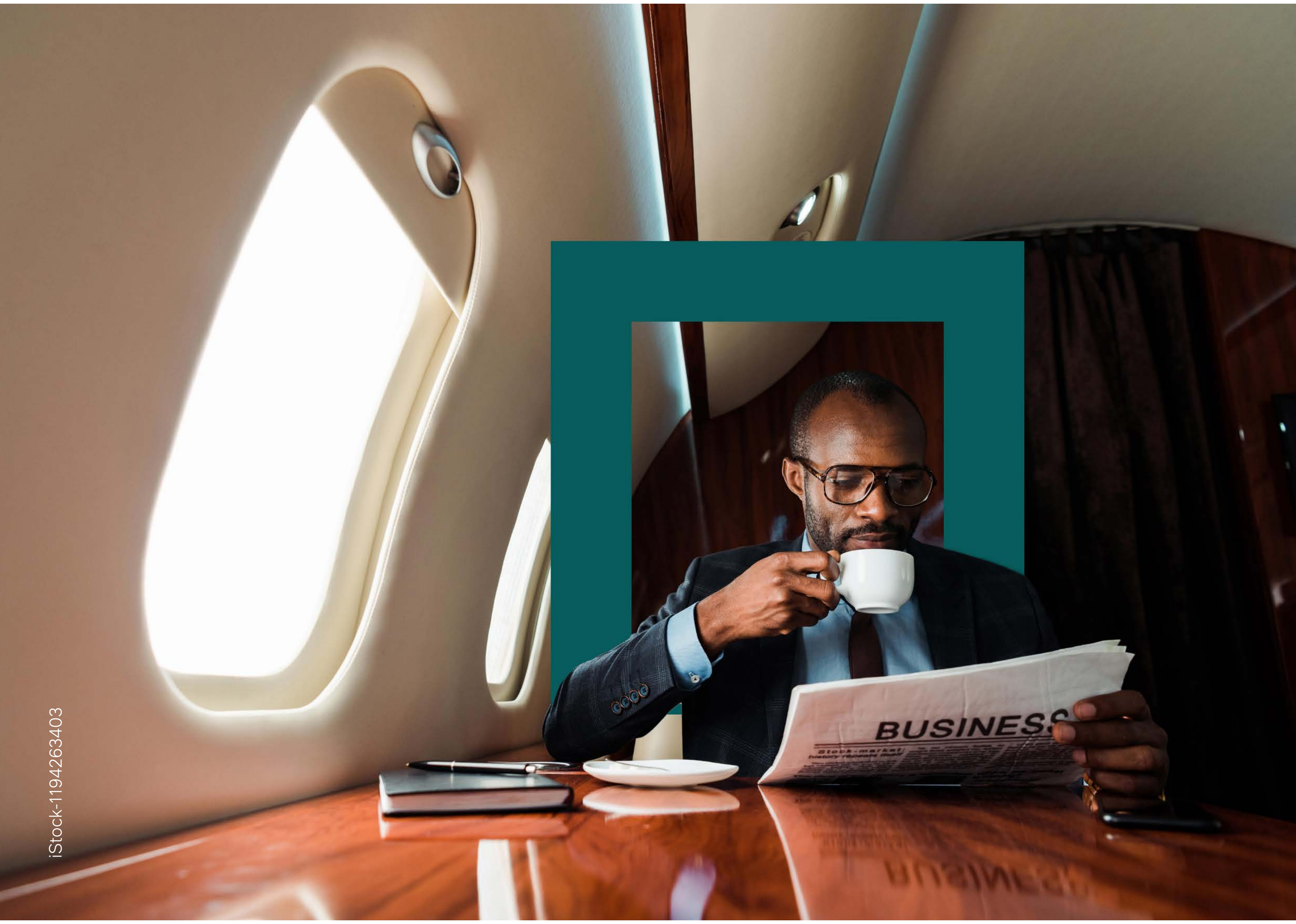
Analysis



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Pitfalls and guidelines in offshore investing

Key take-aways

- South Africans often rely on investing offshore to preserve their wealth over time, and foreign assets can offer the benefits of higher growth potential and greater diversification.
- The SA government recently raised the offshore limits for retirement funds to 45%. In M&G Investments' view, this allowance is sufficiently high to no longer act as a true constraint on investors' "ideal" offshore exposure.
- These days, the offshore vehicle you choose, as well as tax and estate planning issues, are important considerations when investing.

