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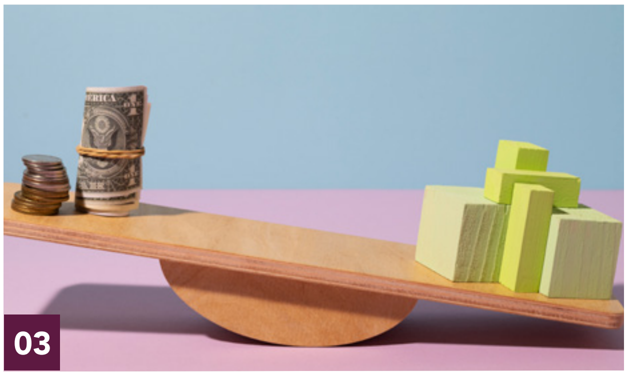
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BASE COST: IMPROVEMENTS AND ENHANCEMENTS

Paragraph 20(1)(e) *of the Eighth Schedule to the Income Tax Act, 1962 (the Act), allows the cost of the improvement or enhancement in the value of an asset to be added to its base cost for capital gains tax (CGT) purposes. On the face of it, it seems like a fairly simple provision, but there is more to it than meets the eye.*

It permits a person to add to the base cost of an asset

> "the expenditure actually incurred in effecting an improvement to or enhancement of the value of that asset".

It finds its provenance in section 38(1)*(b)* of the United Kingdom Taxation of Chargeable Gains Act, 1992 (the TCGA), and section 110-25(5) of the Australian Income Tax Assessment Act, 1997 (the ITAA).

Section 38(1)*(b)* of the TCGA permits an addition to base cost for

> "the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, ...".

Section 110-25(5) of the ITAA deals with the fourth element of the "cost base" (the Australian equivalent of "base cost"). It reads as follows:

> "(5) The fourth element is capital expenditure you incurred:
>
> (a) the purpose or the expected effect of which is to increase or preserve the asset's value; or"
>
> . . .

Paragraph 20(1)*(e)* used to contain the words "if that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal" but they were deleted by the Taxation Laws Amendment Act, 2019, with effect from 15 January 2020. Australia had removed a similar requirement from section 110-25(5) with effect from 1 July 2005, no doubt after having had similar problems with the requirement as South Africa would come to experience.

These words had proved problematic for non-scrip capital contributions. In some countries such as Germany, it is possible for a holding company to make a capital contribution to a wholly owned subsidiary without the issue of shares. Such a contribution would be made for the purpose of enhancing the value of the subsidiary's shares and so should qualify under paragraph 20(1)*(e)*. However, when the subsidiary makes subsequent losses that absorb the capital contribution, it is arguable that the contribution is no longer reflected in the state or nature of the subsidiary's shares. Denying the addition to base cost makes little sense as CGT consequences should not depend on a decrease in the value of shares. For other assets, the part-disposal rules in paragraph 33 would take care of any part-disposal of an asset, making the "state or nature" requirement redundant.

Yet, the UK has not seen fit to remove the state or nature requirement from section 38(1)*(b)* of the TCGA.

There are a number of differences between the wording of section 110-25(5) and paragraph 20(1)*(e)*.

First, it is restricted to capital expenditure while paragraph 20(1)*(e)* is not. In practice, however, paragraph 20(1)*(e)* is likely to also deal with capital expenditure, since deductible revenue expenditure would be eliminated from base cost under paragraph 20(3)*(a)*.

Secondly, the words "the purpose or the expected effect of which" are absent in paragraph 20(1)*(e)*. However, it is submitted that the absence of these words does not mean that the purpose of the expenditure can be disregarded when interpreting paragraph 20(1)*(e)*.

By way of comparison, section 11*(a)* of the Act allows a deduction for "expenditure and losses actually incurred in the production of the income …".

Yet, despite the absence of the word "purpose" in section 11*(a)*, the purpose of the expenditure is a fundamental part of section 11*(a)*. In *Port Elizabeth Electric Tramway Co Ltd v CIR,* [1936], Watermeyer AJP (as he then was) confirmed the importance of purpose when he stated the following:

> "The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible." [1936 CPD 241, 8 SATC 13 at 17].

A common example of enhancement expenditure arises when a person erects a building on land. The cost of the building enhances the value of the land. Non-obligatory improvements effected by a lessee to a building would similarly enhance the lessee's lease right.

Another example is landscaping expenditure which enhances the value of the land.

NOTIONAL EXPENDITURE ATTRIBUTABLE TO THE TAXPAYER'S SKILL AND LABOUR NOT ALLOWABLE

In *ITC 780* [1953] 19 SATC 328 (C) the appellant had constructed plant and machinery and sought to claim a wear-and-tear allowance under the equivalent of section 11*(e)* of the Act on the value of his skill and labour. The court dismissed the appeal on the grounds that the taxpayer had failed to discharge the onus of proving the value of his labour and the fact that the deduction was at the Commissioner's discretion.

> "A payment of directors' or employees' bonuses by a shareholder may also enhance the value of the shares in the company and qualify to be added to the base cost."

In the United Kingdom case of *Oram (Inspector of Taxes) v Johnson,* [1980], the appellant had sought under a provision equivalent to paragraph 20(1)*(e)* to add to the base cost of a dwelling house the value of his skill and labour in improving it. In dismissing the appeal, Walton J stated the following:

> "It is perhaps a matter of first impression based on the impression that the word 'expenditure' makes on one, but I think that the whole group of words, 'expenditure', 'expended', 'expenses' and so on and so forth, in a revenue context, mean primarily money expenditure and, secondly, expenditure in money's worth, something which diminishes the total assets of the person making the expenditure, and I do not think that one can bring one's own work, however skilful it may be and however much sweat one may expend on it, within the scope of paragraph 4(1)*(b)*." ([1980] 2 All ER 1 at 6.)

SETTLEMENT OF DEBTS OR EXPENSES OF COMPANY BY SHAREHOLDER

A holder of shares in a company may be required under an agreement for the disposal of those shares to first discharge the debts of the company without creating or increasing the holder's loan account. Such a holder would be able to add the cost of discharging the debts of the company to the base cost of the shares, provided the purpose of the expenditure was to enhance the value of the shares.

Shareholders sometimes incur expenses on behalf of their companies. If it can be proven that such expenditure was incurred to enhance the value of the shares, it may qualify to be added to the base cost of the shares under paragraph 20(1)*(e)*. In the United States case of *Eskimo Pie Corp v Commissioner of Internal Revenue,* [1945], the court stated the following:

> "Payments made by a stockholder of a corporation for the purpose of protecting his interest therein must be regarded as additional cost of his stock and such sums may not be deducted as ordinary and necessary expenses." [4 TC 669 (1945) at 676]

The Australian Taxation Office recognises in Tax Determination TD 2014/14 that certain capital support payments made by a parent entity to its subsidiary for the maintenance or enhancement of the capital value of the parent's investment in its subsidiary is a cost of the investment under section 110-25(5). The ruling deals with support payments by a holding company to its loss-making subsidiary, or to its subsidiary that is not sufficiently profitable.

A payment of directors' or employees' bonuses by a shareholder may also enhance the value of the shares in the company and qualify to be added to the base cost. This, of course, is not a tax-efficient way of incentivising employees since the shareholder will not be able to secure a section 11*(a)* deduction for the expenditure, while the directors or employees will suffer an income tax inclusion. Such a payment is exempt from donations tax under section 56(1)*(k)* of the Act, which exempts voluntary awards that are included in gross income under paragraphs *(c)*, *(d)* or *(i)* of the definition of "gross income" in section 1(1) of the Act.

SPECIAL LEVIES PAID BY OWNERS OF SECTIONAL TITLE UNITS

Owners of sectional title units have an undivided share in the common property. Sometimes they are required to pay a special levy for the purpose of effecting improvements to the common property, such as the installation of a swimming pool or the erection of a security fence. Expenditure of this nature will normally be of a capital nature, since it provides an enduring benefit. Since it enhances the owner's right in the common property, it may be added to the base cost of the sectional title unit. The same principle applies to owners of share block units who enjoy a right of use of the common property, since such expenditure will enhance the value of their right of use.

In Australia a levy for the installation of underground power cables was found to form part of the base cost of the taxpayer's property under the equivalent of paragraph 20(1)*(e)* (ATO ID 2001/665).

PAYMENT BY BARE DOMINIUM HOLDER TO USUFRUCTUARY AND *VICE VERSA*

The payment by a bare dominium holder to a usufructuary for the termination of the usufruct should qualify as an addition to the base cost of the asset, since restoring full title to the asset should enhance its value.

The same approach would apply when a usufructuary acquires the bare dominium and thus acquires full title.

DEMOLITION COSTS

Depending on the facts and circumstances, demolition costs incurred in removing a building or part of a building for the purpose of erecting a new building, and the levelling of land may enhance the value of the land and qualify under paragraph 20(1)*(e)*.

Difficult questions can arise in some cases. For example, assume that a person owns two buildings which are joined by a walkway. The person wishes to dispose of one of the buildings but the buyer does not want the walkway. Would demolishing it enhance the value of the building to be sold? It could be argued that without removing the walkway the seller would be unable to sell the building at an enhanced value. In other words, if the seller did not incur the expenditure, the buyer would have to and would demand a reduction in the purchase price.

CONCLUSION

Whether expenditure qualifies under paragraph 20(1)*(e)* will depend on whether the taxpayer can discharge the onus of proof under section 102 of the Tax Administration Act, 2011. Often good tax planning can result in a more tax-efficient solution than seeking an addition to base cost, particularly when the recipient of the amount has to include it in gross income.

This article was first published in *ASA October 2023*

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Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "gross income": paragraphs *(c)*, *(d)* & *(i)*); 11*(a)* & *(e)*) & 56(1)*(k)*; Eighth Schedule: Paragraphs 20(1)*(e)* & (3)*(a)* & 33;
- Tax Administration Act 28 of 2011: Section 102;
- Taxation Laws Amendment Act 34 of 2019;
- United Kingdom Taxation of Chargeable Gains Act, 1992 (TCGA): Section 38(1)*(b)*;
- United Kingdom Finance Act 1965: Schedule 6: Para 4(1)*(b)*;
- Australian Income Tax Assessment Act, 1997: Section 110-25(5).

Other documents

- ATO ID 2001/665 (Australian Taxation Office Interpretative Decision 2001/665)

  https://www.ato.gov.au/law/view/document?docid=AID/AID2003665/00001;
- Tax Determination TD 2014/14 (of Australian Tax Office)

  https://www.ato.gov.au/law/view/document?docid=TXD/TD201414/NAT/ATO/00001.

Cases

- *Port Elizabeth Electric Tramway Co Ltd v CIR* [1936] CPD 241; 8 SATC 13 at 17;
- *ITC 780* [1953] 19 SATC 328 (C);
- *Oram (Inspector of Taxes) v Johnson* [1980] 2 All ER 1 at 6; [1980] STC 222;
- *Eskimo Pie Corp v Commissioner of Internal Revenue* 4 TC 669 (1945) at 676.

Tags: non-scrip capital contributions; enhancement expenditure; base cost; donations tax; usufructuary; bare dominium.

SARS BINDING PRIVATE RULING 399: REPLACEMENT ASSETS

Binding Private Ruling 399 (BPR 399), published by SARS on 12 December 2023, deals with the anti-avoidance implications of the disposal of an asset by a company shortly after its acquisition in terms of an asset-for-share transaction, where the asset disposed of was replaced in terms of the special relief available for replacement assets.

