SCOPE FOR USE OF TAX HAVENS BY SOUTH AFRICAN RESIDENTS IN INTERNATIONAL TAX PLANNING

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INTRODUCTION

Objective of paper:

> to consider the scope for use of tax havens by South African residents (individuals and companies) in international tax planning, and specifically, within this, whether this scope is reducing given recent changes both in the international regulatory environment and in the South African legislation including the Income Tax Act.

In order to do so, the following will be covered:

- An introduction to tax havens:
    1. Definition;
    2. Summary of traditional uses of tax havens in personal and corporate international tax planning.
- The increasing international pressure to tighten up on the use of tax havens, driven primarily by the wish to reduce the incidence of:
    1. Money laundry;
    2. Undesirable tax competition between nations;
    3. Other illegal or harmful practices.
    4. Specific mention will be made of SA's efforts to tighten up on money laundry and other illegal or suspicious acts, especially via FICA.
- Developments in SA exchange control and taxation:
    1. Relaxations in, and key implications of current SA exchange controls;
    2. Changes in the late 1990's to the SA tax legislation including because of these reductions of exchange controls;
    3. The change in 2001 to a residence basis of taxation.
- The effect of the relevant provisions in SA's exchange controls, tax and other legislation on the traditional uses of tax havens in personal and corporate international tax planning will then be considered.

AN INTRODUCTION TO TAX HAVENS

Definition

Rohatgi (p225) cites a Financial Times report from September 1994 which mentioned that in the early 1990's over half of the world's financial transactions took place in "international offshore financial centers". Rohatgi notes that six of the nearly seventy recognized international offshore financial centers account for half the world's international banking, corporate finance and investments.

Rohatgi notes that these centers exist because they provide economic benefits which outweigh their costs. Their role includes "a wide range of business activities" including assisting in international tax planning.

Rohatgi cites a US Treasury report which notes that there is no single, clear, objective test that identifies a tax haven *per se*. Their characteristics include, inter alia:

- Low or nil tax on all or certain types of income and capital, as compared to the country of residence;
- Bank and commercial secrecy;
- The lack of exhange controls or a dual currency control system for residents and non-residents;
- Favourable disposition to foreign capital.

Rohatgi notes that offshore financial centers usually, though not always, act as tax havens. Conversely, onshore financial centers can sometimes act as tax havens, especially in a limited sense. Ginsberg (p4) notes that it is "perhaps easier to categorise off-shore centers as countries which offer special advantages to companies and provide an international corporation with greater freedom of action than might be possible if it were tied to a single national base, while tax havens offer special tax advantages to private persons and companies".

Rohatgi notes that tax havens can, broadly, be divided into three main categories for tax purposes:

- Base havens: offshore centers with nil or very low tax on corporate or business income and few or no treaties;
- Treaty havens: countries with reasonable domestic tax rates but with special tax regimes that allow the use of their treaty network for offshore activities;
- Special concession havens: countries with special incentives that may be exploited for a particular international transaction or activity to gain a tax or non-tax advantage, usually with the help of tax treaties.

Ginsberg (p4) notes that there are generally two types of tax havens, "those which levy no taxes at all (at least on the relevant type of income) and those which levy low taxes".

Summary of traditional uses of tax havens in personal and corporate international tax planning

The term tax planning is one with potentially a number of different meanings. For the purposes of this paper, it will be regarded as planning for an entity or person which creates an optimal overall tax result within the confines of the law.

Ginsberg (p7) notes the "most common motivating factors" for using tax havens as being the following (note that Ginsberg, writing from a South African perspective, was writing in 1990, i.e. well prior to the introduction of the residence basis of taxation in South Africa):

- "High taxes in the country of residence, particularly where a progressive system of taxation applies, since this form has the most impact on the individuals in the higher income brackets and on those such as 'entertainment earners', who have fluctuating income;
- Inheritance provisions in the country of residence;
- Overseas employment contracts, particularly in situations where overseas income is free of tax unless remitted to the country of domicile;
- Anonymity and secrecy, particularly as regards using bank accounts, nominees and bearer shares. At present this is one, if not *the* major factor for South African companies using an off-shore arm situated in a tax haven;
- Political considerations which are such as to inhibit wealthy individuals (or companies) from holding their fortune in the country of residence (also pertinent to South Africans);
- Re-routing of export sales (eg in the case of an author or investor) or of overseas purchasing (as in the case of an individual entrepreneur);
- Depositing surplus funds (eg in a family trust);
- Accumulation of income prior to emigration or retirement;
- Geographical expansion needed for multinational corporations;
- For those people intending to divorce or to protect their estates from greedy ex-spouses, tax haven usage is popular;
- Charles Cain makes the point that secrecy is not always intended to screen tax avoidance and many organizations use tax havens not to avoid tax, but to enable them to develop new products or business ideas out of sight of their commercial competitors."

Ginsberg (from p15) notes certain "financial techniques" for using tax havens:

- Distribution of post-tax profits: for example, a Netherlands holding company is interposed between a US subsidiary and a South African holding company in order to minimize withholding taxes;

- Source allocation of pre-tax profits: essentially this entails non-arm's length transfer pricing to take advantage of tax differentials between countries;
- Profit extraction: profits earned in a high tax country can sometimes be extracted to tax havens as interest, royalties, or management charges;
- Minimisation of taxation on executives' remuneration: this technique is of potential application where executives are required to render world-wide services to an international group of companies;
- Techniques for emigrants and retiring individuals: this tends to involve the use of trusts in tax havens;
- Reliance on trusts;
- Treaty shopping: in summary, in a transaction between two countries, a structure involving a third country is introduced in order to create a treaty benefit which otherwise would not have occurred.

