbitrage opportunity exists for a trust.

Chapter 7

TRUSTS

Trusts are often used in tax avoidance schemes (or arrangements). As indicated earlier, there have recently been far-reaching amendments that apply to trusts. Some investors or planners now question as to whether trusts have become obsolete in that they are no longer effective tools for both estate planning and tax planning.

Can a planner still use a trust to plan his affairs to his advantage?

This chapter seeks to answer to this question.

Before investigating the tax implications relating to an offshore trust, a brief explanation of the mechanics and parties to a trust is necessary.

The parties to a trust include

- a creator (sometimes referred to as a donor or settler),
- the trustees representing the trust, and
- the beneficiaries.

Creator

The creator usually specifies the trust's beneficiaries. Normally he is the initial owner of the assets. In terms of a trust deed, he 'transfers' the ownership of his 'growth' assets to the trust. By doing this he divests himself of the asset. He should have no right to dictate to the trustees of 'his' trust. They are responsible to administer the asset of the trust. The trustees administer the asset in terms of the trust deed. It usually comprises of the creator's intentions at the outset. Because of a possible negative estate duty implication arising out of section 3(3)(*d*) of the Estate Duty Act, the rights and powers of the creator should not be reserved.

Section 3(3)(*d*) of the Estate Duty Act reads as follows:

> 'Property which is deemed to be property of the deceased includes . . . property (being property not otherwise chargeable under this Act or the full value of which is otherwise required to be taken into account in the determination of the dutiable amount of the estate) of which the deceased was immediately prior to his death competent to dispose for his own benefit or for the benefit of his estate.'

Section 3(5)(*b*)(ii) applies for the purposes of section 3(3)(*d*) (see above). It reads as follows:

> '[A] person shall be deemed to have been competent to dispose of any property if . . . if under any deed of donation, settlement or other disposition made by him he retained the power to revoke or vary the provisions thereof relating to such property.'

Thus section 3(3)(*d*) deems property that the deceased has a right to dispose of for his own or his estate's benefit, to be his property for the purposes of his estate duty calculation. It is for this reason that the creator who divests himself of all rights to the property, vests its control in the trustee. It should be noted that if the creator was

- competent to dispose of a property,
- if he had the power to appropriate or freely dispose of it, or
- if he is empowered to revoke or vary the trust deed provisions,

the provisions of section 3(5)(*b*)(ii) will be invoked (see above).

In addition, to the possible negative estate duty implications the result when the creator is able to exercise control, there are also income tax implications.

Usually the trustees will recognise the creator's wishes. This amounts to nothing more than a *spes* – meaning a hope or wish. A letter of wishes is often used in a discretionary trust, but it can never override the trustees' discretion.

Trustees

The trustees are forced to act in terms of the trust deed. They are the legal owners of the assets that have been transferred to the trust. The trustees' duties in terms of the trust deed, are referred to as fiduciary duties. These duties are for the benefit of the beneficiaries of the trust. It is crucial that a creator carries out due diligence on the trustees before transferring ownership of the assets.

The jurisdiction of the trustees also plays an important role in that some jurisdictions, because if the legal structures of a trust insist that the control of the assets rests with the creator this could impact negatively on the estate planning of the creator (as discussed above).

Beneficiaries

Beneficiaries could hold

- absolute,
- life, or
- contingent

interests. They are the beneficial owners of the property and the trustees must act for their benefit. When risk profiling is conducted on an investor for investment purposes, the risk profile or investment plan should be conducted taking the beneficiaries into account, and not the creator.

Most jurisdictions insist that a protector be appointed. Generally this is a person who can remove or appoint a trustee. Often this is a personal friend, colleague or relative of the creator. This protector is able then to guide the trustees to give effect to the intention of the creator.

'Transferring' assets

A common mistake made by investors who are planning to invest certain offshore funds through an offshore trust is to assume that the mechanisms for placing assets into an offshore trust is the same as that of a domestic trust. There are various mechanisms in which assets can be 'transferred' to the trustees of a trust. These all have tax implications. Usually they are 'transferred' either by way of a sale or by a donation. The assets are often 'transferred' on a loan-account basis. In some instances this loan is interest free.

The 'donation' method is subject to section 54 of the Income Tax Act, being a provision dealing with donations tax. Should the investor use the 'donation' method, the amount transferred will be subject to donations tax at a rate of 20%. An annual exemption of R100 000 applies when the donor is a natural person. This concession (or exemption) applies equally to donations made to local trusts.

A problem arises when an assumption is made regarding the 'transfer' of an asset to an offshore trust using an interest-free loan, as is often done for local trusts. This is because section 31 of the Income Tax Act, as discussed earlier, makes an interest-free loan vulnerable to its so-called transfer pricing provisions.

Taxation of non-resident trusts

When the move from a source-based to residence-based (or world-wide) tax system for South African residents was first legislated, an offshore trust could have been regarded as a controlled foreign entity in terms of section 9D. This provision was subsequently amended to exclude trusts. But at the same time section 25B(2A) was enacted. Its provisions apply to certain offshore trusts.

An examination of section 7, section 9D and section 25B of the Income Tax Act is necessary so as to understand how the return from investments held in a trust are taxed.

