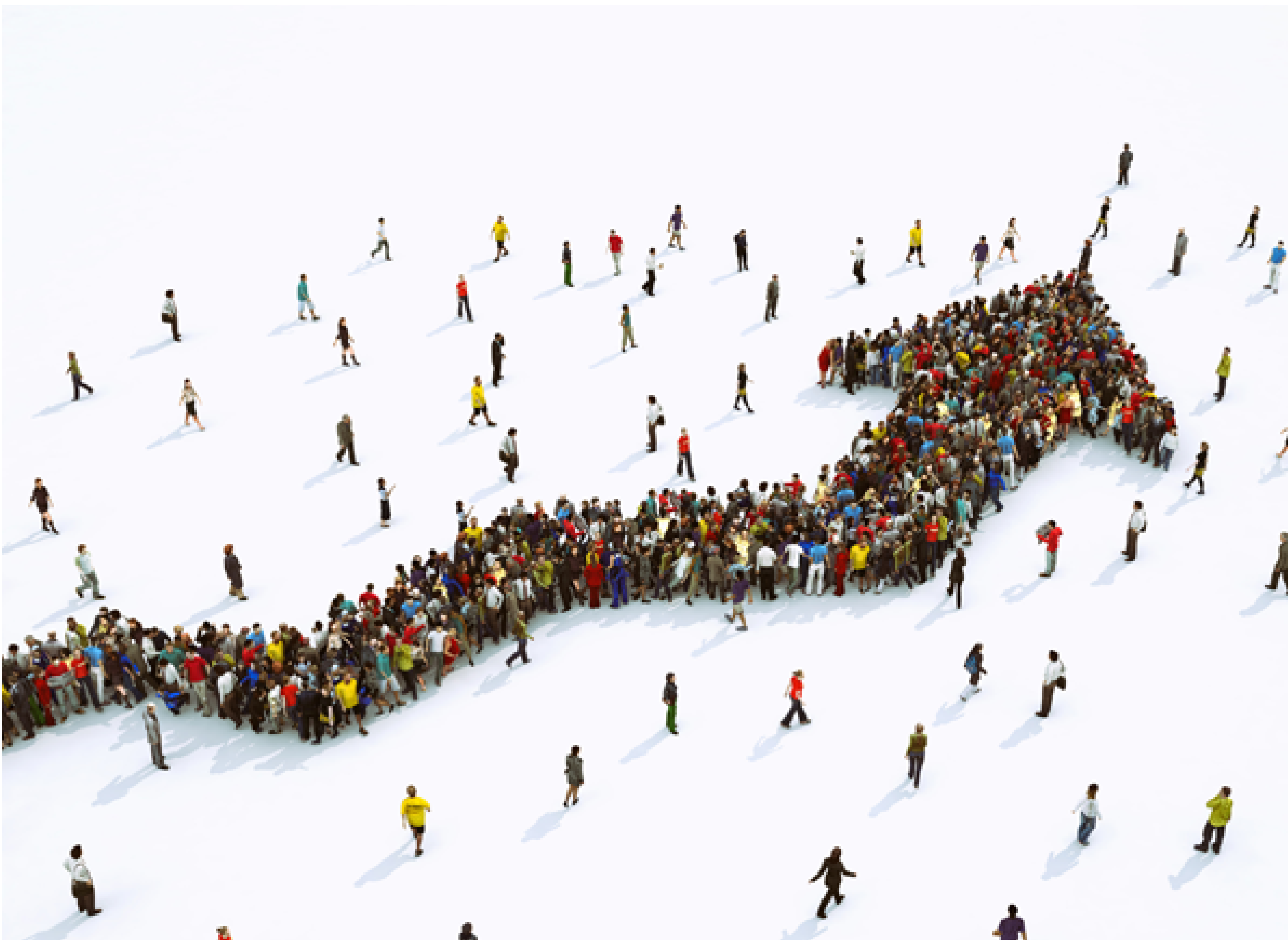
Issue 19 | 2020
February

sait South African Institute of Tax Professionals

Unstructured CPD **150mins**

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional



DIVIDENDS TAX
THE CAPITALISATION OF INTEREST AND SECTION 8F

EXCHANGE CONTROL
RELAXATION OF POLICY ON LOOP STRUCTURES FOR INDIVIDUALS

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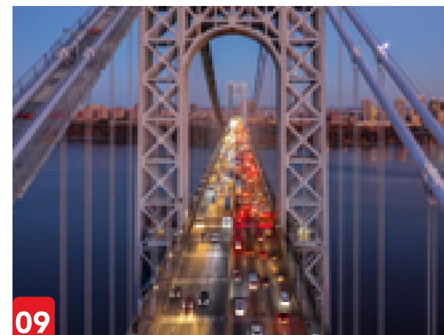

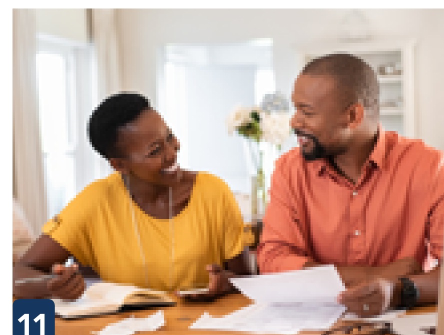

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Mr KG Karro (Chairman), Mr MA Khan, Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Mr Z Mabhoza, Ms MC Foster

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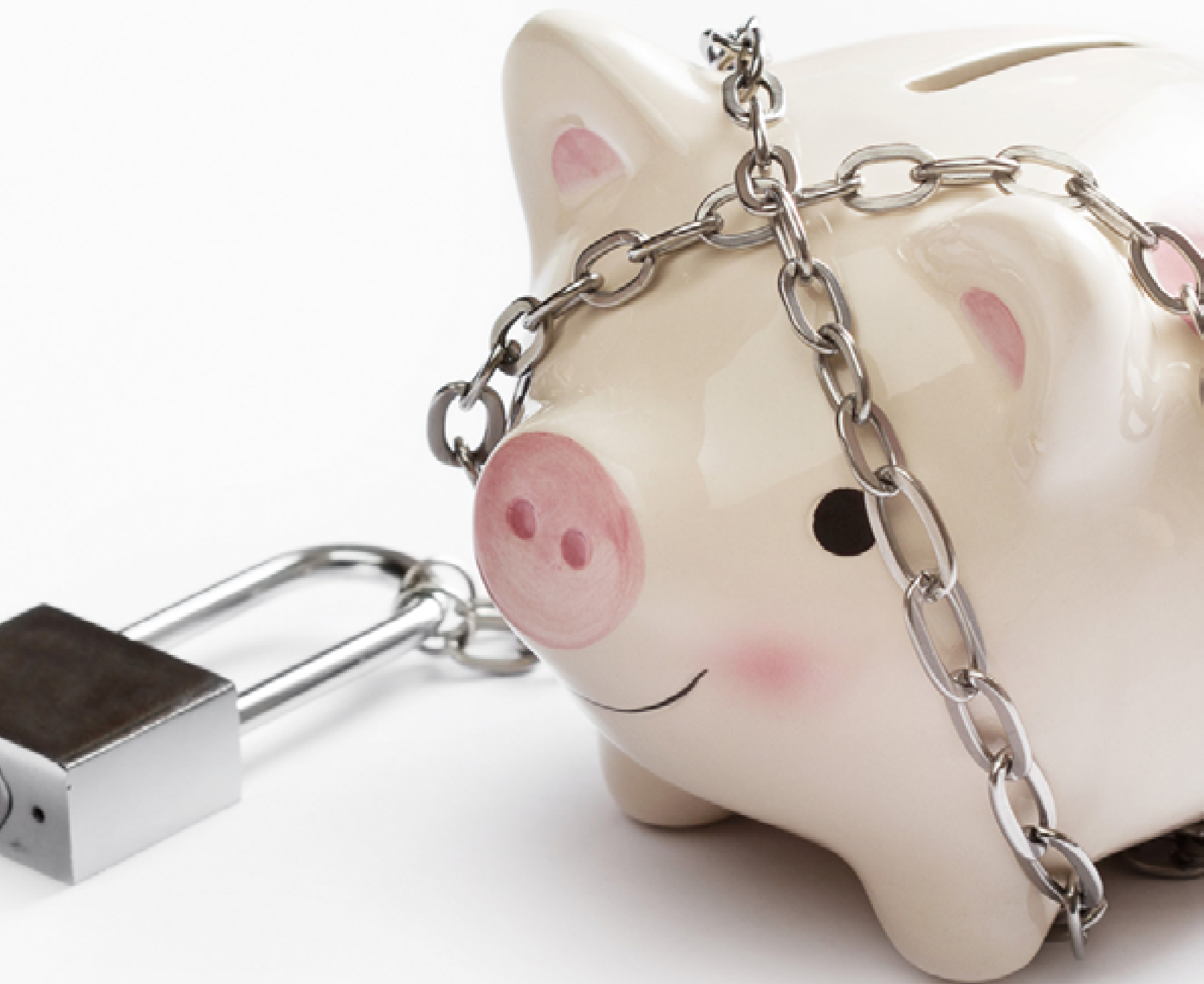
RING-FENCING OF CERTAIN TRADES