Ginsberg (from p29) poses the question of who can (and cannot) benefit from tax havens:

- General application to a company with branches and subsidiaries abroad;
- Utilization of a subsidiary in a tax haven to provide funding and receive interest income on which it is not taxed;
- The use by trusts in tax havens to reduce income, capital gains or inheritance taxes in other jurisdictions;
- The creation of an offshore holding company with a view especially to:

    1. Reduce withholding taxes;
    2. Defer tax on dividends;
    3. "Mix" of foreign tax via the offshore holding company in order, in respect of dividends received from that offshore holding company, to maximize the foreign tax credits for the underlying taxes paid;
    4. Defer capital gains;
    5. Create freedom from exchange control.

        - An offshore holding company may be beneficial as a vehicle to hold real estate investments;
- Offshore companies can be utilized for licensing and patent-holding purposes;
- Tax havens can be utilized for offshore finance companies;
- Tax havens can be utilized for "conduit" finance companies (a mechanism akin to treaty shopping whereby interest is received with minimum withholding taxes);
- Tax havens can be utilized to create hybrid structures, e.g. the use together of a finance company with a conduit finance company;
- Tax havens can be utilized for centralized group borrowing finance companies;
- Tax havens can be utilized for double interest deduction companies;
- Tax havens can be utilized for captive (wholly owned or owned in joint venture) banks;
- Tax havens can be utilized for captive insurance companies;
- Tax havens can be utilized for shipping companies;

- Tax havens can be utilized for tourism companies.

THE INCREASING INTERNATIONAL PRESSURE TO TIGHTEN UP ON THE USE OF TAX HAVENS

Desire to reduce the incidence of money laundry and restrict terrorist financing

The Financial Action Task Force on Money Laundry (FATF) is an independent international body whose Secretariat is housed at the Organisation for Economic Co-operation and Development ('OECD'). From the FATF website:

> "Since its creation the FATF has spearheaded the effort to adopt and implement measures designed to counter the use of the financial system by criminals. It established a series of FATF Recommendations in 1990 that sets out the basic framework for anti-money laundering efforts and are intended to be of universal application. Since then, the FATF has revised the Forty Recommendations twice – first in 1996 and then more recently in 2003 ... – to ensure that they remain up to date and relevant to the evolving threat of money laundering. Indeed, the FATF Recommendations are now the principal standard in this field. Following the terrorist attacks in the United States on 11 September 2001, the FATF expanded its mission beyond money laundering in order to focus its energy and expertise on a world-wide effort to combat terrorist financing. The FATF issued new international standards to combat terrorist financing – the Eight Special Recommendations – and it calls on all countries to adopt and implement these measures. The objective of these measures is to deny terrorists and their supporters access to the international financial system.
> ...
> To reduce the vulnerability of the international financial system to misuse by criminals, the FATF is also involved in examining and identifying the serious and systemic weaknesses in the anti-money laundering programmes of certain jurisdictions (non-cooperative countries and territories or NCCTs).
> The FATF attempts identify emerging methods and trends used for laundering money. Terrorists finance their operations through criminal activity, or they may also use funding from legal sources. In either case, terrorist groups utilise financial networks in the same way that other criminal groups do. That is, they move funds and hide connections between the source of their funding and the perpetrators, organisers, and sponsors of their activity."

The Financial Action Task Force on Money Laundering Annual Report 2003-2004 notes inter alia that in May 2004 its members "reaffirmed their commitment to the FATF effort to combat money laundering and terrorist financing by renewing the Task Force's mandate for a further eight years", which, in that prior extensions had been for only five years, "demonstrates that FATF members remain united in their commitment to AML/ CFT and see the FATF as a critical instrument in this effort" ('AML' refers to 'anti-money laundry'; 'CFT' refers to 'countering the financing of terrorism').

The FATF in February 2000 issued a report on NCCT's, noting, inter alia:

> "International co-operation in the fight against money laundering not only runs into direct legal or practical impediments to co-operation but also indirect ones. The latter, which are probably more numerous, include obstacles designed to restrict the the supervisory and investigative powers of the relevant administrative or judicial authorities or the means to exercise these powers. They deprive the State of which legal assistance is requested of the relevant information and so prevent it from responding positively to international co-operation requests."

The FATF set up its twenty five criteria (consistent with its overall recommendations) for defining NCCTs:

"<u>A. Loopholes in financial regulations</u>

(i) No or inadequate regulations and supervision of financial institutions
1. Absence or ineffective regulations and supervision for all financial institutions in a given country or territory, onshore or offshore, on an equivalent basis with respect to international standards applicable to money
laundering.
(ii) Inadequate rules for the licensing and creation of financial institutions, including assessing the backgrounds of their managers and beneficial owners

2. Possibility for individuals or legal entities to operate a financial institution without authorisation or registration or with very rudimentary requirements for authorisation or registration.

3. Absence of measures to guard against holding of management functions and control or acquisition of a significant investment in financial institutions by criminals or their confederates.
(iii) Inadequate customer identification requirements for financial institutions

4. Existence of anonymous accounts or accounts in obviously fictitious names.

5. Lack of effective laws, regulations, agreements between supervisory authorities and financial institutions or self-regulatory agreements among financial institutions on identification by the financial institution of the client and beneficial owner of an account:

- no obligation to verify the identity of the client;
- no requirement to identify the beneficial owners where there are doubts as to whether the client is acting on his own behalf;
- no obligation to renew identification of the client or the beneficial owner when doubts appear as to their identity in the course of business relationships;
- no requirement for financial institutions to develop ongoing anti-money laundering training programmes.

6. Lack of a legal or regulatory obligation for financial institutions or agreements between supervisory authorities and financial institutions or self-agreements among financial institutions to record and keep, for a reasonable and sufficient time (five years), documents connected with the identity of their clients, as well as records on national and international transactions.

7. Legal or practical obstacles to access by administrative and judicial authorities to information with respect to the identity of the holders or beneficial owners and information connected with the transactions recorded.