As mentioned, since March 2001, offshore trusts are taxed in terms of section 25B. In addition, section 25B(2A) was introduced into the Income Tax Act. It deals with discretionary offshore trusts. Thus, the relevant provisions in the Income Tax Act relating to offshore trusts are section 7(8), section 7(9), section 7(10), section 25B and section 31. In this regard Huxhum and Haupt point out the following: [49]

> 'Section 25B contains the provisions in terms of which the income of a trust is taxed. Although the provisions of s 7 do not deal specifically with trusts they play a very important role in the taxation of trust income. This is because s 25B, the principal taxing provision, is subject to the provisions of s 7. In other words, if any of the provisions apply they override the provisions in s 25B.'

Section 25B provides that the income is taxed either

- in the trust, or
- in the hands of the beneficiary.

In essence, if the income vests in the beneficiaries, they are taxed on it, and if it does not, the trust is taxed on it.

An extract from section 25B follows:

> **'Income of trusts and beneficiaries of trusts**
>
> '(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.
>
> '(2) Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that

[49] K Huxham and P Haupt *Notes on South African Income Tax* (2006) at 609.

amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary.

'(2A) Where during any year of assessment any resident acquires any vested right to any amount representing capital of any trust which is not a resident, that amount must be included in the income of that resident in that year, if—

(*a*) that capital arose from any receipts and accruals of such trust which would have constituted income if such trust had been a resident, in any previous year of assessment during which that resident had a contingent right to that amount; and

(*b*) that amount has not been subject to tax in the Republic in terms of this Act.'

Section 7(8)(*a*) reads as follows:

'Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.'

An attempt is made in this chapter to discover under what circumstances, if any, the non-resident trust is regarded as a tax-efficient or a tax-free entity.

Before meaningful discussion of trusts can take place it is also necessary to look to the definitions of

- a 'trust',
- a 'beneficiary',
- a 'person' and
- a 'resident'

in the Income Tax Act.

Trust

A 'trust' is defined in section 1 of the Income Tax Act as follows:

> 'Any trust fund consisting of cash or other assets which are administered and controlled by a person acting in his fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person.'

Beneficiary

A definition of a 'beneficiary' is included in section 1 of the Income Tax Act. It reads as follows:

> 'Beneficiary in relation to a trust is means a person who has a vested or contingent interest in all or portion of the receipts or accruals of the assets of that trust.'

Person

In addition, a 'trust' is included in the definition of a 'person'. A 'person' is defined as including[50]

> 'an insolvent estate, the estate of a deceased person and any trust'.

Non-resident persons

How does a planner ensure that the trust that is created is regarded as an offshore trust, more specifically, a non-resident person?

Resident

The answer to this question lies in the definition of a 'resident'.[51] A resident includes a

[50] Definition of a 'person' in section 1 of the Income Tax Act.
[51] Paragraph (*b*) of the definition of a 'resident' in section 1 of the Income Tax Act.

'person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic. . . '.

A planner must therefore ensure that the trust

- is established or formed outside the Republic, and
- that it has its effective place of management outside the Republic.

There has been much debate around the meaning of the term 'place of effective management'.

Is the 'place of effective management' the place where

- the trustees meet, or
- the resolutions of the trustees are executed.

From his Interpretation Note 6, the Commissioner regards an entity's 'place of effective management' as the place where its day to day activities take place.[52]

Thus an offshore trust can be a non-resident. It could also not have any receipts and accruals from a Republic source. Unfortunately for the planner, the trust is not a party on its own. It is made up of the various parties as discussed earlier, all of whom are dealt with by various provisions of the Income Tax Act.

There are three separate aspects to the taxation of the non-resident trust. These aspects are as follows:

- First, the 'transfer' of the assets to the trust.
- Secondly, the amounts earned by the non-resident trust.
- Thirdly, the trust's distributions to its beneficiaries.

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[52] Income Tax Interpretation Note 6 in paragraph 3 at 3.1.

As indicated above, the provisions dealing with the taxation of trusts and beneficiaries are by and large section 7 and section 25B. They deal with

- the donor,
- the beneficiary, and
- the trust itself.

Section 25B identifies in whose income the trusts receipts and accruals are included.

Accordingly, the main provision affecting Clive's desired plan (see Chapter 1 of this dissertation), is section 7(8). The amounts received and accrued by virtue of the funds being lent by Clive to Sarah's trust, will be included in Clive's gross income. Section 7(8) provides that when an amount is received by or accrued to a person who is not a resident (in this example, Sarah's trust), that would have constituted income had that person been a resident, there must be included in the income of that resident so much of that amount as is attributable to the donation, settlement of other disposition.

Section 7 deals with the person who 'transferred' the asset to the trust. It is an anti-avoidance provision. What is important to note is that section 7 is a deeming provision. This means that it overrides the provisions of section 25B. It follows that the beneficiary will be subject to tax only if section 7 does not apply. If the provisions of section 7 do not apply then the donor is unlikely to be implicated.

The trust on the other hand, will be taxed only if

- the amount is not subject to the provisions section 7,
- a beneficiary has not received an amount, and
- a beneficiary is not vested with a right to the amount.

