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LIMITATION ON USE OF ASSESSED LOSSES

Section 20 of the Income Tax Act, 1962, allows, in most circumstances, for taxpayers carrying on a trade to set off assessed losses brought forward from prior years of assessment against taxable income in the current year of assessment. At present, any unutilised portion of the assessed loss may be carried forward to the succeeding year of assessment.

The Taxation Laws Amendment Bill, 2021, which was introduced in the National Assembly on 11 November 2021 and passed by Parliament on 15 December 2021, proposes significant changes to the treatment of assessed losses in relation to companies. The proposal is that a limitation will apply, such that a company seeking to set off a balance of assessed loss carried forward from a preceding year against current year taxable income, will be able to set off an assessed loss brought forward against its current year taxable income up to a limit of the higher of R1 million and 80% of the company's current year taxable income. Any portion of the assessed loss balance that is not allowed to be set off against current year income may be carried forward to the following year of assessment, so it will not be lost to the company, provided that the company earns income from a trade in the succeeding year of assessment.

The amendments do not apply to assessed capital losses which have been carried forward from prior years of assessment. Assessed capital losses brought forward can be utilised in full in offsetting capital gains realised in the current year of assessment.

This proposal was first outlined in the 2020 Budget Review but was delayed due to the COVID pandemic. The Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2021 (the Draft Explanatory Memorandum), indicates that the rationale for this amendment is to create the fiscal space to allow for a proposed reduction in the corporate tax rate from 28% to 27%. The reduction in the corporate tax rate is seen as necessary to improve South Africa's competitiveness, to promote foreign investment and economic growth and to reduce drivers towards base erosion and profit shifting. In other words, the loss to the fiscus as a result of the proposed reduction in the corporate tax rate will be neutralised, at least to some degree, by the proposed limitations on the use of corporate assessed losses. Both are thus seen as part of a "corporate income tax package" aimed at facilitating the reduction in the corporate tax rate in a revenue-neutral manner.

The effective date of the amendments to section 20 has been linked to the promulgation of a reduced corporate tax rate. The provisions limiting the use of corporate assessed losses will come into operation for years of assessment commencing on or after the date on which a reduction in the corporate tax rate is announced by the Minister of Finance in the annual National Budget. Although indicated in the draft Taxation Laws Amendment Bill (July 2021) that it would be from the April 2022 tax year, there is now no certainty as to when this will be.

"It is pleasing that the effective date of the restriction in the use of corporate assessed losses has now been linked to the enactment of a reduction in the corporate income tax rate as, in absence of this, the amendments to section 20 would not be viewed as providing a level of tax neutrality."

The Draft Explanatory Memorandum makes it clear that the new limitation will apply to a company's balance of assessed loss as at the date of the enactment of the amendment and not only to assessed losses accumulated from the date of the enactment.

The following examples, which have been adapted from those given in the Draft Explanatory Memorandum, illustrate the effect of the limitation in various scenarios. It is assumed for purposes of the examples that the corporate tax rate will be reduced to 27% with effect from 1 April 2022.

Example 1

Company B1 has a year of assessment commencing on 1 April 2022. In tax year ending 31 March 2023 it has R5 million of taxable income before offsetting accumulated assessed losses brought forward of R5.2 million. The accumulated assessed loss balance exceeds R1 million and also exceeds the current year taxable income – and, by implication, is more than 80% of taxable income. Company B1 will be required to pay corporate income tax (CIT) on the portion of its current-year taxable income that exceeds 80% of taxable income, ie, R4 million (ie, on 20% of taxable income, ie, R1 million). As a result, Company B1 will be required to pay CIT of R270,000 (CIT rate of 27% applied to taxable income of R1 million). The remaining balance of the assessed loss of R1.2 million, ie, R5,2 million less R4 million used, can be carried forward to the following year of assessment.

Example 2

Company B2 has a year of assessment commencing on 1 July 2022. It has taxable income of R1 million for its tax year ending 30 June 2023, prior to setting off assessed losses brought forward of R900,000. The assessed loss balance constitutes 90% of current-year taxable income – exceeding the proposed 80% restriction. However, because the balance of assessed loss is less than R1 million, Company B2's assessed loss balance which can be set off against its taxable income will be the full R900,000. Company B2 will pay CIT of R27,000 (CIT rate of 27% applied to taxable income of R100,000).

Example 3

Company B3 has a year of assessment commencing on 1 October 2022. For its tax year ending 30 September 2023 it has taxable income of R5 million before setting off an assessed loss balance brought forward of R2 million. However, since the assessed loss balance of R2 million is less than 80% of taxable income, Company B3 will be able to use its full assessed loss balance of R2 million to reduce its taxable income to R3 million.

As the Draft Explanatory Memorandum notes, there has been a global trend to restrict the use of assessed losses carried forward. Overall, a broadening of the tax base in order to reduce the corporate income tax rate is a sensible approach. It is pleasing that the effective date of the restriction in the use of corporate assessed losses has now been linked to the enactment of a reduction in the corporate income tax rate as, in absence of this, the amendments to section 20 would not be viewed as providing a level of tax neutrality.

Catherine Arbuthnot

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 20;
- Taxation Laws Amendment Bill 22 of 2021.

Other documents

- 2020 Budget Review;
- Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2021.

Tags: assessed losses; taxable income; base erosion and profit shifting; tax neutrality.

TAX FRAUD AND THE CORPORATE VEIL

"Piercing the corporate veil" is a common-law remedy used by courts to address the abuse of the separate personality of juristic entities by directors and shareholders, and has become a codified concept under the Companies Act, 2008. In practice, this remedy enables the courts to ignore the separate personality of the company and hold its incorporators, shareholders or directors (collectively referred to as "Controllers") accountable, in their personal capacities, for the manner in which the business is conducted.

Since entities have their own separate personality distinct from their Controllers and are obliged to pay taxes in South Africa (and outside South Africa), it is quite rare for entrepreneurs or directors to be required to personally cover the taxes due by these entities. Moreover, the Controllers are rarely subjected to criminal prosecution in respect of tax matters involving these entities. However, there have recently been various instances in which directors or entrepreneurs were held to account for taxes due by the entities in which they either serve as directors or hold an interest, with the more apparent reason for personal liability being fraud. [*Editorial note*: The article refers to personal liability of directors or entities in which an interest is held arising due to fraud – clearly any perpetrator of fraud has to be held responsible. However, it should be noted that there are various occasions where directors may be held personally liable for unpaid taxes of the company. This arises from the fact that chapter 11 (section 180) of the Tax Administration Act, 2011, holds the directors of an entity liable to the extent that SARS considers that their negligence has resulted in the entity's inability to pay the debt if they control or are regularly involved in the financial affairs of the entity. Section 181 also holds shareholders liable in predefined circumstances.]

On 6 October 2021, the South African Revenue Service (SARS) published a statement in terms of which the Commissioner for SARS, Mr Edward Kieswetter, expressed great concern about crimes associated with tax, in particular, where juristic entities are used to defraud SARS whilst the individuals in control of these entities essentially hide behind the corporate veil.

Given SARS' stance on holding Controllers accountable, individuals, especially entrepreneurs, must be aware of the repercussions they could face if they and their businesses become involved in schemes to defraud SARS. SARS, the judiciary and the National Prosecuting Authority have not taken this lightly. An example is the decision of the Bloemfontein Regional Court to sentence a businessman running a close corporation, Mr MJ Ntabe, to imprisonment for providing SARS with false supporting documents to substantiate incorrect calculations for value-added tax (VAT). It is reported that the SARS audit department raised additional assessments, which resulted in a total loss of R1 million to SARS. Similarly, during August 2021, the Bloemfontein Regional Court sentenced a director of a catering and accommodation company to imprisonment for submitting nil VAT returns to SARS while the business was actively trading. The imprisonment sentence was wholly suspended on condition that the accused reimburse SARS the tax due by a certain date. In addition, the company itself was subject to a suspended fine as a result of the fraudulent activity.

In light of the COVID-19 pandemic and challenges faced by many taxpaying entities and individuals, in a statement published on 19 August 2021, the Commissioner for SARS reiterated the efforts Government has undertaken to provide affected businesses and individuals with tax relief measures to alleviate hardship in the current economic climate. Considering these efforts, it is difficult to ascertain the reasons behind these fraudulent schemes, especially as the Commissioner for SARS had previously stated that companies and their directors would face criminal prosecution in respect of their transgression of the law and defrauding the fiscus of revenue that was due to the Government.

COMMENT

Entrepreneurs, and taxpayers in general, must strive to always have their tax affairs in order and seek professional assistance when uncertain, as they will face greater hardship should they engage in fraudulent activities. It is clear that, although the concerned entity is in fact "the taxpayer" who is liable to SARS for any taxes due, the authorities are not afraid to look behind the corporate veil and hold the Controllers accountable.

Ursula Diale-Ali & Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Companies Act 71 of 2008;
- Tax Administration Act 28 of 2011: Chapter 11 (specifically sections 180–181).

Other documents

- SARS statement (19 August 2021): Efforts by Government to provide affected businesses and individuals with tax relief measures to alleviate hardship in the current economic climate;
- SARS statement (6 October 2021): Re crimes associated with tax, especially involving juristic entities defrauding SARS whilst the individuals in control hide behind the corporate veil.

Tags: representative taxpayer; tax relief measures; personal liability of directors.

TAX AND EXCHANGE CONTROL

Crypto assets are a young and boisterous part of the current financial landscape. Recent developments point to crypto assets becoming an entrenched, although still volatile, part of the global financial system. A prime example is El Salvador, which on 7 September 2021 became the first country to allow the use of a cryptocurrency as legal tender. In the same week, the US Treasury held engagements with industry representatives to gain insight into the regulatory requirements for a crypto asset known as "stablecoins".

In South Africa the regulation of crypto assets is the terrain of several role players. The South African Reserve Bank (SARB), as the overarching regulator of the South African financial system and transactions in currency, is the lead regulatory entity. The South African Revenue Service (SARS) is brought into the regulatory matrix, because crypto assets represent economic value being traded in and received by taxpayers and disposed of by investors – triggering the Commissioner's taxing authority and taxpayers' obligation on any income or capital events related to crypto assets.

"While the regulation of crypto assets is a nascent part of South African regulatory landscape, the various role players have put in place some concrete requirements within the current legislative framework."

While the regulation of crypto assets is a nascent part of South African regulatory landscape, the various role players have put in place some concrete requirements within the current legislative framework. These stakeholders have also joined together in the Intergovernmental Fintech Working Group (IFWG), through the Crypto Assets Regulatory Working Group (CAR WG), to formulate a collective policy position on crypto assets and the financial service providers facilitating the crypto asset market. The IFWG released a position paper on 21 June 2021 setting out its recommendations on policy positions and regulatory measures for the crypto asset market.

This article briefly covers some of the tax and exchange control compliance requirements where South African tax residents invest in or trade crypto assets. It then notes some of the policy proposals made by the IFWG for the regulation of crypto assets.

