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DIVIDENDS TAX
SCRIP DIVIDENDS AND CAPITALISATION SHARES

GENERAL
DUE DILIGENCE: EXPOSURE AND OPPORTUNITY RISKS

PUBLIC BENEFIT ORGANISATIONS
FUNDING OF ENTREPRENEURS

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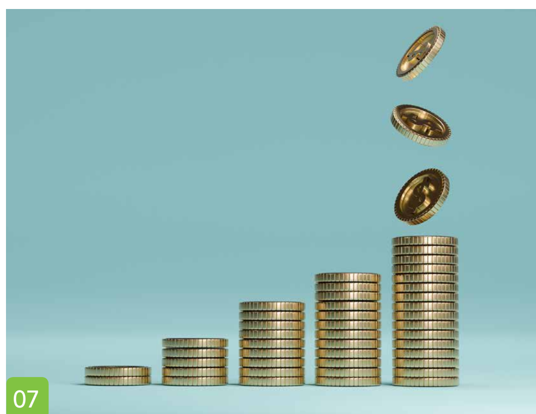

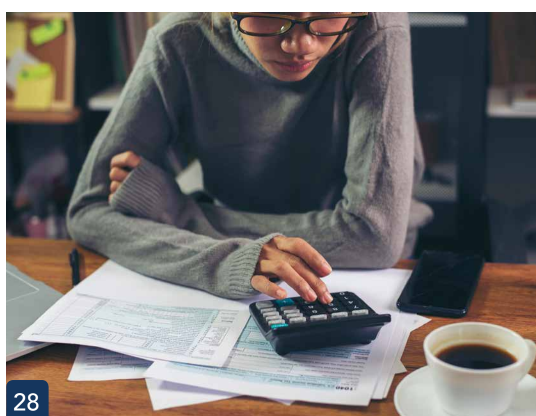

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Mr KG Karro (Chairman), Mr MA Khan, Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Ms MC Foster

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INCOME TAX IMPLICATIONS

If the emotional roller coaster of the crypto asset crash ever since a certain tweet by Elon Musk that Bitcoin and other crypto asset mining consume too much dirty energy such as coal, and his earlier decision that it can no longer be used to buy a Tesla, has got you down, at least one positive spin-off is that the dip may potentially be short-lived.

On the upside, the dip in crypto asset values may also mean that there could be less tax for some taxpayers to pay over to the South African Revenue Service (SARS) in the 2021–2022 tax filing season.

That is assuming you are a tax-savvy crypto asset investor, who is in fact taking the correct steps to stay on the right side of SARS.

The reality is that while crypto assets may still be complex and unchartered waters for global tax authorities and some investors, this does not mean there are not already clear rules about crypto asset investors' tax liabilities.

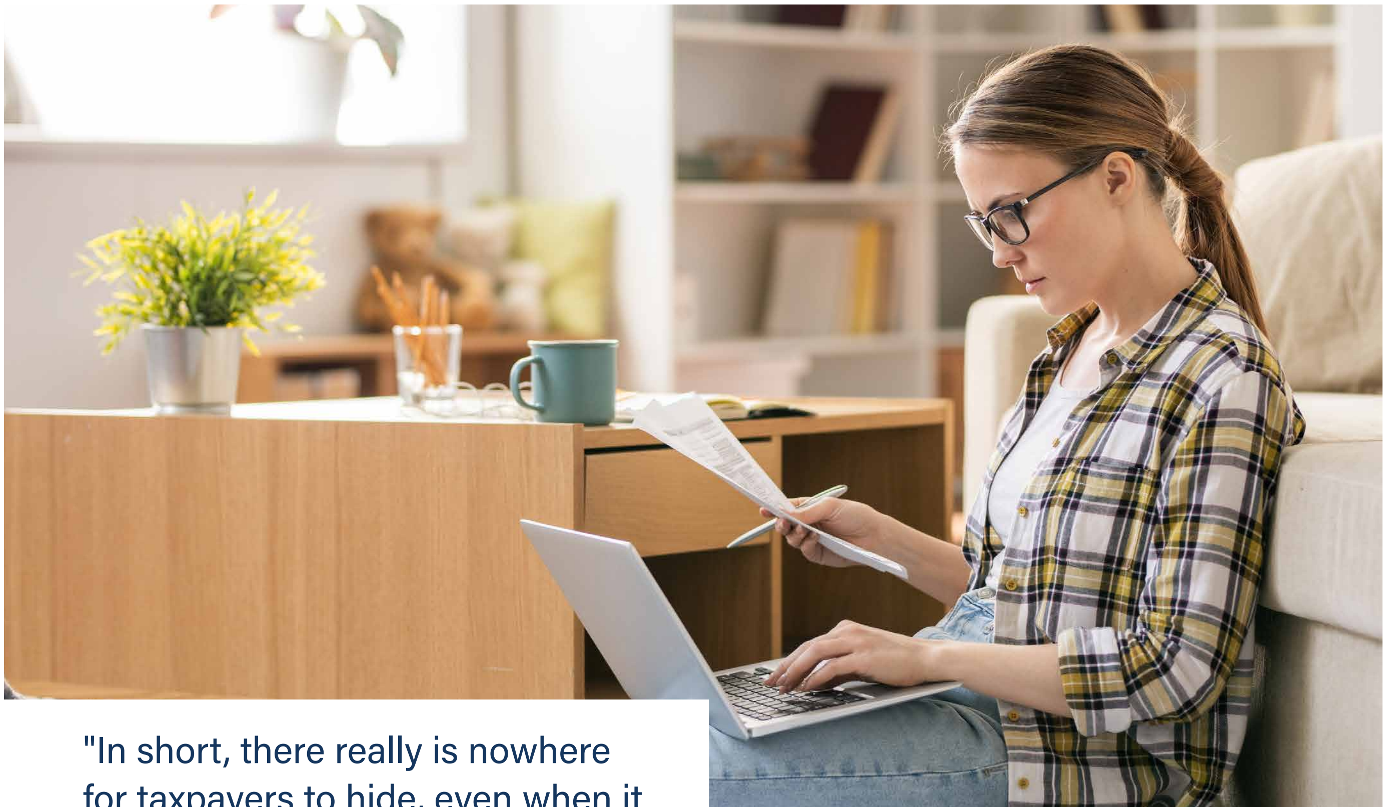
SARS has strengthened capacity to digitally dig into crypto asset earnings

Tax practitioners warn that SARS is already pulling out its big guns to mine for its own revenue in the profits and income of crypto asset investors.

SARS earlier announced that it has allocated an additional R3 billion to modernise its technology infrastructure and systems, expand and improve the use of data analytics and artificial intelligence capabilities, and participate meaningfully in global tax compliance initiatives.

With this in mind, we offer the following advice regarding the top seven factors about which crypto asset investors urgently need to speak to their accountants this tax filing season.

1. The first thing about which you need to speak to your tax advisor is the simple fact that all trades (big and small, profit or loss) in crypto assets are potentially taxable, not just when it is withdrawn from your wallet and/or converted to a fiat currency such as rand or USD.
2. Your tax advisor will also need to know what your intentions are for investing in crypto assets. This informs whether your profits are capital in nature, attracting capital gains tax (CGT), or revenue in nature. CGT is levied at a maximum rate of 18% and revenue will be taxed at the normal income tax rates up to 45% for individuals.
3. Realising crypto assets can be done in several ways, including cashing it out for legal tender or using the coins to purchase goods and services with global providers that accept crypto assets as payment. Unfortunately, purchasing a Tesla is no longer an option. But should you decide to trade your crypto assets for any goods or services, this is definitely a transaction about which your tax advisor needs to know because of the tax implications involved.



"In short, there really is nowhere for taxpayers to hide, even when it comes to investing and trading in crypto assets as revenue authorities and financial institutions are now sharing information globally to widen their collection nets."

4. It is crucial for crypto asset traders to obtain the transaction reports drawn from every relevant exchange or trading platform, and to share these with your accountant. The onus of proof remains on the taxpayer to show that a certain amount is not taxable or deductible when SARS assesses the information provided in the tax return; here direct supporting documentation is key.
5. Another factor to consider would be how you conduct your crypto asset investment activities and whether foreign currency is used. When you are dealing with foreign currencies, there are rules in the Income Tax Act, 1962, that you need to take into account.
6. As a crypto asset trader deriving a profit for the year, you may be required to submit provisional tax returns twice a year. The volatility of crypto assets renders it difficult to provide an accurate estimate for the year and leaves taxpayers and their tax advisors with a challenge. It is important to ensure that a careful and serious computation is done and estimated tax is paid timeously in each case, otherwise onerous penalties may apply.
7. Lastly, ensure that your accountant understands crypto assets and your specific investment methods applied. Not all transactions are created equal from a tax treatment perspective, so it is important to ensure that the correct tax position is taken, and the correct amount of tax liability is determined and paid in each case.

SARS' all-seeing eye will mine tax revenue from crypto asset traders

In short, there really is nowhere for taxpayers to hide, even when it comes to investing and trading in crypto assets as revenue authorities and financial institutions are now sharing information globally to widen their collection nets.

If you don't tell your tax advisor about your crypto asset investments and trading activities, you are very likely going to land yourself in hot water and could even end up subject to criminal sanction because this could speak to potential tax evasion. Some investors claim that SARS does not know about their activities, but it is not up to traders to decide whether or not they owe taxes.

It is vital to use the services of a tax advisor or tax expert who is familiar with the intricacies of crypto asset trading and knows how to ensure legal tax compliance.

Just as crypto asset investing and trading is a specialised field that requires knowledge of the various trading platforms and crypto asset mechanics to succeed, the tax regime surrounding the revenue and profits generated via online crypto asset investment is equally complex. This makes it crucial to engage a tax professional who understands how to best limit tax liability while making compliant disclosures to SARS.

Thomas Lobban

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Acts and Bills

- Income Tax Act 58 of 1962.

Tags: crypto asset investors; volatility of crypto assets.

CONSTITUTIONAL COURT RULING ON SECTION 24C

On 21 May 2021, the Constitutional Court handed victory to SARS in a decision that may have sweeping ramifications for retailers who operate loyalty plans similar to the Clicks ClubCard loyalty programme.

What was at stake for Clicks and other retailers?

The matter of *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service*, [2021], involved the application of section 24C of the Income Tax Act, 1962, to its loyalty programme.

Section 24C allows taxpayers to defer paying tax on income if it accrues in terms of a contract and that income will also be used to finance future expenditure. The taxpayer may then, in terms of section 24C, claim a deduction in respect of such future expenditure, provided the income and the obligation to incur the future expenditure arise from the same contract.