It would appear from a resident planner's perspective that there is little that he can do, or plan for, when 'transferring' assets into a trust to avoid having the trust's receipts

and accruals taxed in his hands. Whenever the donor, donates, settles upon or disposes of an asset (makes a disposition) to a non-resident trust, any amount earned by the non-resident that was caused by the 'donation' is subject to tax in the hands of the person who made the donation, settlement or other similar disposition.

It is generally understood that when a trustee exercises his discretion and amounts are awarded to the beneficiaries then these amounts awarded are then dealt with in terms of section 25B(2). The beneficiaries are then taxed (but subject to the provisions of section 7).

The trusts receipts and accruals will be subject to tax in a discretionary trust only when the donor dies and provided no beneficiary has a vested right to them. A planning opportunity thus exists, in contemplation of the planner's or donor's death.

Although section 7 appears unavoidable for a planner, he can still safeguard the return from his investment from the provisions of section 25B. The planner can plan for the beneficiaries by ensuring that no right vests in them as contemplated in section 25B. In addition, he needs to ensure that the trustees do not exercise their discretion by awarding an amount to a resident beneficiary.

A hypothesis is created of a non-resident trust, with beneficiaries who do not have vested rights to its receipts and accrual, with the donor being a non-resident, and with its receipts and accruals not coming from a South African true or deemed source. Surely this trust is free from being taxed in the Republic?

Perhaps not. Section 25B(2A) may apply to the non-residents trust's retained receipts and accrual if a resident beneficiary acquires a vested right to it.

This provision, as mentioned earlier, can be viewed as an anti-avoidance provision for tax on foreign income. It is likely to apply to a 'blind' trust when there are no income or capital beneficiaries.

If there are no income or capital beneficiaries, section 7 and section 25B cannot apply to the trust's retained receipts or accruals. After some time, however, a resident might acquire a vested right to these retained receipts or accruals (now reinvested as 'capital'). Section 25B(2A) will then apply. This means that the resident will have to include the vested amount in his gross income.

The identity of the amount subject to tax may then become an issue. Section 25B(2A) applies to a situation when an amount representing capital of an offshore trust is distributed. This 'capital' amount then becomes taxable. Does this amount retain its identity of whatever it was before it became an amount representing capital? As the legislation gives no indication it is necessary to look to the 'qualification' made in *SIR v Rosen.*[53]

If the *Rosen* 'qualification' is followed, then an amount representing capital that was funded out of a local exempt dividend that was retained and accumulated and vested in a subsequent year of assessment, may now be taxable because it may have lost its identity as a local exempt dividend.

The purpose of section 25B(2A) is to avoid a situation when a resident beneficiary can receive foreign receipts and accruals after a year end, tax free, by having the distribution paid out from the non-resident discretionary trust as 'capital'.

What section 25B(2A) does is to treat the accumulated receipts and accruals that are awarded as not being capital when they vest.

If the following two criteria are met, the provisions of section 25B(2A) will apply:

- First, section 7 does not apply, and
- secondly, the resident beneficiary had a contingent right to the receipts and accruals in the year when they accrued to the trust.

[53] *SIR v Rosen* 1971 SA 173 (A), 32 SATC 249.

What is important to note is that section 7(10) places the onus of the disclosure of the receipts or accruals on the taxpayer with failure to comply leading to criminal sanctions.

Capital gains tax

Although capital gains tax is beyond the scope of this dissertation, it is necessary to discuss it briefly. A capital gain arising out of the disposal of a trust asset will be taxed either in the hands of the

- trust,
- person who made the donation, settlement or other disposition to the trust, or
- beneficiary.

Disposal of the trusts assets to a beneficiary are subject to the general anti-avoidance provisions.

In terms of paragraph 10 of the Eighth Schedule to the Income Tax Act, 50% of a gain made by the trust is included in the trusts taxable income, unless attribute to someone else.

Accordingly, consideration for capital gains tax is imperative.

Developments

Barry Spitz cautions tax planners using trusts, stating that there have been some international judgments relating to the issue of control that have caused much alarm among the various trust parties.[54] If a *bona fide* trust is set up, a creator has to give control of his assets to people whom the creator may not have met. This proves

[54] In this regard, see B Cameron 'Why Offshore Trusts have lost their Appeal' (2003) *Personal Finance* at 1.

difficult for some. Spitz maintains that recent judgments held in the United Kingdom have ruled that for [55]

> 'a trust to be valid, their must be a genuine transfer of legal ownership of the assets in the trust to the trustee. Where the settlor later seeks to protect his funds against creditors, spouses or tax authorities, in a discretionary offshore trust, but has used devices, such as letters of wishes or protectors, to keep control of the funds, the courts are now seeing right through the trust and declaring the assets to be still vested in the hands of the settler. Papers before the House of Lords indicate that perhaps 90 percent of all offshore trusts are invalid on the grounds that the settler is calling the shots.
>
> 'Recently a US court held that a particular trust was not a true trust and that the donor should pay creditors money owed. In this case, brought by the Federal Trade Commission, Michael and Denyse Anderson were imprisoned for contempt of court after the judge determined that the Andersons had control over trust assets. The court ordered them to repatriate trust assets. The Andersons chose to go to prison and keep the money rather than pay the creditors . . ..'

Are trusts still useful?