Persons are generally allowed to set off any losses incurred in respect of one trade against the income derived from another trade, thereby reducing their overall tax liability.



"Taxpayers with additional income sources should therefore carefully consider the provisions of section 20A to the extent that the current ITR12 income tax return for individuals requires taxpayers to indicate whether or not the losses are ring-fenced."

However, section 20A of the Income Tax Act, 1962, ring-fences losses incurred by natural persons from certain trades under specific circumstances. If applicable, the natural person will not be able to set off the loss incurred from that trade against the income from any other trade, but may only set off the loss against future income derived from the trade to which the loss relates.

The rationale for this provision was to disallow natural persons to conduct hobbies disguised as trades in order to set off expenses from that hobby against other income such as salary income or professional income.

The first requirement for section 20A to apply is that the natural person must fall within the highest income tax bracket during the relevant year of assessment. For the 2020 year of assessment, the sum of the person's taxable income (before taking into account the provisions of section 20A) and any assessed loss or balance of assessed loss (which were set off in terms of section 20) must be equal to or exceed R1,5 million.

The second requirement relates to the nature of the trade carried on by the natural person. In this regard, he or she (or any relative of that person) must be engaged in trades such as: the practising of any sporting activity, any dealing in collectables, any animal showing, or any form of performing or creative arts or of gambling or betting practised.

Also included is the rental of residential accommodation or vehicles, aircraft or boats (unless at least 80% of the accommodation, vehicle, aircraft or boat is used by, and not merely available to, persons who are not relatives of the natural person for at least half of the year). Farming or animal breeding also falls within section 20A unless the relevant person carries on such activities on a full-time basis.

The third requirement is that he or she must have incurred an assessed loss in at least three of the preceding five years of assessment, ending on the last day of the relevant year of assessment.

All three requirements must be met in order for the loss in respect of the specific trade to be ring-fenced.

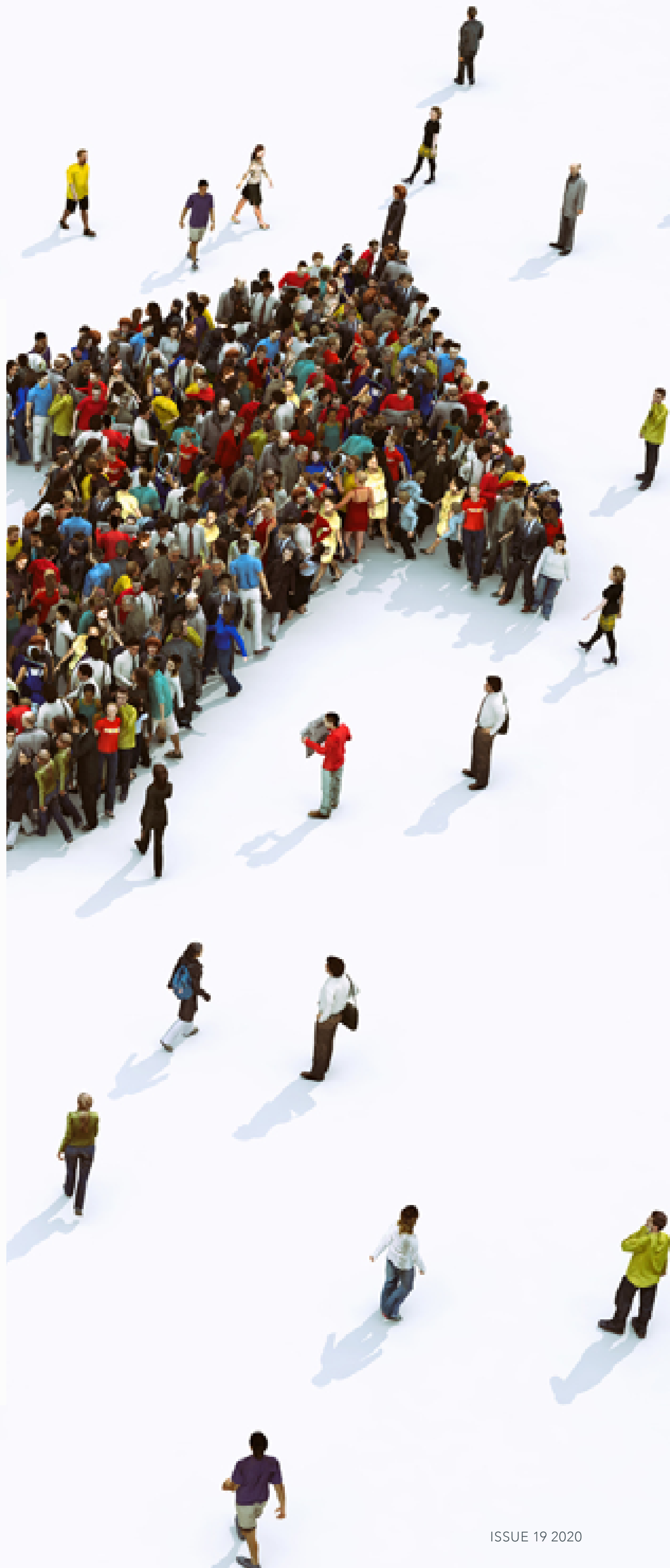
Taxpayers with additional income sources should therefore carefully consider the provisions of section 20A to the extent that the current ITR12 income tax return for individuals requires taxpayers to indicate whether or not the losses are ring-fenced. Taxpayers may also be requested by the South African Revenue Service to confirm why section 20A should not apply in instances where the answer to that question was "no".

PKF

Act sections:

- Income Tax Act 58 of 1962: Sections 20 & 20A.

Tags: natural persons; assessed loss; ring-fenced.



BASE COST OF IMPROVED ASSETS

Capital gains tax may be triggered upon the disposal of an asset by a taxpayer in circumstances where the proceeds or deemed proceeds arising from such disposal exceed the base cost of the asset in the hands of the taxpayer.

In terms of paragraph 20 of the Eighth Schedule to the Income Tax Act, 1962 (the Act), the base cost of an asset is, broadly speaking, the expenditure actually incurred by the taxpayer in respect of the cost of acquisition or creation of that asset together with a number of other costs related to the acquisition or creation of such asset (eg transfer costs) and various other asset-related costs.

In particular, paragraph 20(1)*(e)* of the Eighth Schedule provides that the base cost of an asset includes expenditure incurred in effecting an improvement or enhancement to an asset *provided such improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal.*

"However, it should be noted that a taxpayer should be able to prove improvement costs to the extent that such improvement costs increase the base cost of assets."

For ease of reference we refer to the proviso emphasised above as the "improvement proviso".

Accordingly, where a taxpayer for example acquired a property for R1 million and incurred an amount of R300 000 in building a wooden deck on such property, the base cost of such property for purposes of capital gains tax should be R1 300 000. If, for example, the taxpayer dismantles the wooden deck prior to the sale of the property, the base cost of the property would, in terms of current law, be R1 million as the improvement or enhancement to the property would not exist at the time of disposal.