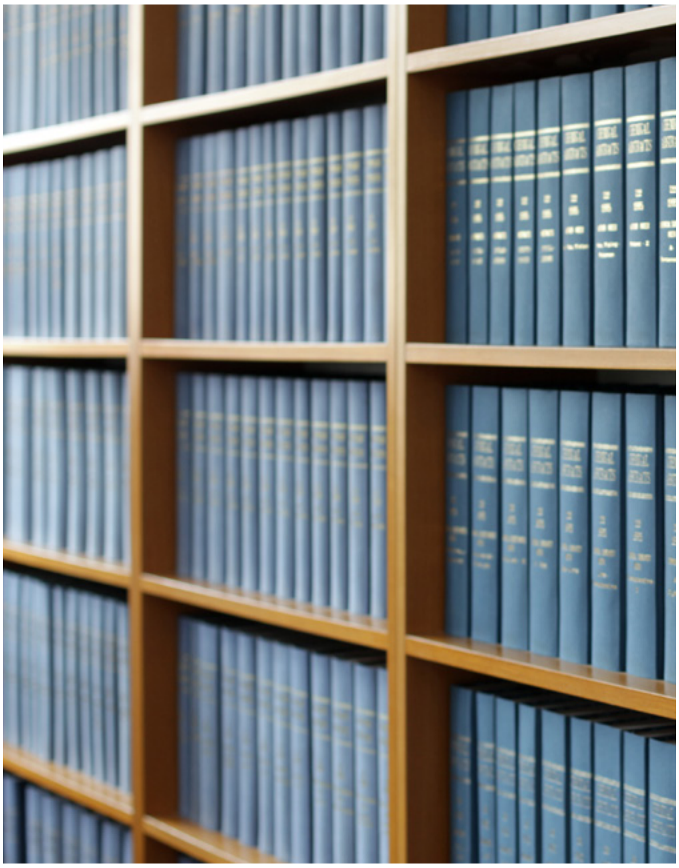
The applicant requesting the ruling is a South African company wholly owned by a natural person who operated a business as a sole proprietor. One of his business assets was an aircraft, which he was in the process of selling, to replace it with a new aircraft.

Prior to the sale and replacement of the aircraft, the sole proprietor wanted to transfer his entire business to his company in exchange for more shares in terms of the tax rollover relief applicable to asset-for-share transactions, as contemplated in section 42 of the Income Tax Act, 1962. The rollover relief, if available, allows an asset to be transferred to a company in exchange for equity shares of equivalent value without any immediate tax consequences. The company, essentially, steps into the shoes of the transferor and inherits the tax profile of the transferor with respect to the asset acquired.

The aircraft which the company acquired from the sole proprietor was treated for tax purposes as a capital asset which qualified for tax-deductible capital allowances, so that the company inherited the tax value of the aircraft acquired.

The rollover relief rules contain specific anti-avoidance provisions. One of the anti-avoidance provisions applicable to asset-for-share transactions determines that a company disposing of a capital asset that qualified for tax-deductible allowances within 18 months of its acquisition in terms of an asset-for-share transaction must ring-fence (and be subject to tax without setting off against losses) –

- so much of a capital gain determined in respect of the disposal of the asset as does not exceed the amount that would have been determined had the asset been disposed of at market value at the time of the asset-for-share transaction; and
- so much of any allowance in respect of that asset that is recovered or recouped as a result of the disposal as does not exceed the amount that would have been recovered or recouped had the asset been disposed of at the time of the asset-for-share transaction.



"The aircraft which the company acquired from the sole proprietor was treated for tax purposes as a capital asset which qualified for tax-deductible capital allowances, so that the company inherited the tax value of the aircraft acquired."

Due to the need to replace the aircraft, the company disposed of the aircraft acquired in terms of the asset-for-share transaction within the 18-month period which triggered the anti-avoidance rule referred to above.

The aircraft was, however, replaced by a new aircraft. The replacement asset relief claimed by the company allows for the capital gain arising from the disposal of an asset, as well as the recoupments arising from such disposal, to be deferred where the asset disposed of is replaced within a certain time by another qualifying asset and the other requirements for the relief are met. In this case, absent the 18-month complication, the company qualified for the replacement relief so that no capital gain or taxable recoupment would have resulted from the disposal of the aircraft.

The ruling therefore dealt with the complication added by virtue of the fact that the aircraft that is being replaced was acquired by the company in terms of an asset-for-share transaction entered into less than 18 months prior to the disposal of the asset.

If the company did not elect the relief available concerning replacement assets, the company would have –

- realised a capital gain on the disposal of the aircraft, and so much of that capital gain as would not have exceeded the capital gain that would have arisen had the aircraft been disposed of at market value on the date of the asset-for-share transaction would be ring-fenced and taxed without the benefit of setting it off against any losses; and

- recouped previously claimed capital allowances, and so much of that recoupment as would not have exceeded the recoupment arising on a disposal at market value on the date of the asset-for-share transaction, would similarly be ring fenced and taxed.

The ruling clarifies that, as a result of the disposal benefiting from the replacement asset relief, there is no capital gain or recoupment on the disposal within the 18-month period which could (to an extent) be ring-fenced and taxed in terms of the anti-avoidance rule. This is an important indication of how SARS views the interpretation of the anti-avoidance rule applicable to the rollover relief provisions that deal with the disposal of assets acquired in terms of the relief, within the 18-month window.

It is submitted that the approach adopted by SARS is correct in that the anti-avoidance rule can only potentially apply if the disposal within the 18-month period gives rise to an actual capital gain or recoupment. If, for some reason, the actual disposal would not give rise to a capital gain or recoupment (for example, because rollover relief applies to the actual disposal, or replacement asset relief applies, or because there is no gain or recoupment due to the amount of disposal proceeds received), the anti-avoidance provision cannot be interpreted to mean that if there would have been a gain or recoupment at the time when the asset-for-share transaction was entered into based on the market value of the asset at that time, such (deemed) gain or recoupment must be recognised, ring-fenced and taxed purely because the disposal occurred within 18 months of the asset-for-share transaction.

The essence of BPR 399 is that:

- Although the ruling and other rulings are non-binding concerning anyone other than the party identified in the ruling and may not be cited as authority in any proceeding other than proceedings involving the applicant for that specific binding private ruling, the views expressed by SARS are consistent with the purpose of the corporate rules and the rollover relief provided therein.

- The absence of an actual capital gain or recoupment on disposal of an asset within 18 months of its acquisition under the rollover relief provisions, constitutes an absolute bar to the application of the anti-avoidance provision aimed at disposals within the 18 months window. The anti avoidance provisions were not intended to levy tax on gains and recoupments which would otherwise not exist. Put differently, if no capital gain or recoupment actually arises on the disposal within 18 months, there is nothing to ring-fence and no tax liability.

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding private ruling* has a binding effect *between SARS and the applicant only*, and is published for general information. It does not constitute a practice generally prevailing. A third party may not rely upon a binding private ruling under any circumstances. In addition, published binding private rulings may not be cited in any dispute with SARS, other than a dispute involving the applicant or any co-applicant(s) identified therein.

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Acts and Bills

- Income Tax Act 58 of 1962: Section 42(1) (definition of "asset-for-share transaction").

Other documents

- Binding Private Ruling 399, published by SARS on 12 December 2023 ("Asset-for-share transaction and replacement asset").

Tags: asset-for-share transaction; tax-deductible capital allowances; ring-fence.

VALUE-SHIFTING ARRANGEMENTS

The notion of shifting value between shareholders of a company is generally a concern of revenue authorities in that, once a value shift takes place, one shareholder receives the benefit of value in the company at no or a reduced cost, while the other shareholder relinquishes value, notwithstanding there being no disposition event for tax purposes, or the transaction being deemed neutral under the Income Tax Act, 1962 (the Act).

The two notable anti-avoidance provisions targeting value shifting are contained in paragraph 11(1)*(g)* of the Eighth Schedule to the Act and section 24BA of the Act. The latter deals with exchange transactions to a company transferee whereby the exchange transaction does not take place on a value-for-value basis.

The former deals with the deemed disposition value-shifting arrangement in terms of which a person who enters into an arrangement that meets the definition of "value shifting arrangement", as defined in paragraph 1 of the Eighth Schedule, could trigger a capital gains tax liability, notwithstanding there being no "active" disposal of an asset. National Treasury proposed an amendment to this "value shifting arrangement" definition in the 2024 Budget.

In the context of group reorganisation transactions, the definition of "value shifting arrangement", read with paragraph 11(1)*(g)*, makes it clear that the capital gains tax event takes place for a holder of an interest in a company if all the following conditions are met:

- there must be an existing shareholder in a company;
- there must be a change in the interest or entitlements of the existing shareholder in the company following an arrangement; and
- the market value of the existing shareholder's interest or entitlement must decrease pursuant to the event;

If the above happens, either of the following further conditions must be met:

- the value of any existing interest in the company (held directly or indirectly) of a "connected person" (as defined in section 1(1) of the Act) in relation to the existing shareholder must increase pursuant to the event; or
- a "connected person" in relation to the existing shareholder must acquire a direct or indirect interest in that company.

National Treasury has recognised that under the present construct of the "value shifting arrangement" definition, consolidating a group of companies might lead to a scenario where the market value of a current shareholder in one entity within the group decreases while another entity's recently acquired shareholding increases, potentially triggering the value-shifting provisions. National Treasury has stated that this circumstance could arise even when:

- the transactions are considered tax-neutral under the corporate rollover relief provisions; or
- the market value of the ultimate holding company's combined direct and indirect interests in all the subsidiary companies remains unchanged.

As a result, National Treasury proposes that the definition of "value shifting arrangement" be amended to exclude certain corporate rollover transactions between groups of companies or where the value of the effective interest of the connected person in question remains unchanged. It will be interesting to see what form this amendment will take with reference to the fact that section 41(2) of the Act (being the preamble provision to the rollover relief provisions) provides that the provisions of paragraph 11(1)*(g)* of the Eighth Schedule will apply notwithstanding the corporate rollover relief provisions.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "connected person"), 11(1)*(g)*, 24BA & 41(2); Eighth Schedule: Paragraph 1 (definition of "value shifting arrangement").

Tags: value shift; value-shifting arrangement; connected person.

SOLAR ALLOWANCES

Renewable energy in South Africa is a hot topic. Not only because South Africa has an energy crisis and climate change needs to be averted, but also because the South African Government is assisting in the transition to a greener, cleaner, and more stable energy supply by, amongst other things, offering favourable tax incentives in this space.

One of the key tax incentives is found in section 12B of the Income Tax Act, 1962 (the Act). The allowance is attractive because renewable energy often requires significant upfront capital outlays that are typically not allowed as an income tax deduction because the costs are capital in nature.

What section 12B does is to provide taxpayers with some relief from tax by providing for an accelerated capital depreciation allowance of 100% or on a 50/30/20 basis, on the costs incurred on plant and equipment utilised in the taxpayer's trade of generating electricity from renewable sources. It also includes costs incurred in respect of the supporting structures. The sister provision of section 12B, section 12BA, includes a temporary separate allowance of 125% of the costs for new and unused assets brought into use for the first time on or after 1 March 2023 but before 1 March 2025. However, one can only claim one of section 12B or section 12BA and not both.

While section 12B, on the face of it, appears relatively simple and straightforward compared to other tax provisions, for the uninitiated, it could result in unwanted consequences and, in a worst-case scenario, the non-application of the allowance. It is therefore no wonder that many taxpayers are approaching the South African Revenue Service (SARS) for rulings on the interpretation of the provision.

The most recent ruling issued by SARS on the topic is Binding Class Ruling 88 (BCR 88), which was issued on 22 February 2024. While rulings issued by SARS are not binding on all taxpayers but only in respect of SARS' dealings with that specific applicant taxpayer, it gives important insight as to SARS' potential interpretation of certain issues and is therefore still valuable to taxpayers.

"GENERATION ASSETS"

One of the key issues faced by taxpayers is what types of assets factually fall within the allowance. BCR 88 provides some insight into this as it refers to a detailed list of "generation assets" that would qualify for the allowance. Apart from the expected assets, such as the solar photovoltaic (PV) panels themselves, battery inverters, battery backup systems and battery units (and their component parts) are also included in the definition of "generation assets".

