Issue 57 | 2023
APRIL

South African Institute of Taxation

Unstructured CPD 150mins

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

DEDUCTIONS AND ALLOWANCES
DEBTORS ALLOWANCE FOR LAY-BY AGREEMENTS

TAX ADMINISTRATION
NEW GROUNDS OF APPEAL

TRANSFER PRICING
ASSOCIATED ENTERPRISES

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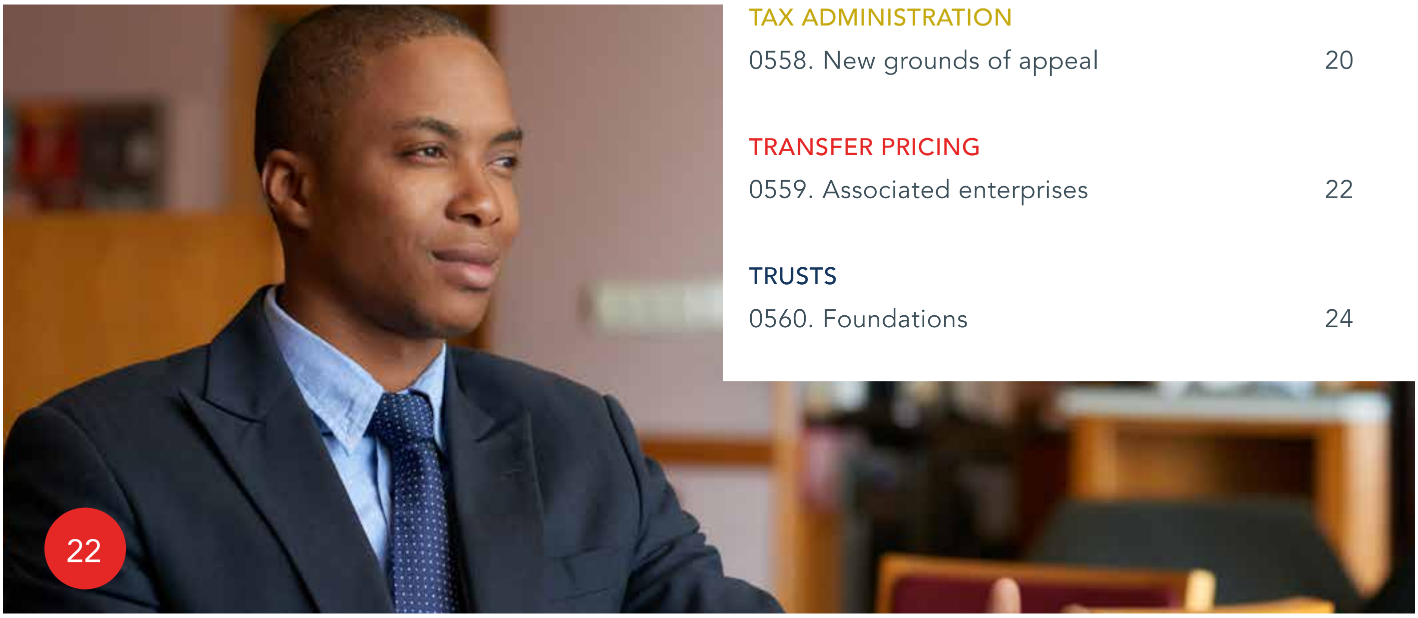


ASSESSED LOSS LIMITATION FOR COMPANIES

The assessed loss rules in section 20 of the Income Tax Act, 1962 (the Act), have always allowed companies to deduct from their taxable income each year any assessed losses from previous years.

The remaining assessed loss balances could be carried forward indefinitely. This meant that a company would only pay income tax once it made a taxable profit *and* all previous assessed losses had been deducted from the taxable income.

These rules have changed and the rules, as amended, apply to companies that have a year end on or after 31 March 2023.

What's new?

Under the new rules, which apply only to companies, assessed losses brought forward from a previous year of assessment can only be offset against the greater of 80% of the current year's taxable income or R1 million. The rules, in section 20(1)*(a)* of the Act, have been amended by section 18(1) of the Taxation Laws Amendment Act, 2021, with effect from 31 March 2023.

This means that many companies will now pay income tax on up to 20% of the taxable income for the year if it exceeds R1 million, even if the assessed loss balance carried forward from previous years exceeds the taxable income. Cash flow forecasts need to be adjusted accordingly.

What taxpayers should know

- The new rules apply to any year of assessment that began on 1 April 2022 onwards and that ends on or after 31 March 2023.
- The new limitation applies to a company's assessed loss balance carried forward from before the effective date and not only those generated thereafter.
- Companies *do not lose* the balance of an assessed loss that cannot be utilised in one tax year of assessment; it is carried forward to the next year of assessment.

- If a company does not trade for a full year of assessment and no income is earned from such trade, the assessed loss balance will be lost.

How will a taxpayer's tax bill be affected?

Some companies will not be affected immediately, for example:

- Companies that made a loss during the year and therefore have no taxable income to reduce;
- Companies that do not have an assessed loss balance brought forward; and
- Companies with a taxable income below R1 million are not affected by the new rules and can still deduct the full balance of an assessed loss against 100% of their taxable income.

"Companies *do not lose* the balance of an assessed loss that cannot be utilised in one tax year of assessment; it is carried forward to the next year of assessment."

However, the changes will have tax cash flow implications for other companies. The examples below illustrate this.

Example 1	**New rules**	**Previous rules**
Taxable income	R1,500,000	R1,500,000
Assessed loss balance brought forward	R3,000,000	R3,000,000
Assessed loss allowed	Greater of 80% of taxable income / R 1 million	100% of taxable income
Assessed loss deducted	R1,200,000 *(80% of R1,500,000)*	R1,500,000
Taxable income after deduction	R300,000 *(R1,500,000 less R1,200,000 deducted above)*	R0
Tax payable at 27%	*R81,000*	*R0*
Assessed loss balance carried forward	R1,800,000 *(R3,000,000 less R1,200,000 deducted above)*	R1,500,000 *(R3,000,000 less R1,500,000 deducted above)*

Example 2	**New rules**	**Previous rules**
Taxable income	R4,000,000	R4,000,000
Assessed loss balance brought forward	R3,500,000	R3,500,000
Assessed loss allowed	Greater of 80% of taxable income / R 1 million	100%
Assessed loss deducted	R3,200,000 *(80% of R4,000,000)*	R3,500,000
Taxable income after deduction	R800,000 *(R4,000,000 less R3,200,000 deducted above)*	R500,000
Tax payable at 27%	*R216,000*	*R135,000*
Assessed loss balance carried forward	R300,000 *(R3,500,000 less R3,200,000 deducted above)*	R0

"Under the new rules, which apply only to companies, assessed losses brought forward from a previous year of assessment can only be offset against the greater of 80% of the current year's taxable income or R1 million."

Example 3	**New rules**	**Previous rules**
Taxable income	R30,000,000	R30,000,000
Assessed loss balance brought forward	R31,000,000	R31,000,000
Assessed loss allowed	Greater of 80% of taxable income / R 1 million	100%
Assessed loss deducted	R24,000,000 *(80% of R30,000,000)*	R30,000,000
Taxable income after deduction	R6,000,000 *(R30,000,000 less R24,000,000 deducted above)*	R0
Tax payable at 27%	*R1,620,000*	*R0*
Assessed loss balance carried forward	R7,000,000 *(R31,000,000 less R24,000,000 deducted above)*	R1,000,000

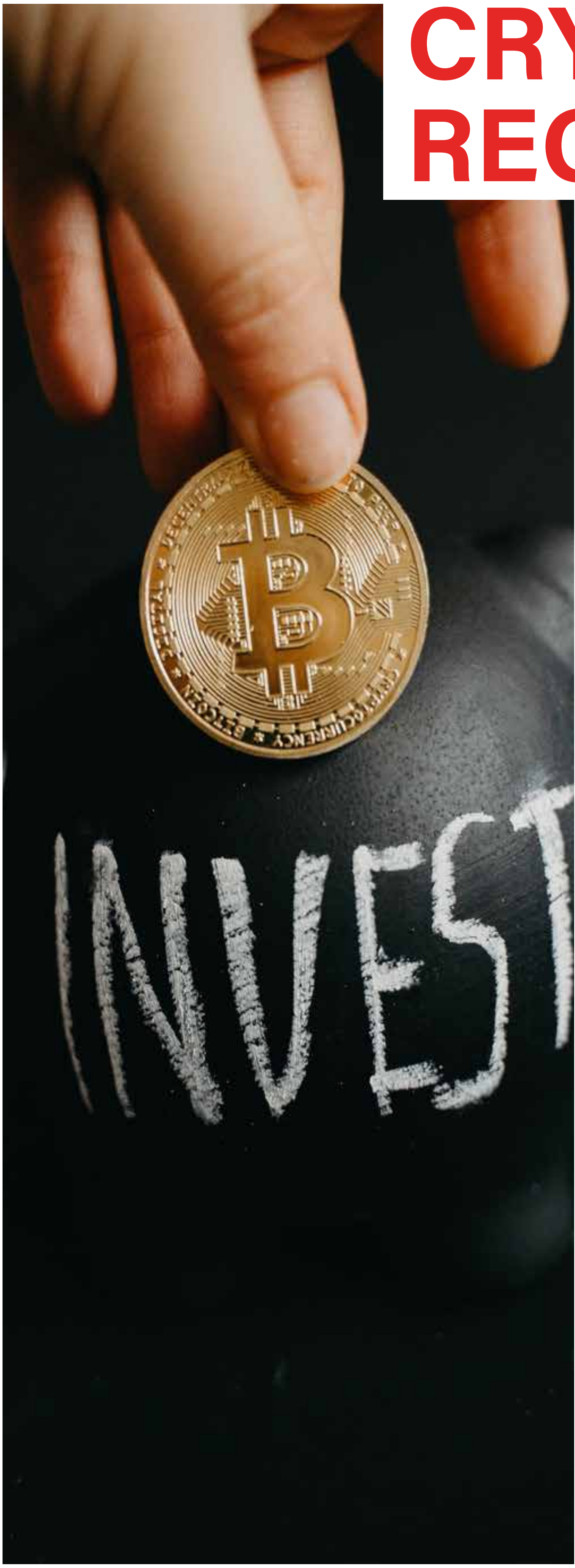
Both the old and the new rules are complex. In addition, some of the wording in the legislation still needs to be clarified.

