

Fertile ground in foreign fields

South African corporates have come a long way in the last decade in terms of their ability to make foreign investments. In fact, in his budget speech on 23 February 2000, the then Minister of Finance, Mr T Mboweni, stated that in terms of new relaxation, South African corporates were entitled to transfer up to R250 million from South Africa per new investment into member states of the Southern African development community and up to R50 million 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. In addition 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 South Africa had a simple source based tax regime. This changed in February 2000 when South Africa started its move towards its current complex worldwide tax system where even the income of offshore subsidiaries of South African companies is taxable in South Africa.

Given the constant changes to the regulatory (tax and exchange control) environment in respect of foreign investments this article seeks to provide some guidance to investors in respect of these issues.

Exchange control

The principal exchange control rule is that authorised dealers, i.e., the commercial banks, may approve foreign investments by South African corporates of amounts up to R500 million. In respect of amounts exceeding R500 million the exchange control department of the South African Reserve Bank ("SARB") must approve such investments.

However, it should be noted that such approvals require written applications either to the authorised dealer or to the SARB. Such applications must, inter alia, set out an outline of the anticipated benefits to South Africa of the foreign investment. This does not include dividend flows. Instead, it should be shown that there will be, for example, increased exports from South Africa or royalties, management fees or other income flows (excluding dividends) into South Africa as a consequence of the offshore investment.

In addition, 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 SARB at the time of the annual report-back. In this regard, offshore entities are allowed to expand their businesses subject to the expansion being in the same line of business.

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. Dividends declared and paid

to South Africa may subsequently be re-transferred abroad to the offshore subsidiary at any time and used by such subsidiary for any purpose.

The SARB has become far more relaxed about approving applications in respect of foreign investments and also more relaxed regarding retaining profits offshore in the offshore entity.

However, there are two important points which need to be noted. Firstly, the “loop principle” which essentially prohibits a South African investor from acquiring an interest in a foreign company which then re-invests into South African assets. This remains a principle which is strongly enforced by the SARB. Until recently South African investors were not permitted to invest into an offshore entity which then re-invested into the SADC region. However, this prohibition has fallen away in the circulars brought out in October 2009.

Secondly, it is important to note that South African owned intellectual property may not be *“transferred by way of a sale, assignment or cession and/or the waiver of rights in favour of non-residents in whatever form, directly or indirectly, without prior exchange control approval.”* It is, therefore, important for South African corporates to understand what constitutes intellectual property and to ensure that no such intellectual property is transferred to an offshore subsidiary. In this regard, intellectual property encompasses, *inter alia*, patents, registered designs, copyright, confidential information/know-how and trademarks.

If any such intellectual property is transferred to an offshore entity, then such transfer is likely to be void and therefore treated as though the intellectual property was never transferred. This may result in adverse tax consequences. For example, all royalties which were paid to the non-resident entity may be taxed in the hands of the South African resident. In addition, such amounts may be required to be remitted to the South African entity.

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 SARB and must be entered into on arm’s length terms with an arm’s length royalty being payable. Such applications for licence agreements are generally granted by the SARB.

South African tax issues

There are three fundamentally 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 South Africa, it will be regarded as a South African resident and, therefore, a South African taxpayer in respect of its world wide 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. This

is not necessarily the place where formal board meetings are held, but rather the place where factually such decisions are taken. In this regard, an Interpretation Note has been issued by the South African Revenue Service in terms of its interpretation of the concept of “effective management”. If this Interpretation Note is read together with the test generally applied internationally then, in order to test where the “effective management” of a company is located, it is principally necessary to have reference to the place where:

- The important management decisions for the company are actually taken (excluding shareholder decisions);
- The day to day decisions by senior management and directors are taken and such decisions are implemented;
- In terms of the Interpretation Note, if the above decisions are taken in more than one jurisdiction, then the place where such decisions were implemented will prevail.

Secondly, the income of a foreign subsidiary of a South African company is taxable in South Africa unless that foreign company has a proper business (foreign business establishment) in the foreign jurisdiction. This requires, *inter alia*, a fixed place of business for the foreign company that has employees who are suitably qualified to carry on that company’s business. Even if a foreign company has such “foreign business establishment”, if it earns certain income streams, such as sale proceeds in respect of sale of goods to a South African company, receives services fees from a South African company or receives passive income (for example dividends, interest royalties), such income is typically taxed in South Africa.

Thirdly, dividends declared back to South Africa by the foreign subsidiaries are taxable unless, *inter alia*, 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 gain is typically also exempt from South African tax provided the South African shareholder holds at least 20% of the shares in the foreign company at the time of such sale.

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