TAX ISSUES RELATED TO SOUTH AFRICAN LOOP STRUCTURES: MANAGING TAX BENEFIT EXPECTATIONS

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 interests in South African companies.

The Liberal Application of Section 42 of the Income Tax Act

Invariably, to implement a Loop will require South African residents disposing of a South African asset into the foreign owned acquirer resulting in material capital gains tax ("CGT") exposure in South Africa for the disposer. Accordingly, **much use (and in our view at times abuse) of the so-called "asset-for-share" roll-over relief provisions provided for in section 42 of the South African Income Tax Act ("the Act") have been applied**. Section 42 is a relatively complex section that over the past few years has been revised in order to eliminate its abuse, and limit its function as "roll over" relief so as to postpone (but not eliminate) the CGT liability arising from a sale of South African assets (which may include shares in a South African company) in defined corporate restructuring situations on the basis that consideration is given for such disposal by way of taking up shares in another South African based company acquiring the assets. In the context of a Loop the local acquiring company will at least be partly owned by the offshore structure involved. The danger in many of the section 42 arrangements is that the effect thereof may often be to artificially limit the interest of the seller in the purchaser entity, and **in our view many of these section 42 arrangements are at a high risk of being attacked by the South African Revenue Services ("SARS") on the grounds of being an "impermissible tax avoidance arrangement"** as contemplated under sections 80A through to 80L of the Act on the grounds of being artificial, abnormal and not what would be expected between parties transacting at arms length.

New Tax Treaty Anti-Abuse Rules

One of the driving forces that encourage Loops is reduced exposure to South African taxation. Whilst it is fairly clear that if the foreign structure is in a jurisdiction that has a Double Taxation Agreement ("DTA") with South Africa, in the absence of immovable property rich South African assets, the likelihood is that if the offshore company in future disposes of its shareholding in the South African companies that it holds in terms of the Loop, such disposals will not give rise to CGT in South Africa. However, **various participants and their advisors on Loops are in our view falsely under the impression that the Loop will reap the benefits of substantially reduced withholding tax on dividends (and interest) received from the South African companies that form part of the Loop**. Typically, in terms of a DTA where a foreign company holds more than a 10% equity participating interest in a South African company, then the dividend withholding tax applicable is reduced from 20% to 5%, often with no further taxes on such foreign dividend income in the hands of the foreign company for certain lower tax paying jurisdictions that have DTA's with South Africa, Mauritius being one example.

The problem with this expectation is the recent introduction and application of an OECD driven Base Erosion and Profits Shifting counter-measure known as the Multilateral Instrument ("MLI"). Simply put, the MLI is an umbrella treaty arrangement whereby its country participants agree to be bound by certain automatic amendments and limitations of their respective DTA's with counterpart countries that are members of the MLI and have made the same elections. South Africa is a party to the MLI with effect from 1 January 2023, (currently there are 102 participating countries) and accordingly SARS may make use of the MLI as a tool to challenge withholding tax relief on various grounds, depending on the elections made with the receiving country with whom it has a DTA. One of the compulsory elections that all members of the MLI have been obliged to make is to subscribe to one of the treaty anti-abuse provisions (the MLI gives three possible options to choose from) in order to prevent the DTA being used as a tax treaty shopping tool whereby the existence of a company or person that is claiming DTA benefits as a tax resident in that country is primarily in order to enjoy the benefits associated with that DTA.

South Africa has ascribed to the lowest test known as the "principal purpose test" ("PPT") which is a subjective anti-avoidance measure based on the reasonable assumption as to the relevant purposes of the party claiming DTA relief being resident in a particular country. **The**

PPT has the effect of denying tax treaty benefits where it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that DTA benefit is one of the principal purposes (it need not be the only purpose) of the party seeking to rely on the relevant DTA.

For example, Mauritius and South Africa have both elected the PPT test as the compulsory treaty anti-abuse provision for their DTA. Applying the PPT to the general situation of a Loop, in the ordinary course the offshore company is established in Mauritius ensuring that it complies with the fairly formalized legal requirements in order to be Mauritian tax resident and therefore be able to rely on the Mauritian DTA network, and this Mauritian company (usually held by offshore trusts resident in Mauritius or elsewhere) is funded directly or indirectly by the SA resident participants and functions as a pure investment holding company in order to passively hold its investment into South African assets that form part of the Loop, hoping to benefit from the growth of the South African assets and the ultimate disposal of South African companies without incurring South African CGT, and in particular to have the benefit of extracting profits from its South African investment in terms of a reduction of dividend withholding tax from 20% to 5% in terms of the Mauritius-South Africa DTA.

The problem here is that given that the Mauritian holding company has no local ownership, no or very limited Mauritian business presence or commercial activity of substance, no investment into Mauritian assets and generally has no plausible reason to be resident in Mauritius other than to take advantage of the DTA, it will most likely fail the PPT and SARS will be perfectly within its rights to deny withholding tax relief on dividends declared or interest paid by its South African companies, resulting in the same 20% dividend tax applying that would have applied had the Loop not been implemented.

Conclusion

In the right circumstances Loops may be highly beneficial in order for South Africans to mobilize legitimate foreign currency towards South African investment opportunities. However, there are various costs to implementing and maintaining a foreign structure, and these costs need to be compared to the financial and commercial benefits over time. Whilst a possible CGT benefit will likely be secured (assuming that the South African investments are disposed by the way of sale of shares in South African companies rather than a sale of business by South African companies), in most circumstances the perception of getting dividend

withholding tax relief in South Africa will likely not be achieved by virtue of the MLI, unless substantially more is done to justify the location in which the foreign company is tax resident. In addition, the CGT exposure on disposal of the South African assets into the offshore structure needs to be carefully executed with due regard to the fact that CGT will likely only be postponed, rather than reduced or eliminated. There are also various other developments in terms of expected changes to the exchange control rules that need to be considered. Clearly, **Loops are not a "one size fits all" by any means, and careful consideration of short and long term costs and tax risk management exposures needs to be prudently analyzed before embarking on a Loop arrangement**.

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