REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM ON THE REGULATIONS PUBLISHED IN TERMS OF SECTION 30 OF THE EXCHANGE CONTROL AMNESTY AND AMENDMENT OF TAXATION LAWS ACT, 2003

Regulation 1.

Definitions

This regulation clarifies the meaning of certain words, which have the same meaning as contained in the Income Tax Act, No. 58 of 1962. Most notably, the term disposal is defined under the Eighth Schedule (rather than other provisions of the Income Tax Act).

Regulation 2.

Indirect and deemed donations to foreign discretionary trust

The Exchange Control Amnesty and Amendment of Taxation Laws Amendment Act provides relief for parties with illegal foreign assets held through discretionary foreign trusts only to the extent these parties donated the foreign assets to the foreign trust. After wide consultation, we now understand that most parties made these donations to foreign discretionary trusts through indirect means. In particular, most individuals with discretionary foreign trusts utilised controlled South African companies and trusts to make the donation.

The regulations accordingly allow amnesty for illegal foreign assets donated by any person (e.g., by South African companies or foreign discretionary trusts) “at the instance of” (i.e., upon the direction of) the applicant. The required level of proof is a sworn affidavit by the donor. The donor need not show a documented trail of each step involved.

The regulations further clarify that donated foreign assets include those received by virtue of a deemed donation. Hence, a transfer of funds to a foreign trust due to under-invoicing or over invoicing (i.e., sales or purchases at other than fair market value) would fall within the amnesty as well as other forms of indirect donations, such as trust distributions from other trusts acting at the instance of the donor.

Regulation 3.

Growth within foreign discretionary trusts

Illegal foreign assets within a foreign discretionary trust are covered by the amnesty only to the extent those assets were donated to the foreign trust. The current rules fail to account for the fact that the originally donated assets may have been replaced with new assets over the years or that the donated assets (or replaced assets) may have generated further funds within the foreign discretionary trust. The regulations ensure that replacement assets and subsequent growth are fully included within the amnesty by including any discretionary foreign trust asset whose value is "wholly or partly derived" from a donation (or a deemed donation).

> *Example. Facts.* Since 1998, Individual has owned all the shares of Domestic Company as well as a contingent interest in Foreign Discretionary Trust, the latter of which has similarly owned all the shares of Foreign Company. In 1998, Domestic Company illegally transferred funds to Foreign Company through under-invoicing of export sales at the instance of Individual.
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> *Result.* Individual can elect amnesty treatment for the Foreign Company shares held by foreign Discretionary Trust. The Foreign Company shares have a value that is partly derived from a deemed donation by Domestic Company that acted at the instance of Individual.

Regulation 4.

Tax cost of foreign discretionary trust assets (paragraph 1(a))

Parties wishing to avail themselves of the amnesty with respect to discretionary foreign trust assets can do so only to the extent those parties elect to be treated as directly holding those trust assets for tax purposes. The current wording fails to describe the tax cost (i.e., base cost in terms of capital gains/losses and cost price in terms of trading stock for purposes of ordinary revenue) for which a foreign discretionary trust asset is deemed acquired for the electing party. The regulations clarify that the electing party is deemed to have acquired the trust asset on 1 March 2002 for an amount equal to that asset's market value on that date (and the electing party is deemed to have incurred any subsequent expenditure incurred by that trust in respect of that asset).

Ongoing use of foreign discretionary trust assets (paragraph (b))

A second collateral issue stemming from the election concerns the tax implications of the election while the electing party is deemed to own that foreign discretionary trust asset. Regulation 4(c) provides that the electing party is "deemed to deal with the trust asset in the same manner as is dealt with by that discretionary foreign trust from 28 February 2003." In other

words, if the trust treats the trust asset as a capital asset, the electing party similarly treats the trust asset as a capital asset. If the trust switches use of that asset to trading stock, the electing party is similarly deemed to have switched use, thereby triggering a deemed disposal and reacquisition under paragraph 12 of the Eighth Schedule. In sum, the electing party is deemed to hold the trust asset directly with all activities by the trust being attributed to the donor.

Deemed disposals of foreign discretionary trust assets (paragraph (c))

A third collateral issue stemming from the deemed asset election concerns the time when the electing party is deemed to dispose of a foreign discretionary trust asset. These special rules are again required because the electing party does not actually own the trust asset at issue. This disposal date is deemed to occur on the earliest date when:

(i) The discretionary trust actually disposes of the asset (including a vesting or other disposal to the electing party; in which case the asset becomes directly owned by the electing party without regard to the amnesty);
(ii) The electing party dies or ceases to be a South African tax resident (i.e., is otherwise subject to a deemed disposal event at the electing party level); or
(iii) The electing party ceases to exist by operation of law (i.e., is otherwise subject to an actual disposal event at the electing party level), meaning that an electing deceased estate is wound-up, an electing close corporation is liquidated, or an electing trust is terminated.

Regulation 5.

