

## MAURITIUS AN OFFSHORE BASE TO BE

**MICHAEL HONIBALL** examines why Mauritius is fast becoming the offshore base to use in international tax planning, especially for multinationals operating in South Africa.

The Mauritian system has been specifically designed to accommodate the many new obstacles placed in the way of multi-national groups under new anti-tax haven legislation. Mauritius has recently introduced tax efficient legislation for multinational groups who choose Mauritius as an offshore base. Mauritius is one of the very few low tax countries which combine a low tax jurisdiction with a relatively wide double tax treaty network. The treaty network with African countries is of particular interest, especially since it is expanding fast and now also includes a treaty with South Africa.

A Mauritian offshore company can choose a tax rate of between 0% and 35% annually. This enables multinational groups to comply with so-called controlled foreign corporation (CFC) rules which typically look through tax haven entities unless a certain minimum tax burden is imposed (for example, 30% in Germany, 75% of the corresponding UK

tax and 85% of the tax burden in South Africa). Furthermore, to qualify for tax treaty benefits, a resident of a contracting state must generally be subject to tax there by virtue of its *domicile*, residence, place of management or a similar criterion. The mechanism allows a company to choose a minimal tax which qualifies it as a tax resident for treaty purposes. The Mauritian system is superior to most tax havens as the tax authorities have issued clear guidelines for tax residency under national tax law, removing the uncertainty experienced in other jurisdictions.

A further common requirement of modern CFC legislation is that the offshore base should carry on business of substance through a suitable business presence in the offshore jurisdiction (for example, the provisions of section 9D of the South African Income Tax Act 1997). In Mauritius, unlike the other tax havens, it is relatively easy to establish a proper base due to its infrastructure, communications network and skilled labour force.

In addition to the nominal corporate tax rate, Mauritius does not impose any withholding taxes on interest, dividends, royalties or service fees paid by such offshore companies. Of particular interest for trade between South Africa and Mauritius is the fact that the two governments are currently negotiating an investment promotion and protection agreement to supplement the treaty.

**Some advantages for investment are:**

### Royalties

Royalties paid by a South African resident to a Mauritian resident are subject to tax in Mauritius only. Foreign companies operating in South Africa could locate their patent or trademark holding company in Mauritius. The holding company will pay minimal tax on royalty income and no withholding tax will be imposed in royalties paid by the South African licensee to the Mauritian holding company.

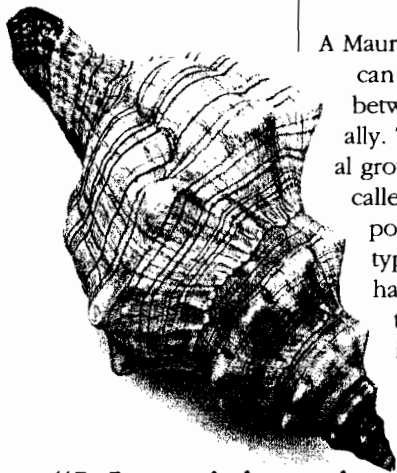
### Interest

There is no South African withholding tax on interest paid to non-residents. However interest income may be sourced in South Africa and thus be exposed to normal tax. A special exemption is available to non-residents in respect of interest income if the lender is managed and controlled abroad and does not carry on business in South Africa. However, certain yields on financial instruments held by non-residents could not be regarded as interest under the common law definition of interest which means that such gains would not qualify for the exemption.

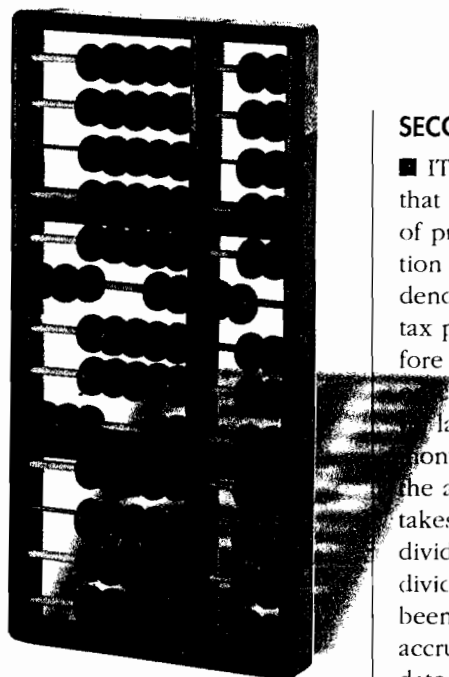
Furthermore, non-resident lenders may lose their own exemption if they visit South Africa regularly to solicit business by virtue of the proviso to the exemption. Article 11 of the treaty provides for interest to be taxed only in the country in which the beneficial owner is resident. The definition of interest in the treaty is wider than under South African common law and specifically includes premiums in respect of bonds. ▶