In an attempt to answer the question posed as to whether offshore trusts will remain attractive vehicles for holding investments it is necessary to look at the original reason used for setting up trusts.

Initially, before amnesty, investors used trusts, amongst other things, to conceal their assets from the authorities. This tax evasion saved them large sums of money. These 'concealing benefits' have subsequently been lost or removed with changes in legislation and amnesty.

The disadvantages of using offshore trusts now include the following:

- True loss of control of the planner's assets when they are 'transferred' to the trust.
- The annual trust fees and running costs of trusts are expensive.

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[55] In this regard, see B Cameron 'Why Offshore Trusts have lost their Appeal' (2003) *Personal Finance* at 1.

- Potential criminal charges.[56]

Possible advantages of using offshore trusts still include the following:

- Estate duty savings (if structured correctly).
- Creditor protection (if structured correctly).
- Estate planning in so far as the allocation of benefits to beneficiaries are concerned especially if the beneficiaries are minors.

When considering the above it seems clear that trusts are losing their attractiveness for tax savings.

Thus, as can be seen from the above, provided the donor and beneficiary of the trust are non-residents and the receipts and accruals are not from a South African true or deemed source, there will be no tax implications for the offshore trust.

The question that then needs to be answered is whether in creating an offshore entity, 'transferring' money to it, which in turn then 'transfers' the money to the offshore trust, would a tax-free situation in the Republic result?

Would this interposing of another entity cause a planner to be free from the application of section 7 and section 25B?

It would appear that the planner would be 'free' if it were not for the anti-avoidance provisions of section 9D of the Income Tax Act. Section 9D has been amended many times in attempts to circumvent the above scenario. (It is discussed in detail in the following chapter.)

[56] In this regard, see B Cameron 'Why Offshore Trusts have lost their Appeal' (2003) *Personal Finance* at 1.

Conclusion

As indicated in the example as detailed in Chapter 1, Clive's wife Sarah, inherited $2 000 000 in trust from her late aunt. This trust is a discretionary trust. Sarah and her children are its beneficiaries but do not have vested rights to its receipts or accruals.

If the trust makes no distributions, there will be no effect on Sarah's gross income as she did not settle the funds on the trust. Section 7(8) therefore cannot apply. In terms of section 25B, only amounts that vest in beneficiaries are deemed to accrue to them. The beneficiaries of Sarah's trust are herself and their children. They are all residents. This means that when receipts and accruals vest in them, they will be subject to tax in the Republic.

If Sarah and the children acquire a vested right to the capital of the offshore trust that arose from non-South African sourced receipts and accruals in a previous year of assessment, the amount that vests in them must then be included in their incomes because they are resident beneficiaries.

Clive recently inherited funds from his father. If Clive settles the funds on the offshore trust, section 7(8) will apply because he is a resident. The amounts received or accrued by the offshore trust from the funds that Clive settled on it will then be included in his gross income. This will apply irrespective of whether he sets up a new offshore trust or uses Sarah's trust. Section 31 could also apply to his loan to the offshore trust.

Chapter 8

COMPANIES

Planners did in the past, and currently use foreign companies to accommodate their investments. Investors wishing to use companies to accommodate their investments need to understand that there are various 'categories' of companies contemplated in the Income Tax Act. An understanding of these differences is therefore important. Because of the abuse of diversionary income, certain anti-avoidance provisions are included in the Income Tax Act to prevent the diversion of amounts from South Africa which otherwise would have been taxed in South Africa.

Amendments to these anti-avoidance provisions are frequently made. Investors who have already invested using these structures and who have applied and been granted amnesty should therefore revisit these structures. In addition, new provisions have been included allowing shareholders to elect certain options that may find themselves in a more favourable position.

It is for this reason that an in-depth discussion of foreign entities is important to this dissertation.

Concealing assets in a company is not a problem unique to South Africa. Other countries using residence-based systems of taxation experience similar problems. A great deal of time and effort has been spent by the legislature on this issue.

What is the motive behind investors arriving at the decision to invest their funds using a company? This is best answered by using the facts taken from the case study (as detailed in Chapter 1 of this dissertation).

Rupert was concerned about the political stability of the country. He then transferred funds abroad. In addition he did not want to pay tax on the interest earned on his investment. In an attempt to distance himself from this income-earning activity, he created an offshore company with an offshore trust being its sole shareholder. He then

lent his funds to this offshore company. This company, in turn, invested the funds in a bank account in the United Kingdom.

What follows is a discussion to determine whether Rupert's intentions and actions will be tax efficient.

A taxpayer is not obliged to pay greater tax than in legally due. This principle was established in *IRC v Duke of Westminister* where Lord Tomlin held the following:[57]

> 'Every man is entitled if he can do to order his affairs so that the tax attaching under the appropriate Acts is less that it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of the ingenuity, he cannot be compelled to pay an increased tax.'

Accordingly, it is the prerogative of a taxpayer to plan his tax affairs to his own advantage within the constraints of the law.

Has this notion been stretched too far by Rupert? Will certain provisions of the Income Tax Act encumber Rupert's plans?