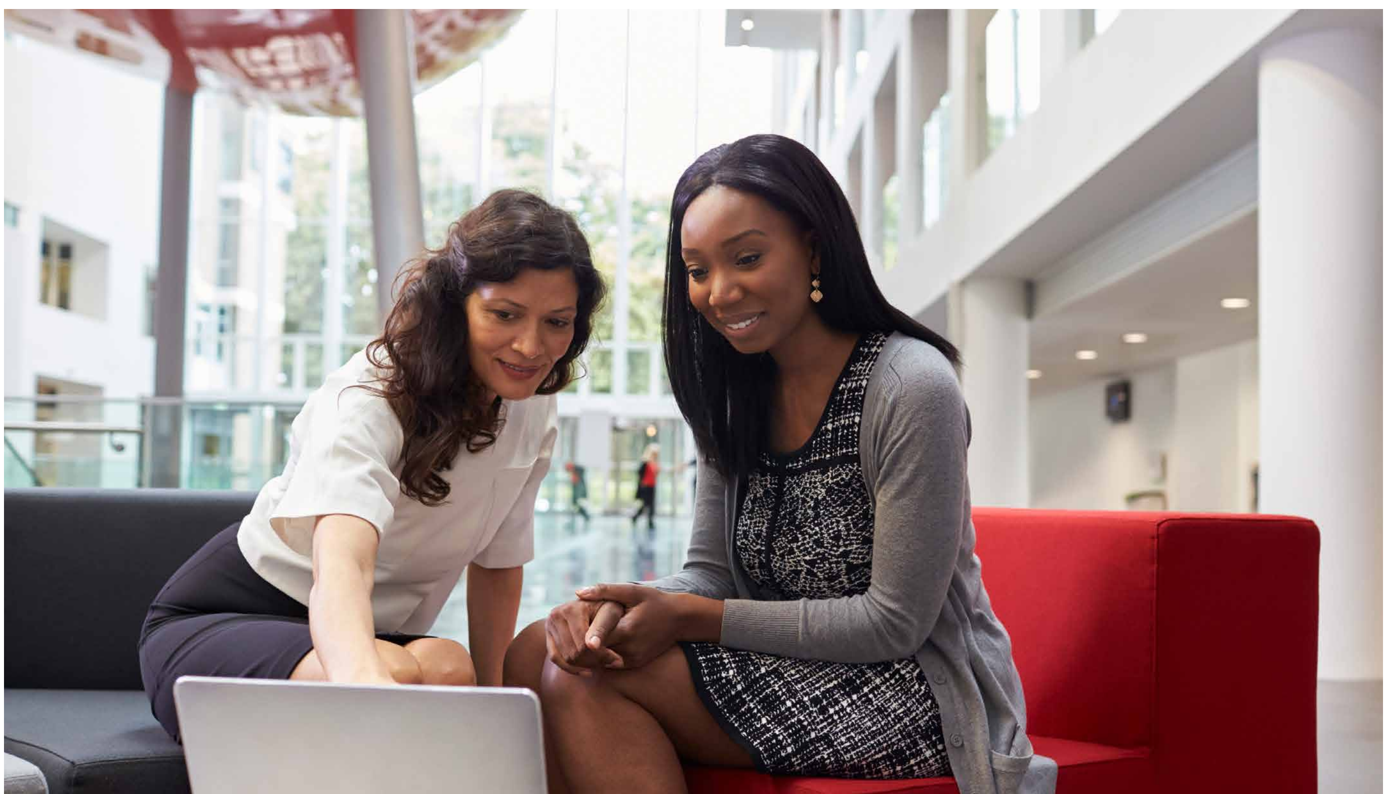
In this case, Clicks sought to utilise this provision on the basis that its ClubCard loyalty programme creates an obligation to incur future expenditure when card holders earn loyalty points by making purchases at Clicks stores. The loyalty points awarded translate to a cost that Clicks will incur on merchandise provided to customers upon redemption of cash back vouchers. In other words, when Clicks makes a sale for which it receives income, an obligation is created at the same time to incur a cost at a future date.

Clicks returns 2% of the value of all qualifying purchases to customers and its inability to deduct this cost will have a significant impact on its cash flow. The import of the judgment, however, extends well beyond the interests of Clicks. The court acknowledged that other retailers such as Pick n Pay, Dischem, Ster Kinekor and Exclusive Books, to name a few, will also be impacted by the court's decision.

The dispute

SARS maintained that Clicks is not eligible for the section 24C deduction, as the income it receives and the obligation to incur the future expenditure arise from separate contracts.

Clicks succeeded in the tax court, which concluded that the income-earning contract and the contract which gives rise to the obligation (the ClubCard contract) are inextricably linked. SARS appealed to the Supreme Court of Appeal (SCA). It is important to note that Clicks' appeal was heard shortly after the SCA handed down judgment in *Commissioner, South African Revenue Service v Big G Restaurants (Pty) Ltd*, [2018] (*Big G*), which dealt with the same issue.



"While the matter does not involve a constitutional question, the Constitutional Court accepted, as with *Big G*, that Clicks should be granted leave to engage its jurisdiction on the basis that the matter involved an arguable point of law which is of general public importance."

In *Big G*, the SCA rejected the notion that section 24C applies where the contracts are "inextricably linked" – the income and the obligation must emanate from the same contract. The SCA therefore set aside the tax court's decision. But *Big G* took the matter to the Constitutional Court, where the interpretation of section 24C was widened, albeit slightly. The Constitutional Court confirmed that section 24C may apply where there is more than one contract, provided they are so inextricably linked that they satisfy the requirement of "sameness".

Big G lost the appeal, but it gave Clicks another bite at the cherry. Clicks filed its appeal to the Constitutional Court, which accepted that there is a significant factual overlap and an inextricable link between the ClubCard contract that imposes the obligation to incur a future expenditure and the contract of sale. However, it is not sufficient for the two contracts to be inextricably linked; the link must be of such a nature that they give rise to a "sameness".

In the present matter, the Constitutional Court found that the link between the two contracts does not render either dependent on the other for its existence; they operate together but they do not meet the requirement of contractual sameness. The upshot is that section 24C does not apply to the Click's ClubCard loyalty programme and the retailer incorrectly claimed these deductions.

Analysis

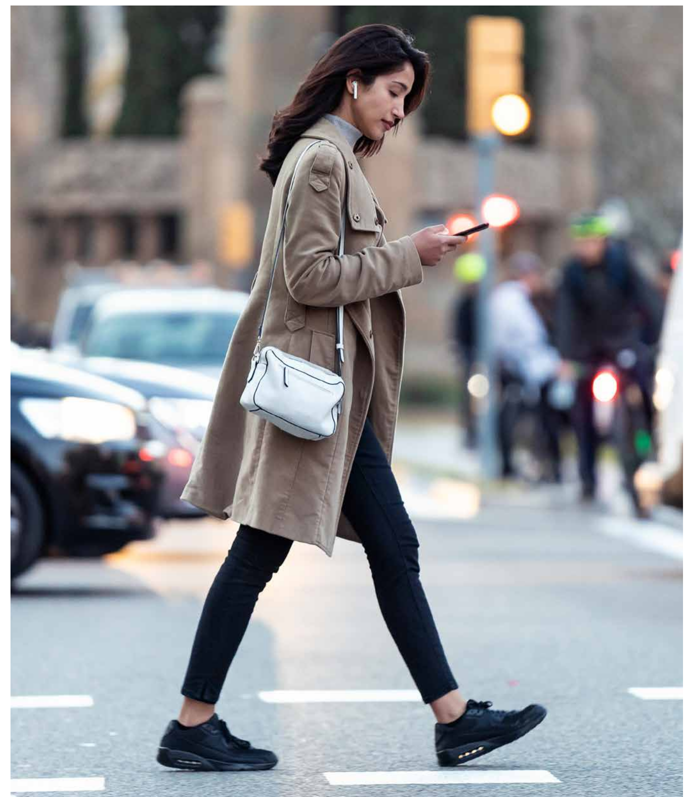
While the matter does not involve a constitutional question, the Constitutional Court accepted, as with *Big G*, that Clicks should be granted leave to engage its jurisdiction on the basis that the matter involved an arguable point of law which is of general public importance. The court held that this is evidenced by the divergent approaches taken by the tax court and the SCA, and the importance to the general public lies in the potential impact for other operators of such loyalty programmes.

The decision to entertain the matter must be welcomed, as it allowed the court to shed some light on the application of section 24C, by giving definition to the sameness test where two or more contracts are involved.

What does the judgment mean for other retailers?

Other entities that similarly sought to claim the section 24C allowance must carefully study the judgment against the operation of their own loyalty programmes. But with a model that is hardly unique, it is difficult to see how their fate would be any different and it is possible that they might inadvertently find themselves in a position of non-compliance.

The judgment again serves as a cautionary tale where contracts are drafted without an understanding of the tax implications, which can make for a nasty surprise down the line.



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Tax Consulting SA

Acts and Bills

- Income Tax Act 58 of 1962: Section 24C.

Cases

- *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* [2021] ZACC 11;
- *Commissioner, South African Revenue Service v Big G Restaurants (Pty) Ltd* [2018] ZASCA 179; 2019 (3) SA 90 (SCA).

Tags: loyalty programme; defer paying tax; section 24C deduction.

SCRIP DIVIDENDS AND CAPITALISATION SHARES

This article outlines certain relevant aspects in respect of scrip dividends and the tax considerations arising for residents and non-residents from the issuing of capitalisation shares. Scrip dividends take the form of capitalisation shares issued by a company to its shareholders – in other words, the relevant company issues shares to its shareholders rather than declaring and making payment of a cash dividend.

RECEIPT/ACCRUAL OF SCRIP DIVIDENDS

The starting point for any person is to consider whether the value of a scrip dividend falls within its "gross income".

The definition of "gross income" in section 1(1) of the Income Tax Act, 1962 (the Act), includes, in the case of a resident, the total amount, in cash or otherwise, received by or accrued to such resident, excluding receipts or accruals of a capital nature. In the case of a non-resident, an additional requirement is that such amount must be from a South African source.

Although paragraph *(k)* of the gross income definition specifically includes any amount received or accrued by way of a dividend or a foreign dividend, specifically excluded from the definition of "dividend" also contained in section 1(1) are amounts transferred or applied by a resident company in respect of any share in that company, where such amounts constitute shares in that company. Therefore, scrip dividends will not automatically be included in the gross income of a taxpayer in the way that cash dividends would.

Resident taxpayers will therefore include scrip dividends in their gross income in instances where the receipt or accrual is not of a capital nature. Non-residents will, in addition, need to be satisfied that such amount is from a South African source.

Capital or revenue?

The question as to whether a receipt or accrual is of a capital nature is ultimately a question of fact dependent on the specific circumstances. Reference would need to be drawn from case law principles in determining the capital or revenue nature of amounts received or accrued by way of scrip dividends. In this regard, case law exists that supports the argument that the receipt or accrual of scrip dividends, depending on the facts, is of a capital nature. There are also non-binding indications that the South African Revenue Service is of the view that scrip dividends result in the receipt or accrual of amounts of a capital nature.

To the extent that the amount is of a capital nature, resident and non-resident taxpayers will not be required to include such amount in gross income.

However, the receipt or accrual of scrip dividends may constitute an amount which is not of a capital nature. In such cases, a resident will be required to include the amount of the scrip dividend in its gross income. This scenario may arise, for example, where the underlying shares held by the taxpayer form part of a transaction undertaken on a speculative basis or in a scheme of profit making.

"For resident taxpayers, any future disposal of shares received as scrip dividends will have income tax or CGT implications, to be determined with reference to the proceeds in respect of the disposal of the shares. "

Source?

As indicated above, non-residents will only be required to include scrip dividends in their gross income if such amounts are not of a capital nature and if they are from a South African source. Since scrip dividends do not constitute "dividends" as defined, no statutory source rules exist to determine the source thereof and reference must be made to case law principles. This requires that the originating cause of the scrip dividend be determined. Some of the factors to be considered in determining the originating cause include determining the location where relevant activities (which give rise to the scrip dividends) are undertaken, the location where the capital of the non-resident is employed and the question whether the listed shares are issued by a South African resident company.

To the extent that the scrip dividends are not of a capital nature and are sourced in South Africa, the scrip dividends will be subject to income tax in the hands of the non-resident and it will be necessary to consider if the non-resident is entitled to relief in terms of a double taxation agreement.