The Taxation Laws Amendment Bill, 2019 (TLAB), agreed to by Parliament on 6 December 2019, provides for the deletion of the improvement proviso – as a result of which the property in the above-mentioned example should have a base cost of R1 300 000 in the hands of the taxpayer – regardless of whether the wooden deck is in existence at the time of the sale of the property.

The Explanatory Memorandum on the TLAB, released by National Treasury on 21 January 2020, states that the improvement proviso was adapted from the Australian Income Tax Assessment Act, 1997. However, the improvement proviso was removed from that Australian legislation with effect from 1 July 2005. Accordingly, the TLAB provides for the deletion of the improvement proviso in order to align with the Australian tax legislation.

However, it should be noted that a taxpayer should be able to prove improvement costs to the extent that such improvement costs increase the base cost of assets. It is therefore advisable for a taxpayer to retain all documentation (eg invoices and/or building agreements) in relation to such improvements.

PKF

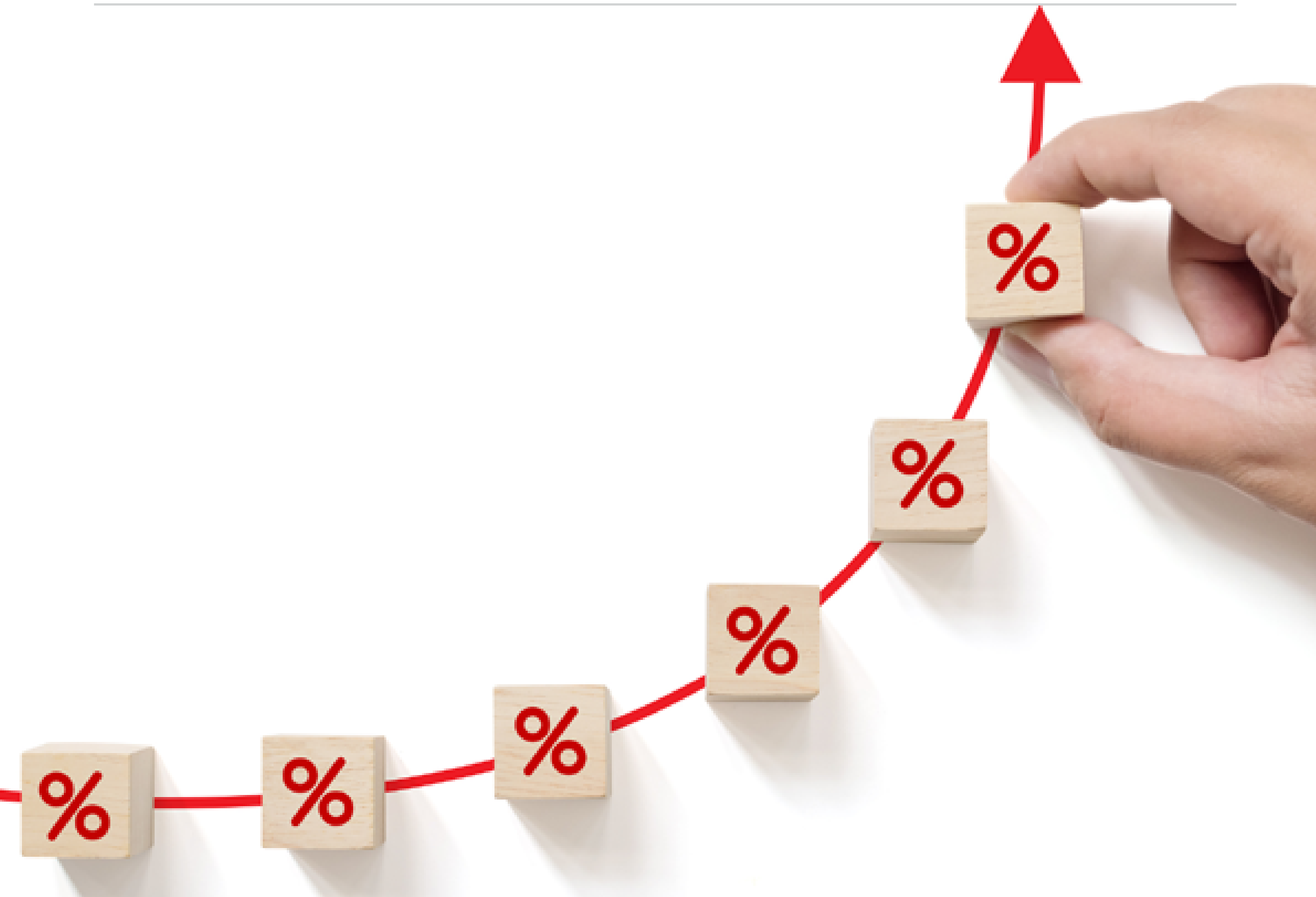
Act sections:

- Income Tax Act 58 of 1962: Eighth Schedule (paragraph 20(1)*(e)*);
- Taxation Laws Amendment Act 34 of 2019: Section 56(1)*(a)*.

Other documents:

- Taxation Laws Amendment Bill 18B of 2019: Clause 56(1)*(a)*.
- Explanatory Memorandum on the Taxation Laws Amendment Bill, 2019.

Tags: disposal of an asset; base cost; improvements.



THE CAPITALISATION OF INTEREST AND SECTION 8F

The provisions of section 8F of the Income Tax Act, 1962 (the Act), regulate "hybrid debt instruments". Broadly speaking, from the time that an interest-bearing debt qualifies as a hybrid debt instrument, the interest incurred in respect thereof will be deemed to be a dividend in specie *that is declared by the company which incurred such amount (ie the borrower) to the person to whom that amount accrued (ie the lender). Furthermore, the borrower is denied a tax deduction in respect of such interest.*

AS A RESULT OF CURRENT ECONOMIC CONDITIONS PARTIES MAY BE PLACING PARTICULAR FOCUS ON:

- the requirement that loan agreements be subordinated (for example, where new borrowings are advanced with the condition that in the event of the financial distress of the borrower, existing creditors will permit the borrower to suspend payments of interest and/or capital in favour of making interest and/or capital payments in respect of the new borrowings); or
- particular terms regulating the payment (or nonpayment) of interest in respect of loans.

The provisions of section 8F which require consideration in the circumstances mentioned above include those found in paragraph *(b)* of the definition of a hybrid debt instrument. In terms thereof, an interest-bearing debt issued by a company may constitute a hybrid debt instrument where the obligation to pay an amount owed is deferred by reason of that obligation being conditional on the market value of the assets of the borrower not being less than the amount of the liabilities of that borrower.

Paragraph *(b)* was inserted into the Act in order to address subordination agreements. It is clear that where a subordination agreement is entered into in respect of a loan, the impact thereof needs to be considered in light of the provisions of section 8F and any exemptions which may apply.

However, the application of paragraph *(b)* is not necessarily limited to subordination agreements. An unsubordinated loan agreement which contains provisions pertaining to the capitalisation of interest may result in the loan constituting a hybrid debt instrument.

For example, the terms of a loan agreement may contain provisions stipulating that interest will not be paid in cash in the event of the borrower being in an insolvent position, but rather that such interest will be capitalised. Where the capitalisation mechanism in the loan agreement is formulated in a way such that the borrower's obligation to pay interest is fulfilled by way of the capitalisation in the event of an insolvent position of the borrower, it could be that there is no "deferral" of such obligation and the requirements of paragraph *(b)* may not be met.

"Where a subordination agreement is entered into in respect of a loan, the impact thereof needs to be considered in light of the provisions of section 8F and any exemptions which may apply."

However, where the capitalisation mechanism does not result in a fulfilment of the borrower's interest payment obligation, but rather a suspension or deferral thereof, then the loan agreement may give rise to hybrid debt instrument concerns. Failure by the parties to recognise this requirement being met once the capitalisation provisions of the loan agreement are triggered could result in adverse income tax and dividends tax (in the case of non-residents, trusts and individuals) implications arising in respect of the loan agreement.