The Income Tax Act deals with the issue of a foreign company and a controlled foreign company (CFC) in section 9D in a highly complex manner. Section 9D has been subjected to constant change. If South Africa's economic partner countries or other countries allowed for the tax recovered by them on South African assets offshore to be paid back to the South African fiscus, there would be no need for the South African legislature to put such a large amount of effort into constructing tax legislation around CFCs. This is not practical. A more-practical approach method of recovering these taxes is by incorporating and focusing on CFCs. It is submitted that recommendations could be advanced to change these provisions to make them simpler and easier to understand and administer. But this is beyond the scope of this dissertation. It could, however, form the topic of further research.

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[57] *IRC v Duke of Westminister* 1936 51 TLR 467, 19 TC at 520.South African courts have also expressed the view contained in this dictum on numerous occasions, for instance in *Hicklin v SIR* 1980 (1) SA 481 (A) at 483F; *CIR v Estate Kohler and Others* 1953 (2) SA 584 (A) at 591F-592H; see also *CIR v Sunningside Centre (Pty) Ltd* 1997 (1) SA 68 (A) at 77F.

Three types of companies are discussed:

- Foreign companies that are residents in terms of the definition of 'resident' in section 1 of the Income Tax Act.
- Foreign companies that are not residents but who have South African shareholders.
- Foreign companies regarded as CFCs.

A shareholder's rights, the place of effective management of an entity and foreign business establishments are factors that influence the status of a company. These differences are important in that they determine how the receipts and accruals of a company are to be taxed.

Resident company

It is important to note from the outset, that a company which has its place of effective management in South Africa is a resident in terms of the definition of a 'resident' in section 1 of the Income Tax Act. It is not regarded as a foreign company for income tax purposes. Consequently, its world-wide receipts and accruals will be subject to tax on those amounts derived within and outside of the Republic. An example would be when the resident company owns foreign property, the foreign rentals earned will be included in its South African gross income.

This must be differentiated from a CFC. The tax consequences of a CFC are governed by section 9D. This distinction becomes relevant in so far as the taxation of its income is concerned.

Looking once again at the definition of 'gross income', in relation to a year of assessment, it means[58]

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[58] Definition of 'gross income' in section 1 of the Income Tax Act.

> '(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of any person other than a resident, the total amount, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic. . .'.

The word 'resident' should be examined to establish whether it includes a company. The definition of a 'resident' is defined in section 1 of the Income Tax Act. For a person other than a natural person, a resident is a[59]

> 'person (other than a natural person) which is incorporate, established or formed in the Republic or which has its place effective management in the Republic. . .'.

A company is a non-natural person. It can be a resident as referred to in the definition of 'gross income'. Thus, when dealing with an offshore company there are a number of tests or enquiries that need to be made to determine if it falls under the definition of a 'resident' before testing the applicability of section 9D.

The following questions are relevant:

- First, is the company incorporated in the Republic?
- Secondly, is it established or formed in the Republic?
- Thirdly, does it have its place of effective management in the Republic?

The first and second enquiry is relatively simple to carry out. The third enquiry, however, has sparked much debate because the Income Tax Act does not define a 'place of effective management'.

An interpretation note was issued by the Commissioner in an attempt to provide certainty.[60] An interpretation note is not law. It is merely the Commissioner's

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[59] Paragraph (*b*) of the definition of a 'resident' in section 1 of the Income Tax Act.
[60] Income Tax Interpretation Note 6.

interpretation of aspects of the Income Tax Act. Given that it is not law it may be challenged by a taxpayer.

This interpretation note states that the term 'place of effective management' is not defined in the Income Tax Act and the ordinary meaning of the words, taking into account international precedent and interpretation, will assist in ascribing a meaning to it. The note goes on to say that the term is used by various countries throughout the world, and as by the Organisation for Economic Co-operation and Development (OECD) in its publications and documentations. The term does not have a universal meaning, and the various countries and the members of the OECD have attached different meanings to it.

The Commissioner in his interpretation note is of the view that the concept of effective management is not the same as

- shareholder control, or
- control by the board of directors.

This concept becomes important when distinguishing whether section 9D will apply when the foreign company is a CFC or whether the entity is a resident as defined in section 1 of the Income Tax Act and, is therefore, subject to tax in its own right. Shareholding plays a role in the application of section 9D.

The tax implications are different depending on whether section 9D is to apply or whether the foreign company is a resident.

The interpretation note states that to determine the meaning of 'place of effective management', it is possible to distinguish between,

- the place where central management and control is carried out by a board of directors,
- the place where the executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors

and make and implement the day-to-day, regular, operational management and business activities, and

- the place where the day-to-day business activities are carried out or conducted.

The interpretation note states that the general approach should be that the effective management is the place where the company is managed on a regular day-to-day basis by the directors or senior managers, irrespective of where its board of directors meets. Management refers to the execution and implementation of policy and strategic decisions made by the board of directors. The interpretation note states that there cannot be absolute guidelines as management structures, reporting lines and responsibility vary from entity to entity.

Practically, if these management functions are executed at a single location, that single location will be the place of effective management. This location might not correspond with the place where the day-to-day business operations are actually conducted. The practice notes states that[61]

> '[i]f these management functions are not executed at a single location due to the fact that director or senior manager manage via distance communication (e.g. telephone, internet, video-conferencing, etc) the view is held that the place of effective management would best be reflected where the day-to-day operational management and commercial decisions taken by the senior management are actually implemented, in other words the place where the business operations/activities are taken out or conducted.
>
> 'If the nature of the person, other than a natural person, is such that the business operations or activities are conducted from various locations, one needs to determine the place with the strongest economic nexus. . ..'

