Issue 26 | 2020
SEPTEMBER

sait South African Institute of Tax Professionals

Unstructured CPD 150mins

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

COMPANIES
SMME TAX OPPORTUNITIES

ROYALTY TAX
CALCULATION OF GROSS SALES

EMPLOYEES' TAX
PAYE ON INSOLVENCY PAYMENTS TO STAFF

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Editorial Panel:
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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SMME TAX OPPORTUNITIES

This article will consider the recent amendments to the Competition Act, 1998, and its interaction with various other pieces of legislation that seek to promote and protect the interests of small to medium-sized firms or enterprises (SMMEs) as well as previously disadvantaged firms. Included are interests advanced and protected by measures such as the Codes of Good Practice on Broad-Based Black Economic Empowerment (BEE Codes) and various income tax incentives that apply to supplier and enterprise development initiatives and SMMEs.

In particular, this article discusses how dominant firms can use the amendments to the Competition Act as an opportunity with reference to the various tax incentives and provisions in the Income Tax Act, 1962 (the Act). [*Editorial note*: The abbreviation "SMMEs" is used, *inter alia*, in the Electronic Communications and Transactions Act, 2002, for the expression "Small, Medium and Micro Enterprises". The expression "small, medium or micro-sized enterprise" is defined in s 1(1) of the Income Tax Act.]

The Competition Amendment Act, 2018 (the Amendment Act), introduced new provisions that seek to advance and protect the interests of SMMEs. These amendments took effect on 13 February 2020.

In terms of the amendments to section 8 of the Competition Act, a dominant firm in certain sectors is prohibited from imposing unfair prices or trading conditions on suppliers who are SMMEs and/or firms controlled by historically disadvantaged persons (HDPs), or may not refuse to purchase and/or avoid purchasing goods and services from such firms.

The amendments to section 9 of the Competition Act provide that a dominant firm may not engage in prohibited price discrimination which impedes the ability of SMMEs and/or firms controlled or owned by HDPs, to participate effectively in the economy.

The Competition Act now provides that a contravention of these sections will attract penalties of up to 10% of the dominant firm's turnover in South Africa.

"The Broad-Based Black Economic Empowerment Act, 2003, and BEE Codes seek to change the way that the private sector approaches the procurement of products and services."

The unique nature of these provisions and the complex conceptual framework that is required to administer these sections of the Competition Act has attracted significant attention. It is evident that the Amendment Act strays beyond the traditional bounds of prohibiting exclusionary acts by dominant firms, and dominant firms now have a "positive duty" to favour certain firms in the market; ie, if you have buyer power you have a positive duty not to use your buyer power in a way that treats SMMEs or HDPs unfairly.

National Treasury released a report titled "*Economic transformation, inclusive growth and competitiveness: towards an economic strategy for South Africa*", which drew on six themes, including modernising network industries to promote competitiveness and inclusive growth, lowering barriers to entry and addressing distorted patterns of ownership.

This report found that South Africa's lagging productivity growth and declining export performance have been partly attributed to a lack of competition both in upstream and downstream industries. Furthermore, while large businesses have the resources to navigate their way through difficult economic times, the combination of impediments such as a high regulatory burden, inflexible labour markets, and high levels of concentration, present significant obstacles for SMMEs. However, the role of SMMEs in creating employment remains very significant and, for this reason, the focus on their success in the economy is justified.

Many impediments faced by SMMEs and HDI (historically disadvantaged individuals) firms are a function of weak economic growth, but the new Competition Act amendments seek to penalise dominant firms, where dominant firms are at fault for the failure of these vulnerable firms to participate in the economy.

The Broad-Based Black Economic Empowerment Act, 2003, and BEE Codes seek to change the way that the private sector approaches the procurement of products and services. The amendments to the Competition Act, dealing with buyer power and price discrimination, have potential areas of overlap with the enterprise and supplier development provisions in the BEE Codes and dominant businesses have an opportunity to streamline and recalibrate their compliance efforts in this area.

In response to these developments, dominant firms could focus on ways in which to promote compliance with the Competition Act by leveraging off existing initiatives, such as their BEE initiatives, and by seeking to benefit from the various incentives which are currently available to them. From a tax perspective, dominant firms could consider implementing certain programmes, providing funding and developing initiatives with reference to the various tax incentives and provisions in the Act.

For example, certain expenditure incurred in respect of enterprise development (ED) and socio-economic development (SED) could be deductible against income in terms of section 11*(a)* of the Act, depending on the underlying facts and circumstances. In this regard, taxpayers should consider the principles enunciated in the pre-eminent case of *Warner Lambert SA Pty Ltd v Commissioner: South African Revenue Service* [2003], wherein a taxpayer incurred social responsibility expenditure for purposes of complying with the Sullivan Principles in order to be able to continue trading in South Africa as a subsidiary of a United States company. Binding Private Ruling 282 should also be considered in this regard. It dealt with the income tax consequences for the operator of a wind farm incurring ED and SED expenditure pursuant to obligations imposed and accordingly undertaken in terms of an electricity generation agreement and licence.

