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Goodbye to the “loop structure” prohibition

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In its typical form, a so-called “loop structure” arises where a South African exchange control resident (individual or company) holds an investment in a foreign company that directly or indirectly owns shares or assets (including loan claims) in the Common Monetary Area (“**CMA**”), which includes South Africa.

The policy of the South African Reserve Bank (“**SARB**”) that in principle prohibits loop structures, emanates from Regulation 10(1)(*c*) of the Exchange Control Regulations, on the basis that such a structure creates a channel for the direct or indirect export of capital from South Africa to an offshore vehicle, for the ultimate benefit of South African residents.

In terms of current policy, the Exchange Control Manual provides for two general exceptions to the “loop” structure prohibition. Firstly, in the context of the foreign direct investment dispensation, South African exchange control resident companies may acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign target entity, which may in turn hold investments and/or make loans into any country in the CMA. Secondly, private individuals are permitted, individually or collectively, to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign target entity, which may in turn hold investments and/or make loans into any CMA country. This has resulted in the need for “parallel’ shareholding structures where South African residents hold shares in an offshore company as well as a South African company in the context of the same business unit.

The complete abolishment of the loop structure prohibition was first alluded to in the Budget Speech in February 2020 and it was stated that this would only be done once certain tax amendments had been introduced. In terms of the Medium Term Budget Speech (“**MTBS**”) delivered on 29 October 2020, the Minister of Finance announced that the loop structure restrictions would be completely abolished with effect from 1 January 2021. In the Explanatory Note on Financial Sector MTBPS Announcements issued by National Treasury on 28 October 2020, the following was stated:

“The full ‘loop structure’ restriction has been lifted to encourage inward investments into South Africa, subject to reporting to Financial Surveillance Department of the SARB as and when the transaction is finalized. This reform will be effective from 1 January 2021 for companies, including private equity funds, provided that the entity is a tax resident in South Africa."

The “entity” that is referred to is understood to be the South African company making the investment into the offshore company which holds investments back into South Africa.

Therefore, from 1 January 2021, no upfront SARB approval will be required for investment into such a structure by a South African resident company. There must, however, be a report back to the SARB in respect of transactions entered into. It is understood that parties can proceed to implement the loop structure and finalise the agreements prior to any feedback/reporting to the SARB. The SARB will then review the loop structure and scrutinise the details thereof in order to ensure that the structure does not give rise to any abuse. The detail of the reporting requirements will presumably be clarified in due course.

To date, no circular has been released by SARB and it does not appear to be a given that this will happen prior to 1 January 2021. Hopefully, the circular will contain clarification as to the ambit of this relaxation. In particular, in the Explanatory Note, reference is made to companies investing abroad, and it does not expressly deal with individuals. It is also uncertain if and how this relaxation will impact structures which contain an offshore trust with South African resident beneficiaries which trust holds investments into South Africa.

The date of 1 January 2021 was selected to coincide with the introduction of the tax amendments that have been proposed in the context of these structures.

In this regard, dividends declared by a South African company to a controlled foreign company ("**CFC**") as contemplated in section 9D of the Income Tax Act, 1962 will no longer be exempt as is currently the case but will be included in the "net income of the CFC to the extent that such dividend has not been subject to dividends tax at the full dividends tax rate of 20%."

Put differently, the amendment ensures that, taking into account any dividends tax suffered upon the distribution of such a dividend by the South African company, the dividend is effectively taxed at 20% where the foreign target company constitutes a CFC. This amendment will therefore not have an impact on current loop structures established within the parameters of the current exception referred above, since if South African residents collectively hold a maximum shareholding of 40% in the foreign company, it will not constitute a CFC.

In addition, the participation exemption contained in paragraph 64B of the Eighth Schedule will not apply in respect of any capital gain or capital loss determined in the hands of a South African resident shareholder in respect of the disposal of any share in a CFC to the extent that the value of the assets of such CFC is attributable to assets directly or indirectly located, issued or registered in South Africa. This amendment is also only applicable where the shares in a CFC are disposed of, and should similarly not have an impact on current loop structures established within the parameters of the current policy.

These amendments will both come into operation on 1 January 2021. The Explanatory Note states that the rationale for the abolishment of loop structures is to encourage inward investments into South Africa. It remains to be seen whether this change will have the desired effect, but it will certainly aid in the simplification of shareholding structures which, as a result of the current dispensation, have been unnecessarily complex and unfamiliar to foreign investors given the limitations imposed by the prohibition.

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