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REPATRIATING OFFSHORE FUNDS- WHEN AND HOW?

The current lockdown in South Africa arising from the COVID19 pandemic has created unprecedented economic hardship to the South African economy which in many cases has severely impacted the financial position of South Africans. For those South Africans that structured their financial affairs so that much of their savings and assets were taken out or kept out of South Africa with approval of the Financial Surveillance Department ("FSD") of the South African Reserve Bank ("SARB"), or in compliance with the Exchange Control Regulations ("the Regulations"), now is the time to consider the necessity of repatriating funds back to South Africa in order to address the shortfall of personal or business cash flow.

For those that have maintained their offshore funds in their personal names, this process is quite simple and does not trigger any specific South African tax event (other than the act of liquidating assets that would likely give rise to capital gains tax), and only requires following the Balance of Payments banking protocols discussed below. However, where offshore assets have been structured in a tax and estate planning efficient manner through the use of an offshore trust, there are a number of issues to consider in order to ensure that the necessary repatriation of funds to South Africa is executed in a tax efficient manner.

A Typical Offshore Trust Scenario

With the correct South African tax advice, a South African settlor would have established an offshore trust in such a manner that it was not formed in South Africa and has its place of effective management elsewhere. This involves a leap of faith by empowering offshore resident trustees to have absolute discretion and control over the trust assets, which would include any request for distributions to South African resident beneficiaries. Typically, the South African settlor would have made a nominal donation to offshore trustees to be held for the benefit of discretionary beneficiaries. Further capital would have been introduced to the trust by way of an interest bearing loan.

The offshore trustees would have applied the proceeds received from the South African settlor by making various investments for the long-term benefit of the trust's discretionary beneficiaries, either directly or through other planning arrangements involving establishing and owning offshore companies.

How to Approach the Trust

It is important to note that neither the South African settlor nor any other SA resident should have any right to demand any funds from the trust. An interested beneficiary should make a formal request to the trustees motivating the reasons why trust funds are needed, including a motivation as to why the sum being requested is appropriate. This process should be formalized in writing (email correspondence will suffice) which clearly evidences that it is the trustees decision alone whether or not and how much to distribute to South African beneficiaries. This highlights the fact that no SA resident controls trust decisions, but rather it is an independent and unfettered decision made by foreign resident trustees.

In theory, there are three ways in which to request funds from the trust, namely-

- Repayment of a loan account claim against the trust;
- A request could be made for a loan from the trust;
- Request the trustees to make a distribution to a beneficiary (essentially a donation).

Repayment of Loans

In terms of section 31 of the South African Income Tax Act, No 89 of 1962 ("the Act") any loan by a South African resident to an offshore trust is deemed to attract interest at the prevailing official rate of interest as published by SARS. This interest income should have been declared and would have been taxed in each year of accrual. The repayment of capital and interest accrued would therefore not give rise to any taxable event in the hands of the South African creditor, other than possible capital gains tax ("CGT") on any currency gain made on foreign currency denominated loan that is converted back to Rands. Clearly, if a loan account claim exists, this is the first and most tax efficient way of drawing funds from the trust. Only once such loan account claims have been depleted will it then make sense to request distributions to beneficiaries arising from the gains held by the trust that exceed the original loan capital introduced. The likelihood of substantial capital having been introduced to the trust by way of donations is unlikely given the donations tax exposure.

Request for Loan Funding

In theory this would be a tax efficient way to extract trust funds. However, the granting of a loan by a non-resident trust to a South African resident individual requires FSD approval in terms of the Regulations. It is the prevailing FSD policy not to approve a foreign loan to a South African resident borrower where the foreign lender is an entity where South African residents have a direct or indirect interest (such interest would include being a discretionary beneficiary of a foreign trust) on the grounds that the loan would constitute a so-called "loop structure". It should be noted that by March 2021 the Regulations are expected to be substantially revised and there is a possibility that receiving foreign loans from an offshore trust may not be a contravention of the Regulations or FSD policy by 2021.

Beneficial Distributions from the Trust

The most likely scenario is that most of the trust fund represents the revenue and capital growth of the original funding or assets introduced to the trust when it was first established. Depending on the nature of such distributions, the South African tax burden may vary substantially. In terms of the common law rules relating to trusts, income of a trust which is distributed to its discretionary beneficiaries in the same financial year as receipt by the trust will be deemed to have accrued to its beneficiary in accordance with the so called *conduit-pipe* principle whereby the nature of the income in the trust is passed on to the beneficiary. This "flow through" principle has been emulated in the wording and the operation of section 25B(2A) (with respect to revenue distributions arising from revenue receipts in previous financial years of the trust) and paragraphs 80(2) and 80(3) of the Eighth Schedule to the Act (with respect to capital receipts distributed by an offshore trust that arose from capital gains in a previous financial year of the trust). These sections effectively provide that where an offshore trust makes a distribution (in terms of a vesting of funds in the hands of a South African tax resident beneficiary) and such distribution represents income or capital gains derived by the trust in a previous year of assessment, then-

- If the revenue or capital gains distributed would have been subject to South African income tax had the offshore trust been a South African tax resident in the year in which such income was received or accrued, then in the year of assessment when such distribution of such revenue or capital gains is then vested into the hands of a South African beneficiary, then the South African beneficiary is exposed to income tax or CGT, as the case may be, on such distributions;
- If the offshore trust would not have been subject to taxation on the revenue or capital gains that had accrued to the trust in previous financial years had the offshore trust been a South African taxpayer, then the distribution of such revenue or capital gains to South African beneficiaries in a subsequent financial year would also not be subject to taxation in the hands of the beneficiaries.