Editorial comment: It is important to note that the funding will qualify as a hybrid debt instrument in terms of paragraph (b) *and fall within the ambit of section 8F as outlined above, only if the obligation to pay an amount owed is deferred by reason of that obligation being conditional on the market value of the assets of the borrower not being less than the amount of the liabilities of that borrower. If the deferral is for any other reason, section 8F will apply.*

ENSafrica

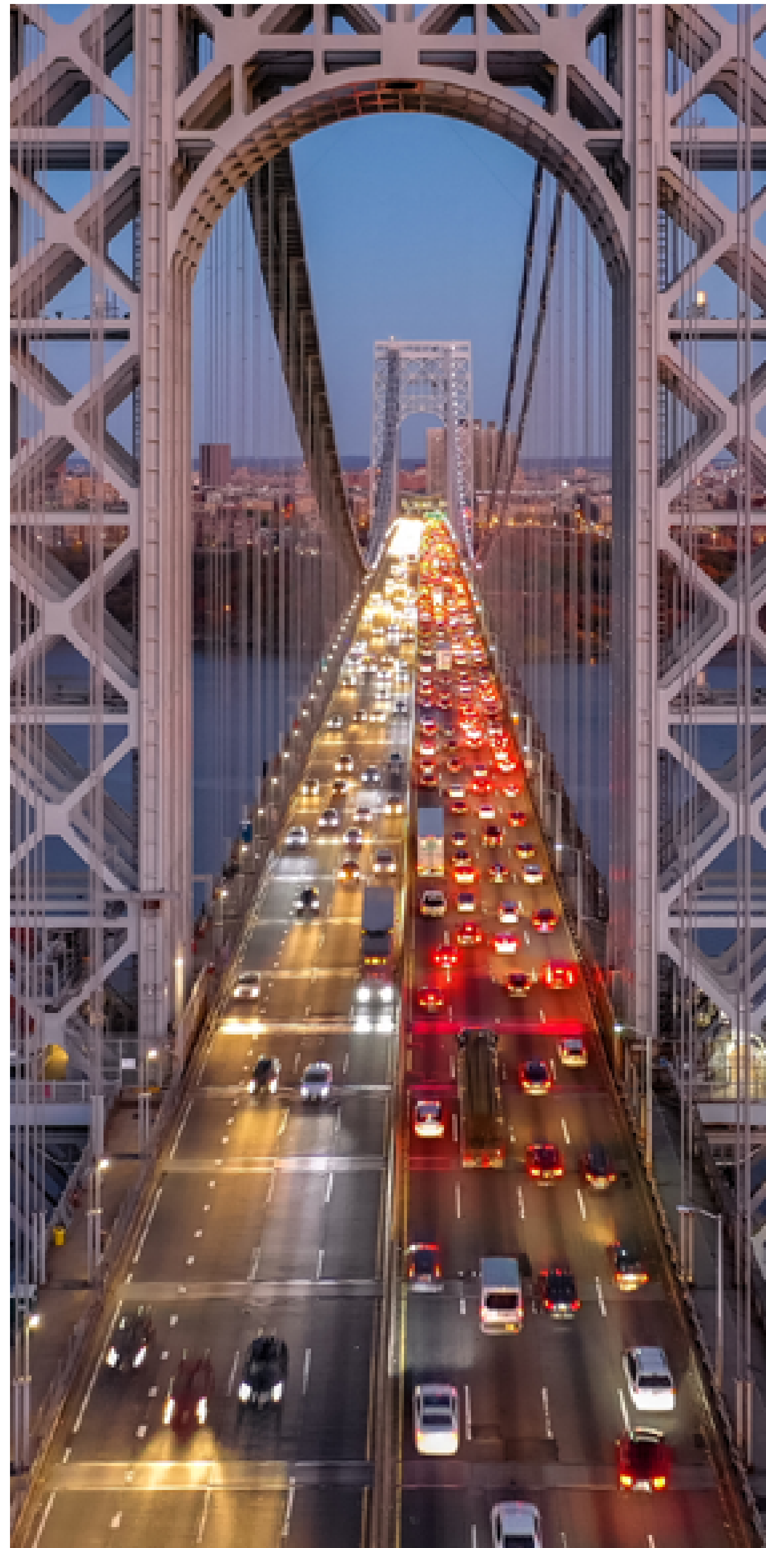
Act sections:

- Income Tax Act 58 of 1962: Section 8F.

Tags: interest-bearing debt; hybrid debt instrument; dividend *in specie*; tax deduction; financial distress; subordination agreements.

RELAXATION OF POLICY ON LOOP STRUCTURES FOR INDIVIDUALS

On 31 October 2019, the Financial Surveillance Department of the South African Reserve Bank (the SARB) released Circular 18/2019 stating that the loop dispensation currently available for South African corporates under the Foreign Direct Investment (commonly known as FDI) dispensation will be extended to private individuals.



It is important to note that this dispensation is extended to private individuals only and not to trusts.

This represents a significant deviation from the current policy of the SARB, in terms of which South African residents are prohibited from investing in a foreign company which in turn invests back into South Africa. This policy deals with so-called loop structures.

While in the past there were a few exceptions to the policy rule applicable to investments made by South African companies, no such exceptions were available for individuals.

Permissible loop structure dispensation available for South African companies

Authorised dealers (ie most commercial banks) are allowed to approve requests by South African companies to invest in companies, branches and offices outside of the common monetary area (CMA), where the cost of the investment does not exceed ZAR1 billion per company per calendar year. Requests for investments in excess of ZAR1 billion must be approved by the SARB. Under this dispensation, the SARB allows a so-called permissible loop whereby a South African company is permitted to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign target entity, which may in turn hold investments and/or make loans into any CMA country. The percentage threshold was previously 10% to 20% and was then increased to 40% in 2018.

Extension of permissible loop structure dispensation for individuals

In terms of Circular 18/2019, private individuals will now be permitted (individually or collectively) to acquire up to 40% equity and/or voting rights in a foreign target entity which may in turn hold investments and/or make loans into any CMA country. This dispensation will, however, only apply in respect of loop structures formed *after 30 October 2019.*

"This represents a significant deviation from the current policy of the SARB, in terms of which South African residents are prohibited from investing in a foreign company which in turn invests back into South Africa."

The circular further states that any existing loop structures, ie those which were created by individuals prior to 30 October 2019 and/or loop structures where the 40% shareholding is exceeded, will have to be regularised with the SARB. In addition, any unintentional loop structures, created with authorised foreign capital invested with non-resident asset or fund managers who invest in foreign companies that have CMA assets/interest and/or offshore global investment funds that directly or indirectly hold CMA investments over which the South African investor has no control, are permitted.

The relaxation of the permissible loop structure for individuals is welcomed, as the mismatch between the dispensations available for South African companies and individuals resulted in many cross-border groups having to structure their group shareholding to accommodate South African resident investors by either having a mirror structure in place to avoid the so-called loop structure or by housing the individual investor's shareholding through a South African company to avail of the permissible loop dispensation provided to South African companies only.

The above-mentioned relaxation of the loop structure may accordingly assist those entities to possibly unwind their mirror shareholding structure or to remove the complexity of a double structure for individual investors who hold their shareholding via a South African company.