(iv) Excessive secrecy provisions regarding financial institutions

8. Secrecy provisions which can be invoked against, but not lifted by competent administrative authorities in the context of enquiries concerning money laundering.

9. Secrecy provisions which can be invoked against, but not lifted by judicial authorities in criminal investigations related to money laundering.

(v) Lack of efficient suspicious transactions reporting system

10. Absence of an efficient mandatory system for reporting suspicious or unusual transactions to a competent authority, provided that such a system aims to detect and prosecute money laundering.

11. Lack of monitoring and criminal or administrative sanctions in respect to the obligation to report suspicious or unusual transactions.

B. Obstacles raised by other regulatory requirements

(i) Inadequate commercial law requirements for registration of business and legal entities

12. Inadequate means for identifying, recording and making available relevant information related to legal and business entities (name, legal form, address, identity of directors, provisions regulating the power to bind the entity).

(ii) Lack of identification of the beneficial owner(s) of legal and business entities

13. Obstacles to identification by financial institutions of the beneficial owner(s) and directors/officers of a company or beneficiaries of legal or business entities.

14. Regulatory or other systems which allow financial institutions to carry out financial business where the beneficial owner(s) of transactions is unknown, or is represented by an intermediary who

refuses to divulge that information, without informing the competent authorities.

C. Obstacles to international co-operation

(i) Obstacles to international co-operation by administrative authorities

15. Laws or regulations prohibiting international exchange of information between administrative anti-money laundering authorities or not granting clear gateways or subjecting exchange of information to unduly restrictive
conditions.

16. Prohibiting relevant administrative authorities to conduct investigations or enquiries on behalf of, or for account of their foreign counterparts.

17. Obvious unwillingness to respond constructively to requests (e.g. failure to take the appropriate measures in due course, long delays in responding).

18. Restrictive practices in international co-operation against money laundering between supervisory authorities or between FIUs for the analysis and investigation of suspicious transactions, especially on the grounds that such transactions may relate to tax matters.

(ii) Obstacles to international co-operation by judicial authorities

19. Failure to criminalise laundering of the proceeds from serious crimes.

20. Laws or regulations prohibiting international exchange of information between judicial authorities (notably specific reservations to the anti-money laundering provisions of international agreements) or placing highly restrictive conditions on the exchange of information.

21. Obvious unwillingness to respond constructively to mutual legal assistance requests (e.g. failure to take the appropriate measures in due course, long delays in responding).

22. Refusal to provide judicial co-operation in cases involving offences recognised as such by the requested jurisdiction especially on the grounds that tax matters are involved.

D. Inadequate resources for preventing and detecting money laundering activities

(i) Lack of resources in public and private sectors

23. Failure to provide the administrative and judicial authorities with the necessary financial, human or technical resources to exercise their functions or to conduct their investigations.

24. Inadequate or corrupt professional staff in either governmental, judicial or supervisory authorities or among those responsible for anti-money laundering compliance in the financial services industry.

(ii) Absence of a financial intelligence unit or of an equivalent mechanism

25. Lack of a centralised unit (i.e., a financial intelligence unit) or of an equivalent mechanism for the collection, analysis and dissemination of suspicious transactions information to competent authorities."

In its Annual Review of Non-Cooperative Countries or Territories dated 2 July 2004, the FATF noted the progress that had been made. From the initial 23 NCCTs identified in September 2001, the list is now down to five: Cook Islands, Indonesia. Myanmar, Nauru, Nigeria the Philippines. Guatemala, Egypt, and Ukraine were removed from the list of NCCTs during 2004.

South Africa became the 30th member of FATF, and the first African member, in June 2003. South Africa had launched an initiative to fight 'dirty money' in 2002. Prior to that blatant violations had been possible (e.g. the opening of bank accounts or purchase of material assets with large amounts of cash). The FATF stated, on SA becoming a member, that the country had a developed a comprehensive legal structure to combat money laundering.

SA's main relevant legislation the Prevention of Organised Crime Act 1998 and the Financial Intelligence Centre Act 2001 ('FICA').

FICA creates a wide range of anti-money laundering activities and has enabled the establishment of the Financial Intelligence Centre ('FIC'). A key component of FICA is that it creates a reporting obligations on a large number of organizations (accountable institutions, which include a large part of the SA financial services sector), as well as individuals within those institutions, to report suspicious activities or transactions. The terms of FICA are very broad placing a heavy burden on entities and people obliged to report to do so on instances which may be illegal. In practice the FICA legislation is expected to dramatically increase the risk of entering into any structure or transaction which could be considered 'aggressive' from an international tax planning perspective.

The FATF noted at the time, in relation to SA's FIC, "[in] a short period of time, the FIC has made significant strides towards becoming a an operational financial intelligence unit and appears adequately structured, funded, staffed and provided with the necessary resources and powers to fully perform its authorized functions".

Desire to reduce undesirable tax competition between nations

In 1998, the Organisation for Cooperation and Development ("OECD") released a report "HARMFUL TAX COMPETITION, An Emerging Global Issue".

This noted that the Ministerial Communiqué of May 1996 had called upon the Organisation to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases".

It also noted that this request had subsequently been endorsed by the G7 countries, which had included the following in its Communique issued by the Heads of State at their 1996 Lyon Summit: "Finally, globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices".

