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Fiduciary Matters

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Structuring offshore investments – the devil is in the detail

With the relaxation of exchange control regulations over the years, South Africans can now invest R4million per year as their foreign investment allowance subject to Reserve Bank clearance and R1million per year as their discretionary allowance without Reserve Bank clearance required. Many reasons exist why clients would consider investing offshore, including the need for currency diversification against a weakening rand, hedging against political uncertainty and matching future expenses to investments, for example should you wish to retire overseas, educate children abroad or if you are a frequent foreign traveller.

The question then arises how these funds should be invested and structured offshore?

1. Individual investment - The funds could be invested offshore in the client's own name. South African residents are taxed on their worldwide income and any income accrued from the investment must be included in their local annual tax return. Should any taxes be levied in the foreign jurisdiction such as withholding tax, due notice should be given to the existence or not of a double tax treaty for tax relief or domestic statutory relief. Should the client die or dispose of the investment, it will be a trigger event for capital gains tax purposes and CGT will be payable at the client's prevailing rate. Alternatively a client may also consider investing in a local SA fund with offshore exposure.

2. Investing in an offshore trust – An offshore trust could prove an ideal vehicle for investing offshore with the added benefits of asset protection, confidentiality, succession and legacy planning. It is however important to evaluate the following when advising:

i. How to fund the offshore trust;
ii. The nature of the proposed investments; and
iii. Selecting the appropriate currency of the funding.

If the offshore trust is funded by way of a donation or an interest free loan, the donor (client) will be taxed on income and capital gains tax accruing to the offshore trust's underlying investments as if they invested therein in their personal name (section 7(8) of the Income Tax Act and par 72 of the 8th Schedule of the ITA). In the case of a donation, donations tax of 20% would also be applicable on the donation in excess of R100,000 per annum.

Should the offshore trust however be **funded by way of a loan** with a market related interest rate, any income and capital gains of the underlying investments will not be deemed to be that of the donor and they will only be taxed on the interest charged in terms of the loan agreement.

If the interest rate is less than market related they will still be taxed on the actual interest rate received as well as the deemed interest rate they should have received. The loan to the offshore trust will remain an asset in the donor's estate for calculation of estate duty, but the growth portion would be excluded from their estate on death.

The nature of the investments should also be considered when determining the funding method to avoid a situation where a lower rate of return is generated by the investments than the interest payable to the donor. It may be advisable to charge a market related interest rate on investments with appreciable levels of growth and an interest free loan on tax efficient investment vehicles (eg policy wrappers, roll up funds).

A problem could potentially arise when the offshore trust holds a variety of assets and investments with variable returns.

When selecting the currency denomination of the loan account, a choice needs to be made whether to make use of the rand (ZAR) or the pound, dollar or euro.

Using the rand has the advantage that should the currency weaken over time against the major currencies, the loan amount is effectively pegged to the initial value and does not increase, thereby not increasing the client's estate for purposes of calculating estate duty. However the fair value South African interest rate needs to be levied on the loan, which could be meaningfully higher than the rate charged in some foreign jurisdictions, thereby increasing tax liability on the interest income.

Should the loan amount be denominated in the pound, dollar or euro, the fair value interest rate of the country/zone of the country of the currency should be used, which could be as low as 1% thereby resulting in a lower amount of income tax payable by the donor on the interest received. However should the rand depreciate over time against the loan currency, the loan amount would increase, thereby increasing the client's estate and resultantly increasing the amount of estate duty payable at death.

As can be seen, advising clients on structuring their offshore investments can be fraught with unforeseen pitfalls. It becomes important to comprehensively understand the client's overall objective for investing offshore whilst also taking into account his income tax and estate position to provide a holistic solution to their needs.

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Membership is drawn from trust companies and banks, as well as the legal, accounting and financial planning professions.

Activities of FISA members include but are not restricted to estate planning, the drafting of wills, administration of trusts and estates, beneficiary funds, tax and financial advice and the management of client assets.

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