TAX AND CRYPTO ASSETS

SARS' position has historically been that normal income tax and capital gains tax principles apply to crypto assets. In a media statement in 2018, SARS stated that it would "continue to apply normal income tax rules to cryptocurrencies and will expect affected taxpayers to declare cryptocurrency gains or losses as part of their taxable income".

The Taxation Laws Amendment Act, 2020, replaced references in the Income Tax Act, 1962 (the Act), to "cryptocurrency", with "crypto asset". This implies that the position SARS has taken regarding cryptocurrencies will be applied to crypto assets more generally. These amendments came into force on 1 March 2021.

Therefore, where a taxpayer is engaged in a trade related to crypto assets, the receipt or accrual of such crypto assets by the taxpayer could constitute gross income for that taxpayer. Similarly, where a crypto asset is held as a capital investment, the capital gain or loss on the disposal of that crypto asset would have to be accounted for by a taxpayer under the prescripts of the Eighth Schedule to the Act.

EXCHANGE CONTROL AND CRYPTO ASSETS

The SARB's historical position has been that crypto assets do not constitute currency or capital under the Exchange Control Regulations, 1961 (the Excon Regulations). However, individuals can make use of their single discretionary allowance of R1 million, or their individual foreign capital allowance of up to R10 million, to purchase crypto assets using foreign currency.

South African exchange control residents are not permitted to elect to receive outstanding foreign payments in the form of a crypto asset, as the transaction is currently not reportable on the FinSurv Reporting System. Furthermore, a non-resident crypto asset service provider (CASP) who introduces crypto assets into the South African market and receives payment in rand, is not able to transfer the sale proceeds abroad. This is in line with section G.(C)(i) of the Currency and Exchanges Manual for Authorised Dealers (section G.(C): "South African assets owned by non-residents").

PROPOSALS BY THE IFWG

The nature of crypto assets, including the maturing of the market, and its misalignment with aspects of South Africa's applicable regulatory framework, have led to a set of policy proposals by the IFWG for the regulation of crypto assets and CASPs.

While no explicit tax proposals have been made, tax evasion and revenue collection risks were identified given the anonymous and non-institutionalised nature of crypto assets. The IFWG has proposed several interventions aimed at ensuring that CASPs are subject to licensing and reporting requirements that would ensure that the necessary information is provided to regulatory institutions. These proposals include the following:

- Inclusion of CASPs as an accountable institution in Schedule 1 to the Financial Intelligence Centre Act, 2001.
- Declaration of crypto assets as a "financial product" by the Financial Sector Conduct Authority for the purposes of the Financial Advisory and Intermediary Services Act, 2002.

These proposals would ensure that know-your-client and other important information regarding the taxpayers involved in crypto asset transactions, including the source of their funds and the scale of their transacting, is captured by regulatory institutions and available to SARS to pursue any non-compliance with tax legislation.

The IFWG has made several proposals on the exchange control regulation of crypto assets by the SARB. These proposals seek to enable increased formal regulation of the marketing of crypto assets, and cashflows which facilitate crypto asset trading and investments. The proposals by the IFWG in this regard focus on amendments to the Excon Regulations and include:

- Empowering the Financial Surveillance Department of the SARB to assume the supervisory and regulatory responsibility for the monitoring of cross-border financial flows in respect of crypto asset services.
- Amending Excon Regulation 10(4) to include crypto assets in the definition of "capital" for the purposes of Excon Regulation 10(1)(c).
- Explicitly permitting individuals in the Excon Regulations to purchase crypto assets using their single discretionary allowance or foreign capital allowance.
- Expanding the authorised dealer with limited authority regime to include crypto asset trading platforms (CATPs) to facilitate cross-border crypto transactions and trading in crypto assets in South African rand.
- Introduction of requirements for CATPs to report crypto transactions to the SARB.
- Amending the Excon Regulations to allow licensed CATPs to source or buy crypto assets offshore for the purpose of selling to the local market.

The proposals by the IFWG would assist in filling the regulatory vacuum that currently prevails in the crypto asset market. Recognising that ordinary tax principles are largely sufficient to capture the exchange or receipt of value in the form of crypto assets, the IFWG has made proposals which aim to limit the possibility for tax evasion by introducing reporting requirements for CASPs and CATPs.

The more significant proposals relate to the exchange control environment. Here, the IFWG has proposed moving towards a formal regulation of the crypto asset market, which has been absent to date. This formal regulation would ensure that relevant stakeholders have an express regulatory mandate regarding the crypto asset market and provide the crypto market with the ability to operate in a compliant manner. This will, in turn, lead to better protection for consumers and greater certainty for market participants.

Tsanga Mukumba

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: References to cryptocurrencies changed to crypto assets; Eighth Schedule;
- Taxation Laws Amendment Act 23 of 2020: References to cryptocurrencies changed to crypto assets;
- Financial Intelligence Centre Act 38 of 2001: Schedule 1;
- Financial Advisory and Intermediary Services Act 37 of 2002: Section 1(1) (definition of "financial product").

Other documents

- Exchange Control Regulations, 1961: Regulation 10(1)(c) & 10(4) (definition of "capital" to include crypto assets for the purposes of Regulation 10(1)(c));
- Currency and Exchanges Manual for Authorised Dealers: section G.(C)(i);
- Position paper released by the Intergovernmental Fintech Working Group (IFWG) on 21 June 2021 (setting out its recommendations on policy positions and regulatory measures for the crypto asset market);
- SARS media statement (2018): Continued application of normal income tax rules to cryptocurrencies; affected taxpayers expected to declare cryptocurrency gains or losses as part of their taxable income.

Tags: stablecoins; financial product; crypto asset trading platforms (CATPs).

TAX AND DECEASED ESTATES

When an individual dies, there are automatic tax implications that become applicable to that estate. In this article we will briefly discuss the most important of these tax effects with specific reference to income tax, capital gains tax and estate duty.

INCOME TAX

In the case of an individual who was liable for the completion and submission of provisional tax prior to death, the estate of that individual will no longer be liable to submit these returns after the person's death. The estate will be responsible only for the normal annual income tax returns and no provisional tax returns need to be submitted after an individual has passed away.

The next important aspect to mention, from an income tax perspective, is the two sets of tax rules that apply – the one set to individuals who passed away prior to 1 March 2016 and the other to individuals who passed away on or after 1 March 2016.

Up and until 1 March 2016 the executor in a deceased estate was only responsible for the completion and submission of income tax returns (which would have included capital gains tax (CGT), as may have been applicable in each tax year) up to date of death. The executor would have had to account separately for any CGT applicable to post date of death sales of CGT-related assets, at which point the executor's tax responsibility ended.

The income tax flowing from income earned after the date of death would be for the heirs in the estate to reflect in their own tax returns with the executor having the responsibility to ensure that the heirs are aware of the amounts to be accounted for in their tax returns and the fact that they were obliged to declare that income.

SARS, however, found over the years that they were losing out on millions in income tax, due to many heirs not reflecting the income in their tax returns, whatever their reasons may have been.

Due to the above, the entire income tax position changed quite dramatically on 1 March 2016.

SARS amended legislation in 2016, which changed the position to one where the executor now receives much more responsibility from a tax point of view in that that they would not only be responsible for the income tax (inclusive of CGT as and where applicable) to date of death. In addition to the existing duty they would now also have to register the estate as a separate / new taxpayer thereafter and complete and submit tax returns for all taxable income earned within the estate (with an annual R23,800 interest exemption being applicable). These returns would have to be submitted until the finalisation of the estate. The CGT that the executor would have previously accounted for on *post date of death* sales would no longer have to be dealt with separately, but would now form a part of the applicable tax return for the year in which the asset was sold.

This change ensures that SARS is placed in a position where it is able to keep track of income earned as this, by law, has to be declared by the actual executor. Simultaneously it places SARS in a position to physically collect the tax due on this income prior to finalisation of the estate, with the executor requiring tax declarations from SARS proving that both the pre-and-post-date-of-death taxes have been satisfactorily finalised before the Master of the High Court would be willing to provide them with a filing slip (basically a written confirmation that the estate is finalised).

Unfortunately this change in position has caused the general estate administration process, which is already a lengthy and time-consuming exercise, to be delayed for an even longer period. Whilst the processes have become easier to comply with since the law was amended, they do remain problematic at times.

"Death itself is deemed as a CGT disposal of assets and thus in the deceased's final tax return this deemed disposal of CGT-related assets would have to be reflected."

CAPITAL GAINS TAX

Capital gains tax (CGT) would be applicable in any estate where the deceased held assets to which this tax applies. The main assets being affected by this being immovable property, shares/unit trusts and business interests (the above is not a complete list of assets subject to CGT).

Death itself is deemed as a CGT disposal of assets and thus in the deceased's final tax return this deemed disposal of CGT-related assets would have to be reflected.

The exception to the rule in this particular instance is if the asset subject to CGT is bequeathed to a *resident* surviving spouse. Should this be the case then there is a rollover of the capital gain to the estate of the surviving spouse and thus the deemed disposal falls away, with the surviving spouse taking the asset over at the base cost at which the deceased obtained it (and not the value at the date of death of the deceased). This rollover does not apply to a non-resident surviving spouse and would also not be applicable if the CGT-related asset bequeathed to the spouse is sold out of/by the estate after death (in which case the calculations related to both the deemed and actual disposals would have to be calculated and declared by the executor in the relevant tax year).

In the cases where the rollover to a surviving spouse is not applicable there could potentially be two separate CGT calculations involved, with the first being the deemed disposal of the asset as at date of death, and the second being an actual disposal of the asset in the event that it is sold by the estate. As indicated under the income tax heading above, the CGT calculation on an actual sale of asset by the estate is no longer attended to on its own, but now rather forms a part of the tax return of the deceased estate in the year in which the sale occurred.

There are, however, exclusions that can be claimed, for example for a primary residence there would be an exclusion of R2 million available to the estate as well as in the individual's CGT calculation in the year of death where the normal exclusion available to an individual or natural person (in the amount of R40,000 per annum) is increased to R300,000 for that particular tax year.

Under paragraph 48*(d)* of the Eighth Schedule to the Income Tax Act, 1962, a primary residence held by a deceased estate is treated as being ordinarily resided in by the deceased person for a maximum period of two years after the date of death. Should the executor take longer than two years to dispose of the residence, the period exceeding two years will not qualify as a primary residence, and the gain or loss must be apportioned on a time basis. The exclusion of R2 million in paragraph 45 may be set off only against the portion of the gain applicable to the first two years following the date of death.

There are also other exclusions that could potentially be applicable but may not be mentioned in this article.

ESTATE DUTY

Currently estate duty is levied at the rate of 20% on the *net* asset value in an estate that exceeds R3.5 million (see below), with an estate where the said *net* asset value exceeds R30 million, being liable for 25% estate duty on the balance exceeding R30 million (applicable from 1 March 2018).