The report notes, by way of introduction to its comments on tax competition:

> "Historically, tax policies have been developed primarily to address domestic economic and social concerns. The forms and levels of taxation were established on the basis of the desired level of publicly provided goods and transfers, with regard also taken to the allocative, stablilising and redistributive aims thought appropriate for a country. Whilst domestic tax systems of essentially closed economies also had an international dimension in that they potentially affected the amount of tax imposed on foreign source income of domestic residents and typically included in the tax base the domestic income of non-residents, the interaction of domestic tax systems was relatively unimportant, given the limited mobility of capital. The decision to have a high rate of tax and a high level of government spending or low taxes, and the use of tax incentives, were all matters which were decided primarily on the basis of domestic concerns and had principally domestic effects. While there were some international spillover effects on other economies, those effects were generally limited....
>
> The accelerating process of globalisation of trade and investment has fundamentally changed the relationship among domestic tax systems....the removal of non-tax barriers to international commerce and investment and the resulting integration of national economies have greatly increased the potential impact that domestic tax policies can have on other economies. Globalisation has also been one of the driving forces behind tax reforms, which have focused on base broadening and rate reductions, thereby minimizing tax induced distortions. Globalisation has also encouraged countries to assess continually their tax systems and public expenditures with a view to making adjustments where appropriate to improve the "fiscal climate" for investment. Globalisation and the increased mobility of capital has also promoted the development of capital and financial markets and has encouraged countries to reduce tax barriers to capital flows and to modernize their tax systems to reflect these developments. Many of these reforms have

> also addressed the need to adapt tax systems to this new global environment."

The report proceeds to note that increased competition has led 'multi-national enterprises' to develop 'global strategies' which reduce their links to any one country. In general the OECD views globalisation as having "improved welfare and living standards across the world by creating a more efficient allocation and utilisation of resources".

The report notes that globalisation has additionally had a positive effect on the development of tax systems but has "also had the negative effects of opening up new ways by which companies and individuals can minimise and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital".

These actions, the report notes, "induce potential distortions in the patterns of trade and investment and reduce global welfare [and]...can erode national tax bases of other countries, may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals".

This sort of "pressure" "can result in changes in tax structures in which all countries may be forced by spillover effects to modify their tax bases, even though a more desirable result could have been achieved through intensifying international co-operation".

The report notes more generally that "tax policies in one economy are now more likely to have repercussions on other economies. These new pressures on tax systems apply to both business income in the corporate sector and to personal investment income".

Given that countries need to finance their domestic spending programmes from their tax receipts, and given further that the residents of a country benefit from the results of such spending, the report notes that:

> "[I]nvestors in tax havens, imposing zero or nominal taxation, who are residents of non-haven countries may be able to utilise in various ways those tax haven jurisdictions to reduce their domestic tax liability. Such taxpayers are in effect "free riders" who benefit from public spending in their home country and yet avoid contributing to its financing."

This comment accords with the comments made by the 2002 Chairman of the United States Senate Committee on Finance, who noted that US companies were

> "literally re-incorporating in off-shore tax havens in order to avoid U.S. taxes. They are, in effect, renouncing their U.S. citizenship to cut their taxes...This is very troubling. Especially now, as we all try to pull together as a nation. These tax shelters can do serious harm. They undermine public confidence in the tax system. They make average

> taxpayers feel like chumps, who have to pay more because the big guys are paying less. And there's another important point. Tax shelters are bad for the economy. Professor Michael Graetz once defined a tax shelter as a 'deal done by very smart people, that, absent tax considerations, would be very stupid.' "

British-based Professor Prem Sikka (University of Essex), writing in 2003, similarly notes:

> "Enron, Tyco and WorldCom scandals have heightened public concerns about organized corporate tax avoidance through the use of tax havens, clever financial engineering, transfer pricing and other tricks. Studies show that many major multinationals, including Accenture, Bank of America, Boeing, 3M, Chevron, Exxon, Haliburton, Hewlett-Packard, Intel, Morgan Stanley and Nike are avoiding taxes by using schemes marketed by banks, lawyers and accountancy firms. They are costing the US taxpayer more than $170 billion a year."

Sikka notes that whereas the US Senate Finance Committee is investigating aspects of this, the UK government is being tardy. For illustration purposes, he 'randomly' selected sixteen of the approximately two thousand two hundred companies listed on the London Stock Exchange. Comparing the actual tax payable with that which could have been expected per the statutory rate, he notes a shortfall (i.e. in total for these sixteen companies) of in excess of GBP 5 billion. Interestingly, amongst Sikka's targets for general criticism in this vein are Lakshmi Mittal, the UK-based ultimate key shareholder in Iscor.

Noting broader 'free rider' effects, the OECD report recognizes:

> "that there are no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have implications for other countries, these are essentially political decisions for national governments. Depending on the decisions taken, levels of tax may be high or low relative to other states and the composition of the tax burden may vary. The fact that a country has modernised its fiscal infrastructure earlier than other countries, for example by lowering the rates and broadening the base to promote greater neutrality, is principally a matter of domestic policy. Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so".

The report recognizes that not everyone would view the effects of tax policies in the same way, and further distinguishes between unintentional effects and those attributable to what is sometimes termed 'poaching', where a country deliberately targets the tax base of another or others. The report notes that:

"[p]ractices of this sort can appropriately be labelled harmful tax competition as they do not reflect different judgements about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country's sovereignty in fiscal matters, but are, in effect, tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries' taxes."

Specifically noting tax havens or "harmful preferential tax regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries" have the potential to cause harm by:

- "distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all taxpayers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers."

The report recognizes that not always would aggressive tax practices have all these negative effects.

The report also recognizes that there may be genuine reasons for investors to choose low-tax environments, which are to be distinguished from harmful tax practices.

In attempting to understand the extent of use of tax havens and preferential tax regimes, the report notes that comprehensive data is hard to obtain, including because of non-transparency. However, the Report (1998) was able to note that the:

> "available data do suggest that the current use of tax havens is large, and that participation in such schemes is expanding at an exponential rate. For example, foreign direct investment by G7 countries in a number of jurisdictions in the Caribbean and in the South Pacific island states, which are generally considered to be low-tax jurisdictions, increased more than five-fold over the period 1985-1994, to more than $200 billion, a rate of increase well in excess of the growth of total outbound Foreign Direct Investment".

As at 12 December 2003, only five countries remained on the OECD's list of uncooperative tax havens:

- Andorra;
- Liberia;
- Lichtenstein;
- The Marshall Islands; &
- Monaco.