ENSafrica

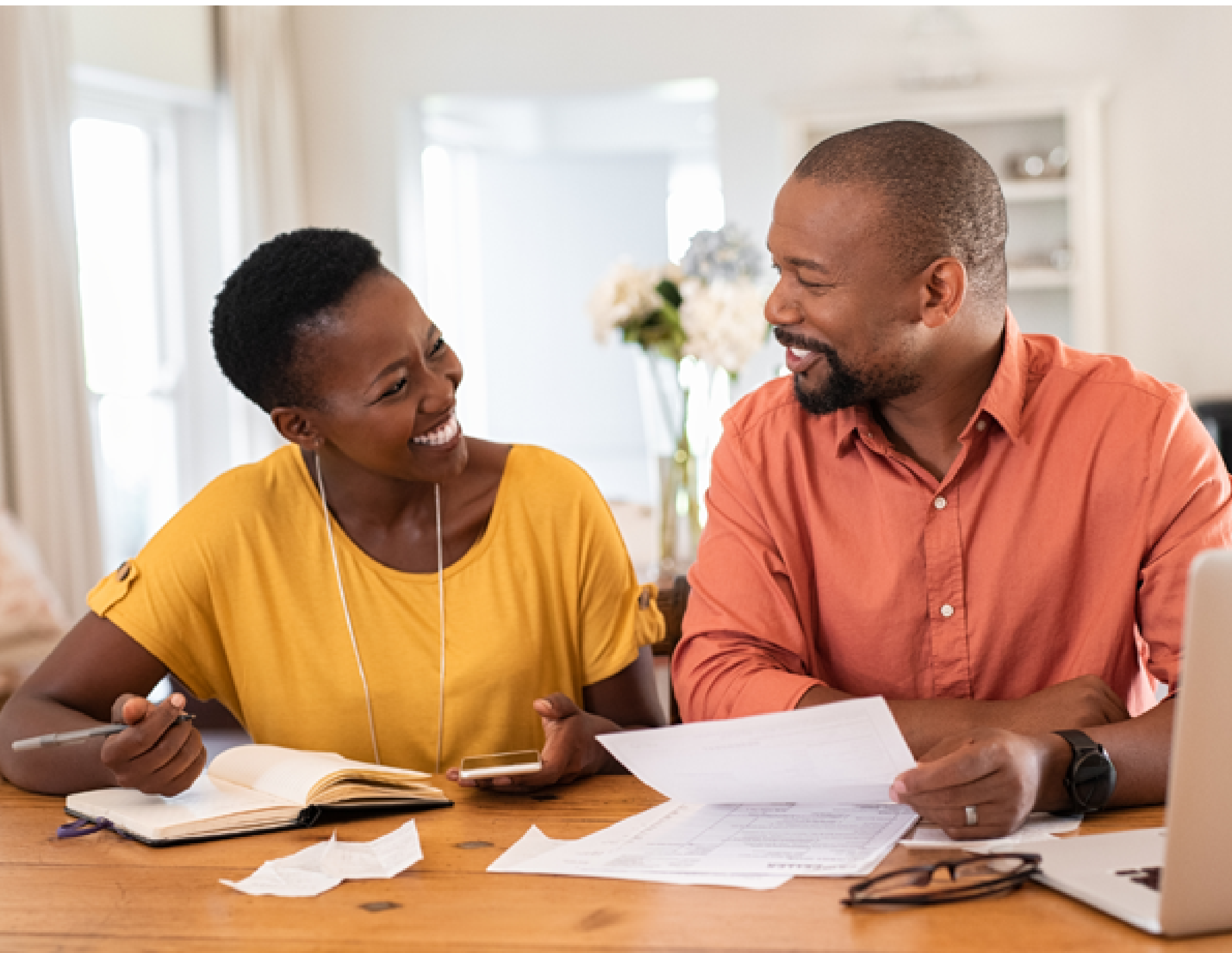
Other documents:

- Circular 18/2019 of the SA Reserve Bank (Financial Surveillance Department).

Tags: foreign target entity; loop structures; asset or fund managers.

FOREIGN EMPLOYMENT INCOME – SARS RELEASES FAQ AND DRAFT INTERPRETATION NOTE

It has been widely publicised that on 1 March 2020, changes to the exemption for foreign employment income in section 10(1)(o)(ii) of the Income Tax Act, 1962 (the Act), will come into effect.



Until 29 February 2020, foreign employment income earned by a South African tax resident will be exempt in the resident's hands to the extent that the person meets the requirements of section 10(1)*(o)*(ii). From 1 March 2020 onwards, only the first R1 million of such foreign employment income earned will be exempt in terms of section 10(1)*(o)*(ii).

DRAFT INTERPRETATION NOTE AND FAQ DOCUMENT

On 7 October 2019, SARS released a Frequently Asked Questions document dealing with amendments to section 10(1)*(o)*(ii) (the FAQ document) and on the same date, it released a draft Interpretation Note 16 (Issue 3) (the Draft IN), which deals with, amongst other things, the application of section 10(1)*(o)*(ii) after the amendment referred to above comes into effect.

The Draft IN states that the key requirements to qualify for the exemption in section 10(1)*(o)*(ii) are the following:

- The taxpayer in question must be a South African tax resident;
- The taxpayer must earn one of the forms of remuneration listed in the section;
- There must be an employment relationship between the taxpayer and the person for whom or on whose behalf the services are rendered;
- The remuneration must be received for services rendered; and
- The services must be rendered outside the Republic of South Africa, for at least 183 full days during any 12-month period and for a continuous period exceeding 60 full days during the same 12-month period.

"Until 29 February 2020, foreign employment income earned by a South African tax resident will be exempt in the resident's hands to the extent that the person meets the requirements of section 10(1)*(o)*(ii)."

Regarding the calculation of the exempt portion of the remuneration, example 2 of the Draft IN explains that from 1 March 2020, where a person earns R1,5 million for services rendered outside South Africa, only R1 million of the remuneration can be exempt under section 10(1)*(o)*(ii) and the remaining R500 000 will be taxable in South Africa.

The FAQ document contains similar information to that contained in the Draft IN, but states that it is aimed at giving the public at large clarity and to ensure consistency on certain practical and technical aspects related to the amendment to section 10(1)*(o)*(ii). The FAQ document is available on the SARS website.

One of the important issues the FAQ document touches on is how to avoid double taxation where the portion of the foreign employment income above R1 million is taxable in both South Africa and the foreign country. In that case, the taxpayer concerned can claim a tax credit in terms of section 6*quat* of the Act, on the portion of the income that is taxable in both countries. If one were to use Example 2 referred to in the Draft IN above, the taxpayer can therefore make use of section 6*quat* so that he does not pay tax on the amount of R500 000 in both South Africa and the foreign country.

Another interesting issue dealt with by the FAQ document is the issue of tax residence. Regarding the issue of financial emigration and its impact on a person's tax residence, the FAQ document states the following:

> "Acquiring approval from the South African Reserve Bank to emigrate from a financial perspective is not connected to an individual's tax residence. Financial emigration is merely one factor that may be taken into account to determine whether or not an individual broke his or her tax residence. An individual's tax residence is not automatically broken when he or she financially emigrates. The deciding factor remains whether or not an individual ceased to be ordinarily resident in the Republic."

COMMENT AND PRACTICAL ISSUES TO CONSIDER

Many South African residents working abroad have been concerned about the potential impact of the amendment to section 10(1)*(o)*(ii), especially those residents who are not liable for income tax in the countries where they are working. To avoid being affected by the amendment, many South African expatriates have considered financially emigrating and ceasing to be tax residents in South Africa. In practice, this is done by means of an application to SARS to confirm one's tax compliance status for purposes of emigration, followed by the submission of an application to the South African Reserve Bank to emigrate from an exchange control perspective. Upon emigration, taxpayers will be subject to an exit tax in terms of section 9H of the Act.

According to the FAQ document, completing the aforementioned financial emigration process is merely one factor that will be taken into account to determine whether a person ceased to be a South African tax resident. While neither the FAQ document nor the Draft IN (pursuant to the publication of the final version) are binding, if an individual employed abroad foresees that he will earn more than R1 million per year and that he will be affected by the amendment, he should carefully consider whether financial emigration is the best option to follow in his particular situation, to avoid being affected by the amendment. To determine whether a person is a South African tax resident, one must consider the definition of "resident" in section 1 of the Act and whether the person will be a resident under the "ordinarily resident" or "physically present" tests in section 1.

Even if a person has financially emigrated to avoid being affected by the amendment to section 10(1)*(o)*(ii), the statement in the FAQ document seems to suggest that SARS could still dispute whether t he person is a South African tax resident. To avoid such a dispute from arising, which may take time and resources to resolve, any person considering financial emigration to avoid being affected by the amendment, should obtain professional tax advice before deciding to financially emigrate. This will also help to prevent adverse tax consequences from arising if the person's residence is disputed by SARS and, at worst, the dispute is resolved in SARS' favour.