This further reinforces the principle, also dealt with in Binding Class Ruling 85, that if batteries are sufficiently integrated into a renewable energy system and form part of the system's energy continuum, then they will also qualify for the allowance. It recognises that stored energy derived from renewable sources falls within the parameters of the allowance – this is important because the sun does not shine at night when energy needs may be at their highest in certain instances.

Another interesting aspect is that overhead power infrastructure and towers, including accessories and foundations, are also included in the ambit of "generation assets". It is not clear from the ruling what exactly these assets are, why they are needed and how they are integrated into the solar system. However, it certainly builds on the extent of critical assets required to operate a solar system that will qualify for the allowance.

SOLAR TAX INCENTIVES UTILISED BY PARTNERSHIPS

BCR 88, however, is not only interesting because of its determinations on section 12B, but also because it deals with the deductibility of expenditure to be incurred, and the limitation of any allowance and deductions claimed by *en commandite* partners (ie, limited partners) investing in solar PV energy assets.

The taxation of partnerships in South Africa can lead one to murky waters; however, there is some guidance to be found in section 24H of the Act. It codifies certain aspects of the taxation of partnerships, although it leaves certain factors open to interpretation. It is in this context that it is noteworthy that SARS ruled, amongst others, as follows in BCR 88:

"Another interesting aspect is that overhead power infrastructure and towers, including accessories and foundations, are also included in the ambit of 'generation assets.'"

- Under section 24H(2) each class member (ie, limited partner) is deemed to carry on the trade of the partnership which is important because section 12B requires the taxpayer that is claiming the allowance to have carried on a trade; and
- each class member (ie. limited partner) is entitled to deduct its proportionate share of the partnership's deductions and allowances, including that allowed under section 12B; this confirms that each limited partner has co-ownership of the relevant underlying assets, which is a prerequisite for the application of the allowance.

What is also interesting to note is that the ruling mentions that once the necessary capital commitments have been secured, the partnership will be closed. It will not be open-ended for further capital contributions by new investors, except where a new limited partner is substituted for an existing limited partner who subsequently withdraws. This is arguably an important differential.

In this regard, it was importantly ruled that new limited partners may claim section 12B(1)*(h)* allowances in respect of their proportionate interests in the partnership assets acquired, provided that the new limited partner is acquiring and bringing such assets into use for the first time.

Partnerships are an attractive business vehicle in South Africa as they have various commercial benefits. However, the interaction between section 12B and the taxation of partnerships can be complex. BCR 88 assists taxpayers by providing some guidance on the interpretation of these somewhat intricate provisions.

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding class ruling* only applies to *SARS and the class referred to in the ruling*, and is published for general information. It does not constitute a practice prevailing. A third party may not rely on a binding class ruling under any circumstances. In addition, published binding class rulings may not be cited in any dispute with SARS, other than a dispute involving the class identified therein.

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Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 12B (specific reference to subsection (1)*(h)*), 12BA & 24H (specific reference to subsection (2)).

Other documents

- Binding Class Ruling 85 ("*En commandite* partnerships investing in photovoltaic solar energy plants", issued on 9 December 2022);
- Binding Class Ruling 88 ("*En commandite* partners investing in solar assets", issued on 22 February 2024).

Tags: renewable energy; generation assets; *en commandite* partners.

ESTATE DUTY AND THE SUCCEEDING USUFRUCT

This article examines a variation of the bare dominium/usufruct arrangement employed by estate planners to avoid estate duty. It involves the creation of a succeeding usufruct for a limited period after the death of the second-dying spouse who is the initial usufructuary.

SECTION 4*(q)* OF THE ESTATE DUTY ACT

Most readers will be aware of section 4*(q)* of the Estate Duty Act, 1955. It grants a deduction from the net value of the estate of the first-dying spouse for assets bequeathed to the surviving spouse. The basic bare dominium/usufruct arrangement makes partial use of section 4*(q)*. Typically, the testator bequeaths the bare dominium to a discretionary family trust, while the usufruct is bequeathed to the surviving spouse.

The bare dominium will be included in the net value of the estate of the deceased with potential estate duty consequences. But depending on the age of the surviving spouse, its value might still be relatively small and might even be covered by the R3,5 million abatement under section 4A. The deceased will pay no estate duty on the value of the usufruct because of the deduction under section 4*(q)*.

However, sooner or later the fiscus will want its pound of flesh in respect of the roll-over of the value of the usufruct that was enjoyed by the first-dying. That moment of reckoning will come when the surviving spouse dies.

TAXING THE CEASING USUFRUCT

Section 3(2)*(a)* of the Estate Duty Act includes as property of an estate

> "*(a)* any fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property) held by the deceased immediately prior to his death;".

Next, section 5(1)*(b)* states how the ceasing usufruct must be valued:

> **"5. Determination of value of property**
>
> (1) The value of any property for the purposes of the inclusion thereof in the estate of any person in terms of section 3 or the deduction thereof in terms of section 4, determined as at the date of death of that person, shall be –
>
> . . .
>
> *(b)* in the case of any such fiduciary, usufructuary or other like interest in property as is referred to in paragraph *(a)* of section 3(2), an amount determined by capitalizing at twelve per cent the annual value of the right of enjoyment of the property in which the deceased held any such fiduciary, usufructuary or other like interest, to the extent to which the person who upon the cessation of the said interest of the deceased in consequence of the death of the deceased becomes entitled to any right of enjoyment of such property of whatever nature, over the expectation of life of such person, or if such right of enjoyment is to be held for a lesser period than the life of such person, over such lesser period: Provided that …"

It is actually the bare dominium holder who will be liable for the estate duty on the ceasing usufruct. Section 11 of the Estate Duty Act provides that it is "the person to whom any advantage accrues by the death of the deceased".

In the absence of section 5(1)*(b)*, the usufruct would simply run out and the surviving spouse would be left with no asset in his or her estate. The growth in value of the bare dominium would arise in the trust and the estate duty saving enjoyed by the first-dying spouse would be permanently lost to the fiscus.

Section 5(3) provides:

> "(3) Where for the purposes of subsection (1) any calculation is required to be made over the expectation of life of any person, such calculation shall, in the case of a person who is not a natural person, be made over a period of fifty years."

Thus, when the usufructuary dies and the bare dominium holder is

"It is actually the bare dominium holder who will be liable for the estate duty on the ceasing usufruct."

a trust or company, the value of the ceasing usufruct for estate duty purposes will be determined at 12% a year for 50 years.

In ASA July 2021, "The aged usufructuary", the option of an aged usufructuary disposing of the usufruct to the bare dominium holder in order to avoid the estate duty liability arising upon the death of the usufructuary was examined. That option involved comparing the sum of taxes payable as a result of such a disposal (transfer duty, CGT and donations tax) with the potential estate duty liability occasioned by the ceasing usufruct. Whether such a disposal is worthwhile will depend on the numbers; it is not a foregone conclusion that a tax saving will be achieved. The time value of money is also an issue because paying tax now rather than later has a cost. [To calculate the future value of a tax saving of, say, R100 at 10% a year for 10 years in Excel: =FV(0.1,10,,100). (Note that the double commas are not an error.)]

Another technique for dealing with a ceasing usufruct is to provide for a succeeding usufruct for a limited period of, say, one year, following the death of the usufructuary. But the "one-year wonder", as it has become known, requires some advance planning as it cannot be implemented after the death of the testator.

Set out below are two examples illustrating the estate duty consequences for a married couple making use of the section 4*(q)* deduction. To keep matters simple, the CGT payable on death by the first-dying under section 9HA(1) of the Income Tax Act, 1962, has been ignored.

Example 1 – Single usufruct created on death of first dying

Facts:

At the time of his death, John owned a property worth R10 million. He bequeathed the bare dominium in the property to the John Family Trust and the usufruct to his wife Sally. At the date of his death Sally would have been 60 at her next birthday. The property has a value of R30 million at the later date of Sally's death.

Result:

According to Table A [Tables A and B were published in regulations under the Estate Duty Act in GNR 1942 (*GG* 2533) of 23 September 1977. Table A sets out the expectation of life and the present value of R1 per annum for life capitalized at 12% over the expectation of life of males and females of various ages.] Sally's life expectancy was 18,78 years and the present value of R1 a year for life was 7,34135.

At the date of death, the value of the usufruct was R10 million ×12% × 7,34135 = R8 809 620. [The result can be checked using Excel: =PV(0.12,18.78,-1200000). The figure of R1,2 million is the annual right of enjoyment R10 million × 12%.] The value of the bare dominium was R10 million less the value of the usufruct, which is R1 190 380. The bare dominium forms part of the net amount of John's estate but is covered by the R3,5 million abatement under section 4A. The usufruct portion bequeathed to Sally is covered by the deduction under section 4*(q)*. John will therefore pay no estate duty.

On Sally's death, the ceasing usufruct has a value of R30 million × 12% × 8,3045 = R29 896 200 under section 5(1)*(b)*. [The trust has a deemed life expectancy of 50 years under section 5(3). Under Table B ("Present value of R1 per Annum Capitalized at 12% over Fixed Periods"), the factor for 50 years is 8,3045.] However, this may not exceed the difference between the current market value of the property (R30 million) and the value of the bare dominium when it was created (R1 190 380) = R28 809 620. [Further proviso to s 5(1)*(b)*.] Sally's estate duty liability will be determined as follows:

"Implementing the bare dominium/usufruct arrangement when the usufructuary is at an advanced age will result in a higher estate duty exposure for the first-dying because it will increase the value of the bare dominium. Starting estate planning early in life can avoid the need for an arrangement such as the 'one-year wonder'."

Value of ceasing usufruct (section 5(1)*(b)*)	R28 809 620
Less: Abatement (John and Sally) R3,5 million × 2 (section 4A(2))	(7 000 000)
Reduced by portion used by John	1 190 380 (5 809 620)
Dutiable amount of estate	23 000 000
Estate duty @ 20%	4 600 000

The trust acquired the property at a base cost of R1 190 380 under section 25(3)*(b)* of the Income Tax Act. If it were to dispose of the property on Sally's death, it would have a capital gain of R30 000 000 – R1 190 380 = R28 809 620. If the trust paid the CGT at 36%, it would have a CGT liability of R5 185 731. But if the gain is vested in the beneficiaries in the same year of assessment, they would pay CGT at a maximum of 18%, namely, an aggregate of R2 592 866 (disregarding the annual exclusion of R40 000 for each beneficiary). Sally would have a capital loss for her ceasing usufruct but this will have to be disregarded under paragraph 15*(c)* of the Eighth Schedule to the extent that it was not used in carrying on a trade. It would be beneficial only if she had other capital gains against which it could be offset.

Example 2 – Succeeding usufruct for one year

Facts:

The facts are the same as in Example 1 except that John provided for a succeeding usufruct to his two children for one year after Sally passed away.

Result:

The estate duty consequences for John are the same as in Example 1, that is, no liability.

The value of Sally's ceasing usufruct is now based on a period of one year, R30 million × 12% × 0,8929 = R3 214 440 [Table B, factor for one year]. This amount is less than the available abatement of R5 809 620 (R7 million – R1 190 380) and so Sally has no estate duty liability.

The CGT consequences for the trust are the same as in Example 2.

Example 2 illustrates the substantial estate duty saving that is achieved through the use of the succeeding usufruct: no duty v R4,6 million.

The "one-year wonder" requires the will of the deceased to make provision for a succeeding usufructuary for a period of one year. Typically, this would be one or more of the children of the deceased, or it could be a public benefit organisation (PBO). There is a danger that if the succeeding usufructuary dies, the estate duty will be substantially increased. It may thus be prudent to provide for an alternative usufructuary such as a PBO.