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▶ A further consideration is the threat of a potential re-introduction of a withholding tax on interest paid by a South African resident to a related non-resident lender (following proposals in the Fifth Interim Report of the Katz Commission). The provisions of Article 11 would prohibit South Africa from imposing such tax. For these reasons it may be appropriate for lenders who are deriving such income from South Africa to locate their finance company in Mauritius.

### Capital Gains

Currently there is no tax on capital gains in South Africa or in Mauritius. Article 13(4) of the treaty provides for gains arising on the sale of property (except for immovable property, movable property forming part of the business property of a permanent establishment and shops or aircraft) to be taxed only in the country of residence of the seller. If capital gains tax should be introduced in South Africa, it would be tax effective for South African investments to be held by holding companies resident in Mauritius.

Investment through Mauritius could result in potential reductions of holdings taxes. The treaties that Mauritius has signed with India, the People's Republic of China, and Pakistan provide for gains on capital to be taxed in the country of residence of the seller only. As there is no capital gains tax in Mauritius, South African investments in the aforementioned countries could be routed through Mauritius to avoid substantial capital gains tax exposure. South African residents could also make use of the tax-free export processing zone in Mauritius for the partial or total assembly or manufacture of exported goods. ■

### RECOUPMENT

■ WHERE A TAXPAYER has deducted an amount from income, and such a deduction is later recovered or recouped, then in terms of section 8(4)(a) of the Act that amount is included in the taxpayer's taxable income.

A new sub-section is to be added to Section 8(4) which is to the effect that where expenditure has been allowed as a deduction but has not yet been paid, the obligation to make payment is subsequently reduced or extinguished, the amount so reduced or extinguished will be deemed to have been recovered or recouped for the purposes of Section 8(4)(a). This amount will, therefore, be included in the taxable income of the taxpayer who deducted it.

The reduction or extinction could occur as a result of the cancellation, termination or variation of an agreement, or due to the prescription, waiver or release of a claim for payment.

The new sub-section came into effect on 4 July 1997 and applies to any cancellation, termination, or variation of an agreement or prescription, waiver or release of any claim on or after this date.

### SECONDARY TAX

■ IT IS ALL too easy to forget that distributions or allocations of profit by a close corporation to its members are dividends as defined for income tax purposes. They are therefore subject to secondary tax as companies (STC), payable later than the end of the month following that in which the accrual to the member takes place. Where no formal dividend declaration occurs, a dividend is deemed to have been declared and to have accrued to the member on the date that the member becomes entitled to any cash or asset. If the allocation is made by bookkeeping entry alone, then the date on which the member is credited with the allocation will be the date of accrual of the dividend.

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**"INVESTING IN AN OFFSHORE MUTUAL FUND SHOULD ENQUIRE AS THE INVESTOR COMPOSITION OF THE FUND SO AS TO DETERMINE WHETHER THE CFE RULES WILL APPLY TO HIS (MINUTE) HOLDING"**

### CFE DEFINITION

■ A CFE (CONTROLLED foreign entity) is constituted where, broadly, South African residents "individually or jointly" hold more than 50% of voting control or beneficial participation rights in an offshore entity. There has been significant debate on the point whether "jointly" indicates a degree of common purpose between the parties concerned or whether it simply denotes a mathematical calculation. Professional opinion remains divided with strong arguments being raised for both interpretations. Revenue's view, however, is that the word refers simply to a mathematical calculation of whether more than 50% of control/rights is held by South African. On that basis, a South African resident investing in an offshore mutual fund should enquire as the investor composition of the fund so as to determine whether the CFE rules will apply to his (minute) holding.



