

# The not-so golden loop structure of cross-border tax

By [Louis Botha](#)

24 Aug 2018

In deciding whether to invest abroad and which country to invest in, taxpayers would potentially consider whether South Africa has a double tax agreement with a specific country.



Louis Botha, associate in the tax and exchange control practice at Cliffe Dekker Hofmeyr

However, it is important that taxpayers also consider South Africa's exchange control rules and ensure that where an offshore investment is made, they comply with these rules. One of the biggest pitfalls to avoid, is creating a loop structure, which is considered to be a serious contravention of South Africa's exchange control rules.

## What is a loop structure and why is it unlawful?

A good description of a loop structure is set out in a policy document that was released by the South African Reserve Bank's Financial Surveillance Department (FinSurv) on 17 November 2016 entitled: *Exchange Control Special Voluntary Disclosure Programme policy dealing with 'loop structures' (including 74/26 structures)*. This document sets out FinSurv's policy regarding the regularisation of loop structures in terms of the exchange control special voluntary disclosure programme that was in place between 1 October 2016 and 31 August 2017.

According to the policy document, loop structures entail the formation by a South African resident of an offshore structure which, by reinvestment into the republic, acquires shares, loan accounts or some other interest in a South African resident company or a South African asset. The document adds that transactions creating loop structures contravene, amongst other provisions, Regulation 10(1)(c) of the Exchange Control Regulations, 1961 (Regulations). Regulation 10(1)(c) states that no person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose, enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the republic.

The Policy Document sets out how a loop structure can be created and its potential consequences, as follows:

- A South African resident individual, trust or corporate entity transfers authorised or unauthorised funds (could also be existing offshore funds or a combination thereof) from the republic to set up, for example, a foreign trust or foreign entity. (Authorised funds are those foreign funds held in a manner that does not contravene the regulations.);
- The foreign trust or entity involved would then directly or indirectly (via another offshore entity) reinvest its authorised or unauthorised funds in the republic, thereby creating a loop structure. The reinvestment could be in the form of South African shares, assets or loan accounts being acquired or created;
- The South African resident would in some instances thereafter export returns made on the South African investment by way of, amongst other things, the payment of dividends, profits, interest and/or loans to the foreign structure; and
- The result of the loop structure is that the investment of funds from the offshore structure into the republic and the payment of dividends, profits or interest offshore results in the accumulation of value over and above the nominal foreign investment that was initially made.

From the above example, one can also see that a loop structure has the effect of reducing South Africa's tax base and could reduce any taxes that the offshore structure would have to pay in South Africa.

South African residents must keep in mind that although the regulations and policy document only refer to the republic, the prohibition against creating loop structures applies to the reinvestment into all countries forming part of the Common Monetary Area (CMA). The CMA consists of South Africa, Swaziland, Lesotho and Namibia. This is stated in the *Currency and Exchanges Manual for Authorised Dealers*, which must be read with the regulations.

## **Are loop structures unlawful under all circumstances?**

As stated above, Regulation 10(1)(c) states that transactions which result in the export of capital from the republic may only be entered into with the permission of the Treasury and on such conditions as the Treasury may impose. According to the manual, the word "Treasury" refers to the minister of finance or National Treasury, including the persons to which the minister has delegated this authority, including the governor and deputy-governor of the South African Reserve Bank. Loop structures may therefore only be created where Treasury has given its permission for this to take place.

In terms of the manual, some of the circumstances under which a loop structure may be created, are the following:

- Section B.2(B) of the manual states that where a South African resident has created an unintentional loop structure, by investing with non-resident asset or fund managers who invest in foreign companies that have CMA assets, or in offshore global investment funds that hold CMA investments (directly or indirectly) over which the South African investor has no control, are permitted. It is important to keep in mind that the South African investor must have made the investment after taking the invested funds abroad legally.
- In terms of section B.2(F) of the manual, South African technology, media, telecommunications, exploration and other research and development companies may establish an offshore company to raise foreign funding for their operations, subject to certain conditions. These conditions include registering with FinSurv and ensuring that the established offshore company is a tax resident in South Africa. Such companies may hold investments and/or make loans into South Africa, even though the investment or loan would create a loop structure; and
- In terms of section B.2(A) of the manual, a South African company is now permitted to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign market entity, which may in turn hold investments and/or make loans into any CMA country. This dispensation does not apply to foreign direct investments where the South African company on its own or where several South African companies collectively hold an equity interest and/or

voting rights in the foreign target entity that exceed 40% in total. Loop structures that exceed the 40% threshold require FinSurv approval with due consideration to transparency, tax, equivalent audit standards and governance. Previously, a South African company could not hold an interest in the foreign entity exceeding 20%. The increase to a maximum 40% interest that may be held was announced in the 2018 Budget and was set out in Exchange Control Circular No. 5/2018, which was released on 21 February 2018.

When considering investing abroad or setting-up offshore structures through which to invest or do business, South African residents must ensure that they comply with not only South Africa's tax laws, but also with South Africa's exchange control laws. FinSurv has broad powers in terms of the Regulations and at worst, could even declare that foreign assets held in contravention of the regulations, such as through an unlawful loop structure, must be forfeited to the state. It is therefore important that before investing abroad, South African residents ensure that they receive correct and accurate advice, especially where large sums of money are involved.

## ABOUT THE AUTHOR

Louis Botha is an associate in the tax and exchange control practice at Cliffe Dekker Hofmeyr

For more, visit: <https://www.bizcommunity.com>