The Income Tax Act does not define the term 'place of effective management'. It would seem that there is, as yet, no South African case law in this regard and that in the South African context, the actual place of effective management should be where

[61] Interpretation Note 6.

the more important management decisions are taken rather than simply looking to the day-to-day management.[62]

In summary, the effective management and shareholders' control are two concepts that are important in drawing the distinction between a resident foreign company and a CFC.

- When considering a CFC, shareholders' participation rights are important.
- When considering a resident foreign company the effective place of management is important.

The distinction is important to this dissertation as the manner in which the foreign company is structured will impact on the taxation of the amounts received or accrued. For example, an investor may invest his assets in a resident foreign company. The company, and not its shareholders, will then be taxed on all its word-wide receipts and accruals.

Foreign companies

A foreign company may have some South African shareholders but these shareholders do not hold more than half the shares or voting rights to make it a CFC.

A distinction needs to drawn between the two. When a South African resident holds shares in a foreign company, the Income Tax Act deals with the taxation of receipts and accruals arising from shareholding of a South African resident as follows:

- If the foreign company is a CFC as determined by section 9D, the amounts received or accrued by it are attributed to the South African resident. Dividends distributed out of profits may qualify for an exemption from normal tax in terms of section 10(1)(*k*)(ii)(*bb*) of the Income Tax Act.

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[62] Kevin Mitchell and Lindsay Mitchell *'Are Your Offshore Transactions Compliant?'* Butterworths 2006 at 22.

- Alternatively, if the foreign company is not a resident and not a CFC, the dividends that their resident shareholders receive from it will form part of the resident shareholder's gross income. The so-called participation exemption may then apply.[63]

It is important to reiterate that when dealing with a CFC, the shareholder's tax status and not the tax status of the foreign company is of relevance.

Section 9D

In the case study, Rupert's funds were 'transferred' to a company and then invested in an interest-bearing security in the United Kingdom. Section 9D provides a 'see-through' or 'look-through' mechanism. It is not the foreign company itself that is taxed in the Republic. If a trust had not been created, Rupert, in his capacity as the resident shareholder would have been taxed. Not taxing the entity encourages international competition and evens the playing fields with foreign countries. It also protects the South African tax base.

Important consequences

An important consequence of section 9D is that section 6*quat* prevents duplication of tax by allowing a rebate for foreign tax payable.

A South African resident may qualify for the section 6*quat* rebate on the foreign tax paid by the CFC. This is limited to the receipts and accruals of the CFC that are deemed to be the South African resident's net income in terms of section 9D. In some respects it is better to have section 9D apply as the section 6*quat* rebate may then be claimed.

If, however, the foreign company is not a CFC, then the South African resident shareholder will be taxed on the foreign dividend.

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[63] K Huxham and P Haupt *Notes on South African Income Tax* (2006) at 314.

Definitions

Section 9D(1) defines certain terms, including

- a 'foreign business establishment',
- a 'controlled foreign company',
- a 'country of residence',
- a 'foreign company',
- a 'foreign tax year',
- 'participation rights', and
- a 'foreign financial instrument holding company'.

This dissertation focuses on the terms that aid the understanding of section 9D in so far as they assist in determining whether a foreign company is worth considering for tax-efficiency purposes.

Foreign business establishment

Amounts attributable to a foreign business establishment are not subject to tax in South Africa in terms of section 9D.

Section 9D(1) of the Income Tax Act defines a 'foreign business establishment' as follows:

> '"[F]oreign business establishment", in relation to a foreign company, means–
>
> (*a*) a place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used by that controlled foreign company for a period of not less than one year, whereby the business of such company is carried on, and where that place of business–
>
> (i) is suitably staffed with on-site managerial and operational employees of that controlled foreign company and which management and employees are required to render services on a full time basis for the purposes of conducting the primary operations of that business;

(ii) is suitably equipped and has proper facilities for such purposes; and

(iii) is located in any country other than the Republic and is used for bona fide business purposes (other than the avoidance, postponement or reduction of any liability for payment f any tax, duty or levy imposed by this Act or any other Act administered by the Commissioner); . ..'

This definition also includes specific provisions dealing with mining, construction, agricultural land, or the use of a vessel or aircraft.

If a foreign company carries on a genuine business, its receipts and accruals will not be imputed to its shareholders. This is because section 9D(9) makes the provisions of section 9D(2) inapplicable to the CFC'S net income from a foreign business establishment.

At first glance it would appear that an opportunity exists for a planner who is the shareholder of a CFC that is foreign business establishment. This foreign company could then invest the 'planner's funds' in an offshore tax haven. Section 9D(9)(*b*)(iii), however, places a 10% limit on the amount of 'passive income' that a company may earn before it will be imputed to the shareholder.