Vesting of discretionary foreign trust assets after 28 February 2003

Applicants wishing to avail themselves of the amnesty with respect to a discretionary foreign trust asset can do so only if that foreign asset was held by the trust on 28 February 2003. Section 4(2)(c) of the Exchange Control Amnesty and Amendment of Taxation Laws Amendment Act further provides that the asset cannot vest in any beneficiary at the time of the election.

The regulation clarifies that any donor making an election under section 4 is deemed to have made that election as at 28 February 2003. This clarification means that subsequent vesting before amnesty relief is granted will not prevent application of the amnesty. Hence, a donor will not be denied the possibility of amnesty relief merely because the trust asset vested to the donor or a beneficiary after 28 February 2003. Subsequent vesting would similarly not prevent amnesty relief (but would create a deemed disposal of the trust asset by the donor – see Regulation 4(c)).

Regulation 6.

Donations from foreign accounts

The Exchange Control Amnesty and Amendment of Taxation Laws Act provides amnesty for failure to pay donations tax if the undeclared sums involved are shifted to foreign locations. However, the amnesty inadvertently covers only a limited set of situations. For instance, the amnesty seemingly applies only if the undeclared donation comes from domestic locations with the funds subsequently shifted offshore (i.e. if the donation precedes the conversion into foreign assets). The amnesty does not seemingly apply if the undeclared donation is made out of funds from a foreign location, such as a foreign bank. We understand that this omission is highly problematic because many parties shifted undeclared funds from foreign bank accounts into foreign discretionary trusts. The regulations accordingly place these foreign donated assets on par with assets donated into foreign discretionary trusts from domestic accounts. Foreign donated assets of this kind will be covered by the amnesty and will be subject to the same 2 per cent domestic levy.

Regulation 7.

No attribution during periods of deemed trust asset ownership (paragraph (a))

Regulation 7(a) clarifies the interaction of the amnesty with certain trust rules under the Income Tax Act (section 7(5), 7(8), and 25B of the Income Tax Act as well as paragraphs 70, 72 and 80 of the Eighth Schedule). In particular, the deemed attribution rules of these provisions do not apply during the period in which the deemed ownership election of section 4(1) remains in effect. Hence, income/loss and capital gain/loss associated with a foreign discretionary trust asset cannot be attributed to any person other than the electing donor during the period in which the donor is deemed to own that trust asset.

No attribution after periods of deemed trust asset ownership (paragraph (b))

Regulation 7(b) further clarifies the interaction of the amnesty with certain trust rules under the Income Tax Act (sections 7(5), 7(8), and 25B of the Income Tax Act as well as paragraphs 70, 72 and 80 of the Eighth Schedule), especially section 25B(2) of the Income Tax Act and paragraph 80(3) of the Eighth Schedule. In particular, the deemed attribution rules of these provisions will not apply to create income/loss or capital gain/loss for a vesting beneficiary with respect to pre-1 March 2002 amounts, even if those trust amounts were never subject to tax by virtue of the amnesty.

Regulation 8.

Estate transfers from foreign locations

The Exchange Control Amnesty and Amendment of Taxation Laws Act has the same shortcomings for failures to pay estate duty as for failures to pay donations tax (see Regulation 6 above). The regulation again places these foreign transferred assets within the ambit of the amnesty subject to the 2 per cent levy.

Regulation 9.

Date for determining related party facilitator status

The amnesty currently covers a wide variety of related party facilitators, including related companies, trusts and deceased estates. At issue is when related party status must be determined because no date for this determination exists under the legislation. The regulation accordingly clarifies that related party status is determined as at the date of the illegal accumulation or transfer from South Africa. This clarification means that subsequent ownership changes will not prevent the application of the amnesty for related party facilitators.

Regulation 10.

Company facilitators held through trusts

The amnesty currently provides explicit coverage for related company facilitators to the extent all the shares of a company are owned by the applicant (or both the applicant and the applicant's relatives). Indirect ownership of this kind through trusts is not explicitly covered, even though the underlying economics are the same. The regulation accordingly extends amnesty relief for related company facilitators when all the company shares are held by one or more trusts if no persons other than the applicant or relatives were vested beneficiaries of trusts on the date of the transgression by vested beneficiaries who were not an applicant (or a relative thereof).

> *Example. Facts.* South African Company is owned by South African Trust, a trust without any vested beneficiaries. South African Company illegally shifts funds to Foreign Company through the use of under-invoicing of export sales. Individual owns all the shares of Foreign Company and has a contingent interest in South African Trust.
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> *Result.* South African Company qualifies as a related party facilitator because the trust does not have any prohibited vested beneficiaries.

Regulation 11.

Company facilitators held by multiple unrelated applicants

We understand that many structures formed for the evasion of Exchange Control and/or tax came in the form of a collaborative effort whereby multiple individuals illegally shifted funds offshore through a single company. For instance, a single company facilitator with five unrelated shareholders could have been used to illegally shift funds offshore equally on behalf of all the shareholders. Alternatively, a single company facilitator with multiple trusts shareholders acting on behalf of unrelated beneficiaries could have similarly been used.