### INSOLVENT ESTATE

■ THE DEFINITION OF a person has been extended to include an insolvent estate. An insolvent estate is given the meaning set out in the Insolvency Act, 1936. The definition of representative taxpayer has been amended to include the trustee or administrator of an estate. Prior to these amendments the trustee of an insolvent estate would not be liable for any tax on income of the estate which was received or accrued after the date of sequestration. The amendments came into operation on 4 July 1997, and apply to any estate voluntarily or compulsorily sequestered on or after that date. As a result of the above, any loss incurred

prior to the date of sequestration may now be set off against the income derived by the insolvent estate. Should the insolvent be rehabilitated, the amount of the assessed loss which can be carried forward must be reduced by the income of the insolvent estate which was set off against the loss. Section 20 of the Act has been amended to provide for this. A new section (25C) deems the estate prior to sequestration and the insolvent estate to be one and the same.

### NEW CASE LAW

■ FOR THE UMPTEENTH time in the past five years a taxpayer has found himself in court, attempting to justify a deduction for interest paid in respect of funds borrowed to declare a

dividend. This situation arises commonly in two different manners.

- Where the company physically pays a dividend to the shareholder and the cash flow for the dividend is clearly linked to a particular borrowing by the company.
- Where there is no physical payment of the dividend but it is credited to the shareholder or member and interest is paid on the resultant loan account.

Although there are strong logical arguments which suggest that the only reason for borrowing is in fact to retain productive assets in the company (rather than realising them to finance the payment of a dividend), the courts have consistently held that if the linkage between borrowing/interest/dividend is clear in terms of causation and/or time, then the interest deduction will be disallowed. The various arguments for and against the deduction have been considered at the highest level in the Appeal court in Bloemfontein and it is unlikely that there will be any change in the future. It is therefore important to be extremely cautious when declaring a dividend if they are in a borrowed position at that time, or if a borrowing will arise contemporaneously with the distribution. Given careful planning, it is possible to avoid the consequences of this interpretation - but, as with most tax issues, once the deed is done, there is little hope of rescuing the situation.

### UNBUNDLING OF COMPANIES

■ UNBUNDLINGS HAD TO be done before a fixed date by the Minister of Finance in the Government Gazette. Section 60 of the Income Tax Act, 1993 has now been amended so that there are no limits as to the date by which an application can be made to Revenue for approval of an unbundling.

## GROSS INCOME

■ THE APPELLANT COMPANIES<sup>1</sup> each concluded a series of agreements with various other parties. A lease of the stand to a pension fund entitled the fund to "erect such buildings or other improvements on the land as it may determine". A sub-lease let the factory building thus built to a company. A subsidiary of the sub-lessee owned the entire shareholding of each appellant thus completing the circle.

Paragraph (h) of the definition of "gross income" in s1 of the Income Tax Act 1962 provides that a taxpayer's gross taxable income includes the benefit accruing from the right to have improvements effected on his land. The appellants contended that there was no such right because the lessee could erect improvements "as it may determine".

The court balanced the principles that a taxpayer is entitled to arrange affairs so as to remain outside the provisions of a particular Statute and that the courts of law will not be deceived by the form of a transaction, but will examine its substance. In terms of the entire arrangement the taxpayer accrued rights capable of being valued in money. There was a wider unexpressed agreement or tacit understanding and the appellants failed to discharge the onus of proving the agreements reflected their actual intention. The factories were taken into account for assessing gross income. The transaction is not necessarily a disguised one because it is devised for the purpose of evading a prohibition in the Act or avoiding liability for tax imposed by it. A disguised transaction is in essence a dishonest transaction.

1) *Erf 3183/1 Ladysmith (Pty) Ltd v CIR 1996 (3) SA 942 (AD)*.



## TAX TREATIES

■ THERE HAS BEEN no treaty between South Africa and the United States since the previous outdated version was abrogated by the US during the apartheid era. The new treaty has moved one step closer to ratification and it now seems that it will enter into force for taxpayers whose year of assessment/financial year commences on or after 1 January 1998.

■ THERE REMAIN A number of countries which are becoming substantial trading partners but with which there is as yet no treaty in place. Amongst these are Australia, Brazil, Greece, India, Japan, Malaysia, Mexico, New Zealand, Portugal and Spain. Readers intending to do business in these countries should be especially careful of the possibility of double taxation arising, and should take advice on the taxation issues even earlier in the process than is usually the case. ■

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