LEVERAGE

Legal and technical update: September 2018

Note from the editor

Sharon Hamman (née Teubes), Senior Legal Adviser: Advice and Wealth Management

October is here! It is often said that October is the start of summer in many of our SA provinces, as the first (proper) summer rains should fall around 10 October, signalling the official start of summer.... MMI Holdings recently released its financial results recently and while it was not the best news, the message from Hillie Meyer is filled with the energy and excitement of summer and all I can say is: "Watch this Space", as good things are happening as we speak!

In this edition we focus on offshore investments. With our economy going into a recession – again – and with the rand taking a tumble, offshore investing generally becomes more topical. Odette has a look at the capital gains tax implications on currency gains realised when investing offshore.

I also share an extract from our Frequently Asked Questions document on Momentum Wealth International products, which is attached as a separate attachment to this newsletter.

Arthie once again ensures an insightful Fiduciary Corner and touches on the topic of offshore trusts. She has undertaken to do a more in depth article on this topic, which we will share with you in the format of an ASAP in due course.

Happy reading!

Foreign investment solutions and Capital Gains Tax (CGT) on currency gains

By Odette Kriel, Legal Adviser: Financial Planning

Two major factors make overseas investment opportunities attractive for SA investors:

- SA contributes a very small part to the global economy – less than 1% by GDP and consumer size; and
- The SA economy will hopefully grow at 1,7% in 2019, while those of the rest of the world have grown at double digit percentages in recent years.

To meet this demand, Momentum Wealth offers these international investment options:

i. The International Investment Option (IIO) – an execution-only service giving investors access to a wide range of international funds. Investors have full access to their investment and can choose from over 1,000 international funds.

ii. The International Endowment Option (IEO) – an insurance product that offers SA investors a tax-efficient way to invest internationally for a minimum period of five years. In addition to the wide range of international funds and share portfolios available for investment, the IEO also allows for flexibility in estate planning.

As SA tax residents, income earned and gains made globally will be taxed in SA. With an unstable rand, investors may ask what the effect of currency gains will be on their efforts to diversify their investment strategies to include foreign investment.

Legislation provides for two methods of translating capital gains and losses into rand: a simple and a comprehensive method.

We will compare the two methods on the following case study:

Jack purchased a US investment for $100 in 2004, when the average exchange rate was $1:R10. He sold it for $1200 in 2018, when the average exchange rate was $1:R15.

For the "comprehensive method":

The base cost is $100 × 10 = R1 000
The proceeds are $1200 × 15 = R18 000
The capital gain therefore
= R17 000 (proceeds of R18 000 less base cost of R1 000).

For the "simple method":

The base cost is $100
The proceeds are $1200
The capital gain is calculated: $1200 (proceeds) – $100 (base cost) = $1 100
Multiply this by 15 (exchange rate for 2018 – the year of disposal)
= R16 500 capital gain in rand.

The difference between the two methods is R500 (R17 000 – R16 500) and is attributable to the fact that:

- The base cost under the simple method is $100 × 15 = R1 500 (using the current exchange rate), while
- The base cost under the comprehensive method is $100 × 10 = R1 000 (using the stronger exchange rate at the time the expenditure was incurred).

In accordance with the 8th schedule to the Income Tax Act, when a natural person disposes of an asset acquired in the same foreign currency, the capital gain (or loss) on the disposal must be calculated by way of the simple method. Under para 43(1), the currency fluctuation between the date the expenditure was incurred and the date of disposal is not taken into account.

This has the effect that the currency appreciation or depreciation on the base cost of the investment is disregarded.

If one considers the investment choices available to natural persons at Momentum Wealth International (MWI), the CGT consequences can be summarised as follows:

- International investment option (IIO) – when the SA investor disposes of the units, the simple method will be used to determine the capital gain or loss. Therefore, the gain or loss is determined in the foreign currency and the relevant exchange rate is then applied to that gain or loss;
- International endowment option (IEO) – when the SA investor makes underlying fund switches or disposes of units to fund withdrawals or loans, the capital gain or loss will be determined using the simple method. The CGT will then be payable into the endowment policy (into the individual policyholder fund) and is paid by the insurer.

Conclusion

When making an investment decision, it is always important to take note of tax considerations. It is therefore necessary to explain the impact of the currency's exchange rate to the investor when the investment is made. As explained, the simple method will generally provide the client with the best tax-outcome. However, as the investor is not offered a choice between the two methods, it is pointless to do a comparison between the methods for the client.

Non-natural persons cannot invest in the MWI products and are therefore not relevant to this article. However, it is worthwhile to note that companies and trading trusts are obliged to use the comprehensive method for all foreign exchange transactions, which is generally in line with how such transactions will be treated for accounting purposes.

Extract from Frequently Asked Questions: MWI products

Extract from Frequently Asked Questions: MWI products

The purpose of the extract is to draw your attention to this useful document when considering the MWI products for your client's international portfolio. It is attached as a separate document to this newsletter. It deals with income tax, capital gains tax consequences, estate planning and estate duty issues related to international financial planning and also take a look at Guernsey probate and Situs rules that apply in the UK and the US.

What products are offered by MWI?

MWI administers the International Endowment Option (IEO) and an International Investment Option (IIO). Please refer to the summary document published by MWI for more detail on the products.

Who can invest in the MWI products?

Natural persons, offshore companies and trusts can invest in these products. However, SA companies, Close Corporations (CCs) and trusts do not qualify for a foreign capital allowance and can therefore not invest in these products.

What happens to the product if the investor dies?