Recommendations of the OECD report on Harmful Tax Competition

These will be summarized here and compared with the recent developments in South African taxation (and, in a related sense, exchange control) set out in greater detail later this in this paper.

The recommendations are divided into three sections:

- Those concerning domestic legislation;
- Those concerning tax treaties;
- Those concerning intensification of international co-operation.

Recommendations regarding domestic legislation

Firstly, a propos South Africa's move from a source to a residence basis of taxation, the report notes in general that the country with a residence basis can to some extent "protect itself against the negative effects and economic behaviour caused by harmful tax practices in other countries by modifying its own tax rules".

The report then makes certain specific recommendations:

- That countries which do not have Controlled Foreign Corporation or similar legislation consider adopting them- South Africa has adopted such legislation;
- That countries which do not have foreign investment fund or similar legislation consider adopting that. This 'FIF' legislation is designed to stop investment into foreign mutual funds at a level lower than would trigger CFC legislation in order to defer tax. SA's tax legislation designed to stop moving passive income into no/ low tax jurisdictions is of application here;
- That countries which do not have restrictions on participation exemptions for foreign source income where such income has benefited from tax practices deemed as constituting harmful tax competitions consider adopting them- SA's practices are consistent with OECD guidelines;
- That countries which do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers consider adopting them and that countries exchange information obtained under these rules- whilst this aspect is not of as direct application to this paper as other aspects it is understood that SA is taking appropriate steps here;
- That countries, where administrative decisions concerning the particular position of a taxpayer may be obtained in advanced of planned transactions, make public the conditions for granting, denying or revoking such decisions- whilst this aspect is not of as direct application to this paper as other aspects it is understood that SA is taking appropriate steps here;
- That countries follow the principles set out in the OECD's 1995 Guidelines on Transfer Pricing and thereby refrain from applying or not applying their transfer pricing rules in a way that would consitute harmful tax competition- SA's laws in this regard are consistent with OECD recommendations;
- That countries should review their laws, regulations and practices which govern access to banking information with a view to removing

impediments to the access to such information by tax authorities- it is understood that SA's laws, regulations and practices are consistent with OECD recommendations.

Recommendations concerning tax treaties

This area is not of as direct relevance to the paper as are the main recommendations concerning domestic legislation (supra). The thrust of the recommendations concerns information exchange regarding tax havens and preferential tax regimes, ensuring that tax treaties preclude benefit for those using harmful tax practices, ensuring that each country's domestic rules are measured against the Model Tax Convention, and that countries co-operate at an administrative level against harmful tax practices.

In summary, South Africa's efforts in these areas are understood in any event to be consistent with the OECD's recommendations.

Recommendations to intensify international co-operation in response to harmful tax competition

This area is not of as direct relevance to the paper as are the main recommendations concerning domestic legislation (supra).

DEVELOPMENTS IN SA EXCHANGE CONTROL AND TAXATION

Relaxations in, and key implications of current SA exchange controls

Exchange controls have the effect of restricting the flows of a country's currency. Exchange controls are usually found in developing, net capital importing countries, and usually do not apply in developed, net capital exporting countries (though, for example, exchange controls were in place in the United Kingdom as recently as the 1970's).

Exchange controls affect the following two categories differently:

- SA Residents; &
- SA Non-residents.

In summary, the effect of current exchange controls is that they apply directly to SA residents (individuals and other entities). They do not, as of 13 March 1995, apply to non-residents (individuals and other entities). Non-residents are though affected by South African exchange control indirectly as non-residents must follow the exchange control processes (e.g. it is necessary to have shares held by non-residents in South African companies endorsed as non-resident) in order *not* to have exchange controls apply to them as they do to residents. There are also taxation provisions (e.g. the anti thin capitalization rules) which affect non-residents.

Exchange controls have relaxed considerably since the post-apartheid government of 1994. A summary of the current exchange control position affecting SA residents (excluding emigrants) is as follows:

- **Individuals** (provided they are in good standing with SARS) are permitted to externalize up to a maximum, cumulatively, of R750k. This amount was established in February 2000, having increased since the principle was first established by Treasury (Exchange Control Circular D124 refers) on 1 July 1997, allowing Authorised Dealers (in effect, banks acting as agents of the South African Reserve Bank) to authorize the transfer of up to a total of R200,000 per private individual resident in South Africa for investment purposes abroad. Note that, currently, there is no obligation to ultimately return these funds to South Africa, i.e. these funds are in effect removed from the ambit of exchange control (individuals are, though, fully subject to the SA Income Tax Act in respect of these funds);
- In summary, in order to make an offshore investment, **companies** must demonstrate to the satisfaction of the South African Reserve Bank that such investment in an expansion, and one in the same line of business. Such investment will demonstrably create monetary benefit for South Africa, as well ideally as other benefit (e.g. skills transfer). As at September 2004, subject to meeting the criteria earlier in this

paragraph, an investment of up to R1bn can be made outside Africa, and up to R2bn within Africa. Note that, unlike the rules applicable to individuals (supra), investments made by companies remain under the ambit not just of the Income Tax Act, but also, to a greater extent than applies to individuals, within the ambit of exchange control (e.g. profits from offshore operations will typically be required to be returned to South Africa; also, to the extent that an offshore operation is sold or wound up, proceeds would be required to be returned to South Africa);

- Other mechanisms, such as portfolio investments by asset managers an assets swaps by certain institutions, are in place but are not relevant for the purposes of this paper.

Changes in the late 1990's to the SA tax legislation, including because of these reductions of exchange controls

Olivier notes (p21) that "several commissions of inquiry into the South African tax system have addressed whether South Africa should retain a source principle of taxation or move to a residence principle".

Differing recommendations were reached and for different reasons, e.g. the Margo commission in 1987 concluded that the source principle be retained, primarily because of the arguments that the residence basis was too complex and would generate insufficient additional revenue because of international convention which would entail South Africa granting credit for foreign taxes already paid.

