Relaxation of loop structures - but at what tax cost?

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The envisaged future relaxation of the prohibition on loop structures will be accompanied by amended tax laws, but current proposals are likely to result in more tax on certain structures

National Treasury has proposed a number of amendments to tax legislation as a result of the potential future relaxation of the South African Reserve Bank's (Sarb's) current prohibition on so-called loop structures. Unfortunately, these tax amendments do not appear to have been the result of a holistic approach to the issue and are somewhat one-sided (in the South African Revenue Services' (Sars' favour). Instead of levelling the playing fields to ensure that the fiscus is no worse off than it otherwise would have been in the absence of a loop structure, the proposed amendments will, in some instances, actually result in more tax being imposed than would be the case now.

Shareholding structures

In the context of shareholding structures, the prohibition on loop structures is aimed at situations in which one or more South African shareholders, either directly or indirectly, hold shares in a foreign entity which in turn holds shares in one or more companies in the common monetary area (South Africa, Namibia, Lesotho and eSwatini). This prohibition is, however, subject to dispensations granted by the Sarb, which have been expanded in recent years. Currently, a loop structure may be permitted provided that the South African resident shareholder in the foreign company (on its own or together with other South African residents) holds no more than 40% in aggregate of the shares or voting rights (whichever is greater) in the non-resident company.

To promote investment, the Sarb has indicated that at some future point, and subject to tax law changes that may be needed, approval will no longer be required where the 40% shareholding is exceeded. With the relaxation of the restrictions, there will be more investment opportunities available to South African investors, which should benefit the local economy in the long term.

The tax authorities are concerned that the existence of a loop structure may result in loss of tax to SA, especially in the context of dividends paid by South African companies to the foreign holding entity instead of directly to local shareholders, and capital gains made by the ultimate South African shareholders on the sale of their shares in the foreign entity, when previously they would have been disposing of local shares.

National Treasury is fortunately not proposing to target all loop structures but only those in which the South African shareholder interposes a controlled foreign company (generally a company held more than 50% from SA) between themselves and companies in SA. The proposal has the effect that dividends paid by the South African company to the foreign company will suffer both local dividends tax (at 20% or a reduced tax treaty rate if applicable) and also income tax under the CFC rules. Whether the ultimate South African shareholders are individuals or companies, more South African tax will be triggered than if the South African shareholders had received the South African dividend directly. There is no clear justification for this.

Short sighted

Dividends paid by a South African company to a South African individual are subject to 20% dividends tax but no income tax. Dividends paid between South African companies are, however, fully tax exempt. Arguably, the proposed amendment should be changed to prevent any income tax from being triggered on the dividend paid to the foreign company where the shareholder in that foreign company is a South African tax resident company. In addition, where the South African shareholders in the controlled foreign company are individuals or trusts, the amount on which the South African income tax is payable should be adjusted to ensure that the rate of South African income tax on the dividend is no greater than 20%, namely the dividends tax rate that would have applied had they received the South African dividend directly.

National Treasury has also proposed that the capital gains tax exemption which can apply on the disposal of shares in a foreign company should not apply to the disposal of shares in a controlled foreign company to the extent that the value of the controlled foreign company's assets are derived from South African assets. Practical difficulties may arise in performing this calculation.

This proposal will penalise South African tax residents for investing in a foreign company which may have held South African assets for many years prior to the South African tax resident's investment in the foreign company. Discouraging investment in this manner appears to be short-sighted and potentially detrimental to economic activity.

Reorganisations

Another problem is that SA's tax neutral group reorganisation rules have not been expanded to cater for reorganisations where loop structures are involved, even though all parties to the relevant transaction are either directly (or indirectly through the controlled foreign company rules) within the scope of South African tax. It is important that, in addition to introducing measures to protect the tax base, National Treasury should also amend the tax legislation to facilitate genuine business transactions which will in future be permitted in the loop structure environment.

National Treasury has acknowledged the submissions made on the difficulties created by the proposed amendments, and we await with interest its response to our concerns.

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