Dominant firms could also consider providing equity funding to certain section 12J venture capital companies (VCCs) that in turn invest in underlying SMMEs. Alternatively, they could leverage off the existing public benefit organisation (PBO) regime whereby donations to such PBOs conducting relevant activities in support of certain SMMEs may be tax-deductible in terms of section 18A of the Act. Dominant firms could also consider utilising the section 30C small business funding entity provisions where donations to and by a small business funding entity are exempt from donations tax, amongst other benefits.

It should also be noted that SMMEs themselves may benefit from one or more of a variety of special taxation provisions, including for example, the simplified turnover tax system for micro businesses (annual turnover of R1 million or less) that provides for progressive tax rates as opposed to the flat rate of 28% for companies. Similarly, small business corporations (as defined in section 12E(4)) with an annual turnover of less than R20 million (SBCs) also potentially qualify for taxation as per the concessionary tax rates which follow a graduated marginal structure as opposed to the usual corporate tax rate of 28%. SBCs, as defined, may also benefit from tax incentives including the section 12E accelerated depreciation allowance on certain capital assets acquired and brought into use by an SBC. Dominant firms engaged with SMMEs and SMMEs themselves would be well advised to consider the various special taxation regimes for purposes of maximising their benefits.

Efforts by dominant firms to lobby government to reduce red tape and barriers to entry and actively seeking to mitigate such impediments by participating in supplier and customer development programmes could assist in mitigating allegations that dominant firms have impeded the participation of vulnerable firms in the economy. The focus will be on dominant firms to demonstrate how they have been engaging constructively with small or HDI firms and refuting allegations that they have not impeded SMME firms and HDI firms from participating in the economy.

To the extent that vulnerable firms continue to fail despite these efforts, and the fault is placed at the door of dominant firms, difficult questions of causality and the reach of the recent amendments will need to be answered by the Competition Tribunal and the courts.

Cliffe Dekker Hofmeyer

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:

- Competition Act 89 of 1998: Sections 5, 8 & 9;
- Income Tax Act 58 of 1962: Sections 1(1) (definition of "small, medium or micro-sized enterprise"), 11*(a)*, 12E (definition of "small business corporation" in subsection (4)), 12J, 18A & 30C;
- Competition Amendment Act 18 of 2018;
- Electronic Communications and Transactions Act 25 of 2002: Section 1 (definition of "SMMEs");
- Broad-Based Black Economic Empowerment Act 53 of 2003.

Other Documents:

- *Economic transformation, inclusive growth and competitiveness: towards an economic strategy for South Africa* (report released by National Treasury in 2019);
- Codes of Good Practice on Broad-Based Black Economic Empowerment, 2007;
- Sullivan Principles;
- Binding Private Ruling 282.

Cases:

- *Warner Lambert SA (Pty) Ltd v Commissioner: South African Revenue Service* 65 SATC 346; 2003 (5) SA 344 (SCA).

Tags: historically disadvantaged persons (HDPs); historically disadvantaged individuals (HDIs); dominant businesses; enterprise development (ED); socio-economic development (SED); social responsibility expenditure; venture capital companies (VCCs).

INTEREST DEDUCTIBILITY LIMITATION

Interest payments are generally viewed as ordinary business expenses which are deductible in determining taxable income.

Varying corporate income tax rates across countries create an environment where a multinational enterprise (MNE) can minimise its global tax burden by advancing interest-bearing debt in group companies located in high-tax jurisdictions. South Africa is a high-tax jurisdiction and a predominantly capital-importing country and so government needs to strike a balance between (a) attracting capital and promoting investment, and (b) protecting the corporate tax base.

Currently, insofar as is relevant here, section 23M of the Income Tax Act, 1962 (the Act), limits interest deductions in respect of loan funding where the creditor is not subject to tax on the interest income and either (i) the creditor is a controlled foreign company and the interest received by it is not included in the income that is imputed to the South African shareholder, or (ii) the creditor is in a controlling relationship with the debtor. Since its introduction in 2015, it is estimated that up to R4.3 billion in interest expense has been denied as a deduction, potentially saving the fiscus around R1 billion in tax revenue.

In the National Budget in February 2020, the Minister of Finance announced that a new rule will be introduced that will prevent taxpayers from deducting net interest expenses (NIE) in excess of 30% of their "tax EBITDA". [*Editorial note*: The abbreviation "EBITDA" refers to "earnings before interest, taxes, tax depreciation (wear & tear), and tax amortisation (wear & tear)".]

National Treasury released an extensive document entitled "*Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments*" (the Review Document). This document sets out, among other things, the proposed amendments and how they were decided upon.

