tax notes international
Volume 58, Number 10 ■ June 7, 2010

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Government Considering Tax Breaks For Foreign Investors

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Reprinted from *Tax Notes Int'l*, June 7, 2010, p. 794

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COUNTRY DIGEST

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Government Considering Tax Breaks For Foreign Investors

The government has released for public comment the first draft of South Africa's 2010 Taxation Laws Amendment Bill (TLAB), together with an explanatory memorandum. Among the measures proposed is the introduction of a regional holding company regime that would allow foreign companies to set up headquarters in South Africa and then invest throughout Africa and that would exempt them from a number of existing corporate tax laws in the Income Tax Act. The TLAB also proposes that qualifying limited partners and trust beneficiaries become eligible for certain tax relief to ensure that tax issues do not deter foreign investors from using South Africa as a regional investment fund location. As proposed, the measures would enter into force on January 1, 2011.

Regional Holding Company Regime

Currently, South Africa's ITA has significant drawbacks that hinder the country's attractiveness as a holding company jurisdiction. First, the controlled foreign corporation provisions expose the foreign shareholders of a South African holding company to a double administrative tax burden if their own country also has CFC rules. Second, the secondary tax on companies adds a 10 percent charge if profits are repatriated from the holding company to foreign investors, even if the funds originate from abroad. Third, if a South African holding company is financed with debt capital, the thin capitalization rules create a critical barrier: If a foreign investor wants to fund the holding company with back-to-back loans, the arrangement will likely be viewed as excessive in relation to the equity capital, leaving the holding company with nondeductible interest payments and corresponding taxable interest income.

Under the proposed amendments, qualifying holding companies would be eligible for some tax breaks, as listed below:

- the foreign subsidiaries of a qualifying holding company would not be treated as CFCs;
- dividends declared by the holding company would generally be exempt from the secondary tax on companies (or the new dividends tax, once it comes into operation); and
- the holding company would not be deemed to be in breach of thin capitalization rules because of the existence of back-to-back cross-border loans involving the holding company.

To qualify for the tax breaks, companies would have to meet the following criteria:

- each shareholder of the holding company would be required to hold at least 20 percent of the equity shares in that holding company throughout the tax year;
- 80 percent of the tax value, or base cost, of the holding company would have to represent (equity or debt) investments in foreign subsidiaries in which the holding company holds at least 20 percent of the equity shares (with compliance to be measured at the end of each tax year);
- 80 percent of the total receipts and accruals relating to the holding company (including management fees, interest, royalties, dividends, and sale proceeds derived from the foreign subsidiaries) would have to be derived from foreign subsidiaries in which the holding company holds at least 20 percent of the equity shares (with compliance to be measured at the end of the tax year); and
- the holding company would have to have complied with the aforementioned requirements for each assessment year since the company's inception (the so-called uninterrupted compliance requirement).

Qualifying holding companies would be deemed to be nonresidents for purposes of the reorganization rollover rules in Part III of the ITA. As a result, nonqualifying companies could not enter into reorganization rollovers with qualifying holding companies. The purpose of this proposal is to discourage artificial entry into the holding company regime so as to avoid the uninterrupted compliance requirement discussed above.

Regional Investment Fund Regime

Currently, under South African law, the tax system does not recognize a partnership as a legal entity and

therefore looks through the partnership to tax the investing partners directly. If the partners are nonresident, they are taxed on a source basis like any other nonresident investor. Foreign investors are subject to tax on their South African-source income, but interest is generally exempt. However, the exemption for interest does not apply to foreign investors if the interest is attributable to a South African permanent establishment.

In limited partnerships, the general partner generally has a presence in South Africa, which then creates a PE for each of the limited partners. As a result, each limited partner is subject to South African tax on its proportionate share of the passive partnership income. However, if the same investors had invested directly into South Africa, most of the same income would have fallen outside the South African tax net.

Similar principles apply to trusts organized as vested bewind trusts (trading vehicles that provide the trustees with limited liability and some tax advantages). Once again, the activities of the trustees with a presence in South Africa will create a PE for the trust beneficiaries, which in turn exposes the foreign investors to South African tax that would not otherwise have existed if the trust beneficiaries had held the underlying passive assets directly.

As proposed in the TLAB, qualifying limited partners and trust beneficiaries would become eligible for some tax relief measures. First, the foreign limited partners (or trust beneficiaries) would be placed in the same position as if they had invested directly in the underlying assets of the partnership (or trust). As such, those investors would not be exposed to South African tax merely because of the activities carried on by a South African general partner (or trustee). And second, the management fees of the South African general partner (or trustee) would remain taxable in South Africa.

The proposed amendments would provide relief for limited partners and trust beneficiaries whose economic position is similar to that of a passive shareholder in a company. To be eligible, a qualifying partner (or trust beneficiary) would have to satisfy the following requirements:

- its liability toward third parties could not exceed the amount contributed (that is, the partner or trust beneficiary must have limited liability like a shareholder of a company);
- the partner (or trust beneficiary) could not participate in the effective management of the business of the partnership (or trust);
- the partner (or trust beneficiary) could not have authority to act on behalf of the partnership (or trust); and
- the partner (or trust beneficiary) could not receive any income for services it performed for the benefit of the partnership (or trust).

Regarding the creation of a PE, the general partner of a partnership (or a trust beneficiary) would be treated as an independent agent in relation to the qualifying partners and trustees. This status would mean that the activities of a general partner (or trustee) in South Africa would not create a PE for the qualifying partner (or trust beneficiary).

The independent agent status would have the same liberalizing impact when applying tax treaties because the South African enabling legislation treats the tax treaty rules as if they are fully incorporated into South African tax law. However, it is important to note that the independent agent status is limited, in that it applies only in relation to gross receipts and/or accruals derived from financial instruments — or the disposal of those financial instruments — and does not apply for any other form of partnership or trust income. ◆

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