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Fertile ground in foreign fields

South African corporates have a much freer hand when it comes to making international investments

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SOUTH African corporates have come a long way in the last decade in terms of their ability to make foreign investments. In fact, in a statement on exchange control issued on 23 February 2000 by former governor of the South African Reserve Bank, Tito Mboweni, it said that in terms of new relaxation rules South African corporates were entitled to transfer up to R250m from SA per new investment into member states of the Southern African Development Community (SADC) and up to R50m per new investment elsewhere.

The South African corporate had to hold more than 50% of the shares and votes in such offshore entities.

Compare this to today where there is no monetary limit in respect of a South African corporate's ability to invest offshore. Further, only 10% of the voting rights need to be held by the South African corporate investor.

From a South African tax perspective, 10 years ago SA had a simple source-based tax regime. This changed in February 2000 when the country started its move towards its current complex worldwide tax system where even the income of offshore subsidiaries of South African companies is taxable in SA.

Given the constant changes to the regulatory environment in respect of foreign investments this article seeks to provide some guidance to investors in respect of these issues.

The principal exchange control rule is that authorised dealers (commercial banks) may approve foreign investments by South African corporates of amounts up to R500m. Amounts exceeding R500m must be approved by such investments.

However, it should be noted that such approvals require written applications either to the authorised dealer or to the Bank. Such applications must, amongst other things, set out an outline of the anticipated benefits to SA of the foreign investment.

This does not include dividend flows. Instead, it should be shown that there will be, for example, increased exports from SA or royalties, management fees or other income flows (excluding dividends) into SA as a result of the offshore investment.

Further, an annual report-back is required in respect of the offshore investments. The retention by the offshore entity of profits earned must be negotiated with the Reserve Bank at the time of the annual report-back.

The offshore entity may declare, but not pay, dividends to its South African shareholder and retain such funds offshore which may then be used for any purpose by the offshore entity. The Bank has become far more relaxed about approving applications in respect of foreign investments retaining profits offshore in the offshore entity.

However, there are two important points which need to be noted.

Firstly, the "loop principle", which prohibits a South African investor from acquiring an interest in a foreign company which then reinvests into South African assets. Until recently South African investors were not permitted to invest into an offshore entity which then reinvested into the SADC region. However, this prohibition has fallen away in the circulars released in October last year.

Secondly, South African-owned intellectual property may not be "transferred by way of a sale, assignment, cession and/or the waiver of rights in favour of non-residents in whatever form, directly or indirectly, without pri-



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or exchange control approval". Intellectual property encompasses patents, registered designs, copyright, confidential information and trademarks.

If any such intellectual property is transferred to an offshore entity, then such transfer is likely to be void and treated as though the property was never transferred. This may result in adverse tax consequences. For exam-

ple, all royalties which were paid to the non-resident entity may be taxed in the hands of the South African resident.

If an offshore entity requires the use of intellectual property owned by a South African entity, a licence agreement should be entered into between these parties. Such licence agreement requires the prior approval of the Reserve Bank and must be entered into on arm's length terms with an arm's length royalty being payable.

There are three important points from a South African tax perspective regarding offshore subsidiaries.


Firstly, even if a company is incorporated in a foreign jurisdiction, this does not mean that it will not pay South African tax. In particular, if such company is "effectively managed" from SA, it will be regarded as a South African resident, therefore a local taxpayer in respect of its worldwide income.

The concept of "effective management" is not defined in the act. Essentially it refers to the place where the important management decisions for the company are taken by its directors and high-level managers.

Secondly, the income of a foreign subsidiary of a South African company is taxable in SA unless that foreign company has a proper business (foreign business establishment) in the foreign jurisdiction.

Thirdly, dividends declared back to SA by the foreign subsidiaries are taxable unless that South African company holds at least 20% of the ordinary shares in the foreign subsidiary.

If a South African company sells shares in an offshore company and earns a capital gain, such a gain is typically also exempt from South African tax provided the local shareholder holds at least 20% of the shares in the foreign company at the time of such a sale.

 **An annual report-back is required in respect of the offshore investments**