International Investment Option

As the investment allows for multiple owners, the impact of the death of the owner will depend on the investment's ownership structure.

Where the investment is owned by one natural person investor, death will result in the investment coming to an end and the funds returned to the deceased's estate of the deceased. The executor will then deal with the funds in terms of the deceased investor's will.

Unless expressly excluded, in writing, by any contract owner, this investment automatically incorporates the joint and survivorship option provisions for contracts owned by two or more persons. This means that upon the death of a contract owner, the deceased person's contract interest shall directly accrue to the remaining contract owners without passing through Guernsey probate. If the joint and survivorship option is excluded, the deceased person's interest in the contract will accrue to the investor's estate, which may be subject to Guernsey probate.

What is Guernsey probate?

Guernsey probate requires Letters of Administration to be obtained in relation to the investor's estate to enable the Guernsey estate to be properly wound up. To obtain Letters of Administration, the registrar of the Ecclesiastical Court in Guernsey will require the investor's will to be proved (or authenticated) in Guernsey and submitted together with a death certificate and an inventory stating the values of the estate. This may entail the added cost of appointing a Guernsey advocate to attend to the application.

If the deceased's wishes are contained in an SA will, this needs to be lodged and resealed by the Master of the High Court in SA before it is submitted to the Registrar in Guernsey for processing.

The Letters of Administration is an official document which enables the person named as the executor in the will to prove to third parties (banks, insurance companies, etc.) that he/she is duly authorised to collect the assets of the deceased for distribution. Without this official document, no institution will pay out any funds to the deceased's estate for a higher amount than a particular threshold they determine. Probate is required for all investments more than USD20,000.

If a person holds a local and offshore will, should there be a local and offshore executor?

In practice, an expert in the jurisdiction where the assets are situated will be appointed to attend to the administration of the part of the estate situated in the particular jurisdiction. This expert may be appointed to act in the foreign jurisdiction on the local executor's behalf either directly in the will, or by a local executor.

Fiduciary Corner

Offshore Trusts – loan funding structures and tax implications for a South African resident?

By Arthie Kander, Senior Fiduciary Specialist

There is growing responsiveness amongst South African (SA) resident investors towards diversification of currency denominations. Such local investors have taken advantage of investing into the plethora of offshore investment vehicles available through offshore trusts, whether for estate planning purposes or otherwise. SA legislation has vast anti-avoidance tax measures which are aimed at curbing the transfer of wealth to offshore trusts on loan account where such loans bear interest at below market related rates. This article will examine the loan funding structures and tax implication for SA residents who invest through Offshore Trusts. In this regard, the focus will be on the broader implications rather than the finer details.

Assets are usually settled into an offshore trust either by means of a donation or in terms of an outright sale at market value. In an instance where the donation is greater than R100,000 per individual per annum, donations tax will be payable and this is so whether the SA resident holds the assets locally or abroad. Generally, SA residents tend to sell assets to offshore trusts on an interest-free loan basis. It is often overlooked that an interest-free loan to an offshore trust may attract taxes such as in the donor attribution rules in terms of Section 7 read with paragraph 72 of the Eighth Schedule to the Income Tax Act (ITA).

In terms of transfer pricing provisions in section 31, where a connected person in relation to the any trust including an offshore trust, enters into a transaction with the trustees of the offshore trust and the transaction is not concluded at arm's length, then such resident may be subject to South African income tax on a deemed basis. An offshore trust is a connected person in relation to a South African resident if such person or their spouse or their respective relatives to the third degree of consanguinity is a beneficiary of the trust. As an interest-free loan to an offshore trust is not an arm's length transaction, SARS could tax the South African resident, being the lender, based on a market related interest rate. Present day taxation law amendments impose Section 7C creates an entirely new tax implication for connected individuals who make interest free loans to any trust or company where the consequence will amount to a deemed donation in the hand of the lending individual.

It is evident that the above pieces of legislation require such an investor to charge a market related rate of interest in providing a loan which funds an offshore trust. Such investor can consider certain factors in determining a market related interest rate and must retain sufficient record. Such factors can be, the principal amount, period and conditions of the loan, the currency denomination for the loan and of course, whether similar loans exist between unconnected parties. The "official rate of interest" contemplated in section 7C is defined in the context of a foreign currency denominated loan as "a rate of interest that is the equivalent of the South African repurchase rate applicable in that currency plus 100 basis points". It is clear that the market-related rate of interest could differ from the official rate of interest for the relevant tax year. If it is less, the difference may be treated as a donation made to the offshore trust by the SA tax resident individual for donations tax purposes. One may mitigate this risk through the terms of the loan funding arrangement between the SA tax resident individual and the offshore trust.

Where the loan made is interest-free or where interest charged is below the market related rate is advanced by SA resident individual to an offshore trust then such individual may be regarded as having made a donation, settlement or other (gratuitous) disposition to the offshore trust for purposes of the application of the donor attribution rules. In terms of these rules, the income and capital gains of the offshore trust may then be attributed to the SA tax resident individual. Such attribution should be limited to the market-related rate of interest that should have been charged on the loan.

SA resident should carefully consider the application of the donor attribution rules, transfer pricing principles and the deeming provisions under section 7C to any loan funding arrangements with offshore trusts. It is also advisable for individuals to obtain advice to these rules where they find themselves in historic loan funding arrangements with offshore trusts.

About Leverage

Momentum Leverage is prepared by the Momentum Legal Advisers: Financial Planning and Fiduciary Specialists from Momentum Fiduciary Services. For financial advisers, please contact your legal adviser or fiduciary specialist should you have any questions. For clients, please contact your financial adviser should you have any questions.