Controlled foreign company

A 'controlled foreign company' means[64]

'any foreign company where more than 50 per cent of the total participation rights in that foreign company are held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents: Provided that–

(*a*) no regard must be had to any voting rights in a foreign company–

(i) which is a listed company; or

(ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;

[64] Definition of a 'controlled foreign company' in section 9D(1) of the Income Tax Act.

(*b*) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(*c*) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if–

(i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company , that person holds less than five per cent of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph (*e*)(ii) of the definition of a "company" in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person–

(*aa*) holds less than five per cent of the participation rights of that scheme or arrangement; and

(*bb*) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other. . .'.

Participation rights

An understanding of the term 'participation rights' is important for two reasons:

- First, it determines if the company will be regarded as a CFC.
- Secondly, it determines what portion of the CFCs net income is imputed to the South African resident.

Participation rights are defined in section 9D(1) as follows:

'"[P]participation rights" in relation to a foreign company means the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature.'

It includes voting rights. Voting rights are relevant only in so far as determining the status of a CFC. Voting rights are ignored when determining the amount to be included in the resident's income.

Voting rights are important, however, in deciding if the company is a CFC. Thus if a resident holds 65% voting rights and only 35% of the shares in a foreign company, the foreign company is a CFC by virtue of the fact the resident holds more than 50% of its voting rights. In determining how the resident shareholder should be taxed, only the participation rights relative to the shareholding apply (35% in the above example).

When indirect voting rights are used for the purposes of the determination of whether a foreign company is a CFC the test performed is as follows:

- Voting rights in a foreign company that can be exercised directly by another CFC in which a resident (together with his connected persons) can directly or indirectly exercise more than 50% of the voting rights are deemed for purposes of this definition to be exercised by him.

If the CFC carries on a bona fide foreign business establishment including, for example, shops or offices, the net income will not be attributable to the resident shareholder. He will be taxed only on a foreign dividend declared.

Net income

Section 9D(2) provides that there must be included in the income (for the year of assessment) of a resident who holds 10% or more of the participation rights in a CFC,

an amount equal to the proportional amount of its net income in the ratio of his participation rights to its total participation rights.[65]

In terms of section 9D(2A), the 'net income' of a CFC for its foreign tax year is

> 'an amount equal to the taxable income of that company determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer, and as if that company has been a resident for purposes of the definition of "gross income", section 7(8), 10(1)(*h*), 10(1)(*h*A), 25B and paragraphs 2(1)(*a*), 12, 24, 70,71,72 and 80 of the Eighth Schedule: Provided that . . .'.

Exclusions

Not all foreign companies are created to avoid tax. In terms of section 9D(9), certain amounts (exclusions) are not included in the determination of the net income of a CFC.

It is possible for the resident shareholder to elect for these 'exclusions' provided for in section 9D(9) not to apply. Section 9D(12) provides the resident with an option of disregarding the exclusions provided for in section 9D(9).

It may be more beneficial for a taxpayer to make an election in terms of section 9D(12) and hence qualify for the section 6*quat* rebate. Section 6*quat* provides for a special rebate for foreign taxes proved to be payable on income from a foreign source, which is included in the taxable income of a South African resident. It thus prevents a duplication of tax by allowing tax credits.

Section 9D(12) applies to a net income that would otherwise be excluded under section 9D(9). The purpose is to extend the benefits associated with a CFC and the tax rebate (section 6*quat*) to a resident who holds the required participation rights.

Section 9D(12) reads as follows:

[65] K Huxham and P Haupt *Notes on South African Income Tax* at 319.

> '[A] resident together with any other resident who is a connected person in relation to that resident, in aggregate holds at least 10 per cent but not more than 20 per cent or more of the participation rights and voting rights of a controlled foreign company may elect that all the provisions of subsection (9) shall not apply in respect of the net income determined for the relevant foreign tax year of any controlled foreign company in which that resident holds any participation rights.'

Section 9D(13) reads as follows:

> 'Any resident who, together with any other resident who is a connected person in relation to that resident, in aggregate holds at least 10 per cent but not more than 20 per cent or more of the participation rights and voting rights of a foreign company may elect that the foreign company be deemed to be a controlled foreign company in relation to that resident in respect of any foreign tax year of that foreign company.'

By exercising this election the shareholder will benefit from the section 6*quat* rebate for the foreign tax paid by a CFC in a *pro rata* share of the foreign income attributable to him, which would otherwise not have been available.

Disclosure

Section 72A(1) deals with the return that needs to be submitted by a resident relating to a CFC. It reads as follows:

> 'Every resident who on the last day of the foreign tax year of a controlled foreign company or immediately before a foreign company ceases to be a controlled foreign company directly or indirectly, together with any connected person in relation to that resident, holds at least 10 per cent of the participation rights in any controlled foreign company (otherwise than indirectly though a company which is a resident), must submit to the Commissioner together with the return contemplated in section 66 in respect of the year of assessment a return containing such information as may be prescribed by the Commissioner.'

The resident must have available for submission to the Commissioner when so requested, a copy of the financial statements of the CFC for the relevant foreign tax year.

If the resident fails to provide financial statements and does not have reasonable grounds for failing to comply, then

- the 'exclusions' do not apply, and
- the provisions of the section 6*quat* also do not apply.