The Review Document is based primarily on the Organisation for Economic Co-operation and Development's (OECD) final report on Action 4 of the Base Erosion and Profit Shifting Project, "*Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*".

Approximately 800 000 companies file tax returns annually in South Africa. The data from the tax returns has been analysed and, together with the work and recommendations of the OECD, has formed the basis of the proposed amendments.

The new interest limitation rule will apply to all entities operating in South Africa that form part of a foreign or South African multinational group. It is proposed that a group and an MNE will be defined as follows:

- Group: a collection of enterprises connected through ownership or control such that it is either required to prepare consolidated financial statements or would be required to if equity interests in any of its enterprises were traded on a public securities exchange.

- MNE group: any group that includes two or more enterprises, the tax residences of which are in different jurisdictions, or includes an enterprise that is resident for tax purposes in one jurisdiction and has a permanent establishment in another jurisdiction.

The Review Document concludes that "tax EBITDA" is the most appropriate method of calculating earnings. By excluding the two major non-cash costs (depreciation of fixed assets and amortisation of intangible assets), EBITDA is the best guide as to whether an entity can meet its interest commitments. The "tax EBITDA" is the sum of the taxable income, net interest expense and deductions in respect of capital assets.

Rules that only target related-party interest expenses are generally regarded as ineffective because companies can circumvent related-party rules by raising external debt with "back-to-back" loans using a third party. Including the total net interest expense (ie, interest paid to connected and third parties) in the NIE/EBITDA ratio, negates the need for additional complex anti-avoidance provisions.

Importantly, the new rule will apply to interest and all payments economically equivalent to interest, such as payments under profit-participating loans, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees and arrangement fees and similar costs related to the borrowing of funds.

The Davis Tax Committee previously raised concerns with a ratio based on earnings as it creates uncertainty for potential investors as to what level of interest deductibility would be available in any particular year. A carry-forward provision can help entities that incur interest expenses on long-term investments that are expected to generate taxable income only in later years and will allow entities with losses to claim interest deductions when they return to profit. Accordingly, the taxpayers will be allowed to carry forward excessive net interest expenses for five years on a first-in, first-out (FIFO) basis.

In order to alleviate the burden of compliance with the new rules for small companies who already face funding constraints, a *de minimis* rule is proposed (currently between R2 million and R5 million) such that companies with a net interest expense of less than this *de minimis* amount will not be required to comply.

"The new rule will replace section 23M of the Act, with transitional measures being implemented for existing third-party loans."

Based on the data that was analysed, using a NIE/EBITDA ratio of 30% approximately 75% of taxpayers with a positive "tax EBITDA" will be able to deduct all of their net interest expense in the year of incurral.

The new rule will replace section 23M of the Act, with transitional measures being implemented for existing third-party loans.

There is at present uncertainty as to the interplay between the current interest limitation provisions and the transfer pricing rules in section 31. The Review Document proposes that companies should first apply the transfer pricing arm's length test to financial transactions and thereafter the interest limitation rules, in other words, the interest limitation rules should apply to net interest expense that has already passed the arm's length test.

Government is considering implementing a safe harbour approach to determine whether taxpayers would need to apply the arm's length principle to the quantum of the financing provided and invites comments in this regard. It would not make sense if the safe harbour rules in both sections were not the same.

Werksmans

Acts:

- Income Tax Act 58 of 1962: sections 23M & 31.

Other Documents:

- *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments* (February 2020);
- Organisation for Economic Co-operation and Development's final report on Action 4 of the Base Erosion and Profit Shifting Project, "*Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*".

Tags: multinational enterprise (MNE); net interest expenses (NIE); earnings before interest, taxes, depreciation, and amortisation (EBITDA); taxable income; long-term investments; interest limitation rules.

PAYE ON INSOLVENCY PAYMENTS TO STAFF

The Fourth Schedule to the Income Tax Act, 1962 (the Act), places an obligation on all employers and representative employers, as defined in the Fourth Schedule, to withhold employees' tax from all remuneration paid to persons who are employees, in terms of the Fourth Schedule.

The application of the Fourth Schedule and the obligation to withhold employees' tax, arose in the recent reported judgment of *Commissioner for South African Revenue Service v Pieters and Others*, [2020] (the *Pieters* case). In this matter, the Supreme Court of Appeal (SCA) had to decide whether liquidators ought to withhold employees' tax from payments made to employees under section 98A of the Insolvency Act 24 of 1936 (the Insolvency Act).

While the focus of this article is the SCA's interpretation of the provisions of the Fourth Schedule, it is necessary to briefly discuss the provisions of the Insolvency Act referred to by the SCA, as set out by the SCA, so that the judgment can be understood in the correct context.

FACTS

The appellants in the *Pieters* case were the liquidators of an insolvent transport company which had employed 700 people. Forty-five days after the appointment of the liquidators, the employment contracts terminated under section 38(9) of the Insolvency Act.