While there may be a commercial reason for such an arrangement, such as ensuring that the property has an occupant while an executor is appointed, it does seem somewhat contrived and designed to obtain a tax benefit. The problem for SARS, however, is that the Estate Duty Act does not contain any general anti-avoidance provisions such as sections 80A to 80L of the Income Tax Act. The arrangement is not a sham because the one year succeeding usufruct is real and does not purport to be anything else than what it is.

National Treasury proposed in the Draft Taxation Laws Amendment Bill, 2009 (dated 1 June 2009), to put an end to the "one-year wonder" by deleting the following words in section 5(1)*(b)*:

> "or if such right of enjoyment is to be held for a lesser period than the life of such person, over such lesser period".

The proposal was, however, withdrawn. The Final Response Document to the Taxation Laws Amendment Bills, 2009, stated:

> **"2.6.2 USUFRUCTUARY SCHEME**
>
> *Comment (Clause 6; Section 5(1) of the Estate Duty Act):* The envisaged aim of the proposal is to close down a scheme whereby testators avoid estate duty by bequeathing a usufruct to a spouse with the remainder first to a one-year trust (or other one-year holder), followed by another shift to the ultimate heir. However, this proposal unfairly penalises all usufructs, many of which have valid non-tax estate planning purposes. For example, a usufruct may be created in favour of a surviving spouse and then transferred to a minor child until such time as the minor reaches majority. Conversely, the proposal can also be misused (eg, through the use of public benefit organisations) to reduce the estate duty in an artificial way.
>
> *Response:* Accepted. It is accepted that a usufruct created in a will can fulfil an important function in estate planning unrelated to the estate duty.
>
> In acceptance of this concern, the amendment is withdrawn for reconsideration. Nevertheless, one-year schemes remain of concern and still warrant an appropriate remedy."

To date no such remedy has surfaced and in practice SARS accepts the validity of the succeeding usufruct.

Other aspects that need to be considered include whether a lower rate than 12% a year for valuing the usufruct is appropriate [See Standing Committee on Finance – Report-Back Hearings, 25 August 2009] and whether "market value less 30%" is applicable (land on which a *bona fide* farming undertaking is being carried on). [Under section 5(2) the Commissioner can approve a lower rate if satisfied that the property could not reasonably be expected to produce an annual yield of 12%.] There is also the risk that the law may be amended along the lines proposed in 2009. If such an amendment were to occur after the testator had died, it would not be possible to amend his or her will and the surviving spouse would be left with a large estate duty liability. One would have to hope that the amendment would apply only to persons dying on or after the effective date of the amendment.

Implementing the bare dominium/usufruct arrangement when the usufructuary is at an advanced age will result in a higher estate duty exposure for the first-dying because it will increase the value of the bare dominium. Starting estate planning early in life can avoid the need for an arrangement such as the "one-year wonder".

CONCLUSION

Estate planning is a complex multifaceted matter that needs to take into account all the various taxes and other circumstances facing a taxpayer. Nevertheless, the "one-year wonder" does offer significant estate duty savings in appropriate circumstances.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 9HA(1), 25(3)*(b)* & 80A–80L; Eighth Schedule: Paragraph 15*(c)*;
- Estate Duty Act 45 of 1955: Sections 3(2)*(a)*, 4*(q)*, 4A (specific reference to subsection (2)), & 5(1)*(b)* (specific reference to the further proviso to this provision), (2) & (3);
- Draft Taxation Laws Amendment Bill, 2009.

Other documents

- Government Notice R1942 in *Government Gazette* 2533 of 23 September 1977;
- Final Response Document to the Taxation Laws Amendment Bills, 2009;
- Standing Committee on Finance – Report-Back Hearings, 25 August 2009.

Tags: discretionary family trust; bare dominium; usufructuary; annual exclusion; estate duty saving

SAFEGUARDING YOUR LEGACY FOR YOUR CHILDREN

For any parent, the question of how to protect and provide for their children after their passing is a burning concern that arises long before the first child is born. In this article, the question as to how parents can safeguard their legacy for their children is explored.

UNDERSTANDING LEGAL CONSIDERATIONS FOR MINOR BENEFICIARIES

In South Africa, children under the age of 18 are considered minors and do not have the legal capacity to enter into agreements or contracts without the assistance of a legal guardian. This also impacts their ability to inherit directly. If one plans to leave assets to a minor child, their inability to inherit directly may pose challenges, as section 43(2)*(a)* of the Administration of Estates Act, 1965 (the AE Act), determines that no sum of money to which a minor beneficiary is entitled by virtue of a valid will, or in terms of the rules of intestate succession, shall be paid to any guardian. Upon one's passing, any money bequeathed to one's minor child will be managed by the Guardian's Fund as overseen by the Master of the High Court.

CHALLENGES WITH INHERITING ASSETS: THE IMPACT ON MINOR CHILDREN

This is not ideal as accessing funds from the Guardian's Fund can be a lengthy process, potentially causing delays in meeting essential expenses of the minor child such as school fees, clothing and other necessities. Additionally, the investment growth in the Guardian's Fund tends to be below conservative, negatively impacting the growth potential of assets over time.

It is important to note that the above comments about the Guardian's Fund only apply in instances where minor beneficiaries are entitled to receive monetary funds as an inheritance. In terms of section 43(1) of the AE Act, any movable assets, including furniture, personal effects or motor vehicles, which a minor child is entitled to receive may be handed to such minor child's natural guardian until the child reaches the age of majority. Immovable property left to a minor child will be registered under their name but will also be managed by their legal guardian until they reach the age of 18.

LEVERAGING TRUSTS: ENSURING TIMELY ACCESS TO INHERITED FUNDS

The most effective strategy to prevent a cash inheritance due to a minor child from being paid to the Guardian's Fund is by bequeathing such inheritance to an existing *inter vivos* trust (a trust that is registered during the founder's life) or to a testamentary trust (a trust that comes into existence after the date of one's death). This will safeguard the inheritance of a beneficiary in the same way that the Guardian's Fund is supposed to; however, the beneficiaries and guardians, in consultation with the trustees, will be able to access the inheritance through simpler and more timely means.

It may also make sense to utilise an existing family trust as part of one's legacy plan and to bequeath one's assets to such an existing trust of whom one's children are the beneficiaries. It is important to note that the trust instrument must allow for the trustees of that trust to accept such bequests. The trust will then receive the assets during the administration of one's deceased estate and the trustees of the trust will be able to administer such assets as part of the trust fund under the provisions of the trust instrument for the benefit of the trust beneficiaries.

The benefit of utilising an existing trust or a testamentary trust to safeguard monetary funds to be paid to minor children, as opposed to bequeathing all funds to a specific individual (including a spouse), is that one can ensure that the funds will be utilised solely for the maintenance, upbringing and welfare of the children, as specified in the relevant trust instrument; ie, the trust deed in respect of an existing trust or one's will in respect of a testamentary trust. It is crucial to realise that even where funds are bequeathed to an adult with a direct request to him or her to utilise these funds for the benefit of minor children, this cannot be controlled or enforced at a later stage, as heirs are entitled to dispose of their inheritance in any manner they deem fit. By creating a testamentary trust or bequeathing one's assets to an existing trust, such assets will then be protected and managed by the named trustees and not by the Guardian's Fund.

THE ROLE OF TRUSTEES IN SAFEGUARDING INHERITED ASSETS

A testator can nominate individuals whom he or she deems trustworthy and reliable to act as trustees; such trustees should ensure that the trust funds are strictly utilised according to the provisions of the trust instrument. It is also advisable to designate an impartial and independent trustee to effectively serve as a safeguard against conflicts of interest and be better equipped to make unbiased judgements. This means that all monetary funds paid to the trust are safeguarded and used solely in the interests of the minor children who are beneficiaries of the trust.

It remains important to consult an estate planner or advisor regarding one's legacy needs and to ensure that the correct option is chosen for the safeguarding of the interests of one's children after one's passing as a lack of planning or poor advice can have dramatic consequences for one's loved ones.

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Acts and Bills

- Administration of Estates Act 66 of 1965: Section 43(1) & (2)*(a)*.

Tags: legal guardian; immovable property; *inter vivos* trust; testamentary trust.


BEPS PILLAR 2

The release of the highly anticipated discussion document for South Africa pertaining to the implementation of Pillar 2 has not disappointed. Apart from the administrative burden on South African multi-national entities (MNEs), South Africa was one of the more than 130 countries that agreed during October 2021 to implement a minimum 15% corporate tax rate for MNEs with a global turnover in excess of €750 million.

This is part of the two-pillar approach that arose out of the Base Erosion and Profit Shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD) that aims to end "the race to the bottom" on tax rates that has been published as part of the efforts to tax the digital economy framework.

Even though the implementation of Pillar 2 is not limited to the digital economy as such, it is aimed at implementing a minimum effective tax rate of 15% throughout all the entities.

As of January 2024, 37 countries have adopted legislation to implement Pillar 2. However, the OECD has agreed that the Under Taxed Profits Rule (UTPR) can only become effective in 2025. Ironically, however, the US Congress has not yet adopted any similar legislation. Even though the Biden Administration supports the agreement, the relevant amendments have been omitted from the relevant legislation.

The countries that have adopted legislation have decided to implement the legislation with effect from 1 January 2024. Amongst others, 18 EU members have adopted legislation to that effect, even though the EU announced infringement decisions against 9 other EU member states that have not implemented Pillar 2 yet. These countries have been given a two-month period to respond and finalise their legislation.

The starting point in determining the effective tax rate (ETR) of an MNE group is the financial statements. However, a very complex calculation needs to be done to adapt these numbers in order to ultimately determine the profits of an MNE. Adjustments to the financial accounts have been kept to a minimum and are mainly focused to address permanent differences, for instance to remove dividends and equity gains and to remove expenses that are disallowed for tax purposes. Rules have also been prescribed to address temporary differences.

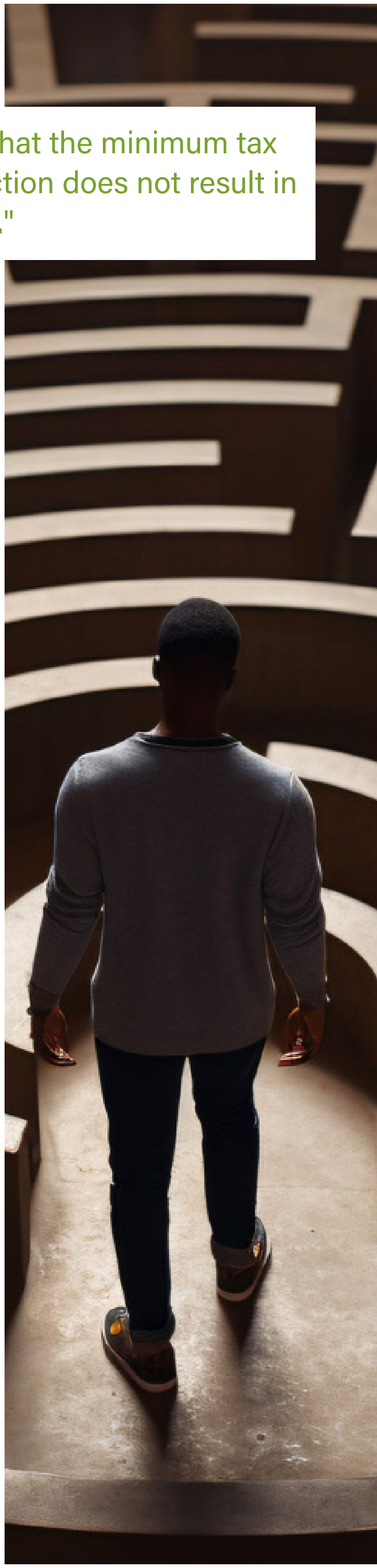
The OECD released a working paper on 9 January 2024 that, amongst others, indicates that some of the results of the implementation of Pillar 2 will be:

- The reduction in profit shifting by approximately half from US$698 billion to US$356 billion;
- the reduction in low-taxed profits on a worldwide basis; and
- the boosting of corporate income tax revenues by an average of US$155 billion to US$192 billion annually.