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "resident"), 6*quat*, 9H & 10(1)*(o)*(ii).

Other documents:

- Draft Interpretation Note 16 (Issue 3);
- Frequently Asked Questions (released by SARS on 7 October 2019).

Tags: South African tax resident; services rendered; double taxation; financial emigration; exit tax.

THE PROVISION OF SAFE TRANSPORT FOR EMPLOYEES

Many South Africans have taken a stand against the surge of violent crimes perpetrated by men against women and have expressed their outrage through protest action. This outcry against gender-based violence (GBV) in South Africa has been echoed worldwide, with many nations standing in solidarity with the women of South Africa.

After the release of the latest crime statistics depicting an increase in the number of women killed each day, as well as indicating that the number of reported rape cases is at its highest in four years, thousands took to the streets of Sandton in September 2019 in the #SandtonShutdown march outside the Johannesburg Stock Exchange in an attempt to raise their concerns regarding GBV. This march followed the protest march held in Cape Town outside the World Economic Forum during which President Cyril Ramaphosa addressed protesters outside Parliament.

One of the demands made by the participants of the #SandtonShutdown was the provision of secure transport by employers for female employees who are required to travel while it is dark before or after their shifts. The provision of secure transport by employers may have tax implications for the employees to the extent that the transport service provided constitutes a taxable fringe benefit in the hands of the employees.

"Paragraph 10 of the Seventh Schedule deals with the provision of free or cheap services by an employer."

LEGAL POSITION

The Seventh Schedule to the Income Tax, 1962 (the Act), makes provision for the taxation of benefits received by taxpayers by virtue of their employment. In considering the tax consequences arising from the provision of transport services, one must consider paragraphs 2 and 10 of the Seventh Schedule along with the Fourth Schedule to the Act.

Paragraph 2*(e)* of the Seventh Schedule states that a taxable benefit is deemed to have been granted by an employer to an employee if any service has, at the expense of the employer, been

"It is commonplace for employers to provide their employees with tickets or money for use on the various modes of public transportation in order to enable them to travel between their homes and their place of work."

rendered to the employee (whether by the employer or some other person) for his or her private or domestic purposes. The expenses incurred in the transportation of employees between their homes and their place of work (and vice versa) as demanded by the GBV movement are considered expenses that are domestic or private in nature. As such, where an employer bears the expenses associated with the transportation of its employees between their homes and the workplace, a taxable benefit may arise in the hands of the employees.

Paragraph 10 of the Seventh Schedule deals with the provision of free or cheap services by an employer. With regard to the value to be ascribed to the provision of such services, paragraph 10(2)*(b)* states that no value will be attributed to any transport services rendered by an employer to its employees for the conveyance of such employees from their homes to the place of their employment and vice versa. If the value attributed to the transport services is nil, the value of the taxable benefit will be nil and no employees' tax will be payable in terms of the Fourth Schedule as a result of the provision of transport services to employees in terms of this provision.

The employee will not pay income tax as a result of receiving the transport service under these circumstances.

In terms of paragraph 2*(e)*, a taxable benefit arises from the provision of transport services by either an employer, or any other person. However, paragraph 10(2)*(b)* only ascribes no value to those services rendered by an employer. This distinction gave rise to uncertainty regarding the application of the no-value provision contained in paragraph 10(2)*(b)* in those scenarios where the employer does not provide the transport service directly but contracts another person to provide the service to employees.

In order to clarify this issue, the South African Revenue Service (SARS) issued Interpretation Note 111 (IN 111) and Binding General Ruling 50 (BGR 50). These publications provide that transport services rendered by an employer to its employees in general for the conveyance of those employees between their homes and their place of employment, will fall within the no-value provisions of paragraph 10(2)*(b)*, to the extent that –

1. The transport service is rendered directly by the employer; or
2. Where the transport service is not rendered directly by the employer (in that it is outsourced to a specific transport service provider), the employer makes it clear in the conditions under which the transport service is provided, that –
   - (i) the transport service is provided exclusively to employees on the basis of predetermined routes or conditions;
   - (ii) the employees cannot in any manner request such transport service from the service provider on an *ad hoc* basis; and
   - (iii) the contract for providing the transport service is between the employer and the transport service provider, and the employee is not a party to the contract.

It is apparent that the no-value provision in paragraph 10(2)*(b)* will only apply in very specific circumstances. If the provision of transport services between home and work is not structured so that it complies with paragraph 10(2)*(b)*, read with BGR 50 and IN 111, employees receiving transport services will be taxed on the value of the transport services provided, less any consideration paid by the employees in respect thereof (if any). Such a taxable benefit will be subject to employees' tax and the employer will be liable to withhold employees' tax for each employee on the value of the benefit derived each month. Income tax consequences will arise in the hands of the employees concerned.

COMMENT

It is commonplace for employers to provide their employees with tickets or money for use on the various modes of public transportation in order to enable them to travel between their homes and their place of work. However, this practice has not only proven to be unsafe for many female employees who are exposed to the risk of violence whilst travelling, but also has the burdensome consequence of requiring employers to withhold, and pay over to SARS, employees' tax on the value of the money or ticket (as the case may be) given to their employees.

To the extent that an employer follows this practice, it may be beneficial for such an employer to consider redirecting its funds to create and implement a secure transportation scheme for its employees that complies with the no-value provision in paragraph 10(2)*(b)*. While the scheme may have to be carefully constructed in order to comply with the requirements set out in paragraph 10(2)*(b)*, read with IN 111 and BGR 50, employees will have the benefit of receiving safe, non-taxable transport services and the employer will be relieved of its burden to withhold and pay employees' tax in respect of the transport services provided.

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: Fourth Schedule; Seventh Schedule (paragraphs 2 and 10).

Other documents:

- Interpretation Note 111;
- Binding General Ruling 50.

Tags: taxable benefit; employees' tax; income tax consequences.

INBOUND INTEREST-BEARING LOANS

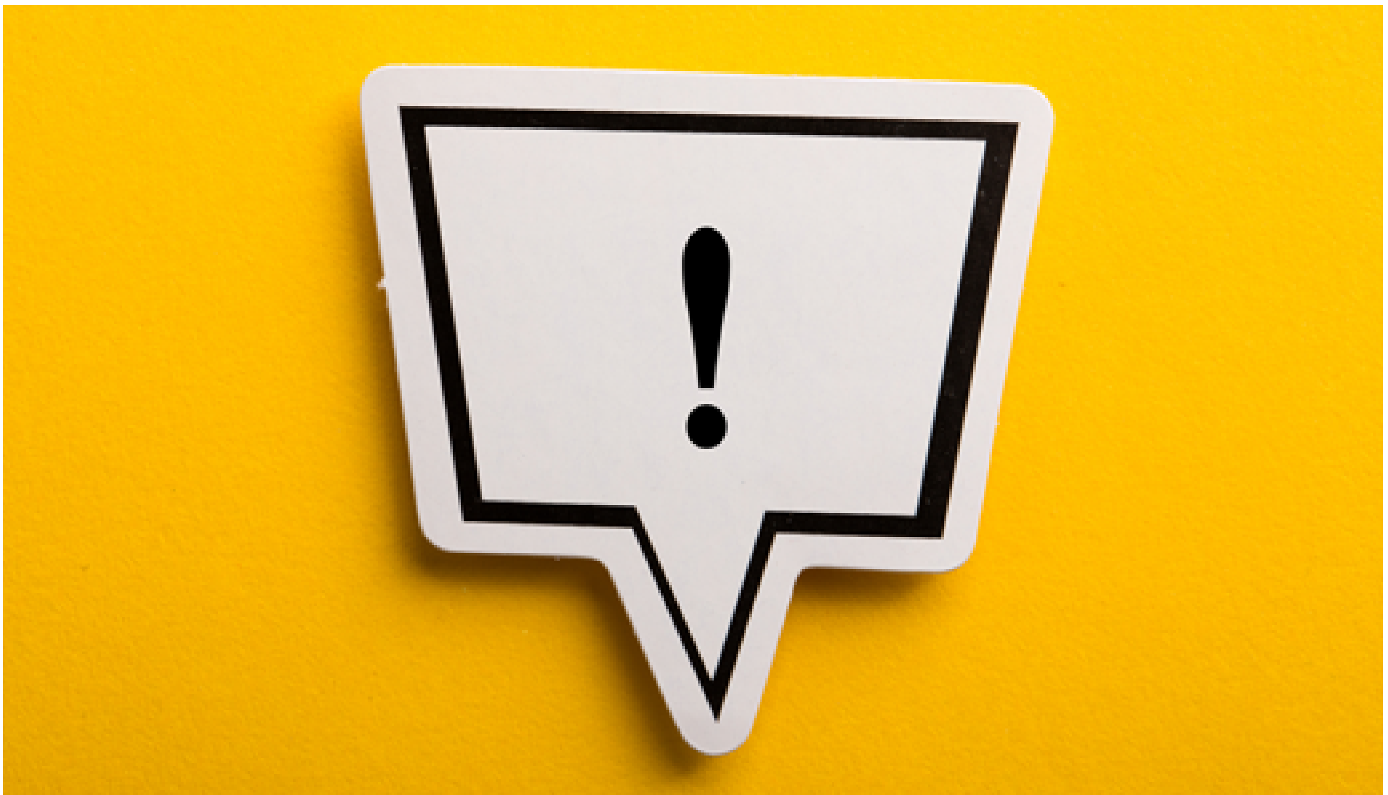
"There can be no objection in principle to the deduction of interest on loans in suitable cases. Loan capital is the life blood of many businesses but the mere frequency of its occurrence does not bring about that this type of expenditure requires different treatment."