DISPOSAL OF SHARES RECEIVED AS SCRIP DIVIDENDS

It is also necessary to consider the tax impact arising from the disposal of the shares received as scrip dividends.

In terms of section 40C of the Act, the expenditure incurred by a taxpayer in acquiring scrip dividends is deemed to be nil. For this reason, the tax implications arising from any future dealings in the shares received as scrip dividends by taxpayers include that a separate detailed analysis with reference to the gross income definition and the relevant capital gains tax (CGT) provisions is required.

For resident taxpayers, any future disposal of shares received as scrip dividends will have income tax or CGT implications, to be determined with reference to the proceeds in respect of the disposal of the shares. As set out above, in terms of section 40C the shares will be deemed to have an acquisition cost of nil and no deduction of, for example, the market value of the scrip dividends on the date of accrual thereof to the taxpayer will be permitted.

Notwithstanding a deemed acquisition cost of nil, from the perspective of a non-resident, the disposal of shares received as scrip dividends will only have income tax implications where the disposal thereof is from a South African source in terms of the statutory source provisions. Furthermore, there will only be capital gains tax implications where the disposal of the shares falls within the scope of paragraph 2(1)*(b)* of the Eighth Schedule to the Act.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definitions of "dividend" & "gross income" (more specifically paragraph *(k)*) and 40C; Eighth Schedule: Paragraph 2(1)*(b)*.

Tags: scrip dividends; accruals of a capital nature; foreign dividend.

RELAXATION OF LOOP STRUCTURES

The complexities arising from the relaxation of South African exchange control rules relating to loop structures and investments to encourage inward investment into South Africa (SA) are discussed in this article. There are clearly advantages and disadvantages for SA residents and emigrants wishing to invest back into SA through a foreign investment structure. The level of disclosure required needs to be balanced against any potential tax and estate duty savings and most importantly whether the return on the investment outperforms current returns on invested funds.

What is a loop structure?

In simple terms a loop structure entails the formation of an offshore structure, where the ultimate beneficial owners (UBOs) are South African exchange control residents (SA residents). The offshore structure (trust or company) then reinvests into SA or the common monetary area (CMA, comprising South Africa, Eswatini, Lesotho and Namibia), by acquiring shares, loan accounts, or an interest in an SA resident company or asset.

Loop regulations and exceptions

Regulation 10(1)*(c)* of the Exchange Control Regulations, 1961, prohibited SA residents from entering into any transaction (or series of transactions) with the purpose or effect of directly or indirectly exporting capital from SA. It effectively prohibited (subject to certain exceptions) the formation of loop structures because they allowed the export of capital (including dividends) from SA for the ultimate benefit of SA residents, whether such capital is transferred to an offshore company or to an offshore discretionary trust of which the SA residents are beneficiaries.

An exception to the loop prohibition was that SA residents (individuals, corporates and private equity funds) were permitted to acquire up to 40% of the shares and voting rights in a foreign company which in turn invested back into SA or a CMA country. Any loop structure where the 40% threshold was exceeded required prior approval, on application, to the Financial Surveillance Department of the South African Reserve Bank (FinSurv). In 2019, FinSurv issued Exchange Control Circular 18/2019, which provided that SA private individuals (in addition to SA corporates and private equity funds) were permitted to acquire by way of their foreign capital allowance (FCA) up to 40% of the shares in a non-resident company which invests back into SA. The 40% was calculated by adding all the SA individuals' interests together.

Offshore trusts with SA resident discretionary beneficiaries, however, were not permitted to invest back into SA via this "loop exception".

The relaxation

On 4 January 2021, FinSurv released Exchange Control Circular 1/2021 (the Circular), which provides for the full relaxation of the SA exchange control rules relating to loop structures and investments to encourage inward investment into SA.

Existing unauthorised loop structures (ie, created prior to 1 January 2021) and/or unauthorised loop structures where the 40% shareholding threshold has been exceeded (and that were created prior to 1 January 2021) must still be regularised by way of an application to FinSurv and may incur penalties.

SA resident individuals, companies and private equity funds with *authorised* foreign assets are now permitted to invest back into SA without restriction. However, where the investment is made via a foreign investment structure (for example, an offshore company, or an offshore trust investing back into SA, either directly or via its shareholding in a foreign company), the investment must be reported to an authorised dealer (AD) in SA.

While the full relaxation of exchange control regulations with regard to new loop investments is welcomed, the decision to make an inward investment into SA needs to be carefully considered specifically in relation to the:

- reporting requirements and the disclosure that needs to be made to FinSurv via the AD;
- tax considerations; and
- reintroduction of funds into SA that have already been externalised as authorised foreign assets.

Reporting requirements

The AD must be provided with an independent auditor's valuation confirming that the transaction is concluded on an arm's length basis for a fair and market-related price.

Once the transaction is completed, the AD must submit a report to FinSurv, which should include:

- the name(s) of the SA-affiliated foreign investor(s);
- a description of the assets to be acquired (including inward foreign loans, the acquisition of shares and the acquisition of property);
- the name of the SA target investment company, if applicable;
- the date of the acquisition as well as the actual foreign currency amount introduced (including a transaction reference number).
- details of the offshore investment structure (including full names of the entities, place of incorporation, tax residence and details of all shareholders and percentage shareholding). If a foreign trust is the shareholder of a foreign investment company, full details of the following are required: the settlor/economic funder of the structure, the trust deed, the discretionary beneficiaries and their tax residence and domicile. This is an onerous disclosure requirement especially in cases where the trust has a mix of SA resident and non-resident discretionary beneficiaries. Non-resident beneficiaries may not want their details provided to a regulatory authority in another jurisdiction.
- the source of funds utilised to fund the offshore investment structure. If the structure was funded or partly funded by an SA resident, evidence would need to be provided to the AD of how funds were transferred from SA to fund the investment structure (dates, amounts and banks which facilitated the outward transfers for the annual foreign capital allowance and single discretionary allowances). If funded with foreign-sourced income, full details of the nature of this income will also need to be disclosed.

Thereafter, an annual submission of a progress report to FinSurv via an AD is required.

Tax considerations

Various amendments have been made to the Income Tax Act, 1962 (the Act) to prevent any tax leakage arising from the relaxation of loop structures.

It is important to consider these provisions and the impact that they may have on SA residents implementing loop structures. These amendments have been targeted specifically at controlled foreign companies (CFCs) making inward investments into SA.

> "Various amendments have been made to the Income Tax Act, 1962 (the Act), to prevent any tax leakage arising from the relaxation of loop structures."

Section 9D(2A)*(d)* of the Act

A CFC is a foreign company in which more than 50% of the participation or voting rights are (directly or indirectly) held by SA tax residents. In terms of the CFC rules, a proportional amount of the net income of the CFC is imputed to an SA resident shareholder based on the percentage of their participation rights held in the company.

The relaxation of loop structures, however, created opportunities for tax leakage. Dividends tax on dividends declared by an SA company to a CFC could be reduced from 20% (the current withholding tax rate) to a lower rate under an applicable double tax agreement (DTA). For example, in terms of the DTA between SA and Mauritius, dividends tax can be reduced from 20% to 5% where the Mauritian company holds at least 10% of the equity in an SA company paying the dividend. Any dividends received by the CFC were also excluded from the net income calculation (being exempt for normal tax in terms of section 10(1)*(k)* of the Act) and therefore not imputed to an SA resident shareholder.

With effect from 1 January 2021, section 9D(2A)*(d)* of the Act now requires a CFC to include a portion of any dividend received or accrued from the SA company in its net income in terms of a formula. The portion of the dividend that is included in the CFC's income is equal to the amount of the dividend, reduced on a sliding scale, with reference to the rate of dividends tax imposed in SA. The result is then multiplied by the ratio of the number 20 to the number 28.

The formula is A = B x (C-D)

'A' represents the amount to be determined;

'B' represents the ratio of the number 20 to the number 28;

'C' represents the aggregate of dividends received by or accrued to the CFC during the foreign tax year of that CFC; and

'D' represents an amount equal to the amount deducted in respect of any dividends tax paid by the CFC. "D" in the formula provides for a deduction of:

- 100% of the amount of the dividend if dividends tax was paid at a rate of 20%;
- 50% of the amount of the dividend if dividends tax was paid at a rate of 10%;
- 40% of the amount of the dividend if dividends tax was paid at a rate of 8%;
- 37.5% of the amount of the dividend if dividends tax was paid at a rate of 7.5%;
- 25% of the amount of the dividend if dividends tax was paid at a rate of 5%.

It is important to note that this provision would not apply where a foreign trust holds 100% of a foreign company that invests back into SA, as under current tax legislation the foreign company would not be classified as a CFC.

The application of the participation exemption - paragraph 64B(6) of the Eighth Schedule to the Act

Paragraph 64B contains the participation exemption for the disposal of equity shares in a foreign company. It states that a person must disregard any capital gain or capital loss when an equity share in a foreign company is disposed of if all the following requirements apply:

- the SA resident holds at least 10% of the equity shares and voting rights in the company;
- the shares were held for at least 18 months;
- the shares are disposed of to a non-resident;
- the proceeds on disposal equal or exceed the market value of the shares; and
- the non-resident is not a connected person nor a CFC in relation to the seller.

With effect from 1 January 2021, the participation exemption on capital gains will not apply to the disposal of any share in a CFC to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued or registered in SA.

The SA tax implications need to be carefully considered when contemplating an inward investment into SA, especially if the shares in the foreign investment company are held directly by SA residents and not through a trust/company structure.

Reintroducing funds into SA

Investing back into SA through a foreign investment structure, which creates a loop, requires an investor to reintroduce funds into SA equivalent to the market value of the investment acquired.

The following three aspects should be considered when contemplating an inward investment:

(i) *Loan of trust structures*

SA residents traditionally fund their foreign investment structures using their annual R10 million foreign capital allowances and loan these funds to the structure at an arm's length interest rate to prevent the application of various anti-avoidance provisions in the Act.

The aim of these investment structures is to achieve a growth rate in excess of the interest rate charged on the loan. Acquiring an equity investment in an SA company with high-growth prospects may produce an even higher rate of return on investment than currently earned on foreign investments, while at the same time capturing that growth in the structure.

One has to consider the investment in high-growth SA companies against any potential capital gains tax (CGT) and securities transfer tax (STT) payable in SA on the transfer of the shares to the foreign investment structure by the SA resident, always remembering that the transaction has to be at arm's length. STT would be payable on any transfer of SA listed and unlisted shares. STT is levied at 0.25% on the higher of the consideration paid or the market value of the shares. Careful planning is required to determine how the shareholding in the SA entity should be acquired to minimise any transaction taxes.

(ii) *SA emigrants*

Under the pre-1 March 2021 exchange control regime, emigrants externalised listed and unlisted investments from SA but often retained these assets in their personal capacity, because transferring them to a foreign structure, where the discretionary beneficiaries were *both* non-resident and SA-resident, created an unintended loop structure into SA partly for the benefit of the SA resident beneficiaries.

Holding shares on an SA share register creates SA situs assets for non-residents (emigrants and others) and accordingly SA estate duty exposure. It is now permissible for these assets to be transferred to a foreign investment structure (which also has SA-resident beneficiaries), thereby eliminating future estate duty exposure on these assets for the non-resident UBO.

Provided the SA investments are not property-rich, there should be no CGT exposure for the emigrant on transferring these assets to a foreign investment structure. Furthermore, as the transfer of these assets would be a transaction between two non-residents (the emigrant and the foreign company or trust), funds would not need to be introduced into SA.