It is noted that the Pillar 2 model rules do not apply to government entities, international organisations and non-profit organisations, nor do they apply to entities that meet the definition of a pension, investment or real estate fund.

Effectively MNEs must calculate their ETR for each jurisdiction where they operate, and pay a top-up tax for the difference between their ETR per jurisdiction and the minimum 15% rate. Any resulting top-up tax is generally charged in the jurisdiction of the ultimate parent of the MNE, for instance South Africa, if the holding company is located in South Africa.

"The UTPR on the other hand serves as a backstop to ensure that the minimum tax is paid where the income of a subsidiary in a low-taxed jurisdiction does not result in the low-taxed income being brought into account under an IIR."



The minimum ETR of 15% is achieved by two main interlocking measures and using a top-down approach, namely the:

- Income Inclusion Rule (IIR); and
- UTPR.

The IIR aims to impose a top-up tax on the parent entity of a low-taxed foreign subsidiary. Under the IIR, the minimum tax is paid at the level of the parent entity, in proportion to its ownership interests in those entities that have low-taxed income. Generally, the IIR is applied at the level of the ultimate parent entity, and works its way down the ownership chain.

The UTPR on the other hand serves as a backstop to ensure that the minimum tax is paid where the income of a subsidiary in a low-taxed jurisdiction does not result in the low-taxed income being brought into account under an IIR. In such case an adjustment is made to increase the tax at the level of a subsidiary.

However, in order to retain the taxes in the jurisdiction of the parent entity (South Africa), jurisdictions can choose to implement a so-called Domestic Minimum Tax (DMT). The DMT takes precedence over the IIR and UTPR in order to ensure that the taxes that would otherwise have been paid overseas are collected in the territory in which the profits are generated. South Africa has chosen for the tax to be levied in South Africa as opposed to the country where the ultimate holding company of the entity is located.

The draft Global Minimum Tax Bill, 2024, was released in February 2024. As expected, South Africa has adopted the general approach in relation to Pillar 2 on the basis that the UTPR is not immediately implemented for South Africa. The thrust is thus more for taxes to be collected at a South African level, and not in the low-taxed jurisdictions.

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Acts and Bills

- Draft Global Minimum Tax Bill, 2024 (released on 21 February 2024).

Other documents

- Pillar 2 model rules;
- Under Taxed Profits Rule (UTPR);
- Income Inclusion Rule (IIR).

Tags: multi-national entities (MNEs); Base Erosion and Profit Shifting (BEPS); Organisation for Economic Co-operation and Development (OECD); Pillar 2; Under Taxed Profits Rule (UTPR); effective tax rate (ETR); Income Inclusion Rule (IIR); Domestic Minimum Tax (DMT).

CORPORATE TAX RESIDENCE BY MUTUAL AGREEMENT

Globally it is common practice for countries to determine the tax residence of a company by applying two primary tests. The first is that a company that is incorporated under the law of that country is tax resident in that country and the second is typically some form of management test. The two most common management tests applied are "management and (or) control" and "effective management" (collectively referred to as management test*).*

This means that a company incorporated in one country, being a tax resident of its country of incorporation, could also be tax resident in another country under the "management test" applied by that other country (dual residence). In most cases this would translate into worldwide taxation of that company in both countries unless a rule applies to prevent this.

The rule could be a local law rule (ie, a domestic tax law). By way of example, the tax law in Jersey states that a Jersey incorporated company that has its management and control outside of Jersey will not be a Jersey tax resident (subject to satisfying certain criteria).

In the alternative, the rule could be contained in a double tax agreement (DTA). In this regard, most DTAs, regardless of the model on which they are based (UN or OECD), contain a clause that deems the tax residence of a company to be in one of the contracting countries where dual residence arises. By way of example, the South Africa-USA DTA deems the company to be a resident of its country of incorporation, while the South Africa-Botswana DTA requires the competent authorities of each country to mutually agree on the residence of the company, considering various factors.

What makes the position tricky is that there is no uniform meaning of the "management test" and the meaning applied by a specific country may differ materially to that of the other country also claiming the company as a tax resident.

This article explores the following questions that are most pertinent to the residency test based on management:

- What is the meaning of "effective management" and "managed and controlled", and are these two terms in reality the same?
- What factors should be considered when seeking to determine the place where a company is effectively managed or managed and controlled?
- What is required in terms of applying the mutual agreement procedure to establish the tax residence of a company under a DTA and how has the enactment of the multilateral instrument (MLI) impacted this?

WHAT IS THE MEANING OF "EFFECTIVE MANAGEMENT" AND "MANAGED AND CONTROLLED", AND ARE THESE TWO TERMS IN REALITY THE SAME?

Effective management

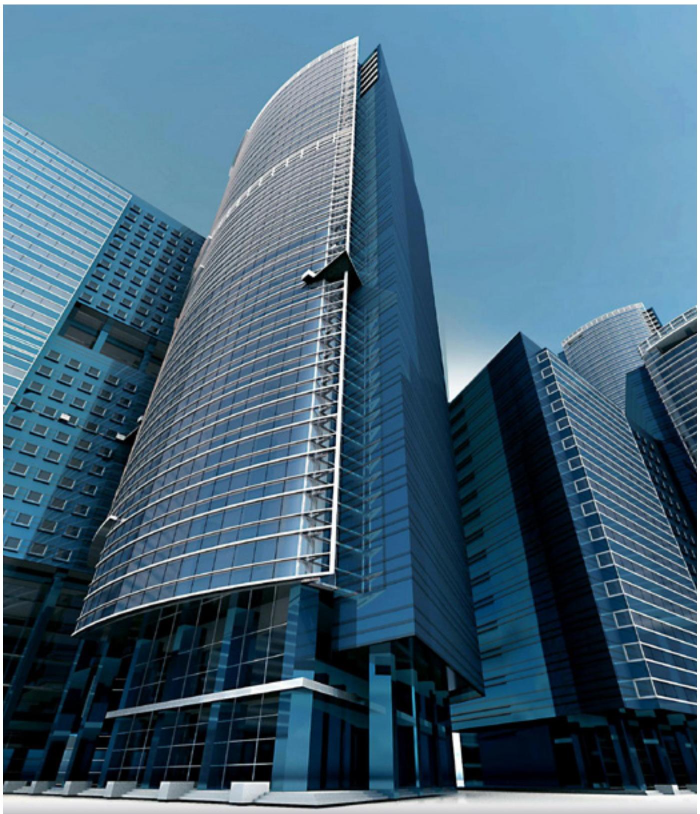
The term effective management has long formed part of the text of the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention. The reason for this will become clearer when the role of DTAs in resolving the dual residence mutual agreement procedure is examined. It is therefore common to consider the meaning per the OECD's commentary when seeking to interpret this term.

The OECD commentary states: "The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time."

The concept of effective management has also been considered by the courts. While most of these cases have taken guidance from the OECD commentary, they have further noted the following:

- Effective management implies the real, top-level, positive management of the company.
- The effective management of a company is typically conducted by, and therefore located where, the most senior executives that "call the shots" exercise their powers.

- When seeking to determine the place of effective management of a company, a detailed analysis of the facts must be performed. Judges tasked with expressing a view on the subject typically include several pages of detailed fact finding in their judgments.

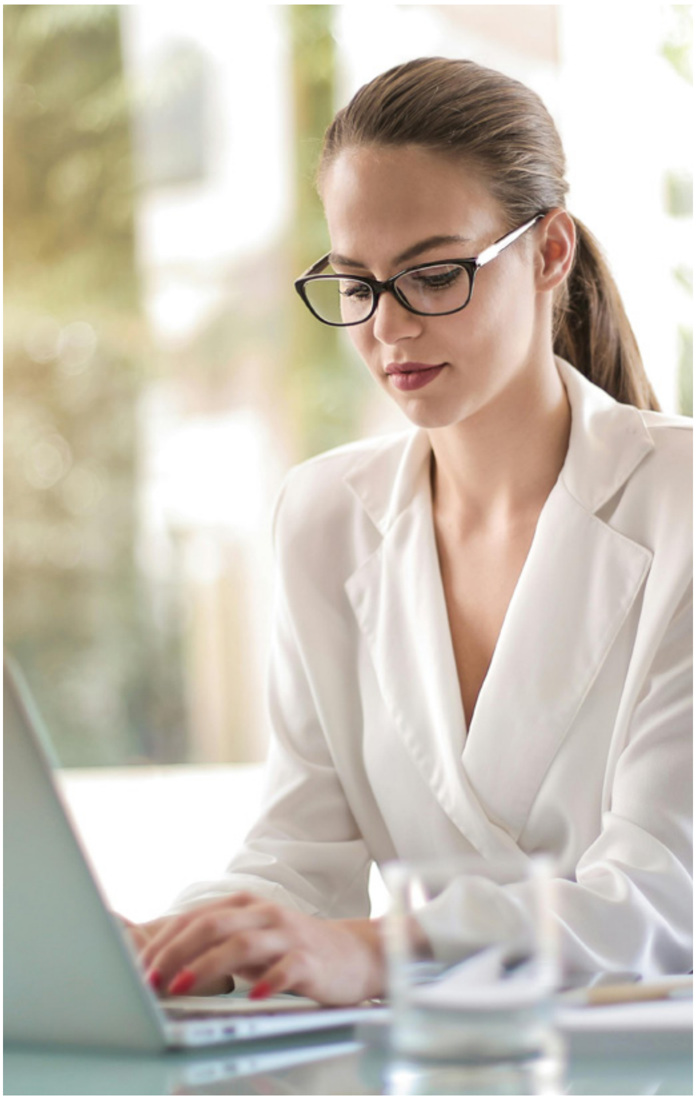


One should therefore not automatically assume that a company's place of effective management will be located where the board of the company meets to take decisions. This would only be the case where the board legitimately consists of the "shot callers" and they exercise their management function through the organ of the board. Where a board merely meets as a formality to rubber stamp decisions already taken, the board would not be considered as the organ responsible for the effective management of the company.

Further, the tax authority may place less emphasis on the role of the board and more emphasis on the actions of the senior executives of the company when assessing the company's place of effective management. What is key is that consideration of all the facts will ultimately determine the finding of a revenue authority or court.

Managed and controlled

The seminal case on the meaning of "managed and controlled" is arguably *De Beers Consolidated Mines Ltd v Howe* 5TC198. This case was heard in the UK and considered whether a South African incorporated company was UK tax resident.



Management and control has been used as a residence test for many years by the UK (applying a central management and control test). The UK has largely been the trendsetter in determining the meaning of this concept, especially having regard to the principle espoused in the *De Beers* case.

Lord Chancellor (Loreburn) held that "A company cannot eat or sleep, but it can keep house and do business. We ought therefore to see where it really keeps house and does business."

This statement has been used by the UK Revenue Authority ("His Majesty's Revenue and Customs" (HMRC)) to define (and in effect take as law) the test that they will apply to determine whether a company is managed and controlled from the UK. The HMRC confirms that it is first necessary to identify who, in law, has the right and duty to exercise the management and control over the company.

The shareholders of a company may have some control over the company and its board of directors, but in the main, the board of directors is considered the body most likely to be responsible for the company's management and control (unless in practice the shareholders usurp such authority). The HMRC further requires an examination of the role played by any agents appointed by the board (including persons holding titles such as managing director) to assess that the central management and control has not been delegated to another person, or organ (eg, committee) of the board.

What is interesting is that the HMRC suggests that effective management is a concept distinct from management and control whereby effective management is "the place where the Head Office is: the Head Office in the sense of – not the registered office – but the central directing source. The place where one would expect to find the finance director, for example, the sales director and, if there is one, the managing director. The company records would normally be found there together with the senior administrative staff."