Conclusion

If an amount is received or accrued to a foreign company that is a CFC, it will be taxed in the hands of the resident in terms of section 9D. This prevents a South African taxpayer, for example, Rupert, from transferring his income-earning activities to a foreign company thereby ensuring that his tax base is protected.

The fact that Rupert's non-resident trust is the sole shareholder, means that section 9D is not applicable to his scenario. The deeming provisions of section 7 and anti-avoidance provisions of section 80A will be applicable in this regard, but they are beyond the scope of this dissertation.

The worse scenario for a resident planner is that of investing his funds in a company when he owns less than 20% of its shareholding. Most foreign dividends that are paid to resident shareholder when his participation rights are less than 20% are taxed in South Africa. The resident shareholder will then be entitled to a section 6*quat* rebate for the withholding tax paid by him to the government of a country other than the Republic. He will not, however, be entitled to a rebate for the foreign tax payable by the foreign company declaring the dividend. This scenario leads to the unfortunate situation of the assets being taxed

- first, in the country of the company's residence, and
- secondly, in the hands of the resident shareholder when the foreign dividend is declared.

Accordingly the assets are subjected to a form of double taxation. A far better scenario is to be taxed as a CFC. This will mean the assets are taxed only once. To overcome the problem for the shareholder with a more than 10% but not more than 20% participation right, the Income Tax Act has two remedies available that will allow the resident planner the option of being taxed as a CFC (section 9D(12) and section 9D(13)).

With some investors having been granted amnesty, it is an opportune time for investors or resident shareholders to rearrange their offshore structures. Previously, for an investor who did not disclose his foreign assets, tax planning was not an area of concern. As these assets have now been disclosed, an investor or resident shareholder should ensure that he is receiving the full advantage that section 9D could offer. He should ensure that when appropriate he is not being taxed on foreign dividends declared by foreign companies.

Chapter 9

CONCLUSION

The change-over process from a source based to a world-wide basis has left many resident investors confused. The need for clarity is exacerbated by the fact that more than 40 000 people applied for and were granted amnesty of funds when the issue of tax was often not contemplated or considered. The overall objective of this dissertation has been twofold:

- First, to examine whether the use of an offshore trusts or a foreign company remains beneficial in light of the recent changes in legislation.
- Secondly, to assist the resident investor in reaching a decision on the most tax-efficient offshore investment vehicle.

These objectives have been achieved through an examination of the legislation and investment vehicles.

Trusts and CFCs

Tax planning for the structures or entities involves limiting a tax liability by avoiding connecting aspects whenever possible. If a connecting aspect cannot be circumvented then the terms of operation should be changed to make it more tax beneficial. The resident investor will be liable for tax if these factors cannot be changed. Recent amendments to legislation have made the avoidance of connecting factors more difficult.

The resident investor's reasons for creating an offshore trust should first be examined. These reasons should be weighed up against the shortcoming of using an offshore trust in light of the recent legislative amendments. Apart from possible estate duty savings, an investor can achieve a similar succession planning outcome by using an offshore endowment.

After an examination of the current tax legislation as it relates to these foreign structures, it is apparent that apart from the need to hide his assets (which is illegal) there are few reasons to use a CFC to house an investment. It may be advisable to dissolve these structures and rearrange the resident investor's affairs in their individual capacities.

Great care should be taken when advising a resident investor with regards to international investments and offshore trusts as a transaction funded by an interest-free loan to an offshore trust could fall within the so-called transfer pricing provisions of section 31. A result is that the resident, being the supplier or the loan, could be taxed on a deemed interest accrued determined at a market-related interest rate.

Vehicle

All vehicles can provide offshore exposure. One of the main consideration for determining how best to allocate the funds to the various vehicles, is tax.

Asset classes generate amounts that are received or accrued. In some situations a withholding tax is applied by the country where the assets are located. If the assets are held directly by the resident investor, the amounts received or accrued from the foreign assets may be subject to tax in the Republic. The resident investor may then be entitled to a rebate, exemption or credit. If the assets are held by investment vehicles it may be administratively impossible to claim these rebates. The resident investor may be taxed twice, namely,

- first, the withholding tax in the country where the assets are located, and
- secondly, foreign amounts received or accrued to be included in the resident investors world-wide income in South Africa.

An important consideration is the marginal rate of tax payable by the resident investor. If a withholding tax is levied against certain assets, it follows that the most

tax-efficient way for a resident investor to invest is to hold the shares or assets directly in his name and qualify for the rebate.

For many reasons a resident investor may choose to invest using vehicles rather than investing directly. Assuming the resident investor is paying the highest marginal tax (at present 40% for a natural person), retirement annuities, pension, provident and preservation funds may provide tax relief as discussed in Chapter 6 and should be considered.

It is the increase of the capital value that is subject to capital gains tax upon redemption of a roll-up fund. The distribution of income and dividends are not considered amounts received or accrued and thus not included in 'gross income'. It is submitted that a roll-up fund seems tax efficient.

Endowments are useful vehicles as a resident investor could take advantage of the arbitrage opportunity of being taxed at the representative rate of 30%.

In some circumstances, distributing OEICs appear to be the least tax efficient as they may be taxed twice.

Tax considerations based on the choice of investments are important. This however, should be only one of the many factors to consider when investing. Resident investors need to obtain professional advice.

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