Salary entitlements, leave pay and severance pay had accrued to these employees over the course of the liquidation process. The liquidators determined the employees' entitlements and paid amounts owing to them under section 98A of the Insolvency Act.

SARS objected to the liquidation and distribution account (the L&D account) lodged by the liquidators, on the basis that no provision had been made for the payment of employees' tax in respect of the payments by the liquidators made in terms of section 98A.

The Master of the High Court accepted SARS' objection and ordered the liquidators to amend the L&D account to reflect the employees' tax as administration costs and deduct the actual employees' tax payable from their liquidators' fee.

SCA'S DISCUSSION OF THE APPLICABLE INSOLVENCY ACT PROVISIONS

The SCA explained that where a company is placed into liquidation, employment contracts and associated payments become regulated by the Insolvency Act. Initially, section 38(1) of the Insolvency Act suspends the operation of all employment contracts concluded by the insolvent employer from the date the provisional liquidation order is granted. Unless otherwise agreed by the employee and liquidator, all suspended employment contracts automatically terminate 45 days after the appointment of the liquidator.

Sections 97 to 102 of the Insolvency Act prescribe the statutory order of preference in which the various creditors of the insolvent company or *concursus creditorum* are to receive distributions out of the insolvent estate.

The SCA quoted section 98A(1) of the Insolvency Act, relevant for purposes of this article, which makes provision for preferential payments to employees and states the following:

> "(1) Thereafter any balance of the free residue shall be applied in paying–
>
> *(a)* to any employee who was employed by the insolvent–
>
> (i) any salary or wages, for a period not exceeding three months, due to an employee;
>
> (ii) any payment in respect of any period of leave or holiday due to the employee which has accrued as a result of his or her employment by the insolvent in the year of insolvency or the previous year, whether or not payment thereof is due at the date of sequestration;
>
> (iii) any payment due in respect of any other form of paid absence for a period not exceeding three months prior to the date of the sequestration of the estate; and
>
> (iv) any severance or retrenchment pay due to the employee in terms of any law, agreement, contract, wage-regulating measure, or as a result of termination in terms of section 38; and
>
> *(b)* any contributions which were payable by the insolvent, including contributions which were payable in respect of any of his or her employees, and which were, immediately prior to the sequestration of the estate, owing by the insolvent, in his or her capacity as employer, to any pension, provident, medical aid, sick pay, holiday, unemployment or training scheme or fund, or to any similar scheme or fund."

"Sections 97 to 102 of the Insolvency Act prescribe the statutory order of preference in which the various creditors of the insolvent company or *concursus creditorum* are to receive distributions out of the insolvent estate."

SCA'S JUDGMENT ON THE MAIN ISSUE

As stated above, the key issue that the SCA had to decide was whether the payments made by the liquidators in terms of section 98A (section 98A payments) are subject to the obligation to withhold employees' tax in the Fourth Schedule.

The Commissioner for the South African Revenue Service (SARS) argued that the liquidators fell within the definition of "employer" in the Fourth Schedule where they made section 98A payments and that this was contemplated in the statutory scheme of preference embodied in the Insolvency Act. Alternatively, SARS argued that any departure from the scheme was warranted by paragraph 3(2) of the Fourth Schedule, which reads as follows:

> "(2) The provisions of paragraph 2 shall apply in respect of all amounts payable by way of remuneration, notwithstanding the provisions of any law which provide that any such amount shall not be reduced or shall not be subject to attachment".

(One should note that paragraph 2 of the Fourth Schedule, referred to in paragraph 3(2), is the provision which imposes the obligation on employers and representative employers to withhold and pay employees' tax to SARS.)

The SCA per Majiedt JA, as he then was, held that section 98A payments are preferential payments, not falling within the employees' tax withholding requirements in terms of the Fourth Schedule.

The primary bases for this finding were the following:

- Firstly, that the amendment of the statutory order of preference to include section 98A was done with a "social justice objective aimed at alleviating the plight of employees who are left unpaid by the financial woes of their liquidated employer company".
- Secondly, that this approach was supported by a careful reading of the Fourth Schedule, which demonstrated a legislative intention to exclude liquidators from the definition of "employer" and therefore from the obligation to withhold employees' tax.

Majiedt JA further held that SARS' arguments had to be rejected as it would, amongst other things, "lead to startling anomalies", as otherwise section 98A payments would rank ahead of PAYE amounts listed in section 99(1)*(b)*(ii) of the Insolvency Act, which would be untenable in law.

Turning to an interpretation of the Fourth Schedule, Majiedt JA held that there was evidence of a legislative intention in the express inclusion of a liquidator in the definition of "representative employer" in the Fourth Schedule and a trustee of an insolvent estate in the definition of "employer".