Whilst these words of Hefer JA in the well-known judgment of *Ticktin Timers CC v Commissioner for Inland Revenue*, 1999, are still apposite two decades later, there has been increased focus by National Treasury on cross-border financing and how it may lead to tax avoidance, base erosion and profit shifting. As a result of this scrutiny, sections which are intended to have an effect on the deductibility of interest incurred in respect of cross-border loans have been included in the Income Tax Act, 1962 (the Act). For the current purposes, we have only focused on section 23M and section 31 of the Act, and specifically revisited the interaction between the two.

Section 23M provides for a limitation on the deduction of interest incurred where a loan has been advanced by a creditor who holds more than 50% of the equity shares or voting rights in such a debtor (ie a "controlling relationship" exists). The limitation will also be applicable where the creditor is not in a controlling relationship with the debtor, if the creditor obtained the funding for the debt so advanced from a person who is in a controlling relationship with the debtor. However, such an interest deduction limitation will only apply if the amount of interest is neither "subject to tax" in the hands of the recipient, nor included in the net income of a controlled foreign company and also not disallowed under the provisions of section 23N of the Act, which deals with the limitation of interest deductions in respect of reorganisation and acquisition transactions.

Generally speaking, the provisions of section 23M apply to cross-border inbound interest-bearing loans advanced by foreign holding companies to their subsidiaries in South Africa. In terms of such an arrangement, the interest income derived by the foreign company would usually not be subject to tax in terms of the provisions of the Act. This is especially prevalent where loans are advanced from creditors who are resident in Luxembourg, Cyprus, and the Netherlands because of the double tax agreements concluded between South Africa and these respective countries.

Such inbound loans may also be subject to the transfer pricing provisions of section 31. This section targets "affected transactions", which are, generally speaking, transactions or agreements concluded between "connected persons" (as defined in section 1(1) of the Act), where one person to the transaction is



"It is submitted that both section 23M and section 31 are intended to combat base erosion and profit shifting, whilst section 23M has the further specific purpose of addressing the bias for debt funding over equity funding, and hybrid entity mismatches."

resident in South Africa for income tax purposes and the other person is non-resident. In addition, a transaction will only be an affected transaction if any term or condition thereof would not have existed if the contracting parties had been dealing at arm's length.

Section 31(2) provides that where such a transaction results in a "tax benefit", the taxable income of the person who derives the tax benefit must be determined as if that transaction had been entered into on the terms and conditions that would have existed between independent persons dealing at arm's length. Accordingly, where the quantum or interest rate of an inbound loan does not reflect what would have been agreed between parties dealing at arm's length (eg between a bank and a third-party borrower), the taxpayer is required to disregard such interest incurred for purposes of calculating its taxable income. This is known as the Primary Adjustment.

In addition, section 31(3) provides that to the extent that the application of section 31(2) causes a difference in any amount applied in the calculation of the taxable income, the difference is deemed to be a dividend *in specie* declared by the taxpayer (ie the Secondary Adjustment). Effectively, the amount of interest which was disallowed as a deduction is treated as a deemed dividend *in specie*, and is subject to dividends tax at a rate of 20% in terms of section 64E(1), read with section 64EA*(b)* of the Act.

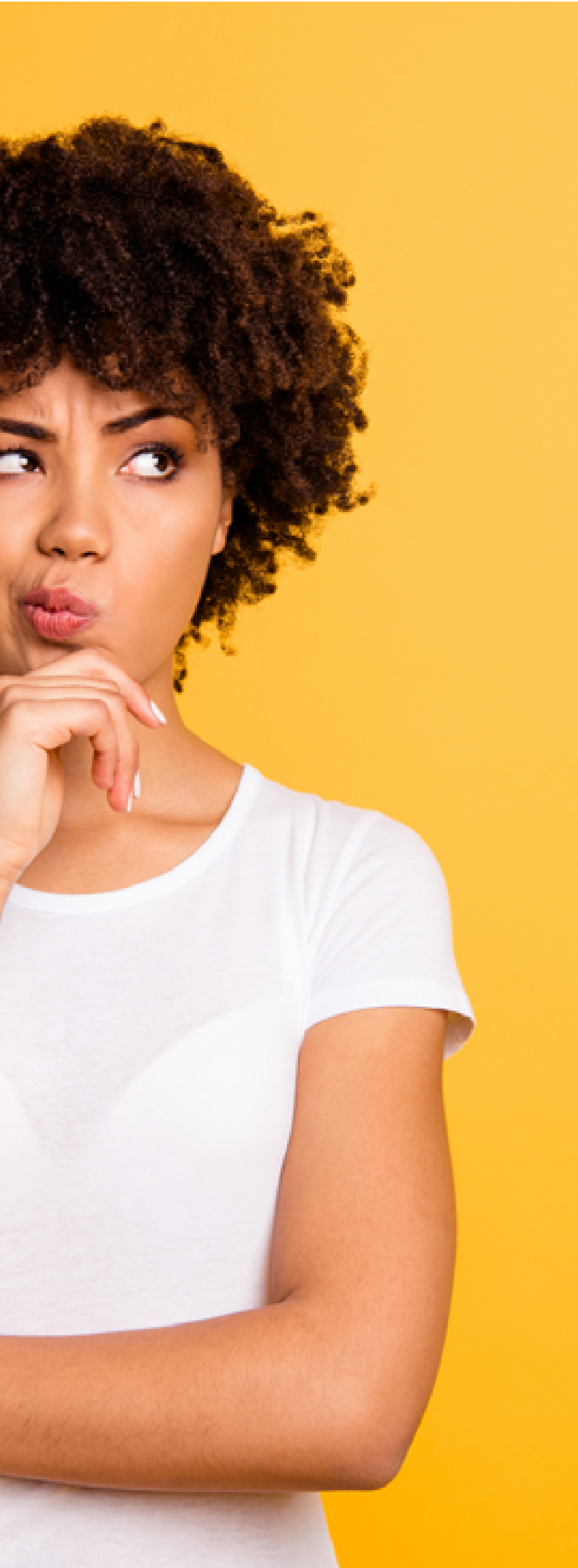
Thus, the question arises: which of these provisions must be applied first in the instances where they both apply to the same inbound loan? We understand that it is the view of National Treasury and the South African Revenue Service, as observed in their Draft Response Document presented to the Standing Committee on Finance in respect of the 2014 Taxation Laws Amendment Bill, that section 31, the transfer pricing, applies first. As stated above, any adjustment in terms of section 31 gives rise to both the Primary and Secondary Adjustment, whereas the application of section 23M only results in a lesser allowable interest deduction, which has the same effect as the Primary Adjustment.