"Net estate" generally refers to the gross assets in the estate, plus all deemed assets, less liabilities and all other allowable deductions, with the dutiable estate being the net estate less the deduction allowed under section 4A of the Estate Duty Act, 1955, currently being R3,5 million per individual.

Subject to certain limitations or restrictions, where assets are bequeathed to a surviving spouse, a rollover (similar to the rollover applicable with regard to CGT *but* in this instance also applicable to a non-resident surviving spouse) would apply. This basically means that the value of assets bequeathed to a surviving spouse, for which deductions have not been claimed elsewhere, is deductible provided that the deduction allowable shall be reduced by the amount awarded to any individual or trust other than the spouse.

As mentioned above, generally each individual has an estate duty rebate of R3.5 million available. Where the deceased was the spouse of one or more previously deceased persons, the amount that can be deducted from the net estate increases to R7 million, less the amount deducted from the net value of the estate of any one of the previously deceased persons (spouses). It is important to note where the deceased is the surviving spouse of more than one marriage, then the amount that can be deducted is limited to one predeceased spouse with the choice of which spouse being that of the executor.

It should also be noted that there are other estate duty deductions available and these are set out in section 4 of the Estate Duty Act, one of these being assets awarded to charities (a charity has to be registered with SARS as a PBO to be recognised as a charity for these purposes).

"Estate duty becomes due and payable to SARS within one year of the date of death or within 30 days of receipt of the estate duty assessment".

Estate duty becomes due and payable to SARS within one year of the date of death or within 30 days of receipt of the estate duty assessment. If the estate duty is not paid within that period SARS would be entitled to levy interest on the estate duty payable on assessment. The current interest rate per annum that is used for this purpose is 6%. Whilst an executor has the right (and duty) to pay a reasonable deposit to the satisfaction of the SARS Commissioner within one year of death and may then request an interest-free extension on the payment of any balance of estate duty, it is important to note that SARS does not have to grant the request and, if the request is declined, the full balance of the duty (estimate as it may be at that point) would have to be paid to ensure that interest will not be charged. It is important to be aware that, should the estate duty be a higher amount at assessment date, interest would still apply to the balance. It is therefore very important to remain aware of estate duty and for the executor to check and calculate as far as possible, before the one-year anniversary of death occurs, whether it would be necessary to pay a reasonable deposit and request an interest-free extension on the payment of any balance.

Another important aspect to mention which could cause potential problems at the point when the estate duty can be properly and correctly calculated, is the question of life policies (note that there are, once again, some exceptions to the rule), the potential estate duty thereon and the responsibility for the payment of this estate duty. Broadly speaking, life policies would be regarded as deemed assets for estate duty purposes even if they are paid directly to beneficiaries outside of the estate. This means that the policy was never a physical asset in the estate, but rather paid out to a spouse, child or other nominated beneficiaries shortly after death.

The executor would have a responsibility to ascertain the value of the policy and to whom it was paid and to include it in the estate duty calculation as a deemed asset. In the event that the estate is dutiable the duty attributable to that policy would potentially have to be apportioned between the estate and the individual who received the policy proceeds. This basically means that, even though the individual in question may not be a beneficiary of the estate itself, they could potentially be liable for a portion of the estate duty as would be attributable to the policy proceeds they received. Whilst SARS would ultimately hold the executor and estate responsible for ensuring that the full estate duty is paid, it would in turn be the responsibility of the executor to ensure that the amount or portion of duty for which the beneficiaries of the policy would be liable is collected and paid over.

This particular matter can become problematic as the final estate duty is normally only calculated at the end of the process and this can in certain instances be 12–18 months or more after an individual passed away with the life policy having been paid out to the beneficiaries many months prior to that, thus potentially leaving the beneficiaries short of cash to contribute the duty for which they are liable. It is therefore important, at the outset of the process (as far as that may be possible at the time), to try and make those beneficiaries of life policies aware of the fact that they may potentially be liable for a part of the estate duty.

"Although there are other taxes, such as VAT, that could potentially be applicable to a deceased estate, income tax, CGT and estate duty are the main and most important ones to consider."

CONCLUSION

Although there are other taxes, such as VAT, that could potentially be applicable to a deceased estate, income tax, CGT and estate duty are the main and most important ones to consider. The emphasis in this instance being that during the estate planning stage, which is cardinal to the process of having a will drafted, these taxes should already be considered and estimates calculated, to ensure that the administration of the deceased estate runs as smoothly and efficiently as possible. Due to ever changing legislation, it is also important to review a will regularly to ensure that it remains tax efficient.

Anica Ungerer

Mazars

Acts and Bills

- Estate Duty Act 45 of 1955: Sections 4 & 4A;
- Income Tax Act 58 of 1962: Eighth Schedule: Paragraph 48*(d)*.

Tags: taxable income; estate duty rebate.

EXIT TAX ON RETIREMENT INTERESTS

Expatriates and those with plans to emigrate will be relieved to learn that the proposal to impose an exit tax on retirement interests will be withdrawn. In presenting their Draft Response Document on the 2021 Draft Tax Bills, National Treasury and SARS confirmed that the proposal would not be included in the final Taxation Laws Amendment Bill, 2021, which was introduced in the National Assembly on 11 November 2021 on the day of the Medium Term Budget Policy Statement (the MTBPS) of the Minister of Finance.

THE PROPOSED EXIT TAX

The 2021 Draft Tax Bills were published in July 2021 and arguably the most contentious proposal included was the imposition of an exit tax on retirement interests when a South African taxpayer ceases residency.

The reason for the proposed tax was that SARS may in certain instances lose out on the right to tax retirement interests of taxpayers if they cease South African tax residency. The concern lies in the wording of certain double tax treaties that allocate the sole taxing right on these amounts to the country where the taxpayer is resident.

To counter the loss to the fiscus in these cases, it was proposed to trigger a tax on the value of the taxpayer's retirement interest on the day before the person ceases residency. The tax would only be due to SARS when the benefit becomes payable in future.

Most notably, the proposal was designed to subvert the provisions of the double tax treaties concluded with some of our treaty partners. For a country that has always respected treaty obligations, this would be unprecedented. Enacting domestic legislation to override treaty provisions flouts not only the agreement with the relevant treaty partner but also South Africa's good faith obligations under the Vienna Convention on the Law of Treaties, 1969.

From the taxpayer's perspective, the knock-on effect would be double taxation, without any recourse, as the tax levied in South Africa would be illegitimate. This would not be the only hardship faced by the taxpayer, as the proposed section would force the individual to incur interest on the postponed tax. Ultimately, the proposal faced a cascade of insurmountable challenges.

The proposal was met with fierce opposition.

WARNINGS HEEDED BY GOVERNMENT

During their feedback session ahead of the MTBPS, National Treasury acknowledged the validity of the comments raised, particularly the concerns around violating international treaty obligations. It was further noted that the proposal will be revisited in subsequent legislative cycles, as this problem must, somehow, be addressed.

While we may see the proposal back on the table in future, the problem can likely only be fixed by renegotiating existing treaties, which will not happen overnight.

Be that as it may, National Treasury's willingness to engage the public in the law-making process must be applauded, and the fact that the warnings were heeded is a most welcome development.

Jean du Toit

Tax Consulting SA

Acts and Bills

- Taxation Laws Amendment Bill 22 of 2021.

Other documents

- Draft Response Document on the 2021 Draft Tax Bills;
- Medium Term Budget Policy Statement, 2021;
- Vienna Convention on the Law of Treaties, 1969.

Tags: South African tax residency; double taxation.

CESSATION OF RESIDENCY AND THE PARTICIPATION EXEMPTION

Constraints on revenue collection as a result of the COVID-19 pandemic have led to the South African Revenue Service (SARS) adopting a more robust approach to revenue collection, placing greater scrutiny on those taxpayers utilising intricate tax-planning structures.

In the 2020 National Budget Speech delivered by the Minister of Finance, changes were announced to tackle a loophole exploited by a number of taxpayers relating to the interaction between the rules around:

- taxing capital gains in the hands of South African tax resident shareholders on the disposal of shares in a South African company, as contemplated in section 9H of the Income Tax Act, 1962 (the Act);
- providing a participation exemption from capital gains tax on the disposal of equity shares held by a South African tax resident holding at least 10% of the equity shares and voting rights in a foreign company, as contemplated in paragraph 64B of the Eighth Schedule to the Act.

Section 9H provides that when a South African tax resident company changes its tax residency to another tax jurisdiction, that company ceases to be tax resident for South African income tax purposes. The cessation of South African tax residence triggers a deemed disposal of all the assets held by the company (subject to named exclusions), for capital gains tax purposes and consequent capital gains tax. The company is also deemed to have declared and paid a dividend *in specie* on the day before it ceased to be a resident – however, this deemed dividend may qualify for a dividends tax exemption under section 64FA.

"Section 10B(2) of the Act exempts foreign dividends from income tax if the shareholder, being a South African resident, holds at least 10% of the total equity shares and voting rights in the foreign company declaring a foreign dividend."

PARTICIPATION EXEMPTION

Section 10B(2) of the Act exempts foreign dividends from income tax if the shareholder, being a South African resident, holds at least 10% of the total equity shares and voting rights in the foreign company declaring a foreign dividend. This is commonly referred to as the "participation exemption". The policy rationale for the participation exemption is to encourage capital inflows and to provide an incentive for South African tax residents to repatriate foreign dividends to South Africa.

Paragraph 64B provides that South African holders of shares are allowed to make a tax-free disposal of foreign shares in a foreign company in which they hold an interest of at least 10% as long as that disposal is made to a non-resident. The policy rationale for the participation exemption in this paragraph follows the notion behind the participation exemption in section 10B(2) for foreign dividends in that:

- the profits realised from the disposal of shares represent unrealised dividends; and
- such profits would in any event have qualified for the participation exemption in section 10B(2) for foreign dividends had they been declared as a dividend to the South African tax resident shareholder.

The concern expressed in the 2020 Budget Speech was that residents that hold shares in a resident company changing its tax residency could, subsequent to the cessation of its residency, dispose of its shares in that (now foreign) company to a third party and qualify for the participation exemption available in paragraph 64B in respect of any realised capital gain. This is especially relevant where a controlled foreign company (CFC) ceases to be a CFC as a result of the disposal of all or some of the equity shares in that CFC. Section 9H provides that the capital gain or loss realised in respect of such disposal is disregarded if the participation exemption under paragraph 64B applies.

This scenario can be illustrated where:

- a South African tax resident company changes its tax residence to another tax jurisdiction (becoming a foreign company) or a CFC ceases to be a CFC, and triggers a deemed disposal of its assets in terms of section 9H on the day preceding its change in residency; and
- after its exit, the South African tax resident shareholders dispose of the equity shares in the new foreign company and qualify for the participation exemption available in paragraph 64B in respect of the gain on disposal of the shares, even though the unrealised growth in the value of the shares occurred while the company was a South African tax resident.

