MEDIA STATEMENT

Ongoing Investigation - Offshore Captives and Protected Cell Companies

This media statement is being released along with the Taxation Laws Amendment Bills, 2010 to highlight the ongoing review of tax issues relating to offshore captives and protected cell companies. Although these issues were raised in the 2010 Budget Review, it was decided that these issues should be investigated further rather than inserted for inclusion within the Taxation Laws Amendment Bills, 2010.

1. Background

Two related concerns were raised in the 2010 Budget Review. One concern was the over-funding of offshore captives in order to artificially generate deductions. A related concern was the growing existence of offshore protected cell companies.

A. Captive subsidiaries

Captive subsidiaries can be a legitimate method of managing risk. Contingent liabilities of a business may be so frequent that these risks can be internally assessed and managed at cheaper cost than reliance on various forms of outsourced risk insurance. Captive insurers come in two basic forms – 3rd party (payments going directly to third party clients of the insured group company) and 1st party (payments going back directly to the insured group company).

Despite their commercial uses, captive subsidiaries (especially offshore captive subsidiaries) may be used to undermine the tax base. The Income Tax system does not generally permit deductions for reserves against future risks. If the captive subsidiary generally pays out claims equal to (and within a short time after) premiums are received, little risk exists to the tax base. The tax base is only at risk once payouts are less than premiums are received or the time delay between the two events becomes too far apart. A related concern also exists
that the over-funding of captives may represent an attempt to obtain deductions for amounts that are otherwise viewed as a non-deductible investment.

In terms of tax avoidance, the main concern is the use of offshore captive insurers. Offshore captive insurers often remain untaxed when receiving premiums, even if the insurer fails to make corresponding payouts after a long period. In some instances, these insurers may even distribute the excess premiums back to the insured free of tax. Although current tax rules relating to controlled foreign companies curtail this practice, the controlled foreign company tax rules have obvious weaknesses. Firstly, not all offshore captives are under indirect South African control (a precondition for applying the controlled foreign company rules). Secondly, the current tax rules allowing for short-term deductions may be too permissive (indeed, if these rules are too permissive, a tax problem for the fiscus may even exist in respect of onshore captives).

B. Protected cell companies

A cell company offers limited liability for each cell within the company. Stated differently, each cell is a stand-alone company for limited liability purposes, meaning that creditors/claimants seeking funds from a cell cannot look to the rest of the cell company for payment if a cell’s funds fall short. Cell companies typically have a main cell reserved for the shareholders with ownership held through ordinary shares. This portion of the cell represents the service-provider. Other cells represent client interests with ownership of each cell held through a separate class of shares.

Variations in the structure of offshore cell entities depend on the protection and ring fencing of the assets and liabilities of each cell. All cell legislation provides limited liability as discussed above. However, some jurisdictions additionally segregate the liquidation of the cells, and other jurisdictions even segregate tax consequences. It should be noted that South Africa does not offer cell companies in a true sense, lacking true cell limited liability. Claimants against a South African cell can recover from all South African cell company assets; however, a cell owner is contractually required to refund the cell for any short-falls.

Cells, like captives, have legitimate non-tax commercial uses. Most notably, cells offer a strong middle-ground alternative to outsourced insurance and captive insurance subsidiaries. Cells allow the insured to limit costs associated with the service premium attendant with typical outsourced insurance without incurring the cumbersome regulatory costs associated with controlled captive subsidiaries (e.g. the annual license fee and upfront registration with the Financial Services Board).

However, it is notable that most jurisdictions offering cell legislation can also be viewed as tax haven or low-tax/no tax jurisdictions. The nature of the cell is such
that cells can easily evade offshore tax avoidance legislation, such as the rules relating to controlled foreign companies. It is these tax avoidance uses that are of concern to the local tax system.

2. Remedial options

Given the range of issues (and the need to balance legitimate commerce against anti-avoidance concerns), it was decided that immediate tax legislation for 2010 is premature. Piecemeal changes not only may miss the mark but also disrupt legitimate commerce. Instead, National Treasury will continue to engage with relevant stakeholders. At the present stage, the following tax proposals remain under consideration:

(i) **Tightened controlled foreign company legislation**: The ownership criteria for controlled foreign companies could be tightened. Under this scenario, each cell in an offshore protected cell company would be measured as a deemed separate company. In addition, the effective management test could be measured cell-by-cell rather than company-by-company. The goal of these changes would be to neutralise the tax benefits of an offshore cell vis-à-vis an onshore cell.

(ii) **Taxable premium calculations**: The current tax rules are designed to ensure that short-term insurance premiums should generally be taxable in the hands of the short-term insurer unless claims relate to the year of receipt. However, a growing number of exceptions appear to be emerging in this regard. Co-ordination will also be required with new insurance regulatory criteria so that over-conservative principles are not utilised to undermine the tax base.

(iii) **Dividend recoupments**: Tax avoidance cycle schemes appear to exist involving the over-funding of captive insurers. Under this practice, the captive is over-funded to reduce the tax base of the insured; the over-funded insurer then repatriates the funds back to the insured via tax-free dividends. One option would be to create a deemed recoupment for dividends recycled in this manner.

(iv) **Limiting deductible payments**: Deductible premiums may have to be limited in the case of captive insurance relationships to prevent over-funding. In addition, the timing rules for insurance premium deductions may have to be reviewed so that insurance premium deductions more closely match the income of captive short-term insurers.
3. Public comments

In order to facilitate ongoing consultation with relevant stakeholders, the National Treasury is formally requesting public comments in respect of the above-mentioned proposals. Comments should be sent to Lutando Mvovo by email at lutando.mvovo@treasury.gov.za or by fax to 012 315 5516. Please ensure that these comments reach the National Treasury by 16 July 2010.

Issued by: National Treasury
10 May 2010