The last commission of enquiry was the Katz commission in 1997. This recommended retention of the source principle but recommended the introduction of a distinction between active and passive income. Olivier notes (p22) that "[broadly] speaking, passive income refers to investment income such as interest or royalties, and active income to income derived from active trade or commerce". The Katz commission recommended that passive income be taxed on a worldwide basis and active income on a source basis. As a result, sections 9C and 9D were introduced into the act.

Section 9D introduced the concept of Controlled Foreign Entities (CFEs) into the act. The definition of a CFE is somewhat complex and will be dealt with in more detail elsewhere in this paper, but for the moment suffice it say that a CFE is, as the title suggests, a foreign entity controlled by SA residents.

9D created the effect of attributing the proportionate share of CFE's passive income (income such as interest, annuities, rentals and royalties, but excluding dividends) to the SA resident controllers. Foreign dividends were included via the insertion of 9E which was introduced in the Revenue Laws Amendment Act 59 of 2000 and came into effect in respect of any foreign dividend received by or accrued to a resident on or after 23 February 2000.

Prior to the introduction of 9D, it was possible to create a situation whereby passive income would accrue to a separate foreign entity (e.g. company) and

not attract SA tax. If this foreign entity was a tax haven, tax on that income could thus have been substantially or entirely be avoided.

The change in 2001 to a residence basis of taxation

Jooste notes (p473) that the introduction of 9D represented a major move toward a residence-based tax system, and that this was because of "the advent of relaxation in exchange control and its perceived threat to the tax base". (As noted above, absent 9D, SA companies with offshore operations would have been able to achieve a low or zero rate on their non-dividend passive income.)

Despite there not having been a further commission of inquiry after the Katz commission (which recommended a retention of the source principle), South Africa changed to the residence basis of taxation in 2001. Oliver notes (p22) that this change followed, inter alia, the advice of certain foreign tax experts who advised that South Africa, absent a move to a resident basis of taxation, would be out of line with the "rest of the world".

Olivier notes (p26) that the main difference between a source and residence basis of taxation is that under the latter a South African resident is also taxed on foreign income, active or passive. The tax net is thus cast much wider under the residence based system than under the source system.

Various changes to the Income Tax Act were required to give effect to this, including:

- The definition of gross income which had previously referred, in essence, to amounts other than those of a capital nature, which were derived from a South African source;
- "person" was replaced by "resident", which was defined;
- 9D was broadened to include all foreign income, not just passive income.

9D has various exclusions which will be examined more closely later in this paper, but including where foreign entities are domiciled in the so-called "designated countries", which are listed in the Government Gazette, and where in those countries the income has been or will be subject to tax at statutory rate of at least 27% (after taking into account the possible application of a double tax agreement) and where the countries taxes such income on a basis similar to South Africa. Tax havens in effect are by definition excluded from the list of designated countries.

The 'Amnesty'

Of importance in understanding developments in Exchange Control, and the regularization of the financial affairs of South African residents in relation to funds they held abroad, was the promulgation of the Exchange Control

Amnesty and Amendment of Taxation Laws Act, 2003 (Act No. 12 of 2003) ('the Amnesty").

The Amnesty, in brief, provided an opportunity, for a specified time (finally extended to end February 2004), for SA resident individuals who had remitted funds offshore in breach of South African laws to advise the South African authorities of the quantum of funds so held at a specified date, and, depending on the respective individual's choice of whether to leave those funds offshore or remit them to South Africa, pay a specified level of penalty on the total amount of the funds. Utilisation of the amnesty would mean that the relevant funds thereafter were included in the assets of the individual which were relevant for South African taxation purposes. Failure to utilize the amnesty would increase the already existing risk arising from the illegal nature of the funds.

The rationale for this was consistent with the wish to widen the tax net following the move to a resident basis of taxation, as described above, as well as to provide the opportunity for a clean slate for people who had previously broken the law concerning exchange control and taxation (certain of such misdemeanors undoubtedly having taken place prior to SA becoming a non-racial democracy).

On 30 September Exchange Control Circular D.405 was issued by the Head: Exchange Control Department, of the South African Reserve Bank to allow for certain "administrative concessions" in relation to the Amnesty.

Within this circular was a section entitled "Re-Investment of Foreign Assets or the Proceeds Thereof Into the Republic", the first paragraph of which read as follows:

> "1. It has come to the attention of the Exchange Control Department of the South African Reserve Bank that certain private individuals, resident in South Africa, have entered into a transaction or a series of transactions ("Transactions"), the purpose, and/ or effect is to export capital, directly or indirectly from the Republic. These Transactions, which contravene the Exchange Control Regulations, including, inter alia, Regulation 10(1)(c), invariably entail the formation by (or at the instance of) a resident of an offshore structure ("Offshore Structure") which, by a re-investment into South Africa, acquires shares or some other interest in a South African resident company or a South African asset."

What this was referring to was the instance of what are sometimes referred to as 'loops', viz. where a South African resident reinvests into South Africa via an offshore structure in which he has an interest (e.g. by way of a discretionary interest in a trust). The Circular made clear, as the above excerpt indicates, that the SARB regards the 'loops' as illegal. The Circular further specified how these structures should be unwound.

Whilst it is not easy to quantify the extent historically of use of such 'loops' by SA residents, it is understood that such use may have been widespread (this is borne out to an extent by the need for the SARB to even make clear its position in the Circular).

The main reasons for SA residents to use such structures were:

- To avoid tax; and/ or
- To 'externalize' wealth from South Africa, i.e. to enjoy the fruits of living in South Africa while allowing the growth in value of South African investments to accrue offshore; and/ or
- As protection from creditors.

Logically, and to the writer's knowledge, such practices would inevitably have involved the use of tax havens in their offshore legs.