There is a saying in Brazil, "Pai rico, filho nobre, neto pobre", which translates to "Rich father, noble son, poor grandson". Similar quotes can be found in different languages in many countries. There is even a well-known "third generation rule" which holds that 70% of affluent families will have lost all their wealth by the third generation. Cornelius Vanderbilt famously said that anyone, even a fool, can make lots of money. However, it takes intelligence to maintain the fortune for the following years.

Responsible stewardship from one generation to the next is paramount, but obviously can be fraught with difficulties. In South Africa, the way that many investors think about preserving wealth is primarily by taking their funds offshore.

Offshore benefits are compelling

Ongoing economic concerns, a broadly depreciating rand, political uncertainty and the quest for diversification have propelled increasing flows into funds that invest outside South African borders. The local opportunity set is small: South Africa makes up less than 0.4% of global GDP and only 0.44% of the global equity universe (as represented by the MSCI All Country World Index). Offshore investing facilitates access to a range of other currencies, geographies and growth opportunities, adding valuable diversification to a portfolio.

South Africans are known to be an innovative bunch, and initially the wealthy were using offshore tax havens to not only preserve their wealth, but also to evade local taxes in the process. In 2016, SARS introduced the Special Voluntary Disclosure Programme to allow for the wealthy to disclose their holdings without facing penalties, which proved to be quite successful, luring more South Africans back into the tax net. Since then, the world (and SARS) has evolved, and SARS now receives reports from around 80+ tax jurisdictions on South Africans' offshore investments. The message is clear: If your name is on the list and you haven't disclosed it to SARS, expect big penalties. South Africans have quickly discovered that it's best to disclose all offshore holdings and earnings.

Not so many restrictions these days

The merits of offshore investing are myriad. The latest budget has also allowed for an increase in the offshore allocation that a Regulation 28 fund can make to offshore assets. This means that pension funds and other funds subject to Regulation 28 can now invest up to 45% offshore. In M&G Investments' view, this higher allowance no longer acts as a true constraint on investors' "ideal" foreign exposure for their retirement portfolios; it is more than adequate to provide the necessary diversification benefits and growth opportunities, as long as the investor wants to retire in South Africa.

In addition, in recent years the SA government has increased foreign travel and investment allowances for individuals. South African residents over the age of 18 years are entitled to a single discretionary allowance of up to R1 million per calendar year. On top of this, South Africans are also entitled to a foreign investment allowance of up to R10 million per calendar year, subject to SARS clearance.

Given the much more relaxed environment and widespread options for going offshore these days, investors typically spend a large amount of time determining which funds of the increasingly growing list of offshore funds to invest in, sifting through tables of top holdings, and getting engrossed in the virtues of technology shares versus more cyclical shares such as airlines and hotels. What has become clear, however, is that they should be spending at least as much time considering exactly how to invest, and determining which vehicle(s) is most suitable for them.

Going offshore: Feeder funds vs Direct funds

Generally there are two ways to access global investments: rand feeder funds domiciled in South Africa or foreign currency-denominated direct funds domiciled offshore, using one's South African foreign investment allowance.

Rand feeder funds can be found on different South African investment platform offering various offshore options. They invest using South African rands, so that when you sell your investment you receive the proceeds in rands. These funds generally have lower investment minimums and lower fees than direct offshore funds, and payments can be made directly into your local bank account. And because they are domiciled in South Africa, estate planning is more efficient and probate and other legal issues are less complicated.

Direct offshore funds, on the other hand, invest via foreign currency, so that the proceeds are returned to you in the foreign currency. Typically their structure facilitates less capital gains tax being paid on disposal in an environment where the rand depreciates, but they also typically require a larger initial investment. Additionally, estate planning and legal issues can be more complex, and the investor has to open an offshore bank account if they want to retain the proceeds offshore in foreign currency.

M&G Investments has a range of global funds available to investors either directly or via several offshore platforms to meet the risk and return requirements of most investors. Here's more information about our **global funds and how to invest**.