This being a distinct test that considers who legally has the ability to manage and control the company, which they suggest would most likely be the board of directors. The HMRC goes on to say that a company with its head office (ie, effective management) in the Netherlands would not suddenly move its effective management outside of the Netherlands if it were to hold an occasional board meeting outside of the Netherlands.

We would suggest, however, contrary to the position adopted by HMRC, that the two concepts are becoming increasingly more aligned. This is because both seem to seek out who the real decision makers are, not only in law, but in substance as well. They both place significant emphasis on where the executives of the business (top management) carry out their duties of making strategic decisions. Most importantly, both seem to place reliance on the need to examine all of the facts of each case.

WHAT FACTORS SHOULD BE CONSIDERED WHEN SEEKING TO DETERMINE THE PLACE WHERE A COMPANY IS EFFECTIVELY MANAGED OR MANAGED AND CONTROLLED?

The following key factors should be considered when applying either of the above management tests.

- **Nature of the business of the company:** A pure holding company lacking material substance may find it difficult to factually prove compliance with the applied management test in the intended jurisdiction. This is especially so where the company is not able to demonstrate that the majority of its directors reside in that country and/or where it has no full-time senior executive(s) based in that country.

- **Level of presence of the company in a particular jurisdiction:** A company with minimal presence in a particular country and an absence of a functional head office in that country may find it difficult to demonstrate that its effective management is conducted in that country.

- **Substance of the board:** A company that appoints a board consisting, in the majority, of members that have no strategic involvement in the operations of the company, or are not suitably qualified or experienced to provide meaningful (real/positive) management to that company may fall short (this is typically the case when "paid for" directors are appointed).

- **Subcommittees:** The formation of subcommittees by the board may undermine an argument that the board is the organ responsible for the effective management of the company. The terms of reference of each subcommittee requires careful consideration to establish if the committee is factually the real/positive management of the company.

- **Shareholder influence:** It is perfectly understandable that in a larger multinational group the strategy for the organisation as a whole would be set by the ultimate shareholder. The need for a particular company to align with that strategy should not alone cause the company to be tax resident in the country of residence of the shareholder. However, where the shareholder effectively usurps the decision-making powers of the company so that the company's executives are mere "puppets", the company will most likely be regarded as tax resident where the shareholder operates.

From these considerations, it is obvious that the formal governance structure of the company (eg, makeup of the board, terms of reference, authority levels, authority delegation, etc) will play a fundamental role. These governance documents should be documented and followed in practice.

WHAT IS REQUIRED IN TERMS OF APPLYING THE MUTUAL AGREEMENT PROCEDURE TO ESTABLISH THE TAX RESIDENCE OF A COMPANY UNDER A DTA AND HOW HAS THE ENACTMENT OF THE MLI IMPACTED THIS?

Where a company incorporated in one country establishes its central management and control or effective management outside of its country of incorporation, it is likely to become dual resident.

A typical example is as follows: a South African group of companies decides to set up shop in the USA. The group obtains all necessary regulatory approvals (including exchange control approval) and incorporates a US corporation. Until such time that the group employs executives in the US and starts its operations, it appoints solely South African resident individuals to the board of directors of the US corporation. The board meets in South Africa, appoints a South African resident executive, working in the South African group, as the acting managing director of the US entity. The board delegates authority to this individual to take all steps necessary to set up the operations of the US company, hire the right staff (at executive level that will be based in the US), liaise with US customers until the business is functional and negotiate and sign all contracts for the US corporation, etc.

A foreign incorporated company with its place of effective management in South Africa is a South African tax resident, unless a DTA states otherwise. In the above-contemplated scenario, the US company will have its place of effective management in South Africa. Oddly, however, in this scenario, the US company will remain US tax resident under the US-SA DTA. It may be viewed as having a tax presence in South Africa (commonly termed a permanent establishment), but it would not be regarded as a South African tax resident. No engagement with a tax authority is needed to confirm this position as the DTA rule is clear. (Note that the US-SA DTA contains a limitation on benefits clause, which may act to deny treaty benefits. The assumption in this situation is that the DTA would apply in the hypothetical scenario.)

If the same scenario were to take place with a UK-incorporated company, until recently, the UK company would have been viewed as a tax resident of the country in which it conducts its effective management. However, with the introduction of the MLI, this has now changed. The UK company will now be viewed as a tax resident of the country that is agreed between the competent authorities of the UK and South Africa. This is a significant change. Furthermore, it is not unique to the SA-UK DTA and could be the position for many other scenarios.

MUTUAL AGREEMENT

While the concept of mutual agreement has formed part of the South African tax landscape for many years, it was not widely used. The primary reason is that the South African DTA network contained very few opportunities for uncertainties to arise when dealing with developed nations. In the case of DTAs with developing nations, the process was considered cumbersome, lengthy and costly, and therefore most taxpayers elected to rather forfeit the benefit available under the DTA.

The MLI stands to change all of that.

The MLI empowers competent authorities of the relevant contracting states to endeavour to resolve cases of dual tax residence on a case-by-case basis through mutual agreement. A competent authority is generally the person who represents the State in the implementation of the relevant DTA, which would generally be the Minister of Finance or the authorised representative of the Minister. In the case of South Africa, there are SARS officials dedicated to this task.

A number of jurisdictions, including South Africa, have elected for the MLI to modify the tie-breaker clause contained in existing DTAs to “mutual agreement” from the previously widely used place of effective management.

A dual tax resident company may approach a competent authority of either country of residence to request a determination of its single residence through mutual agreement under the mutual agreement procedure article contained in the relevant DTA.

The mutual agreement procedure article contained in most DTAs sets out the mechanism for competent authorities to interact with each other outside the formal diplomatic channels and resolve international tax matters, such as the dual tax residency, by mutual agreement. The mutual agreement procedure is not litigation, but rather a process of consultation between the relevant competent authorities.

Most mutual agreement procedure articles provide for a company seeking a determination of its sole tax residence through mutual agreement to approach the competent authorities within a limited period (usually three years). Unfortunately, these provisions do not set specific timelines for resolving disputes nor do they compel competent authorities to reach an agreement or actually resolve the dispute.

This means that dual tax residency disputes may go on for years unresolved. Not only does this put the dual tax resident taxpayer at a disadvantage as the MLIs provide for such taxpayers to be denied tax relief until such time as a single country of residence has been determined; it may also give rise to double taxation as the taxpayer will continue to be regarded as dual tax resident in both states (and subject to tax accordingly). This makes it crucial for companies to take the necessary measures to ensure that they are not dual tax resident.

Companies that intentionally established themselves as dual residents, are advised to urgently assess if they should undertake a mutual agreement process to seek confirmation from the relevant competent authorities that the MLI changes do not impact their ability to continue to be treated as a tax resident of the country selected.

PRACTICAL NEXT STEPS:

- All parties with multinational groups are urged to assess the current residence status of their existing operations.
- Where there are concerns that companies may be dual resident, the impact of implementing measures to address these concerns should be assessed bearing in mind that exit tax costs could be triggered where changes are enacted that have the result of the company ceasing to be a resident of a particular country.
- Companies that are deliberately established as dual resident, and previously applied the place of effective management tie breaker test to achieve this, should assess if they now need to implement a mutual agreement procedure to retain their current tax status.

"Companies that intentionally established themselves as dual residents, are advised to urgently assess if they should undertake a mutual agreement process to seek confirmation from the relevant competent authorities that the MLI changes do not impact their ability to continue to be treated as a tax resident of the country selected."

Nhlamulo Maluka & Robyn Berger

Bowmans

Other documents

- South Africa-USA Double Tax Agreement;
- South Africa-UK Double Tax Agreement;
- South Africa-Botswana Double Tax Agreement;
- Model Tax Convention (of the Organisation for Economic Cooperation and Development (OECD)).

Cases

- *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* [1906] AC 455; 5TC198 (UK).

Tags: dual residence; double tax agreement (DTA); multilateral instrument (MLI); effective management; managed and controlled; South African tax resident; mutual agreement.

ALIGNING TAX AND CUSTOMS PRICING

From ancient cities to modern-day trade hubs, customs officials have long served as gatekeepers, meticulously assessing the declared value of imported goods. However, the rise of multinational enterprises and their adept use of transfer pricing tactics have introduced a new dimension of complexity to this task.

The South African Revenue Service (SARS), on 19 January 2024, responded with targeted amendments to formalise its approach to dealing with TP adjustments and thereby its customs valuation framework. More specifically, the draft amendments to the rules under sections 40(3)*(a)*(i)(C), 41(4)*(b)*, and 120 of the Customs and Excise Act, 1964 (the C&E Act) aim at addressing the potential loopholes exploited through transfer pricing manipulation.

KEY AMENDMENTS

Two new rules, 40.03 and 41A.01, are woven into the existing tapestry of customs law:

- Rule 40.03: This rule acts as a procedural bridge, requiring that original customs declarations (bills of entry) should be adjusted by the retroactive transfer pricing adjustments in terms of the processes outlined in rule 41A.01. Essentially, processing vouchers of correction to amend the original import bill of entry.

- Rule 41A.01: This rule serves as a roadmap to the documentary requirements to support the disclosure made in the submission of the amended invoices (ie, debit or credit notes). It finally provides a definition for terms like "transfer pricing adjustment" and "adjustment period" relevant to the amended framework. Furthermore, it lays out the meticulous steps for submitting the transfer pricing adjustments related to previously imported goods.

The amendments necessitate thorough documentation of transfer pricing adjustments and their impact on customs value. This requires maintaining comprehensive records of invoices, contracts, transfer pricing analyses and adjustment calculations which previously may not have been required. Multinational enterprises with complex intra-group transactions will need to carefully assess the impact of the amendments on their transfer pricing practices and ensure proper alignment with customs valuation procedures.

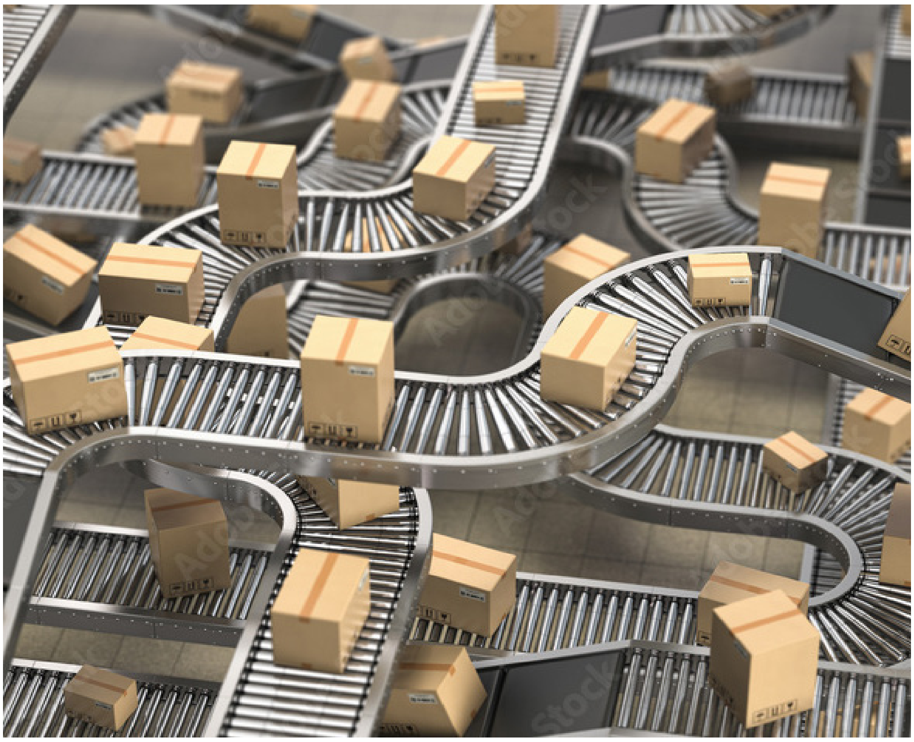
More importantly, SARS' aim is to formalise this declaration process and provide clarity to traders on the documentary requirements supporting these adjustments. It should be noted that a phased approach appears to be undertaken by SARS as the above rules cover mainly debit adjustments. The existing rules are silent on credit adjustments that may result in refunds of customs duties. However, it is believed that, in order to balance the law, SARS will address this after the consultation period with stakeholders.