Given the above application of the Act, it becomes extremely important that at all times the trustees maintain the accounting records of the trust so as to carefully differentiate the following-

- The original capital introduced to the trust by way of donation or loan funding;

- The historical revenue gains of the trust, distinguishing that portion of historical revenue gains that would have been subject to South African tax had the offshore trust been a South African taxpayer, and that portion which would not have been subject to tax;
- The historical capital gains realized by the trust in previous financial years, again differentiating between what would have been exposed to CGT in South Africa and what gains would not had the offshore trust been a South African taxpayer in the relevant years.

Having kept careful records as explained above, *it then becomes critical that the trustees carefully allocate what portion of the historical gains are being distributed to South African beneficiaries.* This should be recorded in a carefully worded trustee resolution. It will be in the interests of the South African beneficiaries to firstly allocate revenue and capital gains that would not have been subject to tax had the offshore trust been a South African taxpayer (thereby not exposing the beneficiaries to South African taxation on the

distributions received), and then only lastly allocate taxable gains with due regard to an effective 18% CGT tax rate, a 20% tax rate on foreign dividends and a maximum marginal tax rate of 45% in respect of taxable revenue gains. The above investigation would invariably involve the necessity for the trustees to obtain considered South African tax advice before finalizing any distribution to its beneficiaries so as to incur the least possible tax exposure.

A few examples will be helpful to illustrate the above principles –

- If the offshore trust makes a distribution of foreign dividends received by it in a previous year arising from a minimum 10% and a maximum 50% shareholding in an offshore company, the offshore trust would have been exempt from South African tax had it been a South African taxpayer by virtue of the exemption on foreign dividend income as provided for in section 10B(2)(a) of the Act, which means that if this foreign dividend income is then distributed to South African resident beneficiaries in a later year, such distributions would also be exempt from tax in the hands of the South African recipients;
- If the offshore trust makes a distribution of foreign dividend income received by it in a previous year arising from less than 10% or more than 50% shareholding in a foreign company, had such offshore trust been a South African taxpayer it would have been subject to tax on foreign dividends in South Africa, which means that if such foreign dividends are

distributed to South African resident beneficiaries, such South African resident recipients would be subject to 20% tax on the beneficial distribution received;

- If the trust makes a distribution of capital gains realized in a previous year, the trust would have been subject to CGT in South Africa, and accordingly if such capital gains are then distributed to South African resident beneficiaries, the South African recipients are subject to CGT at a maximum effective tax rate of 18%;
- If the trust derives trading profits or interest income in a previous year of assessment, the offshore trust would have been subject to full taxation on revenue gains had it been a South African taxpayer, which means that the distribution in a following year of such revenue gains will be subject to taxation in the hands of the South African resident beneficiaries at their respective marginal rates of tax.

The Remittance Process

The application of the Regulations in conjunction with the South African banking protocols requires that any transfer of offshore funds in foreign currency to the South African bank account of a SA beneficiary requires compliance with the Balance of Payments (“BOP”) reporting process. This involves completing an applicable BOP Form to support the inward payment of foreign currency into a South African bank account in the course of an application to the bank to sell foreign currency and purchase South African Rands. All of the South African banks have similar BOP Forms to complete that require disclosure of the nature of the inflow of funds by choosing from a list of defined categories. Once the applicable BOP Form is completed the South African bank will generally confirm an exchange rate for the conversion of the foreign currency inflows into South African Rands. For large inflows it is advisable to shop around with various foreign currency exchange service providers that may provide a far more competitive exchange rate than the commercial banks.

Should the inflow represent the repayment of a loan account claim, generally one would consider what the nature of the original capital was that was advanced to the trust as a loan. For example, should this have been historical foreign earnings paid by a foreign resident employer, this may be disclosed under category number 303 on the BOP Form. Should this have been the annual discretionary allowance or personal investment allowance funds that a South African previously took out of South Africa for the purposes

of lending to the trust, this return of foreign investment allowance may be cleared under one of the sub-categories of category 511. In the case where the trustees make beneficial distributions to beneficiaries out of the funds held by the trust, this constitutes a foreign gift that would be declared in the BOP Form under category 401.

For many South Africans now may be an appropriate time to bring back offshore funds in this time of financial crisis. As has been illustrated above, it would be in the interests of the South African resident beneficiaries to follow the certain protocols to ensure that the repatriation of funds from an offshore trust attracts the lowest possible SA tax exposure.

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