The regulation provides amnesty relief for the related company facilitator by treating all the applicants as a single applicant on condition that all of the original transgressors apply for amnesty. Stated differently, relief exists for a related company facilitator with multiple unrelated shareholders only if all the original transgressing shareholders apply for amnesty. This relief will not apply where any original transgressor has died or has become a non-resident. Relief similarly applies if all applicants involved were acting through trusts.

Regulation 12.

Special rules for calculating the Exchange Control levy for applicants who repatriated assets prior to amnesty unit approval

On 26 February 2003, the Minister announced Government's intent of granting an amnesty. From representations received, it appears that many parties repatriated their illegal offshore assets after 26 February but before the amnesty window period of 1 June to 30 November 2003. Under the current rules, these applicants find themselves in a situation where application of the Exchange Control levy is unclear.

The regulation clarifies that the 5 per cent levy applies and that this amount must be paid out of local currency (since the foreign amount at issue has since been repatriated). In addition, the date of exchange rate conversion for determining the levy will be the date of actual repatriation at the ruling spot rate on that date. Payment of the levy must be made within three months after the deemed date of repatriation (i.e., the date when the amnesty unit grants approval).

Regulation 13.

Former deemed domestic income

Prior to the adoption of worldwide tax in 2001, the South African tax system treated certain foreign income as "deemed" South African source income. The most important category of this deemed domestic source income involves

foreign investment income earned by individuals, which was previously subject to “deemed” South African source treatment. With the implementation of worldwide taxation on 2001, this “deemed” South African source income was eliminated as superfluous since all income became subject to tax regardless of source.

Unfortunately, the Exchange Control Amnesty Act could be interpreted as treating this former deemed South African income as domestic income for purposes of amnesty relief. As a result, this income (being deemed domestic) inadvertently receives only limited amnesty treatment, including required payment of the additional 2 per cent domestic amnesty levy. The regulation accordingly reverses this result by treating this and other deemed domestic source income as actual foreign source income.

Regulation 14.

Information required about dates of domestic tax violations

Applicants seeking amnesty for domestic tax violations must disclose the dates on which the domestic amounts were initially accumulated or converted offshore. The regulations clarify that applicants need only disclose the years of assessments in which those assets were so accumulated or converted. Disclosure of exact days is not required, regardless of whether the accumulation or conversion occurs before, on or after 28 February 1998.

Regulation 15.

Exchange rate conversion for the 2 per cent domestic levy

As stated above, exact days of accumulation and conversion are not required for the 2 per cent domestic levy, merely the year. On a similar vein, the exchange rate for the determination of the 2 per cent levy can either be set at the daily exchange rate or at the annual average exchange published by the South African Reserve Bank (the latter of which will be effectively required if only the year of accumulation or conversion is known).

Regulation 16.

No double domestic levy

The domestic amnesty provides relief from several domestic tax violations – most notably undeclared domestic income illegally shifted offshore and donations. Questions have been raised whether the 2 per cent domestic levy will apply in respect of each violation even though the same sum is involved. For instance, if a party generated R100 000 of undeclared domestic income and also donated those funds offshore without declaring the donation, does the 2 per cent levy apply once with respect to the R100 000 sum involved or twice because two domestic tax violations were involved? The regulations clarify that the 2 per cent domestic levy will apply only once per sum involved.

Multiple levies on the same amount were rejected. [Because a cumulative effect of this kind may discourage applicants from coming forward in view of the potentially high price involved].

Regulation 17.

Unlawful activities and Value-Added Tax ("VAT")

The amnesty does not apply to VAT because VAT violations often involve the fiduciary obligation to pay Government taxes collected on behalf of another. However, per se exclusion of the VAT from the amnesty may unintentionally be interpreted to exclude those parties seeking amnesty relief for other violations fully within the ambit of the amnesty. In particular, it could be argued that parties with foreign funds shifted offshore and who did not disclose it for VAT purposes have committed an "unlawful activity" under the Prevention of Organised Crime Act, thereby preventing amnesty relief for Exchange Control, Income Taxes, and Estate Duty.

Regulation 17 eliminates this potential unintended effect by removing zero-rated goods and services from the scope of an "unlawful activity." For example, failure to report zero rated exports do not constitute a matter that should impede amnesty relief because these violations merely amount to a misrepresentation or non-disclosure that facilitated the illegal shift offshore. No funds have been derived from wrongfully withheld funds.

Regulation 18.

Invalidity of approval and the adverse timing of unlawful foreign assets

Section 20(1)(b) of the Exchange Control Amnesty and Taxation Laws Amendment Bill voids amnesty approval if it is determined at any stage that the applicant has foreign assets or bearer instruments derived from unlawful activities. Regulation 18 clarifies that the unlawful foreign assets or foreign bearer instruments must be with reference to those assets held by the applicant on 28 February 2003. Hence, the existence of unlawful assets on that date will invalidate the amnesty regardless of when these unlawful assets are discovered.

Regulations 19 and 20.

Internal amnesty procedures

The Chairperson of the Amnesty Unit needed clarity about his authority over the unit. The proposed regulations accordingly provide the Chairperson with the authority to determine the amnesty unit's procedures. The Chairperson will also have the authority to fix the quorum required for granting and denying amnesty applications.