This allows South African resident shareholders to benefit from a participation exemption on disposal of the shares in a non-resident company that was a resident company when the shares were acquired and is clearly against the intended purpose of the participation exemption.

"It was therefore proposed that changes be made in section 9H in circumstances where shareholders trigger a dividends tax exemption for the company when a deemed dividend *in specie* is declared (on cessation of residency)."

It was therefore proposed that changes be made in section 9H in circumstances where shareholders trigger a dividends tax exemption for the company when a deemed dividend *in specie* is declared (on cessation of residency). The amendment deems those shareholders to have disposed of all their shares in the company at market value on the day before it ceased to be resident and to have reacquired the shares at market value on the day of the exit.

The proposed amendment will apply retrospectively from 1 January 2021 if passed in its current form and in respect of the holder of shares in a company that ceases to be a resident on or after that date.

Keshen Govindsamy

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 9H, 10B(2) & 64FA; Eighth Schedule: Paragraph 64B.

Tags: tax resident shareholders; tax resident company; controlled foreign company (CFC); non-resident company.

MAURITIUS: RESIDENCE STATUS OF TRUSTS AND FOUNDATIONS

The Mauritius Revenue Authority (the MRA) issued a statement of practice (SOP) on 24 August 2021 to clarify the tax residency of trusts and foundations. This follows the abolition of the declaration of non-residence option for trusts and foundations through the Finance (Miscellaneous Provisions) Act 2021 (FA 2021).

THE REPEALED DECLARATION OF NON-RESIDENCE OPTION

Prior to the enactment of the FA 2021, qualifying trusts and foundations were entitled to declare non-residency with the MRA on a yearly basis by making a declaration of non-residency within three months of the end of each income year.

Such trusts and foundations were exempt from income tax in respect of that income year. The conditions that had to be satisfied to be qualified as non-resident include:

TRUSTS	FOUNDATIONS
• Settlor must be non-tax resident or hold a global business licence; and • In the case of a beneficiary trust, all beneficiaries must be throughout an income year non-tax resident or hold global business licences; or • In respect of a purpose trust, the purpose must be carried out outside Mauritius.	• Founder must be non-tax resident or hold a global business licence; and • All beneficiaries must be throughout an income year non-tax resident or hold global business licences.

"With the changes made to the Mauritian Income Tax Act, 1995 (the ITA), through the FA 2021, the declaration of non-residency for trusts and foundations has been abolished."

With the changes made to the Mauritian Income Tax Act, 1995 (the ITA), through the FA 2021, the declaration of non-residency for trusts and foundations has been abolished.

However, a grandfathering period up to the year of assessment 2024/2025 has been granted to trusts and foundations established prior to 30 June 2021. During the grandfathering period, grandfathered trusts and foundations will not benefit from tax exemptions in respect of new assets or activities, such as intellectual property assets acquired and income from specific assets or projects started after 30 June 2021.

TAX RESIDENCE

Trusts and foundations that are tax resident in Mauritius are liable to pay income tax on their worldwide income. The definition of "tax residency" is found in section 73 of the ITA.

A resident trust is defined as a trust:

- which is administered in Mauritius and a majority of its trustees are residents in Mauritius; or
- whose settlor was resident in Mauritius at the time the instrument creating the trust was executed.

A resident foundation is a foundation which is registered in Mauritius or has its central management and control (CMC) in Mauritius.

Section 73A of the ITA further provides that, notwithstanding section 73, a company incorporated in Mauritius will be treated as non-resident if its CMC is outside Mauritius.

The term "company" is defined in section 2 of the ITA as including a trust and a foundation.

Accordingly, having the CMC in Mauritius is key in the determination of tax residency of trusts and foundations. If the CMC of a trust or foundation is outside Mauritius, the trust or foundation will be considered as non-resident even if the trust or foundation satisfies the conditions set out under section 73 of the ITA.

Until the publication of the SOP, there were no definitions of CMC with respect to trusts and foundations. It was generally understood that the CMC of a trust and a foundation was taken to be where the highest level of decision making took place. The place where such body met in taking final decisions relating to the trust and foundation was considered as being the place of the CMC of the trust or foundation.

The MRA has deemed it appropriate to define what would constitute the CMC for a trust and foundation through the SOP.

A trust would have its CMC in Mauritius if:

- the trust is administered in Mauritius and the majority of the trustees are residents in Mauritius;
- the settlor was resident in Mauritius at the time the instrument creating the trust was executed, or at such time as the settlor adds new property to the trust; and
- the majority of the beneficiaries or the class of beneficiaries appointed under the terms of the trust are resident in Mauritius.

A foundation would have its CMC in Mauritius if:

- the founder is resident in Mauritius; and
- the majority of the beneficiaries appointed under the terms of a charter or will, are resident in Mauritius.

DEMYSTIFYING THE NEW CMC REQUIREMENTS

The SOP has stretched the conditions to be satisfied by trusts and foundations to be considered as tax resident in Mauritius by adding the requirement to have a majority of Mauritian resident beneficiaries (and for foundations, Mauritian resident founders) to be considered as having their CMCs in Mauritius.

This is a surprising move by the MRA in that the management and decision-making powers of a trust are generally vested in the trustees and, in respect of a foundation, in its council of members.

The beneficiaries in each case only hold a beneficial interest in the trust/foundation property.

As a consequence of the definition of CMC in the SOP, meeting the criteria for tax residency for trusts and foundations has become more onerous and trusts and foundations that do not meet any one of the criteria would *de facto* be considered as non-resident.

IMPACT OF THE SOP ON EXISTING TRUSTS AND FOUNDATIONS

Existing trusts, which were qualified to declare non-residency under the repealed declaration of non-residence option (by having non-resident settlors and throughout an income year, non-resident beneficiaries) will have their CMCs outside Mauritius, thus will continue to be considered as non-resident.

Accordingly, such trusts will continue to be exempt from income tax on their foreign source income but will be subject to income tax only on income from Mauritian sources.

In effect, such qualifying trusts will be better off, in that their non-residency is outright and they will no longer be required to make a non-residency declaration within the required timeline for each income year, to be exempt from income tax on their foreign sourced income.

Similarly, foundations that were qualified to declare non-residency under the repealed declaration of non-residence option (by having non-resident founders and throughout an income year, non-resident beneficiaries), will have their CMCs outside Mauritius and thus will continue to be considered as non-resident and exempt from income tax on their foreign-sourced income.

TAXATION OF TRUSTS AND FOUNDATIONS

Tax resident trusts and foundations are subject to income tax at the rate of 15%, although they would be entitled to claim credits for foreign taxes suffered up to the maximum Mauritian tax liability.

Further, the SOP has clarified that trusts and foundations are entitled to benefit from the partial exemption regime to the extent that they satisfy the prescribed substance requirements, wherein the first 80% of certain specified income (such as interest and foreign dividends), are exempt from income tax, and the remaining 20% of such income is taxed at the rate of 15%, making the effective tax rate 3%.

Non-resident trusts and foundations that will only derive foreign-sourced income will not be subject to income tax in Mauritius. However, such trusts and foundations will be required to file a nil income tax return confirming that they do not have any Mauritius-sourced income.

CONCLUSION

The Mauritian trust and foundation maintain their attractiveness to investors and high net worth individuals as a vehicle for investment and estate planning.

Javed Niamut

Bowmans

Acts and Bills

- (Mauritian) Finance (Miscellaneous Provisions) Act 2021 (FA 2021);
- (Mauritian) Income Tax Act, 1995: Sections 2 (definition of “company”), 73 (definition of “tax residency”) & 73A.

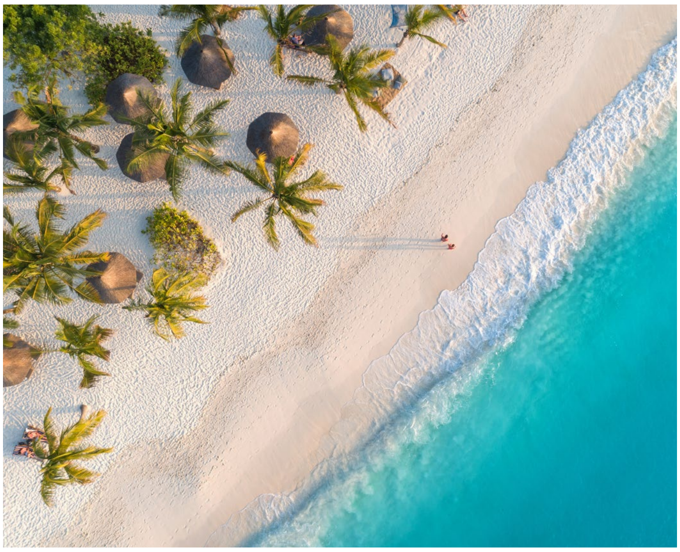
Other documents

- Mauritius Revenue Authority: Statement of Practice (SOP24/21) (issued on 24 August 2021 to clarify the tax residency of trusts and foundations).

Tags: statement of practice (SOP); non-resident founders; non-resident beneficiaries.

PANDORA PAPERS: SOME CONSIDERATIONS FOR SA RESIDENTS

In 2021, 11,9 million financial records known as the Pandora Papers were leaked, revealing the offshore financial assets of many internationally well-known persons. One of the questions raised pursuant to the leak is whether the investments made by these persons are legal from a tax perspective.



From a South African tax perspective, it provides an opportunity for South African residents who have investments offshore, or who intend to invest offshore in future, to ensure that such investments are made in compliance with all relevant South African tax laws. In this article, we discuss some of the considerations and developments that South Africans must bear in mind.

COMMON REPORTING STANDARD AND EXCHANGE OF INFORMATION

One of the most significant changes that have taken place in international tax law in the past few years, is the introduction of the Common Reporting Standard (CRS). In terms of the CRS, the tax authorities of countries that have opted into and implement the CRS, must exchange certain information held by reporting financial institutions operating in their jurisdiction, with the tax authorities of other countries implementing the CRS. Therefore, the South African Revenue Service (SARS) will first collect information from South African institutions that must report information to it under the CRS and, once collected, exchange the information with the relevant foreign tax authorities. As a result, if a South African resident holds an account with a foreign financial institution that is obliged to report information under the CRS to its local tax authority, the information pertaining to that account is likely to come to SARS' attention pursuant to the exchange of information between SARS and the foreign tax authority.

The bottom line is this – South Africans cannot make use of offshore structures to "hide" the existence of assets. South African residents must also keep in mind that even though South Africa does not have double taxation agreements with certain so-called low-tax jurisdictions, it still has agreements providing for the exchange of tax information with many of these jurisdictions. This means that SARS can rely on these agreements, if necessary, to obtain information regarding a South African resident from a specific foreign tax authority.