Fund	Currency	Benchmark	Risk
M&G Global Equity Fund M&G Global Equity Feeder Fund	USD Rand	MSCI All Country World Index	High
M&G Global Property Fund M&G Global Property Feeder Fund	USD Rand	FTSE EPRA/NARIET Global REIT Index	High
M&G Global Balanced Fund M&G Global Balanced Feeder Fund	USD Rand	65% MSCI All Country World Index 25% Bloomberg Global Agg Bond Index 5% FTSE EPRA/NARIET Global REIT Index 5% US 1mo Treasury Bills	Medium
M&G Global Inflation Plus Fund M&G Global Inflation Plus Feeder Fund	USD Rand	Global Inflation	Medium
M&G Global Bond Fund M&G Global Bond Feeder Fund	USD Rand	Bloomberg Global Agg Bond Index	Low

Wills, taxes and other legal considerations

As Benjamin Franklin famously said, “In this world nothing is certain but death and taxes”, and tax planning should certainly be a major consideration when deliberating the “how’s” of offshore investing, along with estate planning.

South Africans are taxed on their worldwide income, which therefore necessitates diligence when choosing the best structure for these offshore investments. Double taxation may arise if the same assets of the deceased person are subject to estate duty in South Africa as well as the equivalent in the foreign country, unless agreements are in place between South Africa and the respective country.

A term that is often used is “situs tax”. Situs refers to the location of an asset, for example where a property is located, or the country where funds are invested. Situs taxes are the taxes levied on such assets upon death. In the US, for example, such situs tax comes into play even at the relatively low level of US$60,000.

Turning to estate planning, under certain circumstances, a separate will is required for assets held offshore. However, even with a separate foreign will, significant complications can occur when winding up an estate. Typically, winding up such a foreign estate at the same time as the SA estate can be difficult where originals of documents are required to be sent back and forth. The South African Master requires an original will, and so do the offshore authorities. Where the amounts invested offshore are small, it is also difficult to find offshore executors willing to help with winding up the foreign portion of the estate as it is not worth their while.

Another complication looms as a result of probate, which occurs where foreign jurisdictions do not recognise the South African executor. In this case, a local court authority has to be appointed before the estate can be wound up. This process can be lengthy and costly. Some countries can even consider a South African-drafted will to be invalid.

An important factor worth considering is forced heirship, of which some form exists in most major countries. Such rules restrict a testator's freedom in deciding how assets are to be distributed after death. These rules then have implications for the existing will when finalising the estate. Once again, the importance of consulting your financial adviser on proper estate planning cannot be underestimated.

Estate duty can be high, depending on the country where this is applicable:

	Estate / Inheritance tax rate
Turkey	10%
Denmark	15%
Japan	55%
US	40%
UK	40%

Source: PWC

For example, an investment in the US done directly through a mutual fund there would attract estate duties in the US, which for non-US residents could be as high as 40%. Fortunately, there are numerous structures made available through South African insurers for South Africans to invest offshore in a way that is beneficial to tax planning as well as estate planning.

Two of the most well-known structures include offshore trusts and offshore endowments. The latter allow the owner to nominate beneficiaries to which proceeds of an investment will be paid on death. This circumvents the issue of probate, which therefore saves significant time and cost. Proceeds can simply be paid out without being subject to executor's fees. Estate duty would still be applicable, but only in the local market, where our estate duty is significantly less. In addition, should a spouse be the beneficiary, there would not be any estate duty payable.

The bottom line here is that offshore investments are a well-known and accepted option for preserving wealth for future generations, and more solutions are becoming increasingly accessible to South Africans. However, it remains just as complicated as ever when it comes to taxation, retirement and estate planning: there are numerous factors at play and landmines are all around. Consequently, the value of an experienced financial adviser who understands these issues and is able to guide an investor down the road of potential options cannot be underestimated. □

Sources:

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Miranda joined M&G Investments in January 2016 as Regional Sales Manager. She is currently responsible for the management of retail distribution in the Gauteng region. With more than 20 years' industry experience, Miranda has served in a range of roles including: business development, manager research, portfolio management and asset consulting to large pension funds. She holds an MSc (Engineering) degree and is a CFA Charterholder.