GUIDANCE GOING FORWARD

So, what does this all mean for taxpayers that deal with customs?

- Taxpayers should ensure seamless integration of transfer pricing documentation, including intercompany agreements, pricing methodologies and supporting economic analyses, with customs valuation data. This will facilitate seamless demonstration of the arm's length principle applied to the transactions.

- It is advised that taxpayers formulate and maintain a well-defined transfer pricing policy that aligns with international best practices and adheres to the arm's length principle. This policy should clearly outline the transfer pricing methodology and documentation practices.



- Taxpayers should align the employed transfer pricing methodology with the chosen customs valuation method under the C&E Act. For instance, if using the transaction value method, ensure the transfer price aligns with the arm's length price of the imported goods under independent market conditions.

- Taxpayers should maintain comprehensive and accessible records of all transfer pricing adjustments, including justification, calculations and underlying data. This documentation will be crucial in demonstrating compliance with the arm's length principle and ensuring accurate customs valuation to withstand a SARS audit.

- The adjustments should be disclosed within 30 business days to ensure that the taxpayer does not face understatement penalties of 25% on the assessed customs duties resulting from adjustments and VAT penalties and interest, which are often difficult to challenge.

"Multinational enterprises with complex intra-group transactions will need to carefully assess the impact of the amendments on their transfer pricing practices and ensure proper alignment with customs valuation procedures."

These amendments strive to bring clarity and uniformity to the process of adjusting bills of entry in response to transfer pricing adjustments affecting customs value.

While South Africa's new draft amendments aimed at transfer pricing adjustments in customs valuation might add to a taxpayer's compliance costs through the additional paperwork required, they also hold promise for fairer trade. Businesses will face increased documentation and communication demands, but hopefully will gain smoother customs clearance, a level playing field, and reduced risk of under-valuation thanks to clearer rules and enhanced accuracy. Similar regulations exist in countries like the US, EU, and Canada, highlighting a global effort to ensure market-reflective customs values. Though specific requirements and enforcement differ, the goal remains the same: fairer, more predictable trade for all.

The proposed amendments represent a significant step towards solidifying a transparent and efficient framework for handling transfer pricing adjustments within the ambit of customs valuation under the C&E Act. These changes contribute to bolstering fiscal integrity and streamlining trade procedures for stakeholders involved in international transactions.

Carridine Brooks & Marcus Stelloh

BDO

Acts and Bills

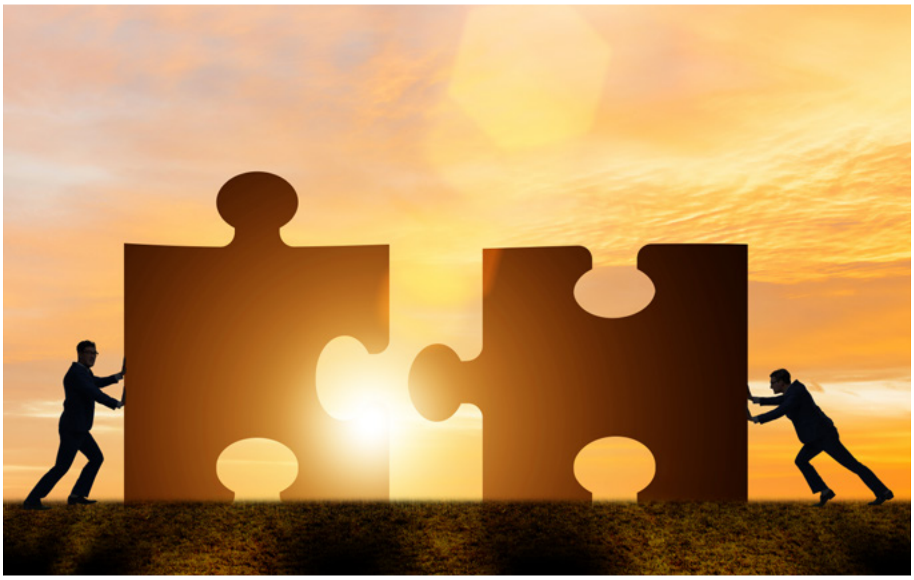
- Customs and Excise Act 91 of 1964: Sections 40(3)*(a)*(i)(C), 41(4)*(b)* & 120.

Other documents

- Rules made under the C&E Act: Rules 40.03 and 41A.01 (definitions of "transfer pricing adjustment" & "adjustment period").

Tags: transfer pricing adjustment; adjustment period; transfer pricing policy; arm's length principle; understatement penalties; under-valuation.

INTERACTION BETWEEN SECTION 7C AND TRANSFER PRICING RULES



Tax advisors, like others in the legal profession, can sometimes be guilty of using jargon and "legalese".

However, considering the number of times that section 7C of the Income Tax Act, 1962 (the Act), has been amended since its introduction in 2017, saying "7C is a problem", might become a common phrase at a Saturday evening braai. In the 2024 Budget, National Treasury is at it again, this time proposing to clarify the interaction between sections 7C and 31 of the Act.

THE CURRENT LEGAL POSITION

Section 7C is an anti-avoidance provision aimed at preventing the tax-free transfer of wealth to trusts using low-interest or interest-free loans, advances, or credit arrangements, including cross-border loan arrangements. The mechanism through which it prevents anti-avoidance is by stating that if the interest rate charged on loans made by individuals to trusts and certain connected-person companies is lower than the official rate of interest, the difference between the interest charged and what would have been charged at the official rate of interest, will be treated as a deemed donation. The "*official rate of interest*" is defined in section 1(1) of the Act as:

- In the case of a rand-denominated debt, the South African repo rate plus 100 basis points.
- In the case of a foreign currency denominated debt, a rate of interest that is the equivalent of the South African repo rate applicable in that currency plus 100 basis points.

For a rand-denominated debt, the official rate of interest is currently 9,25%. To illustrate the application of the section – if a person were to advance an interest-free loan of R1 million to a South African connected person trust, the difference between the interest charged (R0) and the interest that should have been charged in terms of the official rate of interest, being 9,25%, is R92,500. The full amount is treated as a deemed donation in terms of section 7C.

However, section 7C(5) contains a list of exclusions to which section 7C does not apply. One of the exclusions is where the transfer pricing provisions in section 31 of the Act apply to a cross-border loan or advance made by a South African resident to a non-resident. Section 31 applies to so-called "*affected transactions*", which are broadly defined in section 31(1), but for purposes of this article, it is sufficient to state that a loan advanced by a South African resident to a non-resident, at a rate which is lower than the arm's length rate, where the parties are connected persons, will be an affected transaction. This would include a situation where a South African resident is a beneficiary of a foreign trust and advances a loan to that trust.

SARS INTERPRETATION NOTES AND DEBATE

Given the wording of the exclusion in section 7C(5), there has always been some debate as to the interaction between sections 7C and 31. Some commentators have taken the view that, given the wording of the exclusion in section 7C(5), it was unclear whether section 7C could still apply where section 31 applied to a cross-border loan. The more commonly held view has been that if section 31 applies to a cross-border loan, section 7C does not apply. One needs to consider two SARS interpretation notes in this regard.

In SARS Interpretation Note 114 (IN114), published on 2 March 2021, an example is included of an instance where a South African resident makes an interest-free loan to a non-resident discretionary trust. Although IN114 was not intended to expressly deal with the interaction between sections 7C and 31, it provides some useful insight. In the example, SARS states that section 31 may apply on the basis that the loan to the non-resident trust is potentially an affected transaction. However, it continues to state that the South African resident should also consider the possible application of section 7C. While some interpreted the example to suggest that if section 31 applies to the loan, section 7C will not, it was not entirely definitive. The example did not address the question as to whether there would be an issue if the rate that applies in terms of section 31 was lower than the official rate of interest.

However, Interpretation Note 127 (IN127), published on 17 January 2023, seemed to clarify the issue. There, SARS uses an example where an interest-free loan is advanced by a South African resident to a non-resident discretionary trust, which is a connected person, and where the market-related (arm's length) rate is 10%. It notes that the loan is used by the trust to earn rental income of R80,000, which is vested in the South African resident lender in terms of section 7(8) of the Act. Considering that the arm's length amount is R100,000 (10% of R1 million), a transfer pricing adjustment of R20,000 must be made that also constitutes a deemed donation under section 31(3). IN127 then goes on to state that considering the exclusion in section 7C(5) and that "the affected transaction is subject to the provisions of section 31(2) and section 31(3) … section 7C(2) and section 7C(3) do not apply".

BUDGET ANNOUNCEMENT AND IMPLICATION

Despite the above, and while acknowledging that the intention of the exclusion in section 7C(5) is "to avoid the possibility of an overlap or double taxation", it states that:

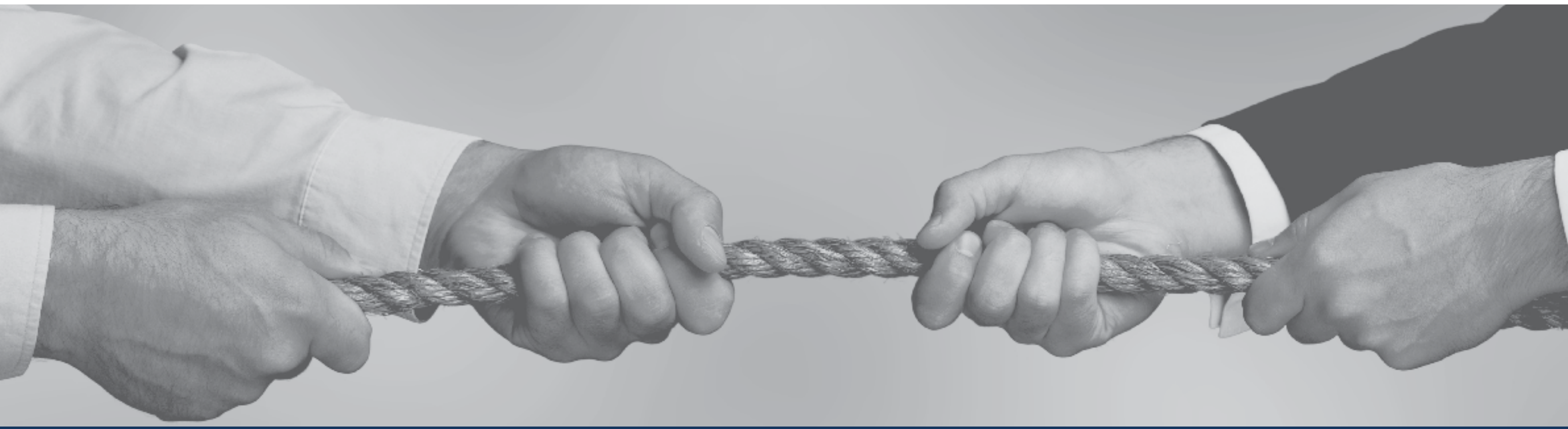
> "[the] exclusion does not effectively address the interaction between the trust anti-avoidance measures and transfer pricing rules where the arm's length interest rate is less than the official rate on these cross-border loan arrangements. It is proposed that amendments be made to the legislation to provide clarity in this regard."

It appears that there is a concern in the context of loans where the arm's length interest rate, determined in terms of section 31, is lower than the official rate of interest that applies where section 7C applies and that this may result in avoidance. It thus appears that the issue the proposal is attempting to deal with arises if the official rate of interest is greater than the arm's length price.

This issue is not addressed in the IN127 example, although at the time that it was published, the official rate of interest was lower than 10% (being the arm's length rate in the example). While it remains to be seen how the issue will be addressed, one can only hope that the proposed amendment will not have the effect of diluting the exclusion by stating that the official rate of interest should also apply to a cross-border loan to which section 31 applies. One should appreciate that IN127 set out detailed considerations that should be taken into account in determining an arm's length rate. It may be arguable that if the proper application of those IN127 considerations results in justifying an arm's length rate that is lower than the official rate of interest, the official rate of interest should not apply.

[*Editorial comment*: Interpretation notes (which are "official publications" and thus create "practice generally prevailing" (PGP)) are intended to provide *guidelines* to stakeholders (both internal and external) on the SARS interpretation and application of the provisions of the legislation administered by the Commissioner. These notes are amended when necessary in line with policy developments and changes in legislation. An interpretation note is published for general information.

SARS is bound by a practice generally prevailing (PGP) as it may not assess a taxpayer in an alternative manner if the taxpayer has relied on a PGP. However, neither the taxpayer nor a court is bound by a PGP and it is not law.]



Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "official rate of interest"), 7C and 31 (definition of "affected transaction" in subsection (1)).

Other documents

- Interpretation Note 114 *("Interaction between section 25B(1) and section 7(8) in case of conflict, inconsistency or incompatibility"*), published on 2 March 2021;

- Interpretation Note 127 *("Determination of the taxable income of certain persons from international transactions: intra-group loans")*, published on 17 January 2023.

Tags: anti-avoidance provision; interest-free loans; connected-person companies; official rate of interest; non-resident discretionary trust; arm's length rate.

ESTIMATED ASSESSMENTS

In relation to a given tax type, in terms of section 95 of the Tax Administration Act, 2011 (the TAA), SARS may issue an assessment based in whole or in part on an estimate (an "estimated assessment") to a taxpayer if the taxpayer –

- does not submit a return;
- submits a return with incorrect or inadequate information;
- submits incorrect or inadequate relevant material requested by SARS; or
- does not submit a response to a request for relevant material (which may include information and/or documentation stipulated in a verification request) after more than one request for such relevant material by SARS.

On 11 December 2023 SARS announced, through its website, that it would implement the issuing of estimated assessments, specifically for VAT, in the fourth of the above circumstances. That is, if the vendor does not submit a response to a request for relevant material (which may include requested information and/or documentation stipulated in a verification request) after more than one request for such relevant material by SARS.

Importantly, if SARS has issued an estimated VAT assessment:

- The estimated assessment will be in the form of a VAT217 notice of assessment;
- The vendor will not be allowed to request a correction for the tax period that is the subject of the estimated assessment;
- If the vendor disagrees with the estimated assessment, it has an opportunity to submit the correct relevant material within 40 business days from the date of the VAT217 notice;
- The vendor may request an extension from SARS of the period of 40 business days to submit the relevant material, if reasonable grounds for the extension are provided;
- The vendor may submit a suspension of payment request in terms of section 164 of the TAA, if the estimated assessment resulted in an amount payable to SARS for that period; and
- The vendor cannot object to an estimated assessment in terms of the normal dispute resolution process; the correct steps to "dispute" an estimated assessment are:
    1. The vendor must submit the complete and correct relevant material requested by SARS within 40 business days from the issuance of the VAT217 notice of assessment; and
    2. Only after the vendor has submitted the complete and correct relevant material and SARS has not subsequently issued a reduced assessment (ie, corrected the assessment), will the taxpayer be allowed to object against the VAT217 estimated assessment.

The TAA does not actually describe an assessment issued in the above circumstances as an "estimated assessment"; instead, section 95(1) of the TAA refers to "[an assessment] based in whole or in part on an estimate" to describe what is commonly referred to as an "estimated assessment". The same section states that such an assessment may either be an original, additional, reduced or jeopardy assessment. Since an assessment issued by SARS is not headed "assessment based on an estimate", the question arises how the vendor is meant to know that the assessment is in fact one that is based on an estimate and not merely a "regular" original, additional, reduced or jeopardy assessment. This is important for the vendor to know because the allowable procedure to dispute an assessment that is based on an estimate is different from the procedure that has to be followed if the assessment is not based on an estimate.

If the assessment is not based on an estimate, the vendor would follow the normal dispute resolution process, which is to object to the assessment in terms of section 104 of the TAA. On the other hand, if the assessment is based on an estimate, then, in terms of section 95 of the TAA, the vendor must first submit the requested relevant material. Only thereafter, if SARS does not issue the vendor with a corrected assessment, is the vendor permitted to dispute the matter in terms of the normal dispute resolution process.

In terms of section 96(2)*(a)* of the TAA, where SARS raises an assessment based on an estimate, it is obliged to inform the taxpayer of the grounds on which the assessment was issued. However, it is not clear whether this would require SARS to stipulate that the assessment was based on an estimate.

In view of these issues, it seems sensible for taxpayers to request reasons for every assessment issued by SARS and to expressly request SARS to indicate, as part of the reasons, whether the assessment was based on an estimate. This would enable the taxpayer to engage with SARS in the appropriate manner.

It must be stressed that it is important for vendors to always submit complete and correct relevant material to SARS upon request (typically as part of the verification process), to ensure compliance and to avoid protracted disputes.

The requests for relevant material will normally be issued on eFiling or may be sent via email to the email address specified for communication purposes on the vendors' eFiling profile.

Following the incorrect process can result in significant delays in obtaining a refund due from SARS or having to enter into a protracted dispute resolution process.

Daniel Schmidt

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Acts and Bills

- Tax Administration Act 28 of 2011: Sections 95 (specific reference to subsection (1)), 96(2)*(a)*, 104 & 164.

Other documents

- VAT217 notice of assessment.

Tags: VAT217 notice of assessment; estimated assessment.

INPUT TAX APPORTIONMENT: BGR 16

The valued-added tax (VAT) incurred on goods and services acquired partly for the purpose of making taxable supplies and partly for some other purpose falls to be apportioned in terms of section 17(1) of the Value-Added Tax Act, 1991 (the VAT Act).

Although the legislation does not stipulate a ratio for apportionment, section 17(1) states that a ratio is determinable by the Commissioner for the South African Revenue Service (SARS) by way of a ruling.

On 27 November 2023, SARS released Issue 3 of Binding General Ruling 16 (BGR16), which sets out the standard turnover-based (STB) method for determining the ratio. Issue 3 is far more detailed than its previous iterations, running to 18 pages, compared to the 2 pages of earlier versions.

$$y = \frac{A}{a + b + c} \times \frac{100}{1}$$

The formula prescribed in Issue 3 is as follows:

In the above formula, having regard to the exclusions and adjustments listed in the BGR:

"y"	=	the apportionment ratio or percentage
"a"	=	the value of all taxable supplies
"b"	=	the value of all exempt supplies
"c"	=	the sum of any other amounts of income not included in "a" or "b" which was received or accrued during the period, whether in respect of a supply or not.

The formula remains unchanged from that contained in Issue 2. It is submitted that the use of "A" (in upper case) in the numerator is probably an error and should have been "a" (in lower case), since that is what the context and history of the Ruling indicates – it is how the formula was constituted in the previous iterations of BGR 16.

The general terms of the BGR are as follows:

- The STB formula is the default method and applies to all vendors unless they possess an approved alternative.
- The BGR applies with effect from all financial years commencing on or after 1 January 2024.
- The previous BGR 16 (Issue 2) formula applies to all financial years preceding the above financial years.
- If an alternative method was previously approved but this BGR is regarded as fair and reasonable, vendors may approach SARS to have that method withdrawn, effective for financial years commencing on or after 1 January 2024.
- Vendors are required to make an adjustment within nine months after the end of the financial year (previously within six months) where they used the previous year's turnover to determine the current year's apportionment ratio. No adjustment is required where the apportionment is performed monthly.

Where Issue 3 differs significantly from earlier iterations is in the comprehensiveness of its exclusions and adjustments. The exclusions and adjustments are not discussed in detail in this article. In summary, the following must be excluded from the formula:

- Foreign exchange differences, but only those which do not arise from hedging activities.
- Accounting entries such as fair value adjustments to record the true economic value of assets and liabilities in annual financial statements.
- The supply of capital assets, since these assets are generally considered extraordinary in nature, usually occur on a once-off basis, and do not form part of the pool of expenses subject to apportionment.

- Extraordinary income which is received due to exceptional circumstances that are unlikely to be repeated.
- The value of any goods or services supplied, where input tax on the acquisition of those goods or services was specifically denied under section 17(2) of the VAT Act (typically entertainment and motor cars).
- The cash value of goods supplied by a financier under an instalment credit agreement.
- The portion of a rental payment relating to the capital value of goods supplied under a rental agreement which is entered into as a mechanism of finance.
- The capital value of loans received, since it is not regarded as income.
- Change-in-use adjustments under sections 18, 18A, 18C and 18D of the VAT Act.
- Indemnity payments received as envisaged under section 8(8) of the VAT Act, to the extent that the indemnity payments relate to extraordinary income or capital assets.
- “Manufactured” interest or dividends received by the borrower in a securities lending transaction.
- The value of equities, debentures or bonds issued to raise funds.
- Interest earned from a vendor’s current account (that is used for day-to-day business operations) and interest received from SARS.

In summary, the following adjustments must be made:

- Interest arising from sections 8F and 8FA (of the Income Tax Act, 1962 (the Act)) instruments must be regarded as dividends and be included, by applying the proxy of (prime rate – Jibar (Jibar means “the Johannesburg Interbank Average Rate”)).
- Net interest must be included on funds that are borrowed with the objective of on-lending the funds.
- Interest received on any investments, including savings accounts, must be included, determined as interest received for the year multiplied by (prime rate – Jibar).
- Trading in financial assets: include a three-year moving average of the gross trading margin (selling value – buying value).
- Dividends from sections 8E and 8EA (of the Act) instruments must be regarded as interest and be included, by applying the proxy of (prime rate – Jibar).
- Dividends received from investment activities (including from investments held in subsidiaries, associates, *ad hoc* or minority investments) must be included, determined using a three-year moving average of dividends received/accrued during the year multiplied by (prime rate – Jibar).
- Profit share from joint ventures or partnerships must be included, determined as the three-year moving average of profit share received/accrued during the year multiplied by (prime rate – Jibar).
- Debt securitisation proceeds must be included, determined as proceeds from the sale of debts under a securitisation transaction during the year multiplied by (prime rate – Jibar).

The BGR itself calls for a proper textual, contextual, and purposive reading to understand and apply it. A vendor must apply the BGR correctly or, on a factual basis, claim that it is not fair and reasonable and seek SARS approval for an alternative method. For many vendors, Issue 3 of the BGR will result in very different VAT outcomes from Issue 2. It is recommended that anyone who needs assistance in determining the BGR’s application or effects on an enterprise, should contact an expert in the field.

Editorial note: This BGR applies with effect from all financial years commencing on or after 1 January 2024, and will apply until it is withdrawn, amended or the relevant legislation is amended.

"If an alternative method was previously approved but this BGR is regarded as fair and reasonable, vendors may approach SARS to have that method withdrawn, effective for financial years commencing on or after 1 January 2024."

Edlan Jacobs

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Sections 8E, 8EA, 8F & 8FA;
- Value-Added Tax Act 89 of 1991: Sections 8(8), 17(1) & (2), 18, 18A, 18C and 18D.

Other documents

- Binding General Ruling 16 (Issue 2): “Standard apportionment method” (issued on 30 March 2015);
- Binding General Ruling 16 (Issue 3): “Standard turnover-based method of apportionment” (issued on 27 November 2023).

Tags: taxable supplies; standard turnover-based (STB) method; exempt supplies.

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