DEVELOPMENTS REGARDING ENFORCEMENT OF TAX LAWS BY SARS

In 2021, the following notable developments occurred:

- In the 2021 Budget, the Minister of Finance announced that SARS would receive additional financial resources to increase its capacity to enforce tax laws and investigate the affairs of so-called high net worth individuals (HNWIs).
- Pursuant to this announcement, SARS' HNWI unit was re-created and started sending letters to taxpayers who it classifies as HNWIs.
- More recently, SARS and the US Internal Revenue Service (IRS) announced that the IRS' criminal investigation division and SARS' enforcement division would be joining forces to fight tax and economic crimes affecting both countries.

In the 2017/2018 period, the Inter-Agency Working Group on Illicit Financial Flows was created; it comprises SARS and the following agencies:

- South African Reserve Bank;
- Financial Intelligence Centre;
- Hawks Directorate for Priority Crime Investigation;
- National Prosecuting Authority;
- Special Investigating Unit;
- South African Police Service; and
- Financial Sector Conduct Authority.

While the Tax Administration Act, 2011 (the TAA), generally prohibits SARS from disclosing certain confidential information regarding a taxpayer to third parties, it does provide for exceptions and specific instances where information can be shared. On the other hand, SARS would be able to obtain information regarding a specific taxpayer from one of the aforementioned agencies, to the extent that these agencies are allowed to share information regarding a specific taxpayer.

What South African residents should therefore bear in mind is that it might be easier for SARS to obtain information regarding their financial affairs than they think.

FROM INFORMATION SHARING TO PAYING ADDITIONAL TAX

While it appears that SARS can obtain information regarding a South African taxpayer's financial affairs or financial status lawfully through different avenues, it is still required to comply with the provisions of the TAA regarding audits before it can assess a taxpayer for additional tax. In other words, the mere sharing of information does not automatically equate to a taxpayer with foreign assets being liable for more tax. In this regard, one should especially note sections 40 and 42 of the TAA.

In terms of section 40 of the TAA, SARS is entitled to audit a taxpayer. It has also been confirmed in *Carte Blanche Marketing CC and Others v Commissioner for the South African Revenue Service*, [2020], that the decision to audit is not subject to review. In other words, a taxpayer faced with an audit cannot prevent SARS from undertaking that audit. However, if SARS does not conduct the audit in accordance with section 42 of the TAA, this could constitute an infringement of a taxpayer's constitutional right to fair administrative action. If so, it could result in the additional assessment issued pursuant to such a flawed audit process being set aside.

CONCLUSION: PRINCIPLES FOR PREVENTION OF TAX PAIN

The saying goes that "prevention is better than cure". In the context of investing offshore and preventing non-compliance with South African tax laws, the same principle applies. Some of the important aspects to consider when investing offshore or into an offshore structure, are the following:

- Setting up or investing into the offshore structure: Where a South African resident intends to set up an offshore structure, all relevant tax considerations should be considered. Where one is investing into an offshore trust structure, one would initially need to advance a loan to the trust or make a donation. Where a donation is used to fund the trust, donations tax will be payable. Where a loan is advanced to the trust, one must ensure that the terms of the loan are compliant with section 31 of the Income Tax Act, 1962 (the Act). One should also consider whether section 7C of the Act applies to the loan, ie, has interest been charged on the loan at the "official rate of interest" (as defined); if not, donations tax will be payable. SARS Interpretation Note 114 (IN114), which provides examples of how these sections can interact, should also be considered. Although IN114 is not binding, it provides some insight as to how SARS might apply sections 7C and 31 in a certain set of circumstances.

- If one is dealing with a direct investment into an offshore company, one would need to consider whether the arm's length requirements of section 31 have been complied with in purchasing shares or subscribing for shares in that company. Where a loan is advanced to that foreign company, that loan must also comply with the transfer pricing provisions in section 31. Aside from the tax considerations, one must also comply with any exchange control rules applicable to the investment into the offshore structure.

- Annual payment of tax: Depending on how the investment into the offshore structure was funded, some tax will likely be payable to SARS on an annual basis. Where a loan is advanced, the interest income will be subject to tax. If the interest is below the arm's length and official rate then transfer pricing and/or section 7C may apply. Furthermore a taxpayer must establish whether the attribution rules apply to the income, capital gains or dividends derived by the offshore structure. The attribution rules could apply whether or not the offshore trust has vested any amounts in a South African beneficiary. Where one holds shares directly in a foreign company, one must consider whether the controlled foreign company rules apply to tax the amounts derived by the foreign company.

- Keeping records is key: The TAA requires that a South African resident must keep records for at least five years after the submission of a tax return. If SARS institutes an audit or verification process in respect of a specific period, the provision of documentary proof is key to avoid having to pay additional tax. If the records are relevant to an audit or investigation under Chapter 5 of the TAA that the taxpayer is aware of or a person lodges an objection or appeal under section 104(2) of the TAA, the person must retain the relevant records until the audit or investigation has been concluded, or the assessment or decision has become final, despite the aforementioned 5-year requirement.

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 7(8), 7C, 25B(1) & 31;
- Tax Administration Act 28 of 2011: Chapter 5 (sections 40–66); sections 40, 42 & 104(2).

Other documents

- SARS Interpretation Note 114 ("Interaction between section 25B(1) and section 7(8)) in case of conflict, inconsistency or incompatibility").

Cases

- *Carte Blanche Marketing CC and Others v Commissioner for the South African Revenue Service* [2020] 4 All SA 434 (GJ).

Tags: Common Reporting Standard (CRS); low-tax jurisdictions; high net worth individuals (HNWIs); additional assessment; arm's length requirements.

PROOF OF CEASING TAX RESIDENCE

The South African Revenue Service (SARS) issued guidance on its website, updated in July 2021, on what the cessation of an individual's South African tax residence entails. The guidance sets out new documentary requirements that must be met to evidence cessation of an individual's South African tax residence. The guidance is applicable from the 2021 tax year onwards.

BRIEF BACKGROUND

Prior to the 2017 tax year, natural persons were not required to declare their current tax residence status or a change in their tax residence status to SARS in their annual tax returns.

From the 2017 tax year, natural persons have been required to indicate their tax residence status by marking with an "X" under the standard question "*Mark with an 'X' if you ceased to be a resident of the RSA during this year of assessment*" on the tax return, but they were not required to indicate the date on which they ceased to be tax resident in South Africa.

SARS' GUIDANCE

Recent changes were made to tax returns for the 2021 tax year in terms of which taxpayers should now indicate, through the e-filing wizard, the date on which they ceased their South African tax residence. If an individual taxpayer ceased to be tax resident in South Africa during the 2021 tax year, the individual must indicate this by marking with an "X" under the standard question "*if you ceased to be a resident of the RSA during this year of assessment*" and inserting the date field in which the individual ceased to be resident.

SARS has indicated that if this route is followed it will request the relevant supporting documents from the taxpayer to support the declaration made. The relevant information that will be requested by, and must be supplied to, SARS will depend on the basis on which the individual has ceased to be a tax resident.

Alternatively, individual taxpayers can inform SARS of a change in their tax residence status by submitting the "*Declaration: Cease to be a Tax Resident*" form via email at contactus@sars.gov.za. The taxpayer will be required to make certain declarations relating to the way in which the tax residence ceased, the date of cessation of tax residence and the new country of residence of the individual.

This approach indicates that SARS would require a taxpayer to have acquired tax residence in another jurisdiction in order to recognise the cessation of South African tax residence.

Individual taxpayers can make use of the declaration form if they previously informed SARS that they have ceased their South African tax residence and require confirmation from SARS, or if they did not inform SARS that they have ceased their tax residence in a prior tax year and would like to place this on record with SARS. When the declaration is made via email, the declaration form must be submitted together with the relevant supporting documentation.

CESSATION DECLARATIONS

SARS now requires all taxpayers who are natural persons to comply with the new requirements to prove that they ceased their South African tax residence. The standard documentary requirements, to be submitted with all cessation declarations, are:

- the signed declaration indicating the basis on which the taxpayer qualifies;
- a letter of motivation setting out the facts and circumstances in detail to support the disclosure that the taxpayer has ceased to be a tax resident; and
- a copy of the taxpayer's passport/travel diary.

In addition to the standard documentary requirements, SARS has published lists of specific additional information to be provided to SARS to evidence the basis on which the individual has ceased to be South African tax resident. These requirements differ depending on the basis on which the individual's tax residence ceased. SARS provides that the specific additional information that must be submitted and which it will take into account in determining whether a taxpayer has ceased to be a tax resident of South Africa includes:

Basis that the individual ceased South African tax residence	Specific additional information to be provided to SARS
1. Cease to be ordinarily resident	• The type of visa on which the taxpayer has travelled to a foreign jurisdiction; • proof of permanent residence in such foreign jurisdiction (if applicable); • a certificate of tax residence from a foreign revenue authority or a letter from such authority that indicates that the taxpayer is regarded as a tax resident in that jurisdiction (if available); • details of any property that the taxpayer may still have available in South Africa and the purpose for which such property is being used; • details of any business interests (such as investment and employment interests) that the taxpayer may still have in South Africa • details of the taxpayer's family ties or interests (such as whether any family members are in South Africa and the reasons therefor); • details of the taxpayer's social interests (such as gym contracts, recreational clubs and societies) and location of the taxpayer's personal belongings; and • details of any return visits to South Africa, the frequency thereof and the reason for undertaking such visits.
2. Cease by way of the physical presence test	• The signed declaration indicating the basis on which the taxpayer qualifies; • a letter of motivation setting out the facts and circumstances in detail to support the disclosure that the taxpayer has ceased to be a tax resident; and • a copy of the taxpayer's passport/travel diary.
3. Cease due to the application of double tax agreement	• A certificate of tax residence from the foreign revenue authority where the taxpayer is treaty resident; or • a letter from the foreign revenue authority in the relevant treaty jurisdiction that indicates the taxpayer's status as a tax resident in that jurisdiction.

Importantly, SARS confirms that it can decline a declaration of cessation of tax residency if the taxpayer does not meet the criteria to cease tax residence or if the taxpayer cannot provide SARS with the relevant or correct supporting information.

REMARKS

It is evident that the cessation process does not involve a simple tick box exercise as SARS will now carefully scrutinise whether an individual correctly applied the relevant residence tests, and more importantly, whether the objective facts support the tax position taken by the taxpayer. It is therefore clear that in order to protect South Africa's tax base, SARS will no longer allow natural persons to leave the South African tax net without satisfying itself that the person has met the relevant legal requirements.

Consequently, taxpayers ceasing their South African tax residence should seek professional advice from a qualified tax practitioner to get an independent tax opinion which:

- correctly applies the residence tests;
- confirms that the taxpayer objectively meets the necessary requirements;
- verifies that the taxpayer has the relevant supporting documents that must be submitted to SARS; and
- establishes a reasonable cessation date.

Nicholas Fairbairn, *Associate; reviewed by* **Doelie Lessing,** *Director*

Werksmans

Other documents

- SARS: Guidance on what the cessation of an individual's SA tax residence entails (updated on SARS website in July 2021);
- SARS: *Declaration: Cease to be a Tax Resident* form.

Tags: tax resident; foreign revenue authority; foreign revenue authority.

SARS AUDITS ON CEASING TAX RESIDENCY

There is an alarming number of South Africans relying on the "tick-box" approach to cease their South African tax residency. Alternatively, there are South Africans who assume that they are no longer tax residents because they reside outside South Africa (either temporarily or permanently), or do not maintain assets in South Africa. These misconceptions flow from the misleading advice that such people continue to receive.

When it comes to ceasing tax residency, one cannot simply tick the box. Despite misleading views peddled by "experts" on social media that the process of proving one's residency status is exaggerated, SARS has now proven that this is not the case. Expatriates must ensure that they are able to support the contention that they are non-resident for tax purposes.

DECLARATION OF NON-RESIDENCY TO SARS

SARS recently confirmed the legal routes through which expatriates can cease tax residency. In summary, there are three bases for proving that you are no longer tax resident. These are; (1) demonstrating that you are not ordinarily resident; *and* (2) proving that you do not meet the requirements of the physical presence test; *or* (3) declaring non-residency through a double tax agreement (DTA). In each case, expats must be aware that the onus lies on you as a taxpayer to properly support your position.

AUDIT REQUESTS

To make good on its promises, SARS is now sending out audit letters requesting substantiating documents / information to those alleging that they have ceased tax residency through the tick-box approach. These audit requests show that it is not a simple process, but an exhaustive factual enquiry. Any expat that is not able to prove the basis upon which they have ceased tax residency will have their non-residency declaration rejected by SARS. Excerpts of the audit letters from SARS are shared below for reference:

DOCUMENTS

[redacted]

Enquiries should be addressed to SARS

Contact Details:

Contact Centre Tel: 0800 00 7277
SARS website: www.sars.gov.za

Details

[redacted]

Always quote this reference number when contacting SARS

Case No.: [redacted]

Issue Date: 2021-09-13

Dear Taxpayer

REQUEST FOR RELEVANT SUPPORTING DOCUMENTS

This is to acknowledge your request to update your tax residency status to non-resident. In order for SARS to verify your change in status, please submit the following relevant supporting documents:

Standard requirements

- The signed declaration indicating the basis on which you qualify (you can download the form from the SARS website, www.sars.gov.za)
- A letter of motivation setting out the facts and circumstances in detail to support the disclosure that you have ceased to be a tax resident.
- A copy of your passport/travel diary.

Specific requirements

In addition to the aforementioned information, also supply the following as applicable:

Qualifying basis 1: Cease to be ordinarily resident

- The type of visa on which you have gone to the foreign country.
- Where you have already taken up permanent residence in the foreign country, submit proof thereof.
- A certificate of tax residence from the foreign revenue authority or a letter from the authority that indicates that you are regarded as a tax resident in that country (If available).
- Details of any property that you may still have available in South Africa (Indicate the purpose that such property is being used for)
- Details of any business interest (e.g. investment and employment) that you may still have in South Africa.
- Details of your family. Indicate whether any family members are in South Africa and the reason thereof.
- Details of your social interests (e.g. gym contract, recreational clubs and societies) and location of your personal belongings.
- Details of any return visits to South Africa, the frequency thereof and the reason for undertaking such visits.

Qualifying basis 2: Cease by way of the physical presence test

- Only the standard requirements must be supplied

[redacted]

Qualifying basis 3: Cease due to application of Double Tax Agreement (DTA)

- A certificate of tax residence from the foreign revenue authority or a letter from the authority that indicates your status as a tax resident in that country.

Please submit the relevant supporting documents via eFiling or the SARS website, using the Online Query System (www.sars.gov.za, click Contact us, Submit supporting documents) within 21 business days from the date of this letter. Should you not adhere to this, we will reject your request and you will be required to resubmit a new request to SARS

BE WARY OF MISLEADING ADVICE

Taxpayers need to be made aware of the misleading approaches offered to ceasing tax residency, with the tick-box approach being one of them. Another example is where the taxpayer is erroneously advised to declare non-residency under the DTA, without requesting a tax residency certificate from the foreign tax authority. It must be stressed that this is an absolute requirement from SARS.

Relying on these illegal approaches will lead to the imposition of penalties by SARS or criminal prosecution. Some remarks that should indicate that you are being misled include:

- Ticking the non-resident box in your returns is proof that you have ceased your tax residency;
- You are considered a non-resident if you have been outside South Africa long enough;
- If you work abroad and pay foreign taxes, you do not need to submit returns in South Africa or declare anything to SARS;
- You are automatically exempt from tax in South Africa because of a DTA;
- SARS does not have access to information on your foreign earnings or assets;
- There is no need to obtain a tax residency certificate from foreign tax authorities;
- You must liquidate all your assets to cease South African tax residency.

KNOW YOUR SOUTH AFRICAN TAX RESIDENCY STATUS

If you have already ceased your tax residency and are not sure whether this was done on the correct basis, it is not too late. You can engage SARS directly by sending a letter for clarification or approach a competent tax practitioner for a second opinion. The alternative should ideally occur before SARS audits your tax profile.

Naomi Kakundu Mudyiwa

Tax Consulting SA

Tags: physical presence test; double tax agreement (DTA); tax residency; tax residency status.

REDEFINING "REASONABLE GROUNDS" FOR THE REMITTANCE OF NON-COMPLIANCE PENALTIES

In the judgment of PERI Framework Scaffolding Engineering (Pty) Ltd v Commissioner for the South African Revenue Service, *[2021], on 23 August 2021, the High Court of South Africa considered an appeal brought by the taxpayer (the appellant) which pertained to a non-compliance penalty imposed by the South African Revenue Service (SARS) for the appellant's late payment of its employees' tax obligation.*

FACTS

Pursuant to the submission by the appellant of its Employer Reconciliation Declaration on 18 December 2017 (which was only due on 31 December 2017), the appellant became liable to pay employees' tax in the amount of R10,648,340.93 to SARS. In terms of paragraph 2(1) of the Fourth Schedule to the Income Tax Act, 1962, the appellant was liable to make payment of its employees' tax obligation within seven days after the end of the month during which the employees' tax was withheld by the appellant.

On the date of submission of the return, the appellant also submitted an instruction to its bank to make payment of the amount owing to SARS on 3 January 2018. However, the payment could not be released on 3 January 2018 due to there being insufficient funds in the relevant bank account.

As a consequence, the appellant sought (and obtained) an overdraft from its bank on 5 January 2018. The overdraft, in addition to a payment that was expected to be received from a debtor on 5 January 2018, would have been sufficient to ensure that the appellant made full, timeous payment to SARS of its . However, the payment ultimately received from the debtor was insufficient to cover the full tax debt and the appellant therefore approached a connected entity for additional funds to make up the shortfall.

The tax debt was paid by the appellant on 8 January 2018.

In terms of paragraph 6(1) of the Fourth Schedule, SARS imposed a 10% penalty on the employees' tax amount that was due on the basis that the employees' tax was not paid to SARS within the period prescribed by paragraph 2(1). SARS also imposed interest in respect of the late payment of the employees' tax.

JUDGMENT

The dispute between the parties was first heard by the tax court, which ruled in favour of SARS. The appellant then appealed the decision in the High Court. The appellant contended that:

1. the calculation of the time period in which payment of its employees' tax obligation was due ought not to have been determined having regard to section 244(1) of the Tax Administration Act, 2011 (the TAA), but should have been determined on the basis of the statutory rules of interpretation as prescribed in section 4 of the Interpretation Act, 1957 (the IA); alternatively,

2. even if it was found that the appellant had been late in making payment of the employees' tax, it had demonstrated reasonable grounds for the late payment as envisioned in section 217 of the TAA (dealing with the remittance of penalties for nominal or first incidence of non-compliance), such that the penalty ought to have been remitted by SARS.

"Section 244 of the TAA provides that if any date specified in a tax Act for payment, submission or any other action (or if the last day of a period within which such payment, submission or other action must be made) falls on a Saturday, Sunday or public holiday, the action must be done not later than the last business day before the Saturday, Sunday or public holiday."

First ground of appeal: Computation of time periods

Section 244 of the TAA provides that if any date specified in a tax Act for payment, submission or any other action (or if the last day of a period within which such payment, submission or other action must be made) falls on a Saturday, Sunday or public holiday, the action must be done not later than the last business day before the Saturday, Sunday or public holiday.

The appellant argued that this section pertains only to deadlines and that it plays no role in the determination of the time period prescribed in paragraph 2(1) of the Fourth Schedule. To this end, it contended that the following interpretation, as set out in sections 1 and 4 of the IA, should be applied by the court:

- the days in a prescribed period must be counted exclusive of the first and inclusive of the last day of the period; and
- to the extent that the last day of the period falls on a Sunday or a public holiday, that last day must be excluded from the reckoning and the next Monday or ordinary day counted as the last day.

On this basis, the appellant argued that in calculating the seven-day period provided for in paragraph 2(1), 31 December was to be excluded from the calculation, and it would therefore start on 1 January 2018 and end on Sunday 7 January 2018. However, as the last day was a Sunday, that day should be excluded from the seven-day period and Monday 8 January 2018 should be taken as the last day of the period. As payment was made on 8 January 2018, the appellant contended that it had complied with its obligations and no penalty should have been imposed.

The High Court disagreed with the appellant's contentions pertaining to the calculation of the seven-day period prescribed in the Fourth Schedule and the calculation method to be employed. It held that section 244(1) of the TAA does, in fact, deal with the calculation of days specified in a tax Act for payment, submission or any other action under the Act and it clearly states that if the last day of a period in which the taxpayer is meant to make payment falls on a Saturday, Sunday or public holiday, such payment should be made no later than the last business day before that Saturday, Sunday or public holiday. The court found that the intention of the legislature as set out in section 244 was clear and prescriptive, as a result of which sections 1 and 4 of the IA would not find application in this instance.

To this end, the court concluded that the seven-day period provided for in the Fourth Schedule ought to be calculated in days, inclusive of weekends and public holidays, and that in the event of a payment due date falling on such days, the payment should be made on the last day before the weekend or public holiday. As such, the payment by the appellant of its employees' tax obligation, which was made on 8 January 2018, was not made in compliance with the time periods prescribed in the Fourth Schedule and this ground of appeal failed.

Second ground of appeal: Reasonable grounds shown for late non-compliance

In its judgment, the tax court found that the 10% penalty that had been imposed by SARS should not be remitted as the appellant had failed to show that reasonable grounds existed for making the late payment of the employees' tax to SARS.

Section 213 of the TAA states that if SARS is satisfied that an amount of tax was not paid as and when required under a tax Act, SARS must, in addition to any other "penalty" or interest for which a person may be liable, impose a "penalty" equal to the percentage of the amount of unpaid tax as prescribed in the tax Act.

Section 217(3) of the TAA provides that SARS may remit a penalty imposed in terms of section 213 if SARS is satisfied that:

- the penalty has been imposed in respect of a "first incidence" of non-compliance;
- reasonable grounds for the non-compliance exist; and
- the non-compliance in issue has been remedied.

On this basis, a penalty in terms of section 213 may be remitted in circumstances where the penalty has been imposed in respect of a "first incidence" of non-compliance (ie, where no other fixed amount or percentage-based administrative penalty has been imposed during the preceding 36 months) or where exceptional circumstances exist, which rendered the taxpayer incapable of complying with the relevant obligation under the relevant tax Act.

The appellant contended that it had never before been non-compliant with any of its tax-related obligations (and in particular it had never been late with paying its payroll taxes) and that it had taken immediate steps to remedy its non-compliance such that payment of the employees' tax obligation was made as soon as possible. As such, the appellant argued that the 10% penalty should be remitted.

SARS, however, argued that the explanation provided by the appellant for the late payment of the employees' tax did not constitute "reasonable grounds" as required in section 217 and that the appellant was therefore not entitled to any relief.

In particular, it argued that paragraph 2(1) of the Fourth Schedule establishes a fiduciary relationship between SARS and an employer as the employees' tax amounts that are deducted and withheld by an employer are collected on behalf of and for the benefit of SARS. It contended that the appellant had failed to act in a manner consistent with the requisite degree of care in its approach to collecting and paying over the amounts due to SARS, because the appellant failed to insulate the employees' tax amounts collected from its employees from the business income. SARS argued that the appellant could not contend that "reasonable grounds exist" in circumstances where it treated the employees' tax amounts deducted or withheld as its own and subjected such funds to the whims of the business. Such conduct, it argued, was unreasonable and unacceptable.

The court disagreed with SARS' contentions regarding the establishment of a fiduciary relationship between SARS and employers and stated that:

> "There have been various distinctions between the accountability of a trustee to his beneficiary and the accountability of a debtor to his unsecured creditor. Under a trust-type of relationship, the beneficiary is given an equitable proprietary interest in some specific trust property or at least the right to have specific trust property administered according to the terms of a trust or legislation, whereas an unsecured creditor only has a personal right against the debtor which is unrelated to any property in the hands of the debtor."

On this basis, the court concluded that the relationship between SARS and employers who are obligated to withhold employees' tax could not properly be elevated to that of a fiduciary relationship which would preclude the appellant from applying the amounts so withheld in its business. To this end, the use of the amounts by the appellant in its business did not exclude the existence of reasonable grounds for the late payment.

A further argument advanced by the appellant in favour of the remittance of the penalty was that a penalty of 10% in the context of the appellant's non-compliance (being the next business day after the due date for the payment) was not proportionate to the seriousness or the duration of its non-compliance. In its counter argument, SARS contended that it was irrelevant whether the appellant was late by one day or by 20 days on the basis that, as long as the as the appellant had failed to pay the declared employees' tax amounts within the stipulated seven-day period, the imposition of the 10% penalty is triggered.

The court concurred with SARS and took the view that the imposition of varying degrees of penalties in relation to varying degrees of lateness would cause uncertainty and would likely expose SARS to a plethora of litigation pertaining to the evaluation of an appropriate penalty for the degree of lateness. On this basis, the court did not see fit to decrease the quantum of the penalty imposed on the appellant based on the degree of the appellant's non-compliance.

However, it held that section 217(3) makes provision for a "mechanism to come to the assistance of an aggrieved first incidence non-complying taxpayer".

The court identified one factor that SARS had failed to consider and which, in its view, could establish reasonable grounds for the appellant's non-compliance. Specifically, SARS had failed to consider the manner in which the appellant, when it realised that it would be unable to comply with the payment instruction on 3 January 2018, attempted to rectify the deficiency.

"While the relevant tax legislation provides various guidelines for SARS to exercise its discretionary powers (as they pertain to the remittance of penalties imposed on taxpayers under the tax Acts), these discretionary powers are broad and their application by SARS officials is very subjective."

Having regard to the steps taken by the appellant to ensure that payment was made, and the fact that payment was effected on the first business day after the payment due date (with the result that SARS suffered no prejudice), and further that there was no malintent on the part of the appellant, the court found that reasonable grounds existed for the penalty to be remitted. On this basis, the appellant's second ground of appeal was upheld and the 10% penalty was remitted.

COMMENT

While the relevant tax legislation provides various guidelines for SARS to exercise its discretionary powers (as they pertain to the remittance of penalties imposed on taxpayers under the tax Acts), these discretionary powers are broad and their application by SARS officials is very subjective.

A stringent approach to penalties is frequently adopted by SARS in practice (as was the case in this instance) and compliant taxpayers who encounter difficulties while trying to maintain their compliance status are often heavily penalised, despite their best efforts. To this end, this is a welcome judgment as it provides insights into what factors may be considered by SARS when ascertaining whether "reasonable grounds" exist for the purposes of remitting penalties.

Louise Kotze

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Fourth Schedule: Paragraphs 2(1) & 6(1);
- Tax Administration Act 28 of 2011: Sections 213, 217 & 244;
- Interpretation Act 33 of 1957: Sections 1 & 4.

Cases

- *PERI Formwork Scaffolding Engineering (Pty) Ltd v Commissioner for the South African Revenue Service* (A67/2020) [2021] ZAWCHC 165 (23 August 2021).

Tags: Employer Reconciliation Declaration; employees' tax obligations; fiduciary relationship; remittance of the penalty.

RETROSPECTIVE VAT APPORTIONMENT

In delivering the judgment in the Australian Full Federal Court decision in HP Mercantile (Pty) Ltd v Commissioner of Taxation, *Hill J noted that the genius of a value-added tax (VAT) system is that while tax is payable at each stage of commercial dealings with goods or services, an entity which acquires those goods or services as a result of a taxable supply made to it, is allowed a credit for the tax borne by that entity. That credit, known as an input tax, is available so long as the acquirer makes the acquisition in the course of carrying on an enterprise. The system of allowing input tax credits thus ensures that there is no cascading of tax and is essential for the operation of any VAT system.*

A vendor that makes both taxable and exempt supplies is only entitled to deduct VAT incurred on expenses to the extent that it makes taxable supplies. This is because the vendor is considered to be the final consumer of goods or services acquired for making exempt supplies. Section 17(1) of the Value-Added Tax Act, 1991 (the VAT Act) provides that the extent to which VAT is deductible in these circumstances, is determined by the Commissioner for the South African Revenue Service (SARS) in terms of a binding general ruling or a binding private (or class) ruling.

In a judgment handed down by the Supreme Court of Appeal (SCA) in *Mukuru Africa (Pty) Ltd v Commissioner for the South African Revenue Service* (520/2020) [2021] ZASCA (16 September 2021), the SCA held that a binding private ruling issued by the SARS Commissioner to approve an apportionment method cannot be applied retrospectively. The judgment impacts on the entitlement of a vendor to deduct input tax in relation to taxable supplies.

THE JUDGMENT

Mukuru commenced trading in 2014 by providing money transfer, mobile phone credit and *bureau de change* services. It therefore makes both taxable and exempt supplies and is required to apportion the VAT it incurs on its expenses in accordance with section 17(1) of the VAT Act.

In its 2017 financial year, Mukuru applied to SARS for approval to apply an appropriate apportionment method. SARS issued a binding private ruling in which it approved the application of a transaction count method. The ruling was made effective from 1 March 2016, the commencement of the financial year in which Mukuru applied for the ruling.

Mukuru requested SARS to make the ruling effective retrospectively from 1 March 2014 when it commenced operations, which SARS denied. Mukuru appealed to the tax court, which found in favour of SARS. Mukuru then appealed to the SCA. Both the tax court and the SCA confirmed SARS' view that the standard turnover-based method as set out in Binding General Ruling 16 (BGR 16) is the only apportionment method applicable to a vendor until SARS issues a binding private or class ruling that allows a vendor to apply a different method. SARS argued further that proviso (iii) to section 17(1) expressly precludes SARS from issuing a ruling that applies retrospectively. The SCA agreed with SARS.

Proviso (iii) to section 17(1) provides that where an apportionment method has been approved by the Commissioner, that method may only be changed with effect from a future tax period, or from another date which the Commissioner considers equitable. However, such other date must be within the vendor's year of assessment for income tax purposes in which the vendor applied for the ruling.

Counsel for Mukuru pointed out that BGR 16 stipulates that a vendor may only use that method if it is fair and reasonable. Because the BGR 16 method was not fair and reasonable given the nature of Mukuru's business, Mukuru argued that BGR 16 did not apply to it. Mukuru also pointed out that proviso (iii) to section 17(1) only applies if there was a change in the apportionment method. Since there was no change in the method applied by Mukuru, proviso (iii) did not find application.

The SCA held that the BGR 16 method is a default method in the absence of any alternative method approved by SARS, and that Mukuru therefore "changed" its apportionment method from the default BGR 16 method to the approved transaction count method. Consequently, SARS was precluded from making the ruling effective to apply to prior financial years.

IMPACT OF THE SCA JUDGMENT

It was common cause that in the circumstances, the BGR 16 method did not yield a fair and reasonable apportionment ratio given the nature of Mukuru's business, but that the approved transaction count method was an appropriate apportionment method.

The SCA did not consider whether the BGR 16 method was a fair and reasonable method for Mukuru's enterprise. It held that in the absence of an alternative approved apportionment method, Mukuru was compelled to apply the BGR 16 method. Mukuru was consequently required to apply an apportionment method to deduct input tax in prior years, which had no resemblance to its business or the extent of its taxable supplies, because it did not apply for a ruling when it commenced trading.

"SARS stipulates in its VAT 404 Guide for Vendors that in deciding whether the BGR 16 method is appropriate, the vendor must apply a common sense approach which would be applied by a reasonable person."

IMPLICATIONS

SARS stipulates in its VAT 404 Guide for Vendors that in deciding whether the BGR 16 method is appropriate, the vendor must apply a common sense approach which would be applied by a reasonable person. The method must achieve a "fair and reasonable" result which is a proper reflection of the manner in which the vendor's resources are applied for making taxable and non-taxable supplies. The SARS statement is in line with the context and operation of the VAT system and the fundamental principle that taxable businesses are entitled to a deduction to the extent that they make taxable supplies.

The BGR 16 method is unfortunately rarely representative of the extent to which a taxpayer applies its resources for making taxable supplies. It requires, for example, that the gross amount of interest and dividends received be included in the denominator of the formula. Generally, no taxable expenses, direct or indirect, are incurred in generating dividends or interest on surplus funds in a bank account. These amounts are included in the formula on the assumption that a vendor applies its resources to generate dividends and interest on the same basis as generating taxable supplies.

The BGR 16 method, which the SCA has now confirmed to be the default apportionment method, hardly ever yields a fair and reasonable result. Vendors therefore generally apply for approval to use an alternative apportionment method which is a fair reflection of their enterprise activities.