He supported this interpretation with the legislative history of the provisions – the current definition of "employer" in the Fourth Schedule was effected in 2008 and that of "representative employer" in 2014. The legislative intention was held to exclude a liquidator who constituted a representative employer, from the obligation of withholding employees' tax, under paragraph 2(1) of the Fourth Schedule.

Lastly, Majiedt JA held that paragraph 3(2) of the Fourth Schedule, quoted above and relied on by SARS, was not applicable to the Insolvency Act as it did not provide that any amount shall not be reduced or shall not be subject to attachment. It therefore found no application to section 98A payments.

OBSERVATION

Following the *Pieters* case, the position of liquidators and their duty to withhold employees' tax is clear – no employees' tax needs to be withheld from preferential payments made to employees under section 98A.

While not explicitly dealt with in the judgment, it is possible that the same principle could apply to other payments listed in section 98A(1)*(b)*, such as, for example, employer contributions to any pension fund, provident fund, medical aid scheme and so forth. This is because these amounts constitute fringe benefits, which must be included in a person's "remuneration", as defined in the Fourth Schedule.

With the economic impact of COVID-19 being felt across the world and particularly in developing countries such as South Africa, it is of course hoped that the measures employed by governments will mitigate job losses and prevent the closure and liquidation of businesses. However, should employees of a South African employer be affected by the closure or liquidation of the company by which they are employed, such employees can at least know that they will be entitled to the full statutorily prescribed payment, referred to in section 98A.

Cliffe Dekker Hofmeyr

Acts:

- Income Tax Act 58 of 1962: Fourth Schedule – Paragraphs 1 (definitions of "employee", "employer", "remuneration" & "representative employer"), 2 & 3(2);
- Insolvency Act 24 of 1936: Sections 38 & 97 to 102 (including specifically sections 98A & 99(1)*(b)(ii)*).

Cases:

- *Commissioner for South African Revenue Service v Pieters and Others* [2020] (1) SA 22 (SCA).

Tags: preferential payments; representative employer.

THE WILLS ACT AND DIVORCE

On 28 April 2020, Sher J delivered a magisterial 40-page judgment in the High Court of the Western Cape in the matter between JW (appellant) and Williams-Ashman & others (respondents), case 16108/19. In issue was section 2B of the Wills Act, 1953, a relatively little-used and little-known section because of its limited application.

Section 2B provides that:

> "If any person dies within three months after his marriage was dissolved by a divorce or an annulment by a competent court, and that person executed a will before the date of such dissolution, that will shall be implemented in the same manner as it would have been implemented if his previous spouse had died before the date of the dissolution concerned, unless it appears from the will that the testator intended to benefit his previous spouse notwithstanding the dissolution of his marriage".

As the court observed, elderly people tend not to get divorced, and they are more likely to die relatively soon after each other than young and middle-aged couples, who in turn are more likely to get divorced. This would explain the obscurity of section 2B. In its 1991 report, the SA Law Commission had recommended the insertion of section 2B into the Act after extensive research into the position in a number of other countries. The rationale is the acknowledgment that in so inevitably stressful and sometimes traumatic an experience as divorce, redrafting your will is often the last thing on your mind. The Commission recommended, however, that three months was long enough time for persons newly divorced to take stock of their new situation and take remedial action. The result was the introduction of section 2B in 1992.

The appellant's spouse, NW, died less than three months after their divorce had been finalised. She had signed a will shortly before the couple's marriage, referring to JW as "my husband". The court found that this premature description did not invalidate the will. In the will she bequeathed her estate to her husband. No children were born of the union and NW had no children of her own. Her executor applied section 2B, which had the effect of disinheriting JW and devolving NW's estate upon her parents in terms of the Intestate Succession Act, 1987. JW appealed against this decision on broadly two grounds. In response to each of the grounds, as mentioned below, the court devoted considerable attention.

"Section 25(1) of the Constitution provides that no one may be deprived of property except in terms of a law of general application, and no law may permit the arbitrary deprivation of property."

Section 25(1) of the Constitution provides that no one may be deprived of property except in terms of a law of general application, and no law may permit the arbitrary deprivation of property. In 73 closely crafted paragraphs, too long to consider in this brief summary, the court found that section 2B does not deprive beneficiaries of their right to benefit under a will, partly because they had no right but only a *spes*. This part of the judgment deserves an article of its own.

Section 34 of the Constitution provides that everyone has the right to have a dispute which can be resolved by the application of law decided in a fair public hearing before a court, or, where appropriate, another independent and impartial tribunal or forum. JW contended that section 2B offends against section 34 of the Constitution because in the first place it "seeks to exclude the Court's 'general oversight function' (sic). Secondly, because it ousts the 'general discretion' which the Court has in terms of the Wills Act (such as that which it has to condone non-compliance with the formalities required for a will or the revocation of a will), thereby preventing it from accepting evidence which a former spouse may be able to put forward of a testator spouse's intent, which might be recorded in another document, or which may have been expressed in terms of an oral agreement which is 'publicly accepted as true' (sic). Thirdly, the applicant contends that the provision is in conflict with section 34 as it 'deletes' (sic) the constitutional right which the applicant has to seek judicial redress in circumstances where he is able to provide 'direct' evidence of a testator spouse's testamentary intentions, and instead directs that the Court must operate under a 'false fiction' that a former spouse has predeceased a testator spouse, which is contrary to public policy". In a mere 33 paragraphs, which also deserve their own article, the court demolished JW's second constitutional challenge.

