

SOUTH AFRICAN LOOP STRUCTURES: EXPECTED CHANGES TO THE EXCHANGE CONTROL RULES

What is a Loop Structure?

Due to its legalization since the beginning of 2021, the use (and abuse) of loop structures has been popular. In simple terms a “loop structure” (herein after referred to as a “Loop”) is an arrangement whereby South African resident individuals directly or indirectly hold an interest (including a discretionary interest) in foreign resident entities that in turn have financial interests within South Africa, usually in the form of loan claims, other economic rights or equity ownership interests. Many South African residents have opportunities to invest into n South Africa, but wish to hold such interests through an appropriate structure that is resident outside of South Africa, with the objective of saving South African taxation, as well as having South African assets which can ultimately be liquidated and the proceeds remitted out of South Africa into foreign currency with less exchange control restrictions. Political risk management and enhancing the attractiveness of location of ownership for sale of a business internationally are also possible advantages.

Given the fairly clear meaning and the policing of Loops by the Financial Surveillance Department (“FSD”) of the South African Reserve Bank of SARB (“SARB”) over the years, either directly or through South African banks that act as authorized dealers for SARB, a very wide interpretation of what constitutes a Loop arrangement is taken and **in our experience often taxpayers and their advisors take the view that a particular arrangement does not constitute a Loop, when in fact it does.** This includes the following –

- The incorrect understanding that for a Loop to exist this must involve the taking out of South African funds from a South African source, which are then “looped” back into South Africa through an offshore structure in the course of making a loan, acquiring rights against SA residents or acquiring South African assets. This is not a requirement for a Loop, and **a Loop will exist even if there has been no previous remittance of funds from South African that finds its way back into South Africa**, such as where the funding of an offshore structure being part of a Loop is obtained from foreign sourced funds such as foreign earnings, foreign capital gains and investments, foreign inheritances or even third party funding from non-South Africans. The key factor that determines the existence of a Loop is

simply that the direct or indirect ultimate beneficiaries of such foreign structure are South African residents;

- For estate and income tax planning purposes invariably a Loop involves SA resident individuals establishing an offshore discretionary trust that will act as the shareholders of a foreign company that in turn will make a South African investment. Another false understanding is that if South African residents do not have a vested interest in the offshore trust or through other types of contractual arrangements do not have an existing real right to benefit from the offshore structure, such as the simple situation of being a discretionary beneficiary of an offshore trust, this does not constitute a Loop as no South African resident has an immediate claim or real right in the offshore structure. This is not how the FSD interprets such arrangements, and the FSD has for decades held a firm view that where an offshore structure is set up and funded by South African tax residents, alternatively **where South African residents have a future contingent right to benefit from the offshore structure, such as being discretionary beneficiaries of an offshore trust, this does constitute a Loop.**

Until 2019 the Regulations clearly provided that any South African resident participating directly or indirectly in a Loop was in breach of Regulation 10(1)(c) which prohibits the exportation of capital from South Africa, which Regulation is very widely interpreted and applied by the FSD. The South African Treasury realized that making a Loop a contravention of the Regulations was preventing South African residents from investing their legitimate foreign funds into South Africa through a foreign structure. In order to encourage South Africans to invest their foreign currency held indirectly in foreign structures back into South Africa for the benefit of the South African fiscus the illegality of Loops was partially removed in terms of Exchange Control Circular 18 of 2019 whereby with effect from 31 October 2019 a Loop was legalized only for individuals and only to the extent of a maximum 40% South African individual direct or indirect participation in such Loop. This partial relaxation was then completely relaxed in terms of Exchange Control Circular 1 of 2021 whereby as from 1 January 2021 any Loop established after that date would not constitute a breach of the Regulations, but subject to a reporting requirement through an authorized dealer giving full details of the Loop, including the following-

- An explanation of how the Loop was established, full details of all participants in the Loop (including non-residents of South Africa), how the foreign structures in the Loop were funded and illustrating that authorized funds were used in the case of SA resident funding, and full details of the various transactions that form part of such Loop;
- Independent confirmation from an auditor verifying that the transactions comprising the Loop are on an arm's length basis, and for fair and market related consideration;
- An undertaking to provide an annual progress report to the FSD through an authorized dealer relating to the Loop.

Abuse of Loops and Expected Changes

The spirit of the legalization of Loops was to encourage fair and market related consideration in the form of foreign currency flowing into South Africa in order to acquire South African based growth assets. In practice, many corporate consultants, tax advisers, lawyers and audit firms came up with aggressive arrangements not only to limit the tax exposure that arises from a Loop being implemented, but also to facilitate the ease of promoting Loops where the necessary foreign currency required to be remitted into South Africa in exchange for South African assets was lacking. A typical arrangement to illustrate this is the establishment of an offshore company held by offshore trusts (with South African discretionary beneficiaries) that were funded with authorized assets of a relatively nominal value, followed by the establishment by the offshore company of a wholly owned subsidiary in South Africa that was funded with a nominal amount of foreign currency inflows (given that it is a shelf company or newly incorporated company with no value), and thereafter the South African subsidiary acquires the target South African business or company with growth value at fair market value but based on an acquisition on loan account, with a long purchase price payment obligation. The result of such an arrangement is that nominal inflows of foreign currency come into South Africa, with the foreign structure acquiring an interest in South African growth assets that it has not had to pay for until a future time, resulting in all growth of the South African investment effectively accruing to the offshore structure with no benefit to the South African fiscus.

The FSD realized the extent of this abuse, and **since around mid 2022 the original notification and reporting obligation (previously not being an application for FSD**

approval of a Loop) has been changed by way of the FSD informing all authorized dealers not to permit a Loop to be executed unless the authorized dealer is satisfied that the Loop is concluded in a fair and market related manner involving-

- The immediate inflow of the entire purchase price in foreign currency to acquire the South African asset;
- Careful scrutiny as to the basis of valuation of the South African assets sold directly or indirectly to the foreign structure, including through a locally held subsidiary;
- If in doubt the Loop should be reported by the FSD for consideration before it is executed.

Accordingly, for at least the last 18 months the exchange control departments of authorized dealers are instructed to carefully scrutinize the proposed Loop and ensure that there is no artificiality, including ensuring that the spirit of the legalization of Loops have been achieved, being the inflow of foreign currency into South Africa without any delayed payment terms and at consideration that is fair value for the South African assets being acquired, with careful consideration to arrangements whereby South African subsidiaries of foreign companies are established.

This means that a number of the early Loops in 2021 and 2022 that were reported may in the eyes of the FSD be unlawful and when the time comes for the remittance of currency out of South Africa, the FSD or the authorized dealer may deny such outflow, examine the original Loop's establishment, and if not acceptable the Loop would need to be unwound.

Authorized dealers have been advised by the FSD that the SARB are working on a guideline to be published hopefully in 2024 that gives clear criteria of what they would endorse as a legitimate Loop, with the possible change of becoming an application for approval process rather than being only a reporting process.

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