In respect of legislation one should attempt to read the relevant legislative provisions together and, only in circumstances where they conflict, to consider which provision should apply in preference to the other. We analyse below whether it may be possible for the provisions of section 23M and section 31 to be read together.

As stated above, section 23M applies a statutory formula which limits the deduction of interest. This provision tests factual issues and may therefore be applied in the context of the above-mentioned inbound loans.

The definition of "adjusted taxable income" in section 23M(1) refers to an amount of interest incurred that has been allowed as a deduction from income. In this regard it is arguable that consideration could be given to any interest incurred which has been disallowed as a deduction in terms of section 31(2).

In terms of section 31 it is necessary to consider, *inter alia*, whether there is any "tax benefit" and whether the terms of the loan are arm's length in nature. In particular consideration will be given to the quantum and interest rate on the loan. If any term of the loan (in particular relating to quantum and interest rate) is not arm's length and a tax benefit arises, then it will be necessary to calculate the taxable income of the borrower as if the loan was entered into on arm's length terms.



In this regard the borrower's taxable income will already be reduced by the application of the statutory formula set out in section 23M and this should be taken into account in applying the provisions of section 31.

In *Natal Joint Municipal Pension Fund v Endumeni Municipality*, 2012, which is now considered the seminal case on the purposive approach to statutory interpretation, the Supreme Court of Appeal (the SCA) held that when interpreting legislation, one should consider the text of the document under consideration (as a point of departure), read in context and having regard to the purpose of the provision and the background to the preparation and production of the document. It is submitted that both section 23M and section 31 are intended to combat base erosion and profit shifting, whilst section 23M has the further specific purpose of addressing the bias for debt funding over equity funding, and hybrid entity mismatches. Accordingly, having regard to the purpose of both provisions does not sway the interpretation in favour of applying either of the provisions before and to the exclusion of the other. This supports the argument that both sections could be read together.

In the *Endumeni* case, the SCA held that where a person is faced with two or more possible interpretations of a statute, the one which gives rise to "impractical, unbusinesslike or oppressive consequences" must be avoided.

In conclusion, where the provisions of section 23M and section 31 apply to the same inbound loan, the first approach should be to attempt to read the provisions of these sections together. This would mean firstly applying the statutory formula set out in section 23M. The only input required in terms of section 31 in relation to the statutory formula would be the amount of interest incurred that has been allowed as a deduction from income.

The provisions of section 31(2) would then be applied to the same loan and a determination made as to whether there is a tax benefit and whether the arrangement constitutes an "affected transaction". A further adjustment to the taxable income may be necessary having regard to the provisions of section 31(2).

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Act sections:

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "connected persons"), 23M (including definition of "adjusted taxable income" in subsection (1)), 23N, 31, 64E(1) & 64EA*(b)*.

Cases:

- *Ticktin Timers CC v Commissioner for Inland Revenue* 1999 (4) SA 939 (SCA) (at 942I);
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA).

Tags: controlling relationship; controlled foreign company; acquisition transactions; at arm's length; dividend *in specie*; in-bound loan.

EXTENDED SCOPE OF "ELECTRONIC SERVICES"

On 18 March 2019, South Africa's National Treasury published revised Electronic Services Regulations, significantly expanding the scope of electronically supplied services that are subject to value-added tax (VAT). The publication follows the Minister of Finance's announcement in the 2017 Budget Review that the regulations defining electronic services would be broadened.

"The extensive scope of the new regulations now includes any electronic or digital content that is supplied by electronic means, such as cloud computing, data warehousing, software applications (apps), downloading of digitised products, web-based broadcasting services and online training."

South Africa introduced e-services legislation with effect from 1 June 2014, which shifted the VAT liability from the domestic recipient to the non-resident supplier of electronic services. This replaced the e-services recipient's obligation to self-assess VAT on imported services (an existing taxation framework similar to the reverse charge mechanism). *Editorial comment: The reverse charge mechanism rule in regard to imported services still applies other than in regard to imported services which are not electronic services.*

Essentially, a foreign supplier is regarded as carrying on an "enterprise" for South African VAT purposes if it supplies "electronic services", as prescribed in the regulations, to a recipient where at least two of the following circumstances are present:

- the recipient of the service is a South African resident;
- the payment for such services originates from a South African bank account; or
- the recipient has a business address, residential address or postal address in South Africa.

The 2014 e-services regulations prescribed various categories of electronic services that were subject to VAT. These categories intentionally limited the scope of electronic services at the time and included non-regulated educational services, games and games of chance, internet-based auction services, subscription services to websites and web applications, as well as various miscellaneous services entailing the supply of digitised content, such as music and e-books.

NEW REGULATIONS

Effective 1 April 2019, the various categories of electronic services have been removed from the new regulations and "electronic services" is now defined to mean "any services supplied by means of an 'electronic agent', 'electronic communication' or the 'Internet' for any consideration". Each of these terms is defined in the Electronic Communications and Transactions Act, 2002.

Services that are specifically excluded from the ambit of the new regulations are limited to the following:

- transactions between group companies with a shareholding of at least 70%;
- telecommunication services (but not the content thereof); and
- educational services supplied by foreign-regulated educational institutions.

The extensive scope of the new regulations now includes any electronic or digital content that is supplied by electronic means, such as cloud computing, data warehousing, software applications (apps), downloading of digitised products, web-based broadcasting services and online training.

BUSINESS-TO-BUSINESS TRANSACTIONS

What is interesting is that the new regulations do not provide for any distinction between business-to-business and business-to-consumer supplies. The lack of such distinction is contrary to the recommendations of the Davis Tax Committee (March 2018), as well as international best practice advocated by the Organisation for Economic Co-operation and Development.

National Treasury indicated that this outcome was intentional to avoid an unfair cash-flow advantage for non-resident suppliers on the basis that the same distinction does not exist for domestic supplies between businesses.

VAT REGISTRATION THRESHOLD

On a positive note, the e-services registration threshold was also increased with effect from 1 April 2019, from the previous ZAR50 000 per annum, to bring it on par with the domestic compulsory threshold and thereby offering relief to some of the smaller e-service providers.

Foreign suppliers of electronic services are therefore required to register for VAT in South Africa if the total value of their e-services has exceeded ZAR1 million in any consecutive 12-month period.

"One can only hope that the South African Revenue Service is fully prepared for the influx of VAT registrations."

INTERMEDIARIES

Where a foreign supplier supplies e-services via an intermediary (eg, by using an intermediary's platform or electronic marketplace), the intermediary will be deemed to be the supplier of the services and will be required to register and account for VAT in South Africa on these supplies. Such administrative relief is applicable in circumstances where the intermediary facilitates the supply of the electronic services and is responsible for issuing the invoices and collecting payment for the supplies.

SHORT TIME FRAME

Notwithstanding that draft regulations were in circulation for just over a year, the final new regulations were published only two weeks before becoming effective, which provided a short time frame in which to ensure compliance by 1 April 2019.

Besides getting to grips with their new VAT reporting obligations, foreign e-services suppliers will urgently need to update their systems to allow for VAT to be charged on their South African supplies, and to accommodate the necessary invoicing and exchange rate requirements prescribed in Binding General Ruling (VAT) 28.

Foreign suppliers are no longer able to rely on VAT rulings on electronic services and these will need to be reconfirmed. In addition, all e-commerce contracts will need to be reviewed from a pricing perspective to identify South African VAT exposure and to ensure competitiveness.

Since e-services were first taxed in this manner, a streamlined VAT registration and administrative process has served to reduce the compliance burden for affected foreign businesses. One can only hope that the South African Revenue Service is fully prepared for the influx of VAT registrations.

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Act sections:

- Electronic Communications and Transactions Act 25 of 2002.

Other documents:

- Binding General Ruling (VAT): 28 (Issue 2).

Tags: electronic services; international best practice.