In the result, the court found that section 2B "serves a legitimate and compelling social purpose and the deprivation which it affects when it applies is not arbitrary in terms of s 25(1), and there is sufficient reason for it. It is also not procedurally unfair. In addition, the terms of s 2B do not constitute a limitation of the applicant's right of access to a Court, in breach of s 34. Consequently, the application falls to be dismissed".

Readers would do well to take the time to read and digest this judgment as an example of judicial interpretation at its best.

Professor Peter Surtees

Acts:

- Wills Act 7 of 1953: Section 2B;
- Intestate Succession Act 81 of 1987;
- Constitution of the Republic of South Africa, 1996: Sections 25(1) & 34.

Cases:

- *J W v Williams-Ashman NO and Others* (16108/19) [2020] ZAWCHC 27 (28 April 2020).

Tags: competent court; remedial action; judicial redress.

REITS AND FOREIGN DIVIDENDS

In essence, real estate investment trusts (REITs) are treated as conduits through which the income they derive, flows to their shareholders.

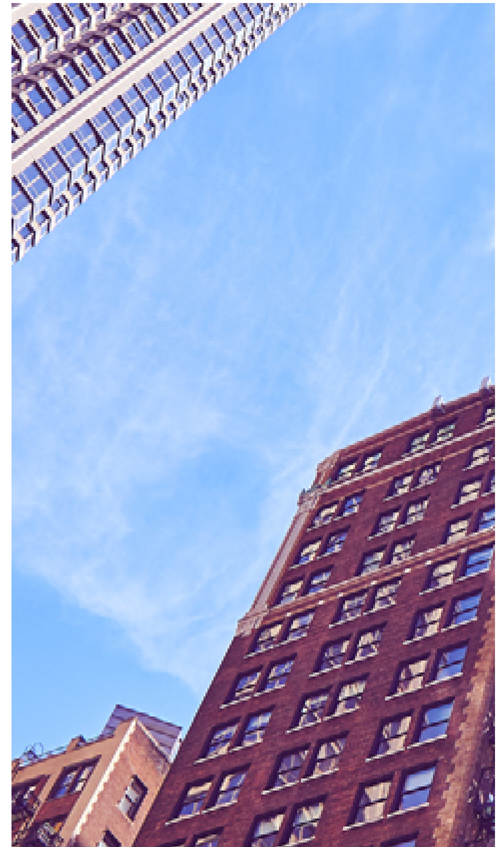
The main advantage of a REIT is therefore that a deduction of the distribution made by the REIT to its shareholders may be claimed against its income provided that it is a qualifying distribution. By nature, REITs distribute most of their income to their shareholders and will usually pay little or no income tax on the distributions; instead, shareholders will be liable to pay income tax on the distributions received from REITs. REITs are, however, taxed on the taxable income they retain at the standard corporate tax rate.

The 2020 Budget Speech, (the Budget) delivered by the Minister of Finance (the Minister), contained various tax policy proposals including those aimed at refining the REITs tax regime. These proposals include clarifying the definition of REITs and clarifying the meaning of a share in the definition of REITs. The Budget also proposed amending the provisions regarding the taxation of foreign dividends received by REITs and this article unpacks this proposal in a little more detail.

LEGISLATIVE FRAMEWORK AND KEY DEFINITIONS

In section 1(1) of the Income Tax Act, 1962 (the Act), a REIT is defined as a company that is a resident, the shares of which are listed on an exchange (as defined in section 1 of the Financial Markets Act, 2012), and are listed as shares in a REIT (as defined in the listing requirements of an exchange approved in consultation with the Minister). Section 25BB(2)*(a)* of the Act provides that there must be deducted from the income (for a year of assessment of a REIT or controlled company that is a resident), the amount of any "qualifying distribution" made by that REIT or "controlled company" (being a subsidiary of a REIT for IFRS purposes) during that year of assessment.