Vendors who do not apply timeously for approval for an alternative apportionment method, find themselves in the unfortunate position that they are forced to apply the BGR 16 method to their detriment. A vendor that receives a substantial once-off dividend at its financial year end and only manages to apply for approval of an alternative apportionment method a day after its year end, will not be allowed to apply the ruling retrospectively. Instead, the BGR 16 method will apply as default to include the total dividend in the formula and the vendor will find itself in the unenviable position of not being entitled to deduct a substantial portion of its input tax for the prior financial year, even though no expenses are attributable to the dividend.

In a similar vein, if a vendor obtained approval to apply an alternative apportionment method, but the ruling expires and the vendor omits for any reason to apply for a renewal of the ruling before the end of the next financial year, the vendor will be required to apply the default BGR 16 method. The vendor could be deprived of a significant portion of its input tax deductions even though there was no change in its business operations, only because it omitted to apply timeously for a ruling.

"Bearing in mind that the SCA has confirmed that the BGR 16 method must be applied as a default apportionment method, BGR 16 also requires urgent revision."

A vendor that applies the BGR 16 method which does not yield a fair and reasonable result, but in favour of the vendor (for example where the vendor has substantial non-taxable activities in respect of which it does not receive any consideration), may also find itself in trouble. The SARS Guide for Vendors stipulates that, although the term "fair and reasonable" will usually be perceived as a subjective concept, vendors applying the BGR 16 method should be objective and consider that the result must be perceived as "fair and reasonable" from the Commissioner's perspective as well. It therefore appears that, if in SARS' view the application of the BGR 16 method yields an unfair result in favour of the vendor, SARS will seek to apply a different method retrospectively. However, if the same method yields an unfavourable result, in favour of SARS, SARS is precluded from approving the application of a fair and reasonable method retrospectively by virtue of proviso (iii) to section 17(1).

The purpose of section 17(1) is to clarify the extent to which vendors making mixed supplies are entitled to deduct input tax. It is not an anti-avoidance provision and does not serve an administrative purpose. It also does not seek to impose additional non-deductible VAT on a vendor but ensures that VAT is deducted to the extent that the vendor makes taxable supplies, in accordance with the operation of the VAT system.

The problem is that proviso (iii) to section 17(1) prohibits SARS from approving the application of a fair and reasonable apportionment method to prior financial years. Such a prohibition is in direct contrast with the context and operation of the VAT system which allows an input tax deduction to the extent that a vendor makes taxable supplies. There is no reason to deny an input tax deduction to a vendor in relation to its taxable supplies, even retrospectively. Otherwise, the operation of the VAT system is distorted, and it gives rise to a cascading of tax. Following the judgment in the Mukuru case, the legislature should consider removing proviso (iii) to section 17(1) of the VAT Act.

Bearing in mind that the SCA has confirmed that the BGR 16 method must be applied as a default apportionment method, BGR 16 also requires urgent revision. The inclusion in the formula of the total amount of non-taxable revenue which does not require the application of any taxable resources, does not yield a result which is a fair and reasonable reflection of the application of resources by a vendor.

Until the legislation is amended and BGR 16 is revised, vendors who make both taxable and exempt supplies will have to apply timeously for approval of an alternative apportionment method, or they will face the risk of being burdened by non-deductible VAT on their taxable supplies.

Gerhard Badenhorst

Cliffe Dekker Hofmeyr

Acts and Bills

- Value-Added Tax Act 89 of 1991: Section 17(1) (specific reference made to proviso (iii) to subsection (1)).

Other documents

- Binding General Ruling 16;
- VAT 404 Guide for Vendors.

Cases

- *HP Mercantile (Pty) Ltd v Commissioner of Taxation* (Australian Full Federal Court decision);
- *Mukuru Africa (Pty) Ltd v Commissioner for the South African Revenue Service* (520/2020) [2021] ZASCA (16 September 2021).

Tags: taxable supply; apportionment method; transaction count method; standard turnover-based method.

TEMPORARY LETTING OF RESIDENTIAL PROPERTY

The sale (supply) of a dwelling in the normal course or furtherance of a property developer's business (VAT enterprise) usually attracts VAT at the standard rate of 15%. Due to economic circumstances such as market conditions a dwelling may not be sold but rather temporarily let out until it is sold. The letting of a dwelling is, however, an exempt supply in terms of section 12(c)(i) of the Value-Added Tax Act, 1991 (the VAT Act). Without any relief provisions, a change in use adjustment is required to be made by the property developer when the dwelling is used to make exempt supplies (even if it's temporary). As a consequence, the property developer is required to make an output tax adjustment in terms of section 18 of the VAT Act.

From 10 January 2012 until it expired on 31 December 2017, section 18B of the VAT Act provided temporary relief for property developers. Section 18B provided that where a property developer "… constructed, extended or improved… [a dwelling]… for the purpose of sale and.." the dwelling was temporarily used for exempt purposes, such as for generating rental income, the "change" would not be taxable and the dwelling would have been deemed to have been supplied at a later stage, within the time frame stipulated in the legislation.

As section 18B is no longer in existence, where a property developer subsequently entered into an agreement to temporarily let out a dwelling "…for the first time, on or after 1 January 2018…" output tax was required to be accounted for on the change in use in accordance with section 18(1) and the property developer was required to account for the output tax adjustment based on the open market value of the dwelling.

There was, however, concern about the value placed on the change in use adjustment amount as well as some confusion as to whether the change in use adjustment resulted in the subsequent supply (sale) of the dwelling being permanently or only temporarily removed from the scope of VAT.

As a result of the above, changes have been made to the VAT Act by the insertion of a new section, namely section 18D (per clause 54 of the Taxation Laws Amendment Bill, 2021 (the TLAB 2021), which will provide for the deemed change in use adjustment required when a dwelling is let for the first time, if the dwelling remains permanently in the scope of VAT and the deemed supply made when the dwelling is subsequently sold. Section 18D will come into effect on 1 April 2022.

Section 18D provides as follows in respect of the temporary letting of residential property:

"(1) For the purposes of this section—

(a) **'developer'** means a vendor who continuously or regularly constructs, extends or substantially improves fixed property consisting of any dwelling or continuously or regularly constructs, extends or substantially improves parts of that fixed property for the purpose of disposing of that fixed property after the construction, extension or improvement; and

(b) **'temporarily applied'** means the application of fixed property or a portion of a fixed property in supplying accommodation in a dwelling under an agreement or more than one agreement for letting and hiring thereof which agreement or agreements relate to a combined ***total period not exceeding 12 months*****:** Provided that 'temporarily applied' does not include the application of fixed property in supplying accommodation in a dwelling under an agreement for the letting and hiring thereof where any such agreement is for a fixed period exceeding 12 months, in which case this section will not apply, but the provisions of section 18(1) shall apply.

(2) Notwithstanding the provisions of section 18(1), where goods being supplied consist of fixed property consisting of any dwelling and such fixed property—

(a) is developed by a vendor who is a developer wholly for the purpose of making taxable supplies or is held or applied for that purpose by that vendor; and

(b) is subsequently temporarily applied by that vendor in accordance with section 12*(c)*, such fixed property shall be deemed to have been supplied by that vendor by way of a ***taxable supply for the consideration*** contemplated in **section 10(29)** and shall take place in accordance with section 9(13).

(3) Where a vendor who is a developer subsequently supplies fixed property contemplated in subsection (2)*(b)* ***by way of a sale*** within the period that the fixed property is temporarily applied, ***such supply shall be a taxable supply*** in the course or furtherance of the vendor's enterprise and shall take place in accordance with section 9(3)*(d)*.

(4) Where fixed property contemplated in subsection (3) is supplied by that vendor, the supply ***shall be deemed to be made for a consideration as contemplated in section 10(2).***

(5) Where fixed property—

(a) contemplated in subsection (3) is supplied by that vendor within the 'temporarily applied' period;

(b) is temporarily applied as contemplated in subsection (2)*(b)* and is no longer applied in supplying accommodation in a dwelling immediately after the expiry of the 'temporarily applied' period; or

(c) contemplated in the proviso to the definition of 'temporary applied' in subsection (1) is subject to the adjustment in section 18(1), the Commissioner shall allow such vendor a deduction in terms of section 16(3)*(o)*, ***and the deduction so made shall be deemed for the purpose of that section to be input tax.***" [Own **emphasis**]

Section 10(29) will also be inserted into the VAT Act with effect from 1 April 2022 (per clause 51 of the TLAB 2021) and provides that where a dwelling is supplied in accordance with section 18D(2) above, the supply will be deemed to be made for a consideration equal to *the adjusted cost* to the vendor of the construction, extension or improvement of the dwelling *as opposed to the open market value*, which would apply in the case of a section 18(1) adjustment. The *adjusted cost* is the cost of goods or services incurred by the property developer where VAT has been charged or would have been charged had VAT been applicable prior to 1991; or alternatively, amounts in respect of which the property developer would have been entitled to claim a notional input tax deduction, whereas the open market value, at a high level, is the amount the dwelling could be sold at in an arm's length transaction.

The provisions of section 18D(4) will be triggered if the property is sold within the period that the fixed property is temporarily applied (ie, within 12 months). The property developer will then be obliged to declare output tax on the value as determined in section 10(2), ie, on the consideration for the supply. The consideration is, if in money, the amount of money, or the market value of the consideration received, to the extent that such value is not in the form of money as envisaged in section 10(2), read with section 10(3). The *time of supply* will be the earlier of the date on which any payment is made or the date on which the property is transferred in the deeds registry in terms of section 9(3)*(d)*.

The application of section 18D(5) is slightly confusing in its wording as it appears to provide that the property developer would then be entitled to claim an input tax deduction in accordance with section 16(3)*(o)*, which also comes into effect on 1 April 2022 (per clause 53 of the TLAB 2021).

Section 16(3)*(o)* states that the input tax to be deducted is "an amount calculated in accordance with section 10(29)", which determines the amount of the deemed consideration (ie, the *adjusted cost* to the vendor). This is confusing as it seems to provide that the whole amount incurred to acquire/ develop the property is eligible to be claimed as input tax. A property developer would therefore claim more input tax than it has declared as output tax which does not appear to be correct. It appears that there is an issue with the wording used as one would think that SARS is referring to the tax fraction applied to the adjusted cost as determined by section 10(29), which would mean that the input tax claim is equal to the input tax previously deducted by the property developer on the adjusted cost.

We will wait to see whether the legislation is amended in future or whether there is further guidance on the application of this provision.

Kabelo Sehlapelo, Leila Wright & Leonard Willemse

Mazars

Acts and Bills

- Taxation Laws Amendment Bill 22B of 2021: Clauses 51, 53 & 54;
- Value-Added Tax Act 89 of 1991: Section 9(3)*(d)*, (6) & (13); 10(2) & (29); 12*(c)*(i); 16(3)*(o)*; 18 (more specifically subsection (1)); 18B (in force from 2012 to 2017); 18D;

Tags: exempt supply; output tax adjustment; fixed property.