Crowe

Acts and Bills

- Income Tax Act 58 of 1962: Section 20 (with emphasis on subsection (1)*(a)*);
- Taxation Laws Amendment Act 20 of 2021: Section 18(1).

Tags: assessed losses; taxable income.



CRYPTO ASSET REGULATION

Government Notice 2800 was published in Government Gazette *47596 on 29 November 2022 (the Notice) to amend Schedules 1, 2 and 3 to the Financial Intelligence Centre Act, 2001 (the FIC Act). In terms of the Notice, several new entities have been classified as "accountable institutions" and accordingly included in Schedule 1 to the FIC Act.*

The FIC Act, *inter alia*, requires accountable institutions to (i) verify the identity of a prospective client before the accountable institution enters into a transaction and/or business relationship with such a client, (ii) perform ongoing identification verification on their clients and (iii) submit reports to the Financial Intelligence Centre (the FIC). The FIC Act also prohibits accountable institutions from establishing a business relationship or concluding a transaction with an anonymous client or a client using a fictitious name.

Paragraph 22 of the Notice states that any person who carries on the business of one or more of the following activities or operations for or on behalf of a client, will now be classified as an accountable institution under the FIC Act –

1. exchanging a crypto asset for a fiat currency (ie, government-issued currency) or *vice versa*;
2. exchanging one form of crypto asset for another crypto asset;
3. conducting a transaction that transfers a crypto asset from one crypto asset address (using the public cryptographic key that allows for the transfer of crypto assets between crypto addresses) or account to another crypto asset address;
4. safekeeping or administration of a crypto asset or an instrument enabling control over a crypto asset; and
5. participation in, and provision of, financial services related to an issuer's offer or sale of a crypto asset (collectively "Crypto Asset Service Providers").

For purposes of paragraph 22 of the Notice, the definition of a "crypto asset" is a digital representation of a perceived value that can be traded or transferred electronically within a community of users of the internet who consider it as a medium of exchange, unit of account or store of value and use it for payment or investment purposes. The definition, however, specifically excludes a digital representation of a fiat currency or a security as defined in the Financial Markets Act, 2012.

The designation of Crypto Asset Service Providers as accountable institutions in terms of the Notice requires these Crypto Asset Service Providers to verify the identities of prospective crypto asset transactors and, as such, it will become legally impossible to deal anonymously with crypto assets in South Africa. The FIC may impose administrative sanctions (as set out in section 45C of the FIC Act) on accountable institutions who fail to comply with their statutory requirements.

The amendments set out in the Notice took effect on 19 December 2022.

[*Editorial note:* Fiat money is a government-issued currency that is not backed by a physical commodity, such as gold or silver, but rather by the government that issued it. The value of fiat money is derived from the relationship between supply and demand and the stability of the issuing government, rather than the worth of a commodity backing it.]

Natalie Scott, Kyra South & Janice Geel

Werksmans Attorneys

Acts and Bills

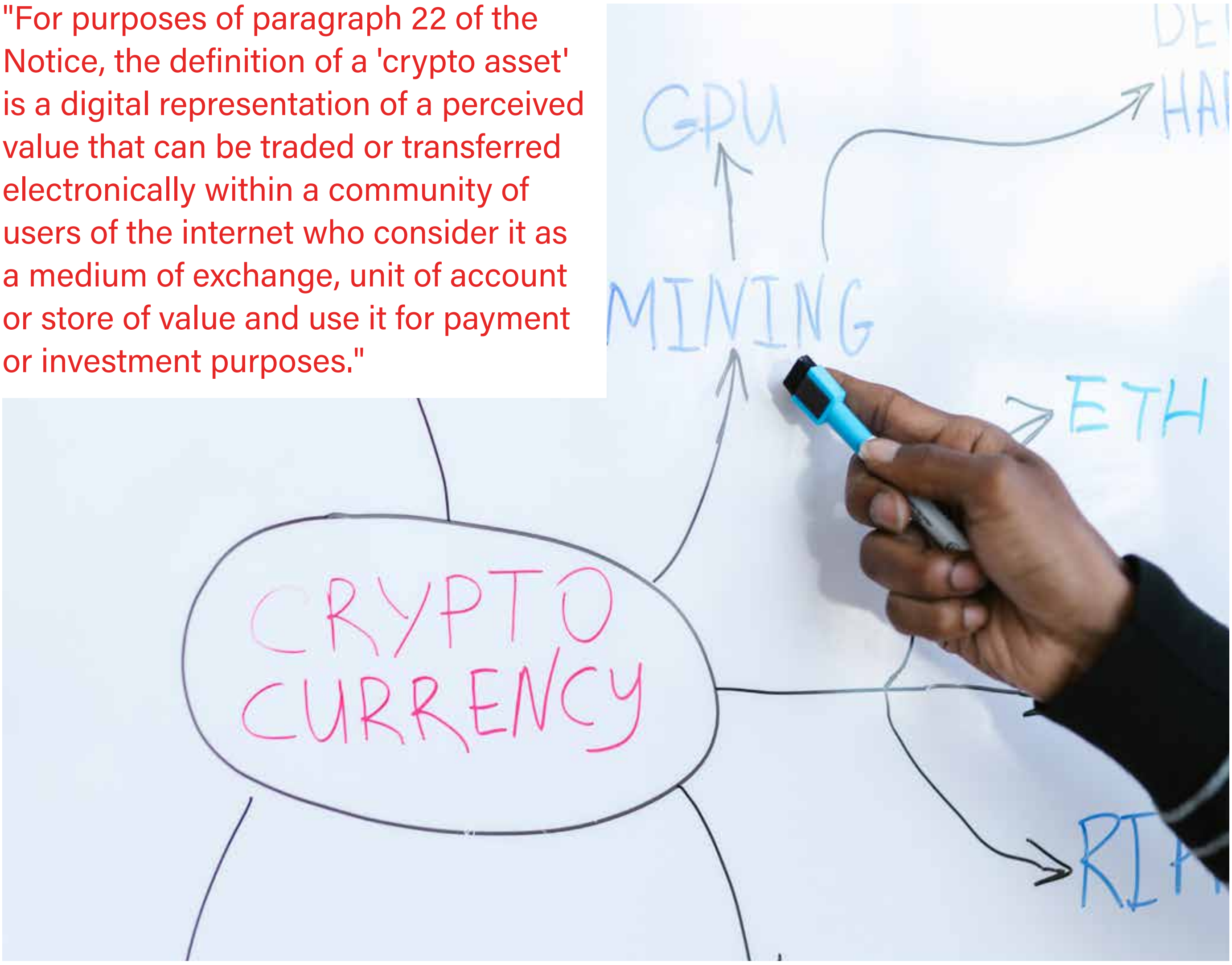
- Financial Intelligence Centre Act 38 of 2001: Section 45C & Schedules 1, 2 & 3;
- Financial Markets Act 19 of 2012: Section 1 (definition of "securities").

Other documents

- Government Notice 2800 (published in *Government Gazette* 47596 of 29 November 2022): Paragraph 22 (including definition of "crypto asset");
- *Government Gazette* 47596 of 29 November 2022 (contains Government Notice 2800).

Tags: accountable institutions; fiat currency.

"For purposes of paragraph 22 of the Notice, the definition of a 'crypto asset' is a digital representation of a perceived value that can be traded or transferred electronically within a community of users of the internet who consider it as a medium of exchange, unit of account or store of value and use it for payment or investment purposes."



DEBTORS ALLOWANCE FOR LAY-BY AGREEMENTS

Amendments made to section 24 of the Income Tax Act

INTRODUCTION

Since the COVID-19 pandemic hit South Africa, consumers have faced financial constraints and found themselves under severe cash-flow pressure that continues to prevail during endemic times. Lay-by agreements are interest-free, which make them very attractive to be utilised by consumers as a cheap method to finance the acquisition of general household goods. The latter caused a spike in the number of consumers making use of lay-by agreements, especially at the start of a new school year, in acquiring items such as new school uniforms and stationery for dependants.

This article takes a closer look at the amendments made to section 24 of the Income Tax Act, 1962 (the Act), as part of the 2022 legislative cycle. Lay-by agreements are now specifically included within the scope of this section. These new provisions (section 24(2A) and section 24(2B)) are aimed at providing income tax relief and have been inserted in the Act by section 13(1)*(b)* of the Taxation Laws Amendment Act, 2022. The new provisions became effective on 1 January 2023 and apply in respect of years of assessment ending on or after this date.

THE CONCEPT OF A "LAY-BY AGREEMENT"

To determine how a lay-by agreement is defined and described for normal tax purposes, the Act, in section 24(2A), refers one to section 62 of the Consumer Protection Act, 2008, which deals with lay-bys and states as follows in the preamble to subsection (1):

> *"If a supplier agrees to sell particular goods to a consumer, to accept payment for those goods in periodic instalments, and to hold those goods until the consumer has paid the full price for the goods"*

Hence, a lay-by agreement constitutes a sales agreement which enables a consumer to acquire goods by means of paying for such goods over a pre-determined period without becoming liable for the payment of interest. In return for the interest-free benefit granted to the consumer, the purchased goods will "lay-by" the supplier, and the consumer will only obtain access to such purchased goods once the amount due has been paid for in full. Therefore, lay-by agreements could assist in reducing the levels of indebtedness and could be viewed as a form of saving as they enable a larger portion of consumers to acquire goods without making use of standard credit sale agreements that are generally associated with high interest rate liabilities.

The main differences between a standard credit agreement and a lay-by agreement could be summarised as follows:

VARIABLE	STANDARD CREDIT AGREEMENT	LAY-BY AGREEMENT
Items supplied under the agreement:	Any property *(Both movable and immovable in nature).*	General household goods *(Movable in nature).*
Repayment term:	In general, the repayment term exceeds 12 months.	In general, the repayment term does not exceed 12 months and typically ranges between 3 and 6 months.
Other costs associated with the agreement:	Usually subject to interest and value-added tax.	Interest-free, but possibly subject to value-added tax.

Section 24

In terms of the general definition of "gross income" (as defined in section 1(1) of the Act) an amount becomes taxable and needs to be included in a taxpayer's gross income upon the earlier of it being received by, or when it accrues to, such taxpayer. In addition, accrual only takes place when a taxpayer becomes unconditionally entitled to an amount (principle established in *Mooi v Secretary for Inland Revenue*, [1972]). In *ITC 1900*, [2017], it was held that the entitlement to payment will only vest in a taxpayer as soon as an agreement becomes enforceable at the request of either of the parties involved. In terms of a standard credit sales agreement, ownership of property (either movable or immovable in nature) will only transfer to the buyer upon or after the receipt by the supplier of the full amount payable under such an agreement.

However, the provisions of section 24 override this gross income timing rule on the taxability of an amount and deem the amounts not yet received in terms of a standard credit agreement (excluding the accrual of interest in terms of section 24J(2) of the Act) to have accrued to such taxpayer in full on the day on which the agreement was entered into. This deemed accrual provision only applies in instances where the entire deemed accrued amount has not been received in full at the close of the supplying taxpayer's accounting period.

A mismatch could occur between the terms and conditions determining the timing at which the ownership of the item being sold on credit will pass on to the buyer, as opposed to the legislative requirements regulating the timing that the amount(s) receivable in terms of the sale becomes taxable. Such a mismatch could place the supplying taxpayer in terms of a credit agreement in an unfavourable income tax position since the deemed section 24(1) accrual of the entire sales consideration could occur prior to the actual receipt of the full amount of the cash. Hence, income tax relief, to the supplying taxpayer, is provided for by means of an allowance allowed to be deducted in terms of section 24(2) to prevent the undue deferral of income earned in terms of a credit agreement as it matches (to a limited extent) the recognition of the deemed accrual of income with the actual receipt of cash.

Cognisance should be taken of the fact that this income tax relief provided by section 24(2) is only temporary in nature, as the supplying taxpayer's income tax position is again restored in the immediate subsequent year of assessment where the prior year of assessment's section 24(2) allowance that was granted to the supplying taxpayer needs to be added back to such supplier's income in terms of the proviso to section 24(2).

THE EFFECT OF THE 2022 AMENDMENTS MADE TO SECTION 24

Although a lay-by agreement's full consideration has always fallen within the scope of the deemed accrual provision contained under section 24(1), a lay-by agreement never qualified for the income tax relief provided for in terms of the deemed allowance under section 24(2). The reason for the latter is because section 24(2) only allows a deemed allowance to be netted off against the deemed accrual under section 24(1), if at least 25 per cent of the sales consideration becomes due and payable on or after the expiry of a period of not less than 12 months after the date on which the credit agreement was entered into. This mismatch in the application of the deemed accrual triggered for lay-by agreements in terms of section 24(1), without qualifying for the deemed allowance under section 24(2), necessitated amendments to be made to the provisions of section 24. Consequently, section 24(2A) and section 24(2B) were inserted in section 24.

In terms of Interpretation Note 48 (Issue 3) the section 24 allowance applicable to standard credit agreements could be determined based on the application of one of the following methods: (i) individual debtor-by-debtor basis; (ii) aged-debtors basis; (iii) moving-weighted-average method; or the (iv) current year's gross profit percentage method. However, it is important to note that these methods to determine the section 24 allowance do not apply to lay-by agreements. For lay-by agreements, section 24(2A) determines that the section 24 allowance that might be granted will constitute all amounts which are deemed to have accrued to the supplier under the lay-by agreement, but which have not yet been received by the supplier at the end of such taxpayer's year of assessment.

Simplified example illustrating the temporary income tax relief provided for lay-by agreements:

Scenario:

XYZ Clothing (Pty) Ltd ("XYZ") (with a February financial year-end) sold a school uniform in terms of a lay-by agreement to a local customer at R1 200 on 2 January 2023. The terms and conditions of the lay-by agreement stipulated that the amount will be repayable in three equal and interest-free instalments, which are due and payable at the end of each month, starting on 31 January 2023. In addition, XYZ will keep the school uniform until the customer has paid for it in full, after which ownership of (and access to) the school uniform will transfer to the customer.

Since the ownership of the school uniform supplied has not yet passed from XYZ to the customer on 28 February 2023 and the money paid is considered a deposit that remains the property of the consumer until the goods are received in good order, XYZ is not unconditionally entitled to the full sales consideration of R1 200 during its 2023 year of assessment. This is because XYZ is still subject to the condition that it must make the final supply of the school uniform on 31 March 2023, after the sales consideration has been received in full. However, even though no actual receipt or accrual of the full purchase consideration of R1 200 has taken place by 28 February 2023 (ie, the end of XYZ's 2023 year of assessment) in terms of the "gross income" definition, section 24(1) deems the entire amount of R1 200 to have accrued to XYZ on 2 January 2023, namely the day on which the agreement was entered into between XYZ and its customer.

"In addition, it is important for suppliers to take note of the fact that their section 24(2A) allowances are allowed to be used in either creating an assessed loss, or to increase a balance of assessed loss position during any specific year of assessment."

XYZ will now also qualify for a section 24 allowance amounting to R400 during its 2023 year of assessment in terms of section 24(2A). This R400 allowance constitutes an amount which is equal to the final instalment (ie, R1 200 ÷ 3 = R400) still to be paid by the customer to XYZ on 31 March 2023. Hence, the allowance amount of R400 formed part of the R1 200 that was deemed to have accrued to XYZ in terms of section 24(1), but which was not yet received by XYZ on 28 February 2023 (ie, the end of XYZ's 2023 year of assessment). This means that the net effect of section 24 on XYZ's 2023 taxable income results in a taxable amount of R800 (ie, the amount it has received).

Furthermore, in terms of section 24(2B), XYZ will be required to add its section 24(2A) allowance of R400 (which was claimed as an allowance during its 2023 year of assessment) to its income in its 2024 year of assessment (ie, during its immediately following year of assessment). It is therefore evident that the income tax relief provided by section 24 on lay-by agreements is only temporary in nature.

CONCLUSION

In essence, the effect of section 24 on the taxable income of the supplying taxpayer under a lay-by agreement is twofold. Firstly, in terms of section 24(1), the full lay-by agreement sales consideration is deemed to have accrued to the supplying taxpayer on the day on which the lay-by agreement is entered into. Secondly, an allowance in terms of section 24(2A) is allowed to be deducted from the supplying taxpayers' income in respect of all amounts which have been deemed to have accrued under such lay-by agreement, but which have not been received by the end of such taxpayer's year of assessment.

As the upfront inclusion of lay-by agreement proceeds into gross income under section 24(1) without a qualifying matching income tax relief measure by way of a section 24(2) allowance had an adverse tax effect for supplying taxpayers under lay-by agreements, it is paramount for these suppliers to take note of the newly introduced section 24(2A) allowance. This new provision is specifically aimed at providing temporary income tax relief when entering into a lay-by agreement. In addition, it is important for suppliers to take note of the fact that their section 24(2A) allowances are allowed to be used in either creating an assessed loss, or to increase a balance of assessed loss position during any specific year of assessment.

Prof Herman Viviers

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1 (definition of "gross income"), 24 (with emphasis on section 24(2A) & (2B)) & 24J(2);
- Consumer Protection Act 68 of 2008: Section 62.

Other documents

- Interpretation Note 48 (Issue 3) *(Instalment credit agreements and debtors' allowance).*

Cases

- *Mooi v Secretary for Inland Revenue* [1972] (1) SA 674 (A));
- *ITC 1900* [2017] 79 SATC 341.

Tags: lay-by agreements; standard credit agreement; income tax relief measure.

SARS UPDATED INTEREST RATES

TAX, VAT, FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX

It is important to remember that interest and penalties paid to SARS are not deductible expenses for income tax purposes. On the other hand, interest received from SARS is fully taxable (after deducting the current initial exemption of R23 800 per annum (R34 500 if you are 65 or older) for all local interest income earned by natural persons).

- **INCOME TAX, PROVISIONAL TAX, DIVIDENDS TAX, ETC**

Payable to SARS on short payments of all such taxes (other than VAT): 10.5% per annum from 1 March 2023 (was 9.75% per annum with effect from 1 January 2023).

Payable by SARS on refunds of tax (where interest is applicable): 6.5% per annum from 1 March 2023 (was 5.75% per annum with effect from 1 January 2023).

If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 10.5% per annum from 1 March 2023 (was 9.75% per annum with effect from 1 January 2023).

- **VAT**

Payable to SARS on late payments: 10.5% per annum from 1 March 2023 (was 9.75% per annum with effect from 1 January 2023).

Payable by SARS on VAT refunds after prescribed period: 10.5% per annum from 1 March 2023 (was 9.75% per annum with effect from 1 January 2023).

- **FRINGE BENEFITS**

Official interest rate for loans to employees below which a deemed fringe benefit arises: 8.25% per annum with effect from 1 February 2023. See below for details of historical changes.

- **DIVIDENDS TAX**

Official interest rate for loans (designated in rands) to shareholders below which the interest on such loans can be deemed to be dividends on which dividends tax is payable: 8.25% per annum with effect from 1 February 2023. See below for details of historical changes.

- **DONATIONS TAX**

  Loans to trusts by connected natural persons with interest charged at rates below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

- **PENALTIES**

  The amount of penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX – INTEREST RATES

- If inadequate interest is charged to an employee (including working directors) on loans (other than for the purpose of furthering their own studies) in excess of R3 000 from their employer (or associated institution), tax on the fringe benefit may be payable.

  Unless interest is charged at the "official" rate or greater, the employee is deemed to have received a taxable fringe benefit calculated as being the difference between the interest actually charged and interest calculated at the "official" rate.

  For employees' tax purposes, the tax deduction must be made whenever interest is payable; if not regularly, then on a monthly basis for monthly paid employees, weekly for weekly paid employees, etc.

"It is not the amount of the loan but the interest reduction which is deemed to be a dividend."

- Subject to a number of exceptions, distributions of income and capital gains from a company / close corporation are normally subject to dividends tax at the flat rate of 20%. Loans or advances to or for the benefit of a shareholder / member will be deemed to be dividends but only to the extent that interest at less than the "official" rate (or market-related rate in the case of foreign currency loans) is payable on the loan, or fringe benefits tax is payable on an interest-free (or subsidised-interest) loan to an employee.

  It is not the amount of the loan but the interest reduction which is deemed to be a dividend. Low-interest loans are accordingly subject to dividends tax payable by the company and only in respect of the interest benefit.

- Loans to trusts by natural connected persons with interest charged below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

- With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African "repo rate" plus 1%. For foreign-currency loans, the rate is the equivalent of the foreign "repo rate" plus 1%. The South African repo rate currently stands at 7.25% per annum (with effect from 1 February 2023).

THE "OFFICIAL" RATE OF INTEREST OVER THE PAST FIVE YEARS

With effect from		*Rate per annum*
1 April 2018	–	7.50%
1 December 2018	–	7.75%
1 August 2019	–	7.50%
1 February 2020	–	7.25%
1 April 2020	–	6.25%
1 May 2020	–	5.25%
1 June 2020	–	4.75%
1 August 2020	–	4.50%
1 December 2021	–	4.75%
1 February 2022	–	5.00%
1 April 2022	–	5.25%
1 June 2022	–	5.75%
1 August 2022	–	6.50%
1 October 2022	–	7.25%
1 December 2022	–	8.00%
1 February 2023	–	8.25%

Kent Karro

Tags: deductible expenses; natural connected persons; donations tax; taxable fringe benefit; low-interest loans; repo rate.

THE EFFECT OF PAST TRANSACTIONS ON THE SALE OF A BUSINESS

The sale of a business is often a complex venture and requires consideration of various facts in examining the financial reality behind the sale.

From the outset, it is important to consider historical transactions and how they may have a detrimental impact on the current sale being considered.

For purposes of this article, several factors are highlighted to consider in pursuance of the sale of a business. These factors, amongst others, include:

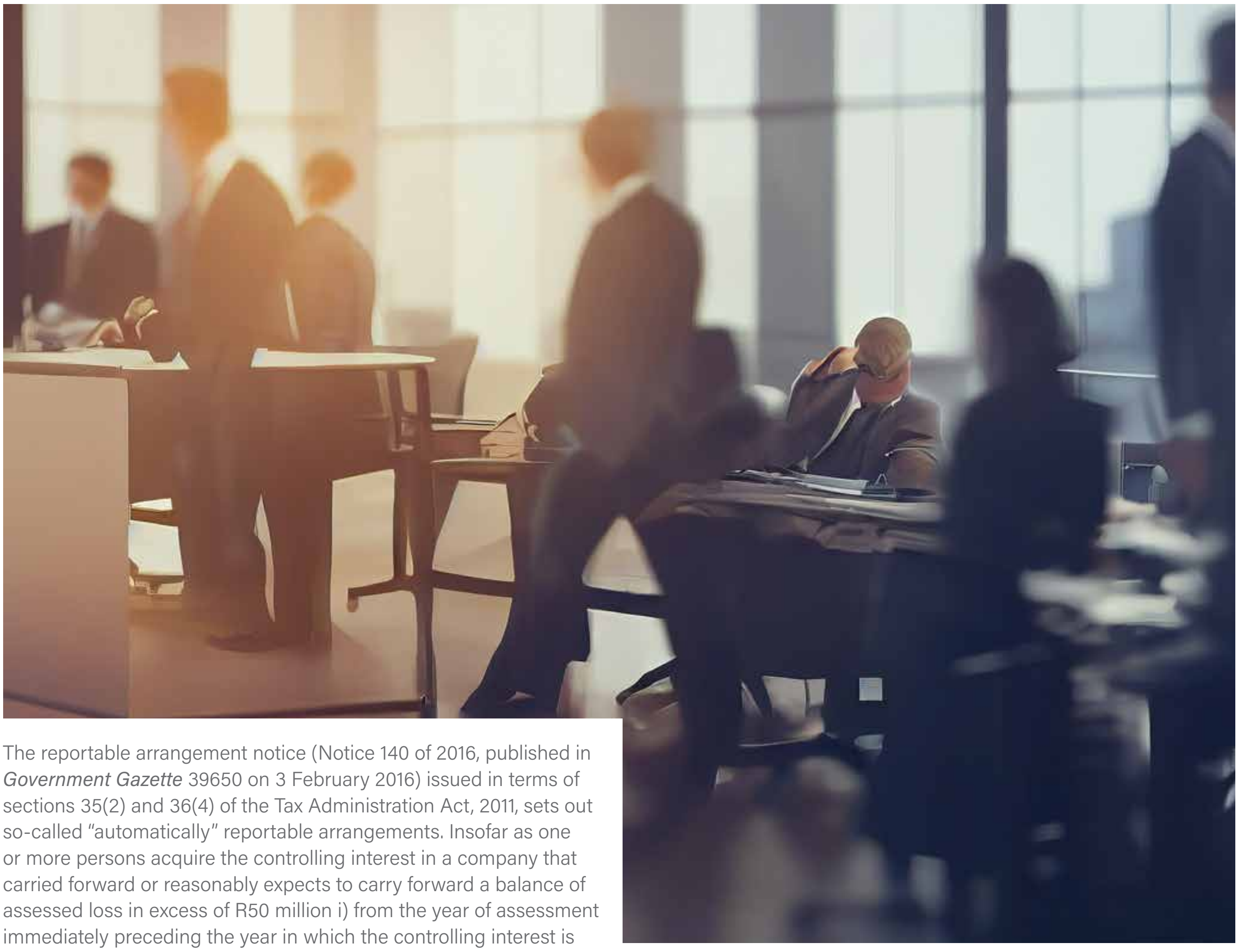
- **Clawback provisions of the corporate restructuring rules:** These rules, as contained in sections 41 to 47 of the Income Tax Act, 1962 (the Act), potentially provide corporate roll-over relief for assets transferred between companies forming part of the same group. It is important to be mindful of the impact of these rules.

Most of these rules impose a restriction on the use of losses on the transfer of assets for 18 months of the acquisition thereof. If this "clawback" applies, the assets sold must be included in the income of that party if any amount received by or accrued to that party in respect of the disposal of that asset is less than or equal to the market value of that asset at the beginning of the 18 months.

- **Dividend stripping:** This is generally done by extracting value from a business prior to a sale by means of an exempt dividend. Dividend-stripping rules were inserted to curb the use of dividend-stripping structures to artificially reduce capital gains tax consequences. Dividend stripping generally occurs when a resident shareholder company that is a prospective seller of shares in a target company avoids income tax, including capital gains tax by ensuring that the company being sold declares a significant (tax-exempt) dividend to the resident shareholder company before it sells the shares in the target company to the prospective purchaser.

The sale can then be effected at a lower amount by avoiding higher taxes, including capital gains tax. It is, in this regard, important for taxpayers to be aware of the implications of section 22B and of paragraph 43A of the Eighth Schedule to the Act. Despite their similar wording, the former applies to shares held as trading stock, and the latter applies to shares held as capital assets.

- **Reportable arrangements:** As contemplated in Part B of Chapter 4 of the Tax Administration Act, 2011, an "arrangement" falling within the criteria set out in section 35(1), or one specifically outlined in the public notice issued by the Commissioner of SARS in terms of section 35(2), will be reportable to SARS within 45 business days of any amount first being received by or accruing to, or first being paid by or incurred by, any participant in the said arrangement unless the arrangement is specifically excluded in terms of section 36 of the same legislation, or by the Commissioner for SARS in a public notice issued in terms of section 36(4). The term "arrangement" includes any transaction, scheme, operation or understanding.



The reportable arrangement notice (Notice 140 of 2016, published in *Government Gazette* 39650 on 3 February 2016) issued in terms of sections 35(2) and 36(4) of the Tax Administration Act, 2011, sets out so-called "automatically" reportable arrangements. Insofar as one or more persons acquire the controlling interest in a company that carried forward or reasonably expects to carry forward a balance of assessed loss in excess of R50 million i) from the year of assessment immediately preceding the year in which the controlling interest is acquired, or ii) in the year of assessment in which the controlling interest is acquired, or directly or indirectly holds a controlling interest in a company referred to in (i) and (ii), such arrangement will be reportable.

Even though these factors do not represent a closed list, taxpayers should avail themselves of the potential detrimental impact of these past transactions on the prospective sale of their businesses and their underlying assets.

"Dividend stripping generally occurs when a resident shareholder company that is a prospective seller of shares in a target company avoids income tax, including capital gains tax by ensuring that the company being sold declares a significant (tax-exempt) dividend to the resident shareholder company before it sells the shares in the target company to the prospective purchaser."

T Roos

Acts and Bills

- Income Tax Act 58 of 1962: Sections 22B and 41 to 47; Eighth Schedule: paragraph 43A;
- Tax Administration Act 28 of 2011: Part B of Chapter 4 – sections 34 to 39 (more specifically sections 34(1) (definitions of "arrangement" and "reportable arrangement"), 35(1) & (2), 36 & 36(4)).

Other documents

- Notice 140 of 2016 (published in *Government Gazette* 39650 on 3 February 2016) issued in terms of sections 35(2) and 36(4) of the Tax Administration Act and listing reportable arrangements;
- *Government Gazette* 39650 of 3 February 2016.

Tags: dividend-stripping rules; reportable arrangements.

UNEVEN BARTER TRANSACTIONS

Case law gives guidance on the correct values to be used for tax purposes in the event that assets are exchanged for more or less than the market price.

Some 3 000 years ago people traded goods and services through barter or exchange. This method was later largely replaced by a medium of exchange such as salt, shells or animal hides and later by money in the form of notes and coins. The Chinese invented paper money around 770BC and the first coins were manufactured on an industrial scale in Europe in 600BC. In the 21st century we also have crypto assets as a medium of exchange. However, barter or exchange transactions continue to this day and are a normal part of commercial life. Occasionally, they can produce some strange results when determining capital gains and losses.

References in this article to paragraphs are to paragraphs of the Eighth Schedule to the Income Tax Act, 1962, and to sections are to sections of that Act.

PROCEEDS UNDER A BARTER OR EXCHANGE TRANSACTION

The proceeds from the disposal of an asset are determined under paragraph 35 and are equal to the "amount" received or accrued on its disposal. In *WH Lategan v Commissioner for Inland Revenue* [1926] CPD 203, 2 SATC 16 (at 19), Watermeyer J stated the following on the meaning of "amount":

> "In his Lordship's opinion, the word 'amount' had to be given a wider meaning, and must include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal which had a money value."

In *Commissioner for Inland Revenue v Butcher Brothers (Pty) Ltd,* [1945] AD 301, 13 SATC 21 (at 34) the court held that the word "amount" should be taken to mean an amount having an ascertainable money value, as opposed to mere conjectural value. In *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* [2007] (6) SA 601 (SCA), 69 SATC 205 (at 214), the court stated that whether an amount can be turned into money is merely one of the ways to determine whether it has a money value and that "it did not follow that if a receipt or accrual could not be turned into money, it had no money value.

. . .

The test was objective, not subjective".

EXPENDITURE IN A BARTER OR EXCHANGE TRANSACTION

On the meaning of "expenditure" Harms AP stated the following in *Commissioner, South African Revenue Service v Labat Africa Ltd:* [2013] (2) SA 33 (SCA), 74 SATC 1 (at 6):

> "The term 'expenditure' is not defined in the Act and since it is an ordinary English word, this meaning must be attributed to it unless context indicates otherwise. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended."

ARM'S LENGTH BARTER OR EXCHANGE TRANSACTIONS

In *South Atlantic Jazz Festival (Pty) Ltd v Commissioner, South African Revenue Service,* [2015], the taxpayer staged annual international jazz festivals. In the course of that enterprise, it concluded sponsorship agreements with various suppliers under which the sponsors provided money and goods and services for the festivals, in return for which the taxpayer provided goods and services to the sponsors in the form of branding and marketing. Binns-Ward J noted that the transactions under the sponsorship agreements were essentially barter transactions, despite their part-cash components. The judge stated the following:

> "In consequence, and accepting, as one may, that the transactions were at arm's length, the value of the goods and services provided by the appellant to the sponsors in each case falls to be taken as the same as that of the counter performance by the relevant sponsor.
>
> ...
>
> In an ordinary arm's length barter transaction the value that the parties to it have attributed to the goods or supplies that are exchanged seems to me, in the absence of any contrary indication, to be a reliable indicator of their market value."

PRINCIPLES

From these cases, we can deduce the following principles when X exchanges asset A with Y for asset B:

- X will have proceeds equal to the market value of asset B.
- The base cost of asset B for X is equal to the market value of asset A immediately before the exchange, which represents the amount by which X has been impoverished.
- In an arm's length transaction, asset A's market value should be equal to that of asset B.

"The principle of barter or exchange plays a critical role in determining the base cost and proceeds on disposal of assets. The illogical results that flow from uneven barter transactions can be resolved if the interpretation suggested in this article is followed."

UNEVEN TRANSACTIONS AS A RESULT OF PARAGRAPH 31

The term "market value" is defined in paragraph 1 and means market value contemplated in paragraph 31. Paragraph 31(1)*(a)* provides that the market value of a financial instrument listed on a recognised exchange for which a price was quoted on that exchange is the ruling price for that financial instrument on that recognised exchange at close of business on the last business day before the specified date.

> "The term 'expenditure' is not defined in the Act and since it is an ordinary English word, this meaning must be attributed to it unless context indicates otherwise. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent."

Sometimes, it can happen that when listed shares are exchanged, their respective "market values" as prescribed in paragraph 31(1)*(a)* will result in unequal value being exchanged.

Divergent prices may arise because the buyer wishes to incentivise the seller to part with listed shares so that the buyer can obtain a controlling interest. Alternatively, the prices may have been the same when the transaction was announced but by record date they have moved apart. In other situations, the sale may be subject to a suspensive condition, with the quantity of shares to be exchanged fixed under the agreement when the values were equal, but by the time the condition is satisfied, the prices have diverged. The following example illustrates the problem:

Example – Uneven market values

Facts:

The shares of Company A and Company B are listed on a recognised exchange, with their prices determined under paragraph 31(1)*(a)*.

Jack owns shares in Company A with a base cost and market value of ZAR 100. Jill owns shares in Company B with a base cost and market value of ZAR 110. Jill offers Jack one Company B share in exchange for his Company A share as she needs it to acquire a controlling interest. Jack accepts the offer.

Result:

Jack's proceeds are equal to the market value of the Company B share giving him a capital gain of ZAR 10 (ZAR 110 – ZAR 100), while Jill's proceeds are ZAR 100, giving her a capital loss of ZAR 10 (ZAR 100 – ZAR 110). Jack's base cost for the Company B share is ZAR 100 (equal to the amount by which he was impoverished in giving up the Company A share), while Jill's base cost for the Company A share is ZAR 110, equal to the market value of the Company B share she exchanged. Should they immediately sell their shares, Jack will make a gain of ZAR 10 while Jill will make a loss of ZAR 10. As can be seen, uneven market values lead to the duplication of gains and losses.

A POSSIBLE SOLUTION?

As noted above, the term "market value" is defined in paragraph 1 with reference to the values in paragraph 31. However, the opening words of paragraph 1 state that the definitions apply "unless the context otherwise indicates".

In *Canca v Mount Frere Municipality* [1984] (2) SA 830 (TkS) (at 832) Davies J stated the following:

> "The principle which emerges is that the statutory definition should prevail unless it appears that the Legislature intended otherwise and, in deciding whether the Legislature so intended, the Court has generally asked itself whether the application of the statutory definition would result in such injustice or incongruity or absurdity as to lead to the conclusion that the Legislature could never have intended the statutory definition to apply."

This principle was applied in the context of the equivalent of section 7(2) in *Commissioner for Inland Revenue v Simpson,* [1949], in which Watermeyer CJ held that the term "income" must be construed as meaning "profits and gains" and not income in the sense of "gross income less exempt income" as defined. This interpretation is still followed today, for example, when attributing "income" to a donor from a trust under section 7(5). If this were not done, gross income would be attributed to the donor and the related expenses would be left behind in the trust.

Logically, Jack's Company A shares were worth more than their listed price because they were capable of realising value of ZAR 110 (see the passage cited from the *Jazz Festival* case, in which it was stated that in an arm's length transaction one would expect the value of the counter-performance to be equal to the value of the goods provided). It is therefore submitted that the actual value Jack received of ZAR 110 should be used to determine the market value of the Company A shares, not their listed price. Since Jack was impoverished by ZAR 110, this will represent the base cost of the Company B shares he acquired. Similar reasoning can be applied to Jill's Company B shares, which were capable of realising only ZAR 100, and this should be taken as their market value in the circumstances. If this approach is followed, the problem of double gains and losses is eliminated.

TRANSACTIONS BETWEEN CONNECTED PERSONS

Paragraph 38 provides that when an asset is disposed of between connected persons at a non-arm's length price, it must be treated as being disposed of at its market value. In other words, the proceeds would not be equal to the market value of the asset received in exchange but rather the market value of the asset disposed of. Paragraph 38 also applies when the consideration is not measurable in money, such as when a company makes a contribution to an employee share trust and the consideration takes the form of a motivated and contented workforce. Again, the proceeds are equal to the market value of the asset being disposed of.

In *GB Mining and Exploration SA (Pty) Ltd v Commissioner, South African Revenue Service,* [2015], the appellant disposed of an interest in one joint venture in exchange for another. The court confirmed that this exchange was a disposal. Strangely, the SCA held that the proceeds were not measurable in money, and hence were equal to the market value of the interest disposed of. Why it was possible to value the *interest disposed of* but not the *interest acquired* was not explained.

CONCLUSION

The principle of barter or exchange plays a critical role in determining the base cost and proceeds on disposal of assets. The illogical results that flow from uneven barter transactions can be resolved if the interpretation suggested in this article is followed. Taxpayers would welcome guidance from SARS in this regard.

(This article was first published in ASA April 2022)

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Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Section 7(2) & (5); Eighth Schedule: Paragraphs 1 (definition of "market value"), 31 (emphasis on subsection (1)*(a)*), 35 & 38.

Cases

- *WH Lategan v Commissioner for Inland Revenue* [1926] CPD 203, 2 SATC 16 (at 19);
- *Commissioner for Inland Revenue v Butcher Brothers (Pty) Ltd* [1945] AD 301, 13 SATC 21 (at 34);
- *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* [2007] (6) SA 601 (SCA), 69 SATC 205 (at 214);
- *Commissioner, South African Revenue Service v Labat Africa Ltd* [2013] (2) SA 33 (SCA), 74 SATC 1 (at 6);
- *South Atlantic Jazz Festival (Pty) Ltd v Commissioner, South African Revenue Service* [2015] (6) SA 78 (WCC), ZAWCHC 8, 77 SATC 254;
- *Canca v Mount Frere Municipality* [1984] (2) SA 830 (TkS) (at 832);
- *Commissioner for Inland Revenue v Simpson* [1949] (4) SA 678 (A), 16 SATC 268;
- *GB Mining and Exploration SA (Pty) Ltd v Commissioner, South African Revenue Service* [2015] (4) SA 605 (SCA), 76 SATC 347.

Tags: sponsorship agreements; market value

NEW GROUNDS OF APPEAL

In the case of Nesongozwi v Commissioner for SARS *(838/2021) [2022] ZASCA 138 the importance of a taxpayer sticking to their original grounds of objection on the road to the tax court (and beyond) is demonstrated.*

In a decision handed down on 29 November 2022 *(IT45710)*, the tax court reiterated the importance of this principle, but not without discussing the exception to it.

FACTS

The taxpayer in *IT45710* declared gross income of R320 846 361 for its 2018 tax year and claimed a deduction of R11 072 237 from this amount. When the South African Revenue Service (SARS) audited the taxpayer for this year of assessment, it disallowed the R11 072 237 deduction and issued an additional assessment. This additional assessment was only in terms of this deduction and did not adjust the taxpayer's gross income at all.

The taxpayer disputed SARS' additional assessment on the grounds that SARS had erred in disallowing the R11 072 237 deduction, and that this should therefore be deducted from its gross income in determining its taxable income. SARS disallowed this objection and the taxpayer appealed to the tax court.

The taxpayer's notice of appeal indicated that it was lodged against SARS' disallowance of the R11 072 237 deduction, and on no other ground. However, following SARS filing its Rule 31 statement of grounds of assessment, in response to the taxpayer's notice of appeal, the taxpayer sought to rely on a new ground of appeal in its Rule 32 statement of grounds of appeal, namely that the R11 072 237 it had claimed as a deduction should not have been included in its gross income in the first place. This new ground was raised by the taxpayer in the alternative to its initial ground of appeal and included in its objection, being against SARS' disallowance of the R11 072 237 deduction. The amount in question related to a profit distribution to a related party referred to in the taxpayer's financials as a partnership. The alternative ground of appeal was that the amount did not form part of the taxpayer's gross income, as it did not accrue to and was not received by the taxpayer.

"The taxpayer's notice of appeal indicated that it was lodged against SARS' disallowance of the R11 072 237 deduction, and on no other ground."

SARS challenged the taxpayer's ability to raise this new ground of appeal under Rule 32(3) of the rules promulgated under section 103 of the Tax Administration Act, 2011 (the Rules). The taxpayer, on the other hand, argued that it was permitted to do so under Rule 32(3) and Rule 33(2).

RULE 32(3) AND RULE 33(2)

Rule 32(3) of the Rules provides for the taxpayer to file a statement of its grounds of appeal, and states:

> "The appellant may not include in the statement a ground of appeal that constitutes a new ground of objection against a part or amount of the disputed assessment not objected to under Rule 7."

Rule 33(2) then provides for SARS to file a statement in reply to the taxpayer's statement of grounds of appeal, and states:

> "The reply to the statement of grounds of appeal must set out a clear and concise reply to any new grounds, material facts or applicable law set out in the statement."

The taxpayer argued that Rule 32(3) only prohibited it from raising a new ground of appeal if this new ground was against a part or amount of the disputed assessment against which it had not already objected. As the R11 072 237 was already in dispute, the taxpayer argued that it was permitted to raise the new ground of appeal. Further, the taxpayer argued that Rule 33(2) contemplated new grounds of appeal being raised by a taxpayer, and this rule permitted SARS to reply to these new grounds of appeal.

SARS on the other hand raised three arguments:

1. That the R11 072 237 deduction was in dispute and not the taxpayer's R320 846 361 gross income, and the taxpayer's new ground of appeal concerned its gross income.

2. That the taxpayer's initial ground of objection only disputed SARS' disallowance of the R11 072 237 in the additional assessment, and did not dispute the entire additional assessment.

3. That the taxpayer's two grounds of appeal would not render the same result if successful as the original ground would result in an alteration to the taxpayer's allowable deductions, while the new ground would result in an alteration of the taxpayer's gross income.

The court in *IT45710* therefore had to assess:

- whether Rules 32(3) and 33(2) of the Rules permitted the taxpayer to rely on a new ground of appeal against a part of the additional assessment that was already in dispute; and, if so

- whether in fact the taxpayer's gross income was already in dispute.

DECISION

In coming to its decision, the tax court examined the legal development of the Rules and their application in various past cases. Notably, the court focused on the case of *ITC 1912* [2017] 80 SATC 417 .

In *ITC 1912* the taxpayer had also relied on a new ground of appeal, arguing this to be permitted by Rule 32(3) of the Rules as it concerned a part of the assessment already in dispute. Here the court found that the taxpayer had merely adopted a different approach to the same issue that was before it, and therefore the new ground of appeal was permitted.

However, in the present case of *IT45710* the court was not convinced that the taxpayer's new ground of appeal was comparable to the taxpayer in *ITC 1912*. Looking at the case of *Matla Coal Ltd v Commissioner for Inland Revenue* [1987] (1) SA 108 (A), the court found that the taxpayer had to show that the substance of its two grounds of objection were the same.

As the taxpayer's new ground of appeal was against a different amount (its gross income) which was never in dispute, the court found that the substance of the new ground differed from the substance of the taxpayer's original ground. Therefore, the court found that an objection to a disallowance of a deduction is not equivalent to an objection against gross income. As such, the court decided that the taxpayer's new ground was not a repackaging of its original ground of objection, and therefore did not fall within the ambit of Rule 32(3) of the Rules.

FOOD FOR THOUGHT

The court's reiteration of the principles from *ITC 1912* and *Matla Coal* does leave a taxpayer with food for thought while on the road to the tax court. Furthermore, the case under discussion *(IT45710)* would have been heard prior to the *Nesongozwi* judgment being handed down by the Supreme Court of Appeal (SCA) on 24 October 2022. The judgment in *IT45710* was handed down on 29 November 2022. An interesting question to consider is whether the tax court would have reached a different decision, had it considered and applied the approach adopted in *Nesongozwi*, where the SCA found that some of the grounds raised for the first time in the High Court appeal (after the tax court hearing) could be raised, in accordance with the *Matla Coal* principle. As indicated in *Matla Coal* and applied in *Nesongozwi*, although as a rule a taxpayer is not permitted to raise new grounds of objection on appeal, the exception to this is where a new ground is so close to the original ground of objection that these grounds are the same in substance. Provided a taxpayer remains within these lines, this can be a valuable tool where a ground was not originally raised in an objection. However, what *IT45710* and *Nesongozwi* appear to illustrate, is that the application of the principle in *Matla Coa*l will depend on the facts and that the nature of the amount to which the new ground of appeal relates (gross income or deduction in the current instance) must be considered.

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Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 1962: Section 103.

Other documents

- Rule 31 statement of grounds of assessment;
- Rule 32 statement of grounds of appeal;
- Rules for dispute resolution (issued in terms of section 103 of the Tax Administration Act): Rules 31, 32(2) & (3) & 33(2).

Cases

- *Taxpayer A v Commissioner for the South African Revenue Service* [2022].
- *Nesongozwi v Commissioner for SARS* (838/2021) [2022] ZASCA 138;
- *Taxpayer B v Commissioner for the South African Revenue Service* (IT45710) [2022] ZATC 10 (29 November 2022);
- *Matla Coal Ltd v Commissioner for Inland Revenue* [1987] (1) SA 108 (A);
- *ITC 1912*, [2017] 80 SATC 417.

Tags: declared gross income; grounds of assessment; notice of appeal.

ASSOCIATED ENTERPRISES

To be [associated] or not to be? That is the question – though not for Hamlet in this instance, but for taxpayers resident in South Africa, as well as foreign companies with a South African presence.

After a couple of years of implementation delays, from 1 January 2023 the South African Revenue Service (SARS) introduced the concept of "associated enterprises" into South African transfer pricing regulations. The current definition of "connected person" remains intact. The introduction of associated enterprises widens the transfer pricing "net". The changes will be effective from years of assessment starting on or after 1 January 2023.

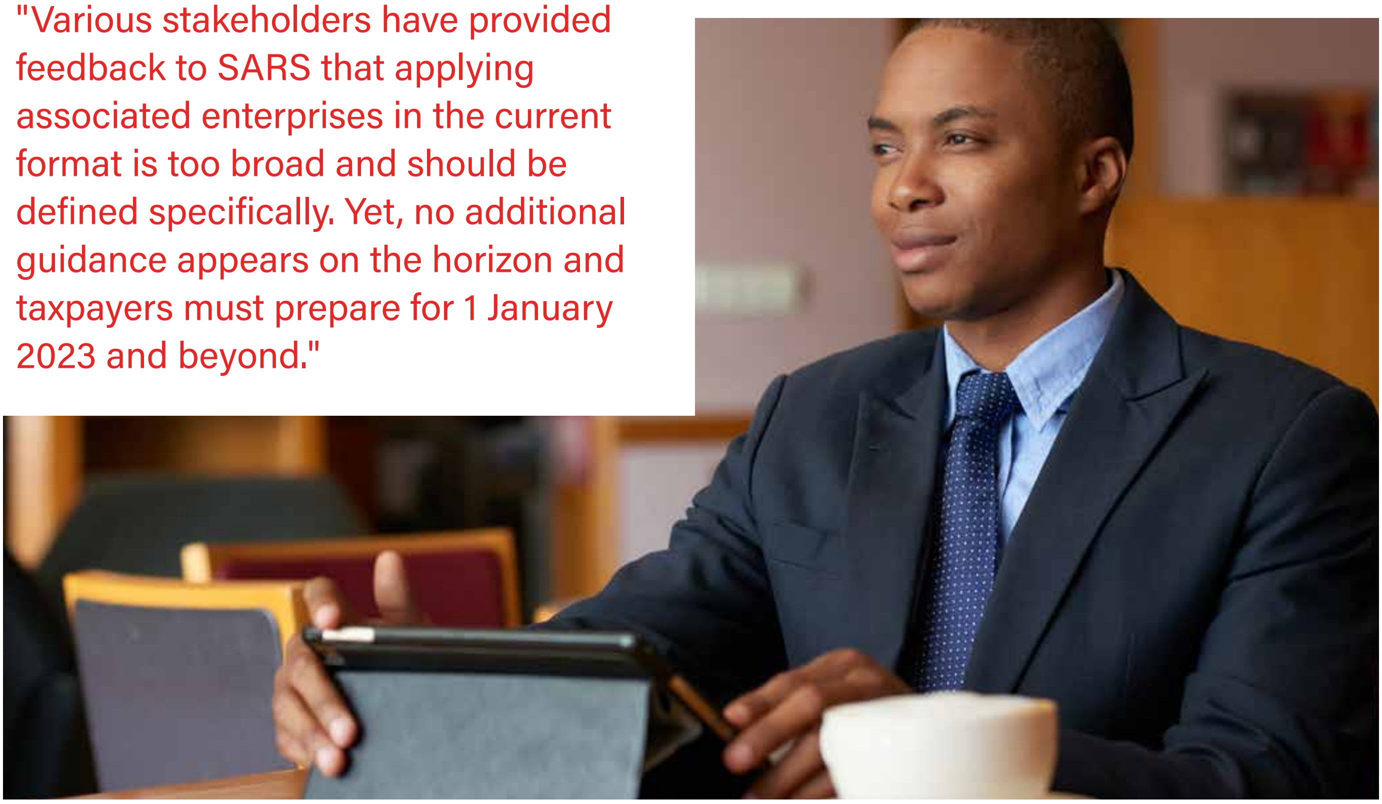
To provide guidance on the definition of associated enterprises, SARS published a draft interpretation note on 14 October 2022 (the IN). The IN acknowledges that the current transfer pricing rules, based solely on the connected party definition, may not always capture arrangements between associated enterprises, where, by virtue of the association, there is significant influence over the determination of transfer prices. To correct for this, and to bring the legislation in line with international standards, the term associated enterprise, as contemplated in Article 9(1) of the OECD Model Tax Convention, has been inserted into section 31(1) of the Income Tax Act, 1962.

Section 31(1) does not define the term itself, but rather refers to Article 9. This very wide definition states that two enterprises are associated enterprises where –

- an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or
- the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Various stakeholders have provided feedback to SARS that applying associated enterprises in the current format is too broad and should be defined specifically. Yet, no additional guidance appears on the horizon and taxpayers must prepare for 1 January 2023 and beyond.

"Various stakeholders have provided feedback to SARS that applying associated enterprises in the current format is too broad and should be defined specifically. Yet, no additional guidance appears on the horizon and taxpayers must prepare for 1 January 2023 and beyond."



Taxpayers must consider whether they fall into this wider South African transfer pricing net. Related-party arrangements in any of the following circumstances may result in additional transfer pricing compliance requirements:

- Between entities with direct or indirect participation in management;
- Between entities where there is direct or indirect control;
- Between entities with direct or indirect participation in capital;
- Between a South African head office and its foreign branch or *vice versa* (ie, the same legal entity);
- Economic dependency exists between parties that would not "normally" exist between independent parties transacting at arm's length;
- To bring it back to Shakespeare, rather than revert into a melancholic soliloquy on a company's existential status in this complex transfer pricing world, it is simply recommended that multinational enterprises with a South African presence review their cross-border arrangements to confirm whether the amended rules apply to such arrangements and entities not previously captured. Relevant transfer pricing compliance requirements (eg, filing of transfer pricing documentation) can then be considered accordingly.

Marcus Stelloh & Patrick Grant McLennan

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 31(1) (definition of "associated enterprise").

Other documents

- OECD Model Tax Convention: Article 9(1);
- Draft interpretation note (*Definition of "associated enterprise"* – published on 22 October 2022);
- Transfer pricing rules.

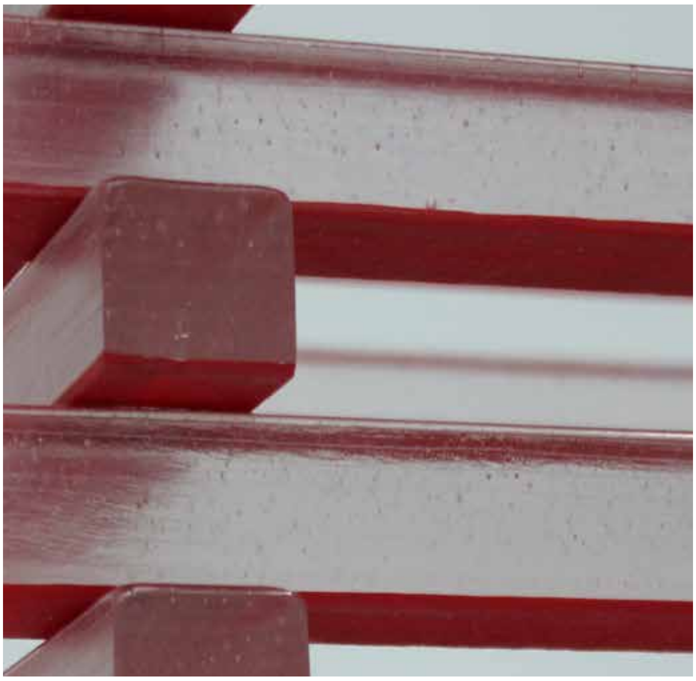
Tags: transfer pricing rules; multinational enterprises.

FOUNDATIONS

The question as to whether to form a foundation offshore instead of a trust is frequently asked, especially for South African beneficiaries. Some of the positives that a foundation has to offer are that it could be seen as a mix between a company and a trust.

However, although it sounds great to achieve the benefits of a company, in terms of, eg, tax-free dividend receipts, and those of a trust, eg, breaking the ownership link, caution is needed.

So, in terms of basics, the Income Tax Act, 1962 (the Act), defines the terms "company" and "trust", but not the term "foundation". Because foundations are not recognised under South African corporate or tax law, applying the tax provisions can only work if they are regarded as either a company or a trust. SARS generally aims to follow the foreign countries' legal and tax treatment of the foundation in South Africa. In essence, if the foreign country views the foundation in a specific way, SARS generally follows suit.



WHAT IF THE FOUNDATION IS TREATED AS A COMPANY?

If the foreign country classifies the foundation as a company (eg, if the foundation is an incorporated entity), SARS would likely treat the foundation as a foreign company for South African purposes as well.

This classification creates quite a conundrum when determining the tax treatment of distributions. Foundations generally have no "shares" and therefore distributions by the foundation cannot fall under the definition of "foreign dividend" in section 1(1) of the Act. An argument could possibly be made that the distribution is a "return of capital" (also defined in section 1(1)), but what happens when all the capital has already been returned?

In addition, should SARS treat the foundation as a company, it could argue that the foundation is a controlled foreign company (CFC) and all income and gains in the foundation should be imputed to the South African beneficiaries and taxed in their hands, unless a particular exemption applies.

Finally, under normal circumstances, the shares in foreign companies would fall into the estate of a deceased South African shareholder. But now there are no shares…..

WHAT IF THE FOUNDATION IS TREATED AS A TRUST?

If the foreign country treats the foundation as a trust, SARS could attempt to mimic this classification. This could create another list of difficulties for the "settlor" and "beneficiaries" of the "trust".

In practice, the founder of the foundation would have a fair amount of control over the decision-making by the council of the foundation. If the foundation is seen to be effectively managed from South Africa by the founder, the foundation will be deemed to be a South African tax resident and will be subject to tax on its worldwide income.

Secondly, if the founder (the settlor) of the foundation is still alive, and the foundation was funded through a donation or low-interest or no-interest loan, all the income and capital gains could be attributable to the founder and taxed in the hands of the founder as and when it arises in the foundation. Furthermore, transfer pricing rules could apply if the interest is not arm's length or a section 7C deemed donation could apply if the interest is below the official rate of interest.

"If the foundation is seen to be effectively managed from South Africa by the founder, the foundation will be deemed to be a South African tax resident and will be subject to tax on its worldwide income."

ANOTHER UNDESIRABLE OUTCOME ...

The burden of proof to show SARS that an amount is not taxable rests on the taxpayer. As a result of all the uncertainty around the treatment of distributions received by South African beneficiaries from foundations, SARS might decide to take the route of taxing receipts from foundations at the maximum tax rate, namely as income of 45%.

The uncertainty and possible administrative risk of proving to SARS that the distributions are not taxable at the sliding scale income tax rates might not be worth using foundations as any kind of structuring tool.

So, in summary, until South Africa has clarified its position on the taxation of foundations, extreme caution needs to be exercised.

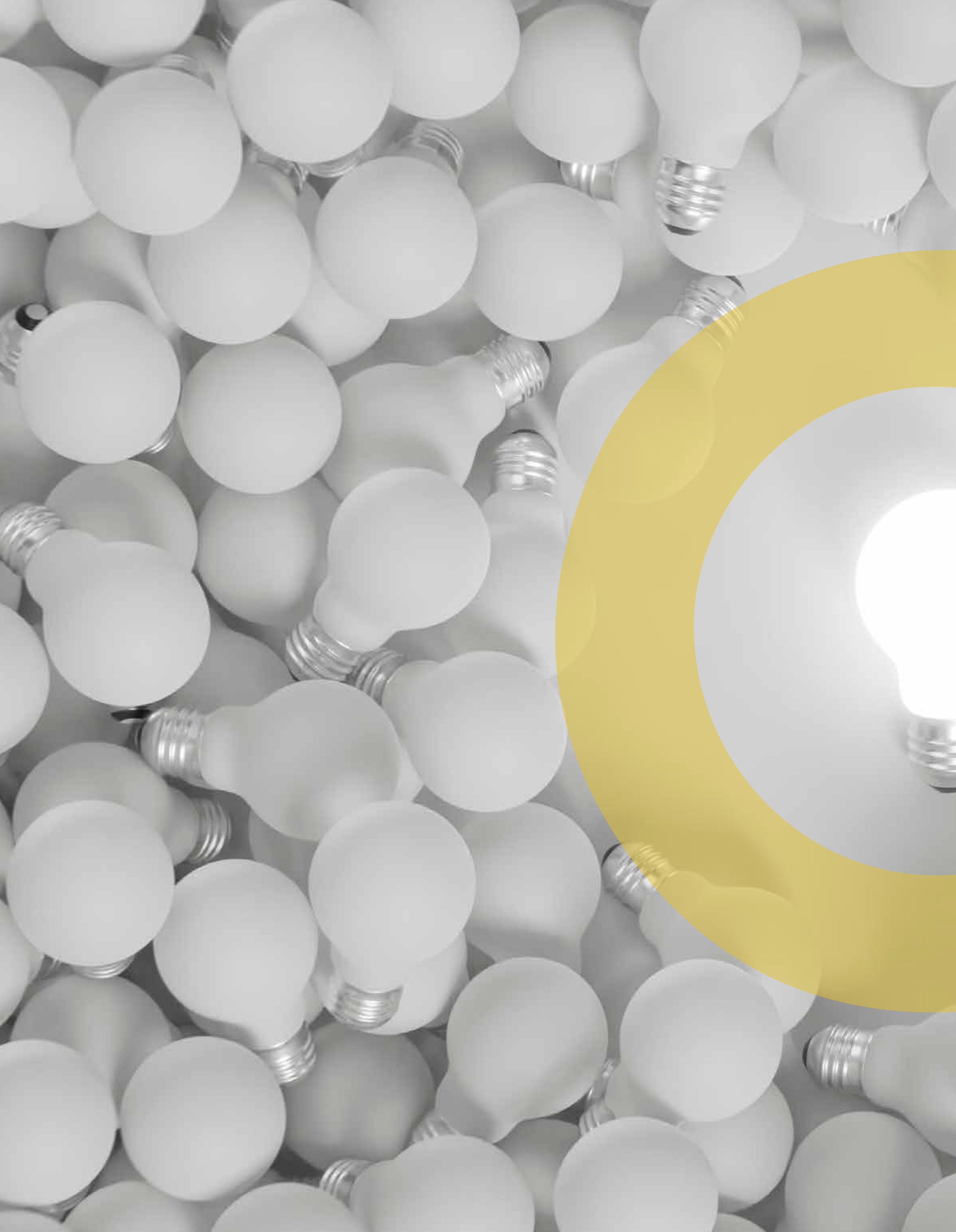
Irma Lategan

Regan van Rooy

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definitions of "company", "controlled foreign company", "foreign dividend", "official rate of interest", "return of capital" & "trust") & 7C.

Tags: return of capital; no-interest loan; section 7C deemed donation; official rate of interest.



South African Institute of Taxation