Before transferring SA situs assets into a foreign investment structure, we strongly recommend that tax advice is obtained in SA and in the jurisdiction in which the emigrant is tax resident to confirm any tax implications which could arise on the transfer. It is also important to note that where there are SA resident beneficiaries on the foreign investment structure it will create a loop and it would also need to be placed on record with the AD in SA.

(iii) *Dividends tax and CGT*

Where the SA resident invests back into an SA company through a foreign company which is tax-resident in a jurisdiction with which SA has a DTA, SA dividends tax can be reduced from 20% to between 5% and 15% depending on the jurisdiction of tax residence of the foreign company. Where the foreign company is not a CFC (ie, the SA resident holds less than 50% of the shares in the company or the shares are held through a foreign trust), the anti-avoidance provisions in section 9D(2A)*(d)* and paragraph 64B will not apply.

There should also be no CGT payable on any future sale of shares in the SA company, provided that the underlying investments of the company are not property-rich. This would, however, need to be considered in conjunction with any applicable DTA.

Concluding comments

Whether or not to reintroduce funding into SA by way of an equity investment should be driven by the following factors:

- whether the risk-adjusted rate of return on the SA investment is more than can currently be gained on the investment of the funds in the foreign investment structure;
- whether DTA relief can be obtained on any dividend extraction from SA;
- potential CGT and other transaction costs;
- future estate duty savings.

A cost benefit analysis should be done to determine if the investment back into SA is commercially sound.

There are clearly advantages and disadvantages for SA residents and emigrants wishing to invest back into SA through a foreign investment structure. The level of disclosure required needs to be balanced against any potential tax and estate duty savings and, most importantly, the question whether the return on the investment outperforms current returns on invested funds. Expert advice in this regard is highly recommended.

Paula Bagraim

Maitland Group

Acts and Bills

- Income Tax Act 58 of 1962: Sections 9D(2A)*(d)* and 10(1)*(k)*; Eighth Schedule: Paragraph 64B(6).

Other documents

- Exchange Control Regulations, 1961: Regulation 10(1)*(c)*;
- Exchange Control Circular 18/2019 (issued by FinSurv in 2019);
- Exchange Control Circular 1/2021 (issued by FinSurv on 4 January 2021).

Tags: exchange control rules; common monetary area; private equity funds; authorised foreign assets; authorised dealer (AD); relaxation of loop structures; securities transfer tax; SA-resident beneficiaries.

DUE DILIGENCE: EXPOSURE AND OPPORTUNITY RISKS

A tax due diligence is a complex, risk-based investigation into the tax affairs of a legal entity and is undertaken for interested parties, such as buyers, sellers, financiers and sponsors of public offerings.

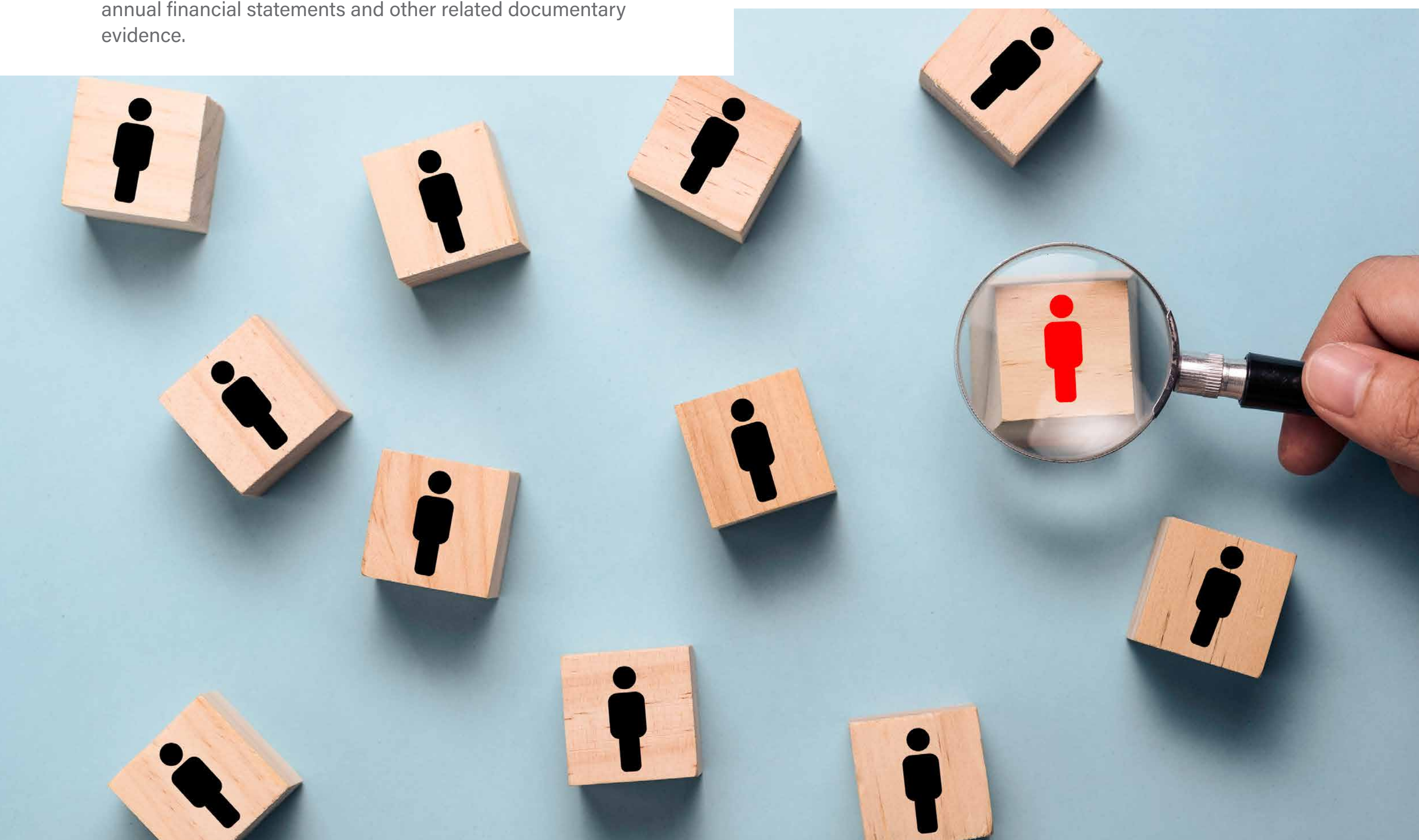
The recent development of various accounting standards (International Financial Reporting Standards) and the introduction of these standards into our tax legislation require assessment, in particular with regard to the creation of timing differences. These developments, coupled with annual amendments to the tax legislation, have necessitated the involvement of both tax law and accounting standards specialists in conducting a tax due diligence.

The tax due diligence process generally entails the review of tax returns (and supporting schedules), contracts/agreements regulating material transactions, share incentive scheme rules, correspondence with the South African Revenue Service (SARS), annual financial statements and other related documentary evidence.

A tax due diligence provides interested parties with an assessment of tax risk, and its financial impact, within an organisation. Tax risk is not limited to negative exposures, exposure risk, but also includes an assessment of opportunities, opportunity risk, not addressed by the organisation.

A potential bidder requires an assessment and quantification of tax risk, and a recommendation in relation to the risk identified. The latter is often an aspect of the tax due diligence investigation, and its report, that is sometimes overlooked. Buyers require input as to whether, in the opinion of the advisor, an issue requires a contractual indemnity or warranty, a price adjustment or whether it can be resolved post-deal.

"A tax due diligence provides interested parties with an assessment of tax risk, and its financial impact, within an organisation."



"A proficient understanding of some of the more recent accounting standards, such as IFRS 15 (Revenue from Contracts with Customers), is required in order to assess whether or not the tax treatment accords with the accounting treatment."

A seller will undertake a due diligence (often where a multitude of bidders is expected) in order to highlight risk within an organisation for potential bidders and to address remediation procedures that have been undertaken or procedures which will be undertaken to limit the identified risk.

Whilst the purpose of the tax due diligence is often risk identification, in our experience, the due diligence is equally a process with the objective of identifying opportunities, such as accelerated allowances and tax incentives, which the organisation may not have considered.

From a tax perspective, the due diligence investigation typically covers the following areas:

- Domestic income tax and capital gains tax (including assessment of cross-border issues);
- Exchange control;
- Employees' tax;
- Value-added tax;
- Dividend withholding tax;
- Securities transfer tax; and
- Customs and excise.

Tax legislation and accounting standards are independently regulated by their own set of rules; however, the interconnectivity between the accounting and tax rules is becoming more prevalent, a) in our tax legislative provisions and b) in assessing the tax dimension of accounting rules and concepts.

A proficient understanding of some of the more recent accounting standards, such as IFRS 15 (Revenue from Contracts with Customers), is required in order to assess whether or not the tax treatment accords with the accounting treatment. Tax professionals are required to work more closely with their accounting counterparts in order to address inconsistencies between the accounting and tax treatment of rights and obligations.

Phuti Kgomo, Adele de Jager and Michael Rudnicki

Bowmans

Other documents

- IFRS 15 (Revenue from Contracts with Customers).

Tags: accounting standards; IFRS 15.

DATE OF ACCRUAL OF PROPERTY SALES

On 20 November 2018 the Supreme Court of Appeal (the SCA) delivered judgment in the case of Milnerton Estates Ltd v Commissioner for South African Revenue Service, *[2018]. The matter was on appeal from the tax court in Cape Town and concerned some of the general principles relating to the accrual of amounts and, more specifically, the deemed accrual of amounts in terms of section 24 of the Income Tax Act, 1962 (the Act).*

The taxpayer had concluded sale agreements for the sale of 25 immovable properties during its 2013 year of assessment. The sale agreements provided that the purchaser would only make payment of the purchase consideration to the taxpayer "against registration of transfer" of the immovable properties. Transfer was given to the purchaser only in the 2014 year of assessment. The taxpayer accordingly did not account for the accrual of the purchase consideration in its 2013 year of assessment and intended to only account for it in the 2014 year of assessment. However, the taxpayer was subsequently assessed by the South African Revenue Service (SARS) on the basis that the consideration accrued during the 2013 year of assessment.

SARS's position was that, on the basic principles, the accrual was not postponed by the requirement that the taxpayer first had to give transfer to the purchaser. In the alternative, SARS argued that, in terms of section 24, the purchase consideration is in any event deemed to have accrued in the year that the agreement was entered into in terms of section 24. On general principles, an amount can be said to accrue to a taxpayer where the taxpayer has become unconditionally and uncontingently "entitled" to that amount (see *Lategan v Commissioner for Inland Revenue*, [1926]; *Ochberg v Commissioner for Inland Revenue*, [1933]; *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd*, [1990]). This would include amounts to which a taxpayer has a legal entitlement or claim, but which have not been actually received.

For purposes of the definition of "gross income" in section 1(1) of the Act, it also does not matter whether the amount is payable yet or not. The proviso to the definition specifically provides that if a taxpayer has become entitled to an amount in a particular tax year, but such amount is only payable in a subsequent tax year, such amount is deemed to have accrued to the taxpayer in the year that the taxpayer has become entitled to the amount and not the year in which the amount becomes payable. The mere deferral of payment to a subsequent tax year does not prevent an accrual in a current tax year where the taxpayer has actually become entitled to the amount in the current tax year. In this regard it must be appreciated that it is still required for the taxpayer to have become unconditionally and uncontingently entitled to the amount. An accrual can still be suspended by way of an appropriate suspensive condition.

The tax court did consider the particular matter on the general principles, and provisionally concluded that the purchase consideration (in respect of all properties, save one) did accrue to the taxpayer during the 2013 year of assessment on the basis that the taxpayer had in fact become entitled to payment in that year. The relevant suspensive conditions were met, and other statutory permissions were obtained, during that year. However, both the tax court and the SCA ultimately decided the matter based on the application of the deeming provision in section 24 of the Act.

Section 24(1) of the Act provides –

> "... if any taxpayer has entered into any agreement with any other person in respect of any property the effect of which is that ... in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, the whole of that amount shall for the purposes of this Act be deemed to have accrued to the taxpayer on the day on which the agreement was entered into."

This section effectively provides for a deemed accrual in certain circumstances during a particular tax year despite there not necessarily having been an actual accrual in that tax year as per the application of the general principles. Section 24(1) of the Act would apply where transfer to the purchaser is subject to receipt by the seller of the whole or a certain portion of the purchase price. The accrual of the full purchase price will then be deemed to have occurred during the tax year that the agreement was entered into, and not only when transfer is passed.

Effectively, section 24(1) removes any argument that there is no accrual to the seller during the tax year in which the agreement is concluded on the basis that the obligation to give transfer is delayed until receipt of payment in a subsequent tax year. Stated differently, the seller cannot rely on saying that it is not yet entitled to the purchase price at the time of conclusion of the agreement because it has not yet given transfer and is not obliged to do so until payment is received.

However, section 24(1) of the Act is not limited to cases where payment is required to be made before transfer. It includes cases where payment is to be made upon transfer – and as such, cases where payment is to be made "against transfer".

The court in this case found that payment was to be concurrent with transfer of ownership by registration. In the SCA's words, the agreements provided for the seller to effectively "pass ownership to the purchaser upon or after receipt of the whole of the purchase price in terms of section 24(1)". The agreements all became unconditional in the same tax year that they were concluded, so there could be no question as to the non-application of section 24(1) on the basis that the agreements were still subject to suspensive conditions by the end of that tax year.

However, what is of particular interest here is the argument advanced by the taxpayer in respect of the application of section 24 of the Act to agreements subject to suspensive conditions. The concern was essentially that, so long as an agreement made provision for the passing of ownership on or after receipt of payment, then the accrual will be deemed to occur on the date that the agreement is entered into, irrespective of whether the agreement is subject to suspensive conditions.

Essentially the taxpayer argued that to uphold the application of section 24 in the current circumstances, would "bring all sales of immovable property subject to suspensive conditions within the ambit of section 24(1)" and that "sellers of immovable property might be liable to pay income tax on amounts the recovery of which was uncertain and in circumstances where, if the worst happened and the transaction failed for any reason, they might not be able to recover the tax they had paid".

However, the SCA referred to the case of *Corondimas and Another v Badat*, [1946], for an answer. The principle upheld in that decision was effectively that "when a contract of sale is subject to a true suspensive condition 'there exists no contract of sale unless and until the condition is fulfilled'".

More specifically, the SCA stated that –

> "If subject to a true suspensive condition then, until the condition is fulfilled, on a proper interpretation of the section there may well be no binding agreement that ownership be passed upon or after receipt of the amount payable to the taxpayer".

The court therefore at the very least proposed some answer to the potentially hazardous consequences of the deeming provision in section 24(1) of the Act.

Heinrich Louw

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "gross income") & 24 (more specifically subsection (1)).

Cases

- *Milnerton Estates Ltd v Commissioner for South African Revenue Service* 81 SATC 193; [2018] ZASCA 155; [2019] (2) SA 386 (SCA) (20 November 2018);
- *Lategan v Commissioner for Inland Revenue* [1926] CPD 203 (2 SATC 16);
- *Ochberg v Commissioner for Inland Revenue* [1933] CPD 256 (6 SATC 1);
- *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* [1990] (2) SA 353 (A); 52 SATC 9;
- *Corondimas and Another v Badat* [1946] AD 548.

Tags: immovable properties; suspensive conditions.

FUNDING OF ENTREPRENEURS

An entity can become an approved public benefit organisation (PBO) under section 30 of the Income Tax Act, 1962 (the Act), if, amongst other things, it conducts one or more of the public benefit activities listed in Part I of the Ninth Schedule to the Act (Approved PBO). An Approved PBO can also be approved for purposes of section 18A of the Act, if it conducts one or more of public benefit activities listed in Part II of the Ninth Schedule, in which case it can receive donations that are deductible in the hands of the donor. In other words, an entity must firstly be an Approved PBO before it can obtain approval for purposes of section 18A.

INCOME TAX EXEMPTION APPLICABLE TO AN APPROVED PBO

This is dealt with in section 10(1)*(c*N*)* of the Act. This paragraph states the following, amongst other things, regarding the income tax exemption of Approved PBOs:

There will be exempt from normal tax the receipts and accruals of any Approved PBO, to the extent that the receipts and accruals are derived –

- otherwise than from any business undertaking or trading activity (subparagraph (i) of section 10(1)*(c*N*)*);
- from any business undertaking or trading activity if the undertaking or trading activity –
    - is integral and directly related to the sole or principal object of that public benefit organisation as contemplated in paragraph *(b)* of the definition of "public benefit organisation" in section 30(1) (subparagraph (ii)*(aa)*(A) of section 10(1)*(c*N*)*;
    - is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost (subparagraph (ii)*(aa)*(B); and
    - does not result in unfair competition in relation to taxable entities (subparagraph (ii)*(aa)*(C));
- from any business undertaking or trading activity other than an undertaking or activity in respect of which subparagraph (ii)*(aa)* to *(cc)* applies and does not exceed the greater of –
    - 5% of the total receipts and accruals of that public benefit organisation during the relevant year of assessment (subparagraph (ii)*(dd)*(i)); or
    - R200,000 (subparagraph (ii)*(dd)*(ii)).

On 29 July 2020, SARS issued Binding Private Ruling 348 (BPR 348), which deals with the income tax consequences for a PBO lending funds to qualifying entrepreneurs, specifically the application of items *(aa)* and *(dd)* of section 10(1)*(c*N*)*(ii). BPR 348 is discussed below.

"On 29 July 2020, SARS issued Binding Private Ruling 348 (BPR 348), which deals with the income tax consequences for a PBO lending funds to qualifying entrepreneurs, specifically the application of items *(aa)* and *(dd)* of section 10(1)*(c*N*)*(ii)."

FACTS OF BPR 348

The applicant is an Approved PBO in terms of section 30(3) and for the purposes of section 18A of the Act. It is approved by SARS to carry on public benefit activities contemplated in paragraphs 4*(a)* and 4*(o)* of Part I and paragraphs 3*(a)* and 3*(o)* of Part II of the Ninth Schedule, relating to the provision of education, scholarships and bursaries.

The applicant's primary and subsidiary objects are directed at the promotion of entrepreneurship through education and training. Its programmes are targeted at the youth. One of the applicant's subsidiary objects is to collaborate with other educational organisations and organisations promoting entrepreneurship and leadership or governance or both.

To promote entrepreneurship amongst the youth, the applicant proposes to solicit funds from philanthropists with which to grant loans to young entrepreneurs who are starting or scaling up their businesses. Its loan funding will be provided as complementary funding of at least an equal amount when the qualifying young entrepreneurs attract funding from other philanthropists or investors. Once the applicant provides funding to the entrepreneurs, the applicant will monitor its investment in their businesses, collect data and disseminate information to existing philanthropists and other stakeholders in the wider philanthropy network to encourage greater participation.

The applicant will target young entrepreneurs who do not have access to funding from conventional commercial lending institutions. Those who apply for funding must have a registered business, a bank account, a business plan, be the founders or have a validated leadership role in the business and be endorsed by the applicant's portfolio manager. Persons who qualify for funding will receive a letter of guarantee that will enable them to seek matching funding from investors.

Conventional interest will not be charged on the loans. Instead, the beneficiaries will repay the loans by paying a small percentage of their monthly revenue (revenue share) to the applicant until 100% of the loan amount plus a very small margin is recovered over the loan term. No revenue share will be payable when the beneficiaries have not generated any revenue. Any income received from the repayment of the loans will either be ploughed back into the programme or otherwise used to further the applicant's public benefit activities.

SARS' ruling

SARS ruled in BPR 348 that the receipts and accruals of the applicant's entrepreneur loan programme will –

- not qualify to be exempt from normal tax under section 10(1)*(c*N*)*(ii)*(aa)*, because the undertaking is not integral or directly related to the applicant's sole or principal object of providing education.
- qualify to be exempt from normal tax under section 10(1)*(c*N*)*(ii)*(dd)*, subject to the basic exemption amount calculated under that provision. The basic exemption amount is applicable to the receipts and accruals of all business undertakings and trading activities of the applicant that qualify under that provision during any relevant year of assessment.

"BPR 348 illustrates how Approved PBOs must bear in mind that depending on the nature of their activities, they may be liable for income tax in a year of assessment."

Analysis and comment

BPR 348 illustrates how Approved PBOs must bear in mind that depending on the nature of their activities, they may be liable for income tax in a year of assessment. Based on the facts of BPR 348, it appears that in the applicant's hands, income from a business undertaking or trading activity (such as the entrepreneurship loan programme) will only potentially be exempt to the extent that it is below the amounts referred to in section 10(1)*(c*N*)*(ii)*(dd)*. This refers to the amount below 5% of the PBO's total receipts and accruals in a year of assessment or R200 000 (whichever is greater).

Entities that are interested in assisting start-ups and small businesses with funding, but wish to be tax-exempt and avoid paying income tax as far as possible, can consider the following options, amongst others, provided for in the Act (aside from the route followed by the applicant in BPR 348):

- The entity could apply to become an Approved PBO that carries on the public benefit activity listed in paragraph 1*(p)*(iii) of Part I and of Part II of the Ninth Schedule. This activity is described as the provision of training, support or assistance to emerging micro enterprises to improve capacity to start and manage businesses, which may include the granting of loans on such conditions as prescribed by the Minister of Finance by way of regulation. Only "emerging micro enterprises" can be assisted in order to comply with the PBO provisions of the Act

- The entity could consider applying to SARS to become a small business funding entity, in terms of section 30C of the Act. If approved, the entity can provide funding to small, medium and micro-sized enterprises. The phrase "small, medium or micro-sized enterprise" is defined in section 1(1) as any person that qualifies as a micro business as defined in paragraph 1 of the Sixth Schedule to the Act or any person that is a small business corporation as defined in section 12E(4) of the Act.

Louis Botha

Cliffe Dekker Hofmeyr

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

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "small, medium or micro-sized enterprise"), 10(1)*(c*N*)*, 12E(4) (definition of "small business corporation"), 18A, 30 (more specifically subsection (3)) & 30C; Sixth Schedule: Paragraph 1 (definition of "micro business"); Ninth Schedule: Part I (more specifically paragraphs 1*(p)*(iii) and 4*(a)* and *(o)*); Part II (more specifically paragraphs 1*(p)*(iii) and 3*(a)* and *(o)*).

Other documents

- Binding Private Ruling 348 ("Income tax consequences for a public benefit organisation lending funds to qualifying entrepreneurs").

Tags: public benefit activities; an Approved PBO.

ARBITRARY PRACTICES BY SARS WHEN ISSUING ASSESSMENTS

The Tax Administration Act, 2011, provides for the audit and verification of taxpayers' tax returns for all taxes administered by the Commissioner for the South African Revenue Service (SARS). In many instances, such requests for information are general, boilerplate letters received by taxpayers, not indicating specifically what additional information SARS requires in the circumstances and which supporting documents must be provided. In respect of both income tax and value-added tax, SARS is taking an arbitrary approach in issuing additional assessments based on information provided by taxpayers in response to the inadequate (or vague at best) requests for information.

INCOME TAX

Many taxpayers (who are natural persons) are receiving requests from SARS in which they list the bank accounts that are registered in the name of the taxpayer, as well as a summary of the total number of credits (deposits) made into these respective bank accounts. SARS then requests the taxpayer to explain why those credit amounts should not all be included in the taxpayer's taxable income. This is a highly arbitrary approach followed by SARS in accepting that all deposits made into a taxpayer's bank account constitute income. There can, of course, be multiple other reasons for such deposits, including donations between spouses, receipt of gifts, loan funding received, prize winnings, transfers between the taxpayer's own accounts, transfers out of bond accounts into current accounts, et cetera. This approach displays a lack of understanding regarding commercial realities and places the taxpayer on the back foot: having to discharge the onus of amounts that should not be classified as income.

VALUE-ADDED TAX

Arguably, no VAT vendor in South Africa has escaped frustration from the administration of the VAT system, particularly as it relates to the verification of VAT returns. A practice that is emerging is that if one or two pieces of supporting documents provided to SARS do not meet the requirements of a valid tax invoice, SARS immediately, and without further inquiry, disallows all input VAT claimed by a taxpayer during the relevant tax period. This is a highly invasive approach in which SARS accepts that none of the goods and services received by a vendor during that period are valid, or that they lack supporting documents. Unless SARS is specific in their requests, a taxpayer cannot identify the information that should be provided to them. The blanket disallowance of all input VAT is an irrational practice that should be addressed at the appropriate level.

The examples above merely illustrate some of the arbitrary practices with which taxpayers are being confronted – as such, taxpayers are advised to carefully navigate the dispute resolution process, since providing SARS with incorrect information, or making incorrect statements in their correspondence with the revenue authority, may lead to severe prejudice as a result of these unacceptable practices of SARS.

T ROOS

Acts and Bills

- Tax Administration Act 28 of 2011.

Tags: audit and verification of taxpayers' tax returns; verification of VAT returns.

BYPASSING THE TAX DISPUTE RESOLUTION PROCESS

In the recent judgment of ABSA Bank Limited and Another v Commissioner for the South African Revenue Service*, 2021 (the* Absa *case), the South African High Court considered whether a taxpayer is permitted to review a decision by the South African Revenue Service (SARS) in the High Court, rather than to pursue the lengthy dispute resolution procedures provided for in the Tax Administration Act, 2011 (the TAA).*

To place the decision in context, in disputes between taxpayers and SARS, the principle of "pay now argue later" applies. This means that a taxpayer is required to make payment of any amount as per an assessment raised by SARS, even if it disputes the assessment (unless a formal suspension of payment is granted on application to SARS).

The TAA provides for the dispute resolution procedures in these situations. This process is generally protracted and SARS often has the benefit of already having received full or partial payment of the amount in dispute. This is on the basis that SARS does not often grant taxpayers a full suspension of payment in respect of disputed tax.

In essence, the court in the *Absa* case had to consider whether SARS' decision not to withdraw notices it issued to the taxpayer in terms of section 80J of the Income Tax Act, 1962 (the Act), and its decision to issue assessments pursuant to these notices, were reviewable while the taxpayer had not exhausted its internal remedies (procedures in terms of chapter 9 of the TAA).

In finding in favour of ABSA Bank Limited (Absa), the court considered section 105 of the TAA, which provides that "[a] taxpayer may only dispute an assessment or 'decision' as described in section 104 in proceedings under this Chapter, unless a High Court otherwise directs". Section 104 provides that a taxpayer may object to and appeal against "any other decision that may be objected to or appealed against under a tax Act".

"The High Court's finding may thus be seen as a victory for taxpayers that could save time and resources."

The court found that the inclusion of the words "unless a High Court otherwise directs" in section 105 plainly denotes an environment for dispute resolution in which there is more than one process, and that a court has a discretion to approve a deviation from what could be called the *default process* in the TAA. In addition, the court could see no reason why a taxpayer may not seek approval for such deviation simultaneously in the proceedings seeking a review where an appropriate case has been made. It was accepted that such appropriate circumstances require "exceptional circumstances" in respect of which the court held that:

> "…the quality of exceptionality need not be exotic or rare or bizarre; rather it needs simply be, properly construed, circumstances which sensibly justify an alternative route. When a dispute is entirely a dispute about a point of law, that attribute[,] in my view, would satisfy exceptionably."

As such, the court agreed with Absa's submission that in the event that there is a pure point-of-law-dispute, a party to the dispute is entitled to approach the High Court directly, without following the dispute resolution proceedings provided for in the TAA.

The High Court's finding may thus be seen as a victory for taxpayers that could save time and resources.

It is, however, important to be aware that the court's finding must be seen in light of the specific facts. In particular, Absa's case was based purely on a point-of-law (ie, there was no factual dispute between the parties). Absa also launched proceedings in the High Court prior to any assessment being raised, requesting a review of SARS' decision not to withdraw its notices issued under section 80J of the Act as requested by Absa in terms of section 9 of the TAA. Absa's pleadings were then amended when SARS subsequently raised assessments to include a review of such assessments.

Carmen Gers

ENSafrica

Acts and Bills

- Income Tax Act 58 of 1962: Section 80J;
- Tax Administration Act 28 of 2011: Sections 9, 104 & 105; Chapter 9 (sections 101 to 150).

Cases

- *Absa Bank Limited and Another v Commissioner for the South African Revenue Service* (2019/21825 [P]) [2021] ZAGPPHC 183 (1 March 2021).

Tags: dispute resolution procedures; point-of-law-dispute.

HIGH NET WORTH INDIVIDUALS

SARS' "High Wealth Individual Taxpayers Unit" (the Unit) is up and running and, as promised, SARS has sent out the first batch of welcome letters to those who meet the criteria to form part of this elite club.

What qualifies as "high wealth"?

How does SARS pick their subjects? The simplest, albeit unlikely, methodology would be to include all taxpayers who fall within the highest tax bracket, ie, those who earn more or less in excess of R1,5 million per annum, translating to more than 113,000 individuals. But the clique is probably more exclusive than that. Perhaps, those with dollar millionaire status will make the cut, which would then encompass around 38,000 individuals.

A more accurate parameter is probably taxpayers with a gross income exceeding R7 million per annum, or with gross wealth exceeding R75 million. Historically, this is SARS' classification of high net worth individuals.

The truth is SARS has not disclosed the selection criteria, but those who fall within the parameters will know soon enough.

What can these individuals expect?

In the welcome letter SARS confirms that the recipient will be assigned a dedicated relationship manager to oversee their profile and to serve as their direct point of contact. Seemingly, the Unit will operate in a similar fashion to the Large Business Centre, almost like having a private banker for your tax affairs.

Depending on your point of view, falling under the jurisdiction of the Unit is a godsend. Others may see the notice as dooming, although it is phrased in the spirit of collaboration. Perhaps, unless you have something to hide, your experience with SARS may vastly improve.

SARS promises that the Unit's service offering will be informed by "global best practice", to ensure it delivers on its mandate. This is encouraging, or unnerving, depending on whom you ask. It serves to note that while the Unit aims to excel in its service delivery, it has been established primarily to enhance compliance among and increase collections from this segment of the tax base.

How will the Unit go about its business?

The standard of "global best practice" is undefined and it would be interesting to know which revenue authority's model SARS will look to replicate.

In the UK, the High Net Worth Individual (HNWI) Unit also uses a single point of contact for every taxpayer, translating to a higher level of service and scrutiny. This division comprises specialist teams and has had relative success in improving collections.

The same unit of the Australian Tax Office uses a risk-based management approach where high net worth individuals are identified and scrutinised according to the risk they pose to the tax system.

The IRS "Wealth Squad" adopts a holistic approach to taxpayer profiles, looking at taxpayers' earnings, the enterprises they control and any other interests they may have, locally and abroad. SARS may take another page from its US counterpart; the IRS has a Whistleblower Office that rewards informants who provide information on tax non-compliance, which has proven useful in complex tax evasion cases.

Time will tell how the Unit within SARS will conduct its business. We know that former judge Dennis Davis will be actively involved in the Unit and based on his comments, lifestyle audits will form an important part of their strategy.

Ultimately, however, the success of the Unit will depend on its resources. Hopefully, SARS has managed to attract the necessary talent in its recruitment drive to stock the Unit sufficiently.

Jean du Toit

Tax Consulting SA

Tags: High Wealth Individual Taxpayers Unit; high net worth individuals.

SOUTH AFRICAN IBOR TRANSITION

This article will consider the transfer pricing and tax perspective of the IBOR transaction in South Africa.

In the major financial markets, reference rates, such as the London Interbank Offered Rate (LIBOR) and Euro Interbank Offered Rate (EURIBOR), are widely used as benchmarks for a large volume and broad range of financial products and contracts. Thus, many financial arrangements such as loans, bonds and derivatives, are pegged to a reference point for variable interest rates such as LIBOR. These reference rates are called interbank offered rates (IBOR) and may differ from country to country.

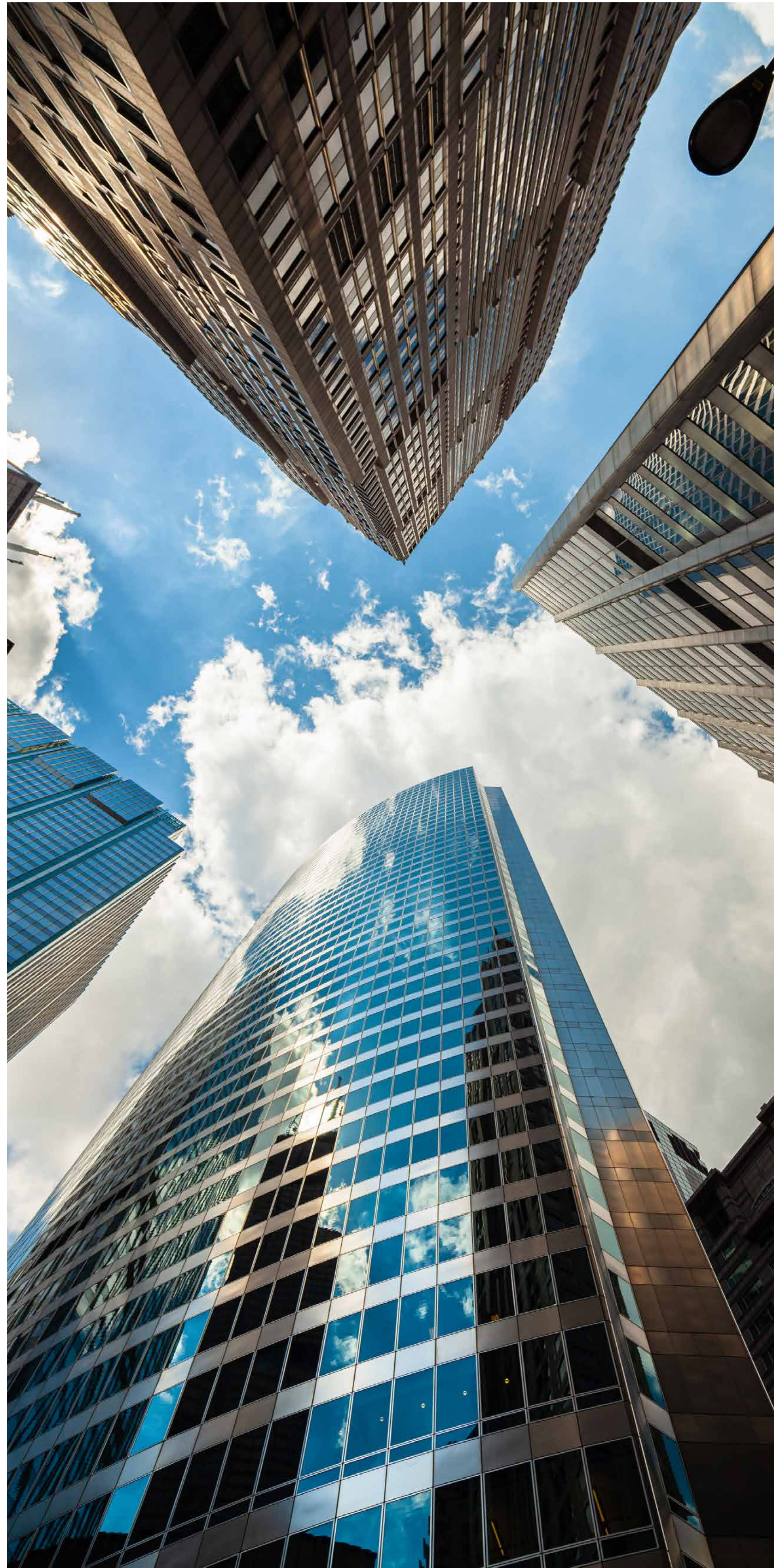
In the case of South Africa (SA), the Johannesburg Interbank Average Rate (JIBAR) is usually used as a benchmark when dealing with short-term interest rates in the SA economy. JIBAR, similar to IBOR, is determined by considering the average of the borrowing and lending rates indicated by a number of local and international banks. Considering that JIBAR and LIBOR are similar, they are interbank offered rates, we have used LIBOR as the main point of discussion for purposes of this article as LIBOR is mostly referenced around the world.

By the end of December 2021, rates such as LIBOR will be retired and replaced with an alternative reference system. The phasing-out of LIBOR has been heralded since 2012 when the combined forces of a high-profile scandal and the 2009 recession exposed the vulnerabilities and weaknesses of LIBOR and the need to find an alternative. Given the scope of the impact of the LIBOR phasing-out, affected businesses should be taking steps now to plan for the transition. It should be noted that the South African Reserve Bank (the SARB) also supports this move as there are shortcomings in the JIBAR and as such, will also look to implement a new rate. The SARB, as the administrator of JIBAR, has indicated that JIBAR will cease at some future point.

The new system will be a variety of alternative risk-free and near-risk-free rates (RFRs), mostly administered by central banks. LIBOR's replacements in the five major currencies chosen are: SOFR (USD), SONIA (GBP), €STR (EUR), SARON (CHF) and TONA (JPY). These will be used for all types of variable interest rate contractual arrangements and financial instruments. The proposed replacement for JIBAR will be the South African Rand Overnight Index Average (ZARONIA).

SA transfer pricing considerations

The adjustment to a world without LIBOR (and other IBORs) will undoubtedly have an impact to most current financial arrangements in place. Businesses need to adjust accordingly and one of these changes would be the potential effect on the arms-length nature of their financial arrangements with related entities.



"The recommended first step is for affected companies to identify current intercompany agreements containing any LIBOR (or other IBOR) references and undertake the processes to modify those agreements."

The scope of this could be significant given the universal nature of variable rates associated with financial arrangements such as loans and other financial contracts between related entities. Examples of these include: financial contracts entered into directly between a parent and subsidiary, a centralised cash management structure such as a group treasury or even back-to-back lending arrangements.

Replacing LIBOR (or other IBORs) on these current arrangements may require companies to evaluate the current LIBOR-based variable interest rate pricing against an alternative base rate applying an arm's length spread so that neither party to the transaction is disadvantaged. Any new intercompany agreements should avoid the risk of going through this change by already setting the terms to an appropriate RFR and an arm's length spread.

It is important that any change, for example from LIBOR to SONIA, requires both parties to end up similar to how they were before the LIBOR change. There are no instructions for how to calculate this arm's length spread, but such an analysis will need to follow the principles set forth under existing transfer pricing rules.

Businesses will also need to ensure that the changes are supported by contractual clauses in their new and existing agreements. To the extent that a LIBOR is referenced in such agreements, the appropriate fall-back language (recommended by the Federal Reserve's Alternative Reference Rates Committee or ARRC) should be included. This is also supported by the SARB, where contracts reference JIBAR.

Unfortunately, SARS has not released any guidance on this yet from a transfer pricing perspective.

Tax effect of changing agreements

Taxpayers may have various ways in which they can amend or change their agreements in order to facilitate the IBOR transition. They might decide to settle the current agreement and then draft a new agreement; alternatively, they could keep the current agreement in place and merely provide an addendum.

Section 24J of the Income Tax Act, 1962 (the Act), provides how interest must be calculated. Thus, it follows that where taxpayers change, amend or enter into a new financial arrangement during the tax year, consideration must be given to section 24J to ensure that the correct amount of interest is incurred or accrued.

In addition, taxpayers who are considered as lenders in the financial arrangement will need to determine if a disposal event has taken place under the Eighth Schedule. Paragraph 11 of the Eighth Schedule may determine that the agreement has been subject to a cancellation, termination or variation of the agreement and thus that a disposal event has taken place. Alternatively, paragraph 11 may also indicate that a non-disposal event has occurred and thus there will not be any tax effect.

The tax effect of changing financial arrangements will ultimately first depend on how taxpayers choose to transition to IBOR.

The key to success

The recommended first step is for affected companies to identify current intercompany agreements containing any LIBOR (or other IBOR) references and undertake the processes to modify those agreements. For new agreements, it is suggested to already incorporate the new RFRs or apply a fixed rate but keeping in mind the transfer pricing principles and applying these accordingly.

Thinking about potentially damaging legal implications now should eliminate them later. Once the impacted agreements have been identified, companies should develop a plan to adjust the pricing of their affected arrangements, so that they are ready once LIBOR is discontinued. With only a few months remaining before LIBOR is replaced, being proactive now will help to mitigate or prevent any future business disruptions.

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Acts and Bills

- Income Tax Act 58 of 1962: Section 24J; Eighth Schedule: Paragraph 11.

Abbreviations used in this article

- €STR: Euro short-term rate (EUR);
- ARRC: Federal Reserve's Alternative Reference Rates Committee;
- EURIBOR: Euro Interbank Offered Rate;
- IBOR: interbank offered rates;
- JIBAR: Johannesburg Interbank Average Rate;
- LIBOR: London Interbank Offered Rate;
- RFRs: risk-free and near-risk-free rates;
- SARB: South African Reserve Bank;
- SARON: Swiss Average Rate Overnight (CHF);
- SOFR: Secured Overnight Financing Rate (USD);
- SONIA: Sterling Overnight Index Average rate (GBP);
- TONA: Tokyo Overnight Average rate (JPY);
- ZARONIA: South African Rand Overnight Index Average.

Tags: London Interbank Offered Rate (LIBOR); interbank offered rates (IBOR).

VESTING OF CAPITAL GAINS THROUGH MULTIPLE TRUSTS

The tax court decision in ABC Trust v Commissioner for the South African Revenue Service*, [2021], (IT 24918, delivered on 18 March 2021), is the first case in which it was considered whether capital gains can be "conduited" through more than one trust in accordance with the provisions of the Income Tax Act, 1962 (the Act).*

Even though this case does not have any binding effect on other courts, it raises some interesting points, especially insofar as the vesting of capital gains by trusts in non-resident beneficiaries are concerned.

Before considering the case, a general overview of the taxation of trusts is necessary. References to sections in this article are to sections of the Act and references to paragraphs of the Eighth Schedule to the Act, containing South Africa's capital gains tax (CGT) legislation.

Taxation of trusts and their beneficiaries

The taxation of trusts and their beneficiaries is governed by section 25B of the Act (for receipts and accruals of an income nature) and paragraph 80 of the Eighth Schedule (for capital gains).

A trust is deemed to be a separate "person" for income tax purposes, even though it is not a person in law. As a general principle income and capital gains that are received by or that accrue to a trust are subject to income tax (at 45%) and CGT (at 36%) in its hands, unless such income and capital gains are treated as having accrued to a beneficiary in terms of section 25B (for receipts and accruals of an income nature) and paragraph 80 (for capital gains), in which case such income and capital gains will be subject to income tax and CGT in the beneficiary's hands at the tax rates applicable to such beneficiary.

In *Armstrong v Commissioner for Inland Revenue*, [1938] (the *Armstrong* case), it was held that the income of a trust retains its identity until it reaches the beneficiary in whose hands it is taxable. Therefore, in terms of our common law, if a trust receives dividends that are vested in or distributed to a beneficiary, then the beneficiary will be treated as having received dividends for purposes of applying the applicable income tax exemption. On the same basis, if a trust vests interest, rentals, royalties or capital gains in a beneficiary, then the beneficiary will also be treated as having received interest, rentals, royalties or capital gains, as the case may be. This is known as the conduit pipe principle, ie, the trust acts as a conduit pipe for transferring the income to the beneficiaries, but if it does not do so, it is taxed in its own right on such income.

"Section 25B to a large degree encapsulates the common-law conduit principle."

The conduit principle, as formulated in the *Armstrong* case, was cited with approval in a number of subsequent cases. In *Secretary for Inland Revenue v Rosen*, [1971], Trollip JA stated the following in this regard at 189:

> "Consequently Armstrong's case in my view *authoritatively established the conduit principle for general application in our system of taxation in appropriate circumstances* … The principle rests upon sound and robust common sense; for, by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends." (*Emphasis added*.)

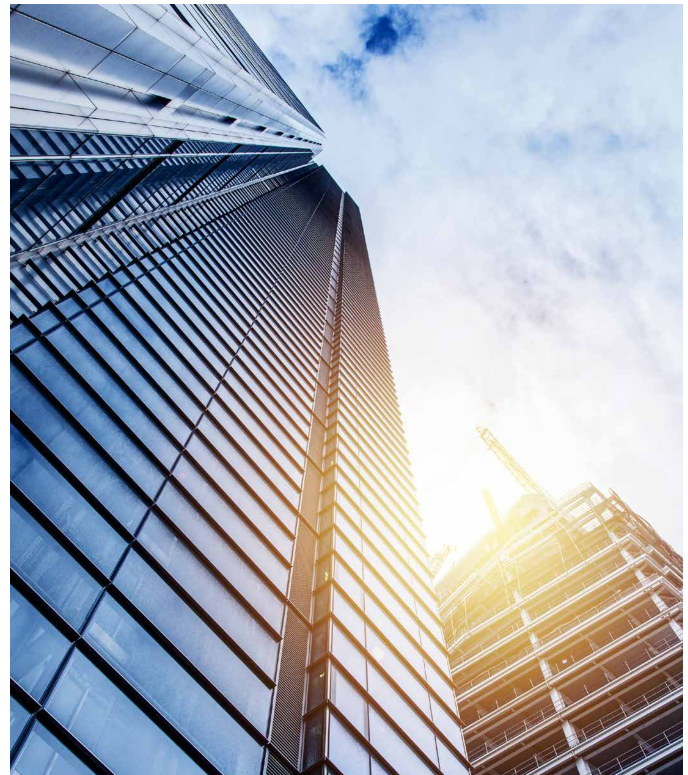
Section 25B to a large degree encapsulates the common-law conduit principle. Prior to its amendment in January 2021, its subsections (1) and (2) stated the following:

> **"25B. Income of trusts and beneficiaries of trusts**
>
> (1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.
>
> (2) Where a beneficiary has acquired a vested right to any amount referred to in *subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her* in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary." (*Emphasis added*.)

Paragraph 80 of the Eighth Schedule stated the following during the 2014 to 2016 years of assessment insofar as it is currently relevant:

> "(1) … where a capital gain is *determined* in respect of the vesting by a trust of an *asset* in a trust beneficiary … *who is a resident*, that gain–
>
> *(a)* must be *disregarded* for the purpose of calculating the aggregate capital gain or aggregate capital loss *of the trust*; and
>
> *(b)* must be *taken into account* for the purpose of calculating the aggregate capital gain or aggregate capital loss of the *beneficiary to whom that asset was so disposed of*.
>
> (2) …. where a capital gain is *determined* in respect of the disposal of an asset by a trust *in a year of assessment during which* a trust beneficiary … *who is a resident* has a vested interest *or acquires a vested interest (including an interest created by the exercise of a discretion) in that capital gain but not in the asset*, the disposal of which gave rise to the capital gain, the whole or the portion of the capital gain so vested–
>
> *(a)* must be *disregarded* for the purpose of calculating the aggregate capital gain or aggregate capital loss of the *trust*; and
>
> *(b)* must be *taken into account* for the purpose of calculating the aggregate capital gain or aggregate capital loss of the *beneficiary in whom the gain vests*." (*Emphasis added*.)

The net effect of section 25B and paragraph 80 is that if a beneficiary of a trust has or obtains a vested right to the income and/or capital gain of a trust during the same year of assessment as that in which such income and/or capital gain is received by or accrues to the trust, then the beneficiary and not the trust will be subject to income tax on the income or CGT on the capital gain at the tax rates applicable to such beneficiary. If no such vested right is obtained by a beneficiary during the same year of assessment as that in which the income and/or capital gain accrues to the trust then the trust will be subject to income tax on the income or CGT on the capital gain at the tax rates applicable to the trust. The trust, if a resident, will then in a subsequent year of assessment be able to award the taxed income and/or capital gain to a beneficiary on a tax-free basis.



Paragraph 80 only allows a trust to disregard a capital gain on the disposal of a trust asset to a resident beneficiary (paragraph 80(1)) or on the vesting of the realised proceeds of a capital gain in a resident beneficiary (paragraph 80(2)). The ostensible purpose of this limitation is to protect South Africa's tax base as it would otherwise be possible for a capital gain to escape taxation if it is vested in a non-resident beneficiary (on the basis that non-residents are only subject to CGT in South Africa on interests in South African immovable property and assets attributable to South African permanent establishments). That said, the fact that these provisions mention only resident beneficiaries cannot automatically mean that if a distribution is made to a non-resident, the trust is taxable. But that is how SARS interprets the provision. Section 25B does not contain such a limitation and it is, therefore, possible for amounts of an income nature to flow through to non-residents for tax purposes. This point is revisited later on.

"It is a well-established principle that amounts of an income nature such as dividends, interest, rentals and royalties can be conduited through multiple trusts to a final beneficiary in terms of section 25B, provided that the vesting by the various trusts takes place during the same year of assessment. "

Conduiting income and capital gains through multiple trusts

It is a well-established principle that amounts of an income nature such as dividends, interest, rentals and royalties can be conduited through multiple trusts to a final beneficiary in terms of section 25B, provided that the vesting by the various trusts takes place during the same year of assessment. Consider the following example:

Example 1

Trust 1 and Trust 2 are both fully discretionary and irrevocable resident trusts for the benefit of the same class of natural person beneficiaries. Trust 1 receives portfolio dividends during the year of assessment which it vests in Trust 2 during the same year of assessment. Trust 2 proceeds to vest the dividends during the same year of assessment in its natural person beneficiaries. In this example, section 25B will require the natural person beneficiaries to account for the dividends for tax purposes and not Trust 1 or Trust 2.

Subparagraphs 80(1) and (2) refer to a trust "determining" a capital gain, which must then be "disregarded" by such trust and "taken into account" by the beneficiary in whom the asset (subparagraph 80(1)) or capital gain (subparagraph 80(2)) is vested. It is generally accepted that the capital gain is "determined" by the trust which actually disposes of the asset (by deducting the base cost of an asset from the actual or deemed proceeds derived from the disposal) and not by the beneficiary in whom the asset or capital gain is vested. Such beneficiary, therefore, only "takes into account" the capital gain "determined" by the trust. It is not, therefore, possible, according to SARS, for a capital gain to be "conduited" through multiple trusts as it is only the first trust in the chain which "determines" the capital gain. Consider the following example:

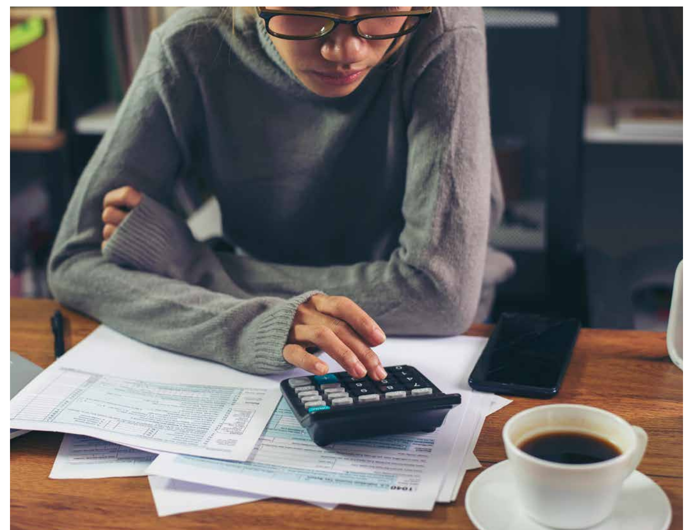
Example 2

Trust 1 and Trust 2 are both fully discretionary and irrevocable resident trusts for the benefit of the same class of natural person beneficiaries. Trust 1 derives capital gains from the disposal of shares and vests the proceeds in Trust 2 during the same year of assessment as that in which the disposal takes place. Trust 2 proceeds to vest the capital gains during the same year of assessment in its natural person beneficiaries. In this example, Trust 1 will "determine" the capital gains which will be disregarded in its hands. The capital gains must, according to SARS, then be "taken into account" by Trust 2 under subparagraph 80(2). As Trust 2 did not "determine" a capital gain from this transaction, it will not, according to SARS, be able to transfer the tax implications resulting from the capital gains to its beneficiaries. In this case, Trust 2 will be required to pay the CGT, notwithstanding the fact that it vested the proceeds in its natural person beneficiaries during the same year of assessment.

Issue in dispute in IT 24918

In this case a resident trust (the ABC Trust) was a vested beneficiary of various other resident trusts which vested capital gains in it over the 2014 to 2016 years of assessment. The ABC Trust, in turn, vested the said capital gains in its own resident beneficiaries during each of the relevant years of assessment. In calculating their tax liability for the relevant years of assessment, the beneficiaries of ABC Trust accounted for the capital gains and the ABC Trust disregarded the capital gains.

The issue in dispute was whether the capital gains should have been taken into account by the ABC Trust or by its own beneficiaries: in other words, whether it was possible for the capital gains to be conduited through the ABC Trust to its beneficiaries for tax purposes. This i*nter alia* turned on the question whether section 25B could apply to the capital gains as paragraph 80(2) does not (according to SARS) allow for capital gains to pass through more than one trust, as explained above.



In dealing with this issue Wright J held that the reference to "any amount" in section 25B should be interpreted widely so as to include the realised proceeds of capital gains, irrespective of the fact that the vesting of capital gains in trust beneficiaries is specifically dealt with in paragraph 80(2). He further relied on the remarks of Trollip JA in the *Rosen* case that the *Armstrong* case "… authoritatively established the conduit principle for general application in our system of taxation in appropriate circumstances". He, accordingly, held that the capital gains were rightly conduited through to the beneficiaries of the ABC Trust as a result of the application of section 25B (as opposed to paragraph 80(2)) and that such beneficiaries, as opposed to the ABC Trust, were required to include the capital gains in their aggregate capital gain or loss calculations.

Subsequent amendment to section 25B

Section 28*(b)* of the Taxation Laws Amendment Act, 2020 (the TLAA), amended section 25B(1) with effect from 20 January 2021 by specifically excluding from its application "an amount of a capital nature which is not included in gross income …". The purpose of the amendment is said to "clarify" that section 25B does not apply to the proceeds derived from the disposal of capital assets and that such proceeds should rather be dealt with in terms of paragraph 80. The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020, states the following in this regard (at 58):

"Furthermore, some commentators have contended that section 25B(1) also applies to amounts of a capital nature (for example, proceeds on disposal of a capital asset). *There is no substance in this contention because the Eighth Schedule contains specific provisions dealing with such amounts, but for the purposes of clarity it is proposed to exclude amounts of a capital nature that are not deemed to be included in gross income from the ambit of section 25B(1).*" (*Emphasis added.*)

It is clear that from 20 January 2021, one would not be able to contend that section 25B allows for the realised proceeds of capital gains to be conduited through to beneficiaries as the section now specifically excludes such proceeds from falling within its ambit. However, up to the effective date of this amendment, one could choose to rely on this argument, both in cases having similar facts and potentially also in cases where capital gains were vested in non-resident beneficiaries as paragraph 80 only allows for capital gains to flow through to resident beneficiaries. One would, however, expect that SARS would challenge such a tax position as it did in IT 24918.

It should be noted that the taxpayer relied on other arguments as well in support of its appeal, but this is the aspect that the court mainly relied upon in arriving at its decision.

Conclusion

Even though the judgment handed down in IT 24918 does not create binding precedent, it does have persuasive authority. The principles emanating from this case should apply equally to capital gains that are vested by resident trusts in non-resident beneficiaries prior to the effective date of the 2020 amendment to section 25B(1). It is, accordingly, important that the said principles be taken into account where trusts and trust beneficiaries are currently under audit where the tax position was adopted that a capital gain can pass through more than one trust to the beneficiary or where a capital gain was vested in a non-resident and the tax position was adopted that the non-resident should account for the resulting CGT, if any. As SARS has noted an appeal to the judgment handed down by the Tax Court, this matter will in due course be settled by the Supreme Court of Appeal.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 7 & 25B (more specifically subsection (1) – also its wording prior to amendment in January 2021); Eighth Schedule: Paragraph 80 (more specifically subparagraphs (1) & (2) – also their wording during the 2014 to 2016 years of assessment);
- Taxation Laws Amendment Act 23 of 2020: Section 28*(b).*

Cases

- *ABC Trust v Commissioner for the South African Revenue Service* (IT 24918) (delivered on 18 March 2021);
- *Armstrong v Commissioner for Inland Revenue* [1938] AD 343, 10 SATC 1;
- *Secretary for Inland Revenue v Rosen* [1971] (1) SA 172 (A).

Tags: taxation of trusts; income tax exemption; non-resident beneficiary.