Circular D.405 required the unwind of loop structures, thus dealing with any historically created structures within the context of the Amnesty.

Further, the official stance on the loop structures was now clear, in relation to any SA resident wishing to use such structures from now.

The Exchange Control Circular D. 405 has been controversial. Its sweep is wide, and it relies explicitly only on an interpretation of Regulation 10(1)(c) of the Exchange Control Regulations Orders and Rules 1961 to reach its conclusions. The relevant extracts of this section are:

> "(1) No person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose- ...
>
> (c) enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic."

It is outside the scope of this paper to dwell on this controversy. In summary those who disagree with the conclusions of Circular D.405 rely on their interpretation of the Regulations, in the context of SARB's historic practices, to conclude that, provided the funds remitted offshore (for subsequent reinvestment into SA) were done so within the Regulations, there is nothing to preclude their reinvestment into South Africa.

There is a strong view that the SARB's initial stance from mid-1997 when exchange controls were somewhat relaxed was mixed, i.e. that in part they didn't approve of loops, but they also acknowledged privately that the Regulations didn't preclude loops. Also, one of their private views was that, given the trend toward liberalizing exchange controls, an attempt to stop loops was inconsistent with that. (A similar view, though not one known to have been expressed by the SARB, is that, provided funds have been taken out of South Africa legally, it is to SA's benefit that they be reinvested into SA (their already having been externalized, and provided such reinvestment happens again within the laws, including as to fair value of assets acquired), given that there by definition not all assets grow in value (i.e. the nature of investment is that it places funds on risk).)

There is even a view that the change to the Exchange Control Manual (subordinate to the Regulations) in July 2003 to state that funds held abroad by South African residents "may not be re-invested directly or indirectly back

into the Common Monetary Area for any purposes whatsoever" is incorrect and inconsistent with the Regulations.

However, despite such controversy, the SARB has, thinking realistically, made its position clear on this practice, thus significantly heightening the risk of any South African resident using the practice. Further, even if the official stance on looping were to prove incorrect (e.g. in a court ruling), the relevant regulations could relatively easily be amended to make them consistent with the official stance.

THE EFFECT OF THE RELEVANT PROVISIONS IN SA'S TAX AND OTHER LEGISLATION ON THE TRADITIONAL USES OF TAX HAVENS IN PERSONAL AND CORPORATE INTERNATIONAL TAX PLANNING

Some specific aspects of the taxation legislation

S9D

A CFE is defined to exist where SA residents, whether individually or jointly, directly or indirectly, hold more than 50% of the participation rights or are entitled to exercise more than 50% of the votes or control of the foreign entity. Jooste, inter alia, has pointed out (p's 466-467) the ambiguity in the definition, e.g.:

- In the word "jointly". In essence, does this imply that the shareholders must be "acting in concert" or must their shareholdings merely be looked at in aggregate?;
- Does the term "more than 50% of" qualify "votes" only, or, as the grammar suggests, "control" too? If control too, what does it mean to exercise some percentage of control?

Income is imputed to the resident shareholder in the same ratio as the participant's rights of the resident in the CFE. "Ringfencing" applies, i.e. available deductions and allowances are restricted to the income of the CFE, but no deduction is allowed for interest, royalties or rental paid by one CFE to another. The SA resident cannot benefit from a loss the CFE would have had after deductions; instead, such loss is carried forward.

There are various exclusions to the application of 9D, including:

- The 10% *de minimis* exemption rule. In essence, 9D will not apply to the SA resident to the extent that he, together with any connected person, holds in aggregate, throughout the foreign year of assessment, less than 10% of participation *and* voting rights of the CFE;
- Where the CFE is domiciled in a so-called designated country and where such country determines that the income has been or will be subject to tax at statutory rate of at least 27% (after taking into account the possible application of a double tax agreement), and that country taxes such income in a manner similar to South Africa;
- The business establishment exemption. Jooste notes (p486) that "the apparent rationale underlying this exemption is the desire to achieve a balance between two objectives. On the one hand, there is the desire to promote international competitiveness by allowing South African-owned foreign entities to compete with their foreign-owned competitors. The business establishment exemption seeks to achieve a balance between

these two objectives by permitting South African CFE's to operate without imputation of their income to their South African owners, in terms of s9D if, from an objective perspective, a rationale exists for operating abroad and the foreign operations present not threat to the South African tax base. In essence, the exemption applies to all foreign income of a CFE except:

1. Mobile business income. This is income derived by a business which lacks economic substance, i.e. is post-box type business. The Act provides three criteria which must all be in place to demonstrate economic substance, viz. permanence, substance, and the fact that the place of business must be utilized outside South Africa for a bona fide business and non-tax saving purpose. Jooste notes (p489) that the last-mentioned criterion "involves a subjective enquiry into the purpose for locating the business abroad. It is not clear whether or not the criterion is satisfied only if the sole purpose is a bona fide non-tax purpose, or whether or not it suffices if it is the main purpose...The use of words 'solely or mainly' in the 'purpose' requirement of the general anti-avoidance provision and their omission in para (ii) of the definition of a business establishment in s9D, is perhaps an indication *that no tax motive, no matter how significant, will be countenanced* (emphasis added)". (The general anti-avoidance provision will be referred to below.); &

2. Diversionary business income. This is income derived by the CFE that has been diverted to that CFE as a result of transactions between the CFE and related South African residents, i.e. income attributable to transactions involving artificial transfer pricing. Jooste notes (p490) that the transfer pricing provisions which exist under s31 (this section is referred to below) and not easily enforceable owing to the difficulty in establishing an arm's length price in a given set of circumstances. The anti-diversionary rule "provides additional armoury in the fight against artificial transfer pricing". The rule works through the operation of two "strategies", viz. an increased penalty and a need to apply a higher business activity standard when the CFE engages in sales or services transactions with connected South African residents. There are three categories of diversionary income and in each case they are excluded from the business establishment exemption unless it can the demonstrated that a. the CFE in question has a non-tax economic nexus with its country of operation, and b. the transaction in question is most likely not of the kind involving abusive pricing. The three categories are: a. sale of goods by a CFE to a connected SA resident (unless certain specified provisos are met); b.CFE sells to unconnected SA residents goods purchased from connected SA residents (unless certain specified provisos are met); c. CFE performs services for a connected SA resident (unless certain specified provisos are met); &

3. Mobile passive income. This is income attributable to assets which can be moved easily, i.e. income such as interest, royalties, dividends, rentals, annuities and insurance premiums.

- The already taxed exemption. This exemption, in respect of income already taxed in South Africa, exists in order to avoid double taxation;
- The related CFE dividend exemption. This exemption in effect covers earnings which have already been taxed and is in effect in place in order to avoid double taxation;
- The related CFE interest, rents and royalties exemption. This exemption also in effect covers earnings which have already been taxed and is in effect in place in order to avoid double taxation.

Section 9E

S9E is designed to capture in the taxable income of an SA resident person foreign dividends received, to the extent that these are not already captured by S9D or are not exempt (e.g. dividends from listed companies and dividends from designated countries).

Entities other than persons

Section 9D covers mainly foreign companies or institutions of a similar nature.

Jooste notes (p474) that prior to the Revenue Laws Amendment Act 59 of 2000, a trust could have qualified as a CFE, but that "this had very little practical effect since very few offshore trusts have beneficiaries with vested rights and discretionary trusts would not have constituted controlled foreign entities".

Trusts are specifically excluded from S9D but the relevant provisions within Sections 7 and 25, notably S7(8), and 25B are of relevance. In summary S7(8) deems to be the income of a resident income received by or accrued to a non-resident as a result of a donation, settlement or other disposition made by the resident. S25B(2A) deals with a resident receiving a vested right to the capital of a non-resident trust which represents income which has not been subject to tax in SA, then, if the resident had a contingent right to such income when it was received by or accrued to the trust, it is taxed in the hands of the resident.

Further, S24H(5) of the Act has the effect that a foreign partnership, of which an SA resident is a partner, receives income (or income accrues to the partnership), the SA partner's share is deemed to be his, i.e. there is a flow-through with no deferral.

S31 - transfer pricing and thin capitalisation

In 1995 a section (S31) dealing with transfer pricing and thin capitalization was introduced into the Income Tax Act. Prior this, in effect the exchange controls in place had stopped artificial pricing to create the effect of

transferring profits from South Africa to a lower tax regime, including a tax haven.

The thrust of this section, which applies to transactions between resident and non-resident connected persons (being persons closely connected as defined in the Income Tax Act) in terms of an 'international agreement' (as defined), is that, if pricing is not at arm's length, adjustments will be made to either achieve the effect as if pricing had been arm's length, or, in the case of thin capitalization (a non-resident has funded a resident on loan account), to disallow 'excessive' interest.

S 103- general anti-avoidance provision

The anti-avoidance provisions contained in S 103 could also play 'long stop', failing the application of any specific provision. In summary S 103 covers the situation where there has been a transaction, operation or scheme entered into with the main purpose of obtaining a tax benefit and the circumstances of which don't connote normal bona fide business practice, the Commissioner is able to determine a tax liability as if such transaction, operation or scheme had been entered into in a manner the Commissioner deems appropriate.

Conclusion

There is no comprehensive set of possible international tax planning techniques utilizing tax havens against which to compare what is now permissible in South Africa, but it is useful to try to categorise the main thrusts of such potential planning and to view this in a South African context.

The move from a source to a residence basis of taxation is key to an inclusion of worldwide income, consistent with SA's liberalization of exchange controls.

That of itself, though, would have left a number of avenues open for tax planning. But the Income Tax Act has been boosted significantly. The main relevant OECD guidelines have, as detailed above, been incorporated into SA's legislation, including the taxation legislation.

Passive income was dealt with summarily. S9D is an intricate one, but one which accords with OECD recommendations and serves to capture the main taxation avoidance or deferral techniques which would otherwise be possible. The CFE is itself a wide, fairly all-embracing definition; for income to be exempt it must really be derived from substantive business activities in substantive (certainly non-tax haven) jurisdictions. The effects of this section are akin to a selective basis of group taxation, in that sense inconsistent with the entity specific legislation otherwise applicable.

The deeming provisions (e.g. S7(8)) whilst tight, may lend themselves to some degree of planning (e.g. by housing all activities in a company held 100% by the trust, which company does not declare dividends) involving tax havens, but

that of itself is debatable, dependent on how exactly the structure is put in place, and potentially open to either the application of S103 or the subsequent tightening of the Income Tax Act.

A non-trivial tightening of a potential planning tool involving tax havens has been the SARB's 'clarification' that it does not allow loop structures.

FICA in particular has heightened materially the risk of being aggressive in relation to taxation or exchange control matters. (Neither FICA nor POCA were designed to 'catch' law-abiding people operating in areas of interpretation at good faith at the margin, as both pieces of legislation instead were to cover serious offences. But their 'stamp' is such that both genuine law breakers, of whom there were/ are a number in SA given the arguably prevalent 'culture' of cherry-picking which laws will (and conversely which will not) apply, and the level of political risk, and those seeking merely to optimize their position will be affected.

The Amnesty has created a 'clean slate' for SA residents and made clear that those who did not choose to utilize it when they should have will face the full weight of the law.

In conclusion, then, it is clear that developments in South Africa's legislation, tax and other, in the five or so years has dramatically reduced the scope for international tax planning utilizing tax havens.

Further, given the international efforts (to which SA is either party or of which it is supportive) to curb money laundry, terrorist financing, and unfair tax competition, this trend is likely to continue, more especially since SA's information gathering methodology, inter-jurisdictional co-operation, as well as information technology in general, are improving all the time.

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