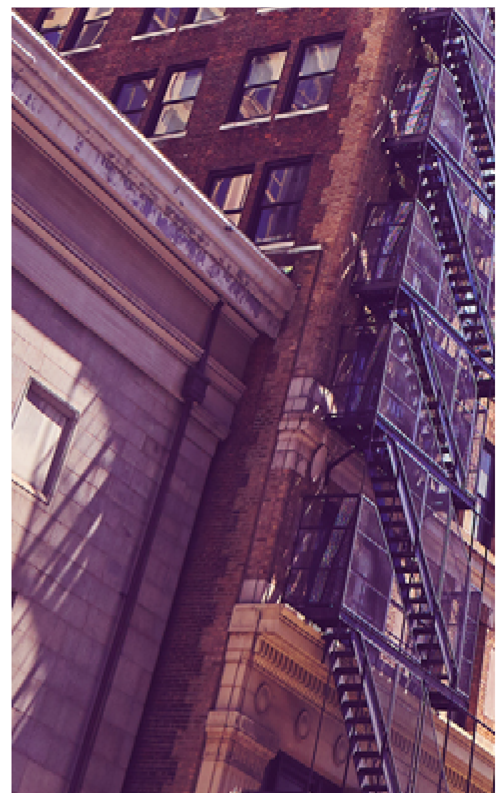
A "qualifying distribution" in respect of a year of assessment for a company that is a REIT (as at the end of the year of assessment), means any dividend paid or payable, or interest incurred in respect of a debenture forming part of a linked unit in that company. Importantly, the dividend paid or interest incurred in respect of a debenture must be determined with reference to the financial results of that company as reflected in the financial statements prepared for that year of assessment. Where that year of assessment is the first year of assessment, at least 75% of the gross income received by or accrued to the REIT must consist of rental income. In any other case (ie, in subsequent years), at least 75% of the gross income received by or accrued to the REIT in the preceding year of assessment must consist of rental income. "Rental income" not only includes the normal concept of rental income (ie, any amount received by or accrued to a person in respect of the use of immovable property). The defined term in section 25BB(1) has an expanded definition and it includes, amongst others, any amount received or accrued as a dividend or foreign dividend from a company that is a property company at the time of that distribution and any amount received as a dividend from a REIT. Importantly, it now also includes any foreign exchange differences arising in respect of an "exchange item" relating to a "rental income" of a REIT or a controlled company.



The definition of "qualifying distribution" excludes a dividend contemplated in paragraph *(b)* of the definition of "dividend", being any amount other than a dividend consisting of a distribution of an asset *in specie* declared and paid, transferred or applied by a company that is resident for the benefit of or on behalf of any person in respect of any share in that company if that amount is transferred or applied as consideration for the acquisition of any share in that company. This essentially excludes a dividend constituting a share buy-back from a qualifying distribution. This is because a dividend constituting a share buy-back is exempt from normal tax in terms of section 10(1)*(k)*(i) of the Act and therefore a REIT is not allowed to deduct it as part of a qualifying distribution.

"National Treasury has now identified a mismatch where a REIT holding shares in a non-resident property company qualifies for a participation exemption in respect of the foreign dividends from that non-resident property company and also gets a full deduction when it distributes profits from those foreign dividends."

A "property company" means a company in which 20% or more of the equity shares or linked units are held by a REIT or a controlled company (whether alone or together with any other company forming part of the same group of companies as that REIT or that controlled company) in respect of which, at the end of the previous year of assessment, 80% or more of the value of the assets reflected in the annual financial statements is directly or indirectly attributable to immovable property. The importance of this definition will emerge below.



TAX TREATMENT OF LOCAL DIVIDENDS RECEIVED BY REITS

Generally, domestic dividends received by or accrued to a resident holder of shares are exempt from normal tax under section 10(1)*(k)*(i). In terms of this section, dividends received by or accrued to any person shall be exempt from normal tax, subject to numerous provisos. This means that generally, when a REIT receives a dividend, that dividend is exempt from normal tax. Paragraph *(aa)* of the proviso, however, provides that a dividend distributed by a company that is a REIT (or controlled company) is not exempt from normal tax. Therefore, when a REIT receives a dividend from another REIT (or controlled company) it will not be exempt from normal tax in terms of paragraph *(aa)* and will thus be subject to normal income tax in the hands of the REIT recipient.

A REIT can make a qualifying distribution with reference to amounts that comprise dividends or foreign dividends from resident and non-resident "property companies", respectively, and will receive a full deduction from its income of the amount of the distribution, provided it meets the requirements of a qualifying distribution.

The amount allowed as a deduction is limited in terms of section 25BB(2)*(b)*, which provides that the aggregate amount of the deduction may not exceed the taxable income for that year of assessment of that REIT before taking into account deductions in terms of section 25BB, any assessed loss brought forward in terms of section 20 and any taxable capital gain included in income in terms of section 26A.

For practical purposes, where a REIT receives a dividend from a resident property company (not comprising another REIT or controlled company) that dividend will be included in the gross income of the REIT. The dividend will, however, qualify for an exemption from normal tax under section 10(1)*(k)*(i). If that REIT makes a qualifying distribution (ie, an amount determined with reference to, *inter alia*, the dividend received from the property company), it will effectively receive a deduction of that amount to the extent that it does not exceed the taxable income of the REIT.

If the shareholder of the REIT is a resident company, the dividend from the REIT is included in the income of the shareholder in terms of paragraph *(aa)* and is subject to normal tax. In terms of section 64F(1)*(l)*, the dividend paid by the REIT to the resident shareholder will be exempt from dividends tax since the dividend is required to be included in the income of the resident. Where the shareholder of the REIT is a non-resident, the dividends received or accrued to that person are exempt from normal tax. These dividends are, however, subject to dividends tax because they do not qualify for exemption under section 64F(1)*(l)* as they do not constitute income in the hands of the recipient.

TAX TREATMENT OF FOREIGN DIVIDENDS RECEIVED BY REITS

In the case of foreign dividends, section 10B(2)*(a)* provides that there must be exempt from normal tax any foreign dividend received by or accrued to a person if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend.

Therefore, where a REIT holds, say, 20% of the equity shares and voting rights in a non-resident property company and foreign dividends are received by the REIT in respect of those shares, then the foreign dividend will be included in the gross income of the REIT but will be exempt from normal tax as it will fall within the participation exemption in terms of section 10B. When the REIT makes a distribution to its shareholders of the income, the distribution will constitute a qualifying distribution, and this will be deducted from its income in terms of section 25BB(2). The foreign dividends received from the non-resident property company will fall within the REIT's rental income and will thus contribute to ensuring that the REIT's gross income breaches the 75% threshold.

Not all foreign dividends received by a REIT will fully benefit from this scenario. Where a REIT holds more than 10% of the equity shares and voting rights in a non-resident company (but less than 20%), the foreign dividends would also be subject to the participation exemption in terms of section 10B(2)*(a)*, referred to above. However, such foreign dividends would not constitute rental income of the REIT as the foreign dividend would not be from a property company as defined in section 25BB(1).

Thus, when the REIT makes a qualifying distribution to its shareholders, the foreign dividends so received will not form part of the 75% calculation.

MISMATCH AND POLICY PROPOSALS

National Treasury has now identified a mismatch where a REIT holding shares in a non-resident property company qualifies for a participation exemption in respect of the foreign dividends from that non-resident property company and also gets a full deduction when it distributes profits from those foreign dividends.

It would appear that National Treasury has identified that the tax effect is that the REIT receives a double benefit in respect of the same amount. In other words, foreign dividends may fall within the section 10B(2)*(a)* participation exemption, thereby being exempt from normal tax and the REIT potentially receives a full deduction in respect of an amount determined with reference to the foreign dividend when it makes a qualifying distribution. This means that the REIT's tax position is no longer neutral as the foreign dividend escapes taxation altogether in the hands of the REIT.

In Annexure C of the 2020 Budget Review, National Treasury proposes that the legislation be amended so that the full foreign dividend is subject to tax if the recipient company is a REIT. This would address the mismatch that occurs when a participation exemption and a deduction are effectively granted in respect of the same amount when the REIT makes a qualifying distribution. The proposal may, however, not be an issue given the flow-through principle. In other words, to the extent that the REIT distributes the foreign dividend to its shareholders it will still be able to claim a qualifying distribution deduction against its income with reference to that foreign dividend.

Interestingly, although the same mismatch occurs with respect to local dividends received by or accrued to REITs, it appears that National Treasury seeks to remedy the position in respect of foreign dividends only. The draft amendment Bill has now been issued by National Treasury with details of the proposed amendments.

Cliffe Dekker Hofmeyr

Acts:

- Income Tax Act 58 of 1962: sections 1(1) (definition of "REIT"); 10(1)*(k)*(i); 10B(2); 20; 25BB(1) (definitions of "property company" & "rental income") & (2)*(a)* & *(b)*; 26A & 64F(1)*(l)*;
- Financial Markets Act 19 of 2012: Section 1(1) (definition of "exchange").

Tags: real estate investment trusts (REITs); listing requirements; qualifying distribution; controlled company; share buy-back; domestic dividends; resident property company; equity shares.

CALCULATION OF GROSS SALES

On 25 March 2020, judgment was delivered in the Supreme Court of Appeal (SCA) following the appeal lodged by SARS against the High Court judgment in the well-known "UMK case".

In *United Manganese of Kalahari (Pty) Ltd v Commissioner for the South African Revenue Service*, [2017], United Manganese of Kalahari (Pty) Ltd (UMK) approached the High Court of South Africa (High Court) for a declaratory order regarding the correct interpretation and application of section 6(3)*(b)* of the Mineral and Petroleum Resources Royalty Act, 2008 (the Royalty Act).

The dispute with the Commissioner for the South African Revenue Service (SARS) related to the correct manner of determining the company's "gross sales" for the purpose of calculating the royalty payable by it in terms of section 3(2) of the Royalty Act, and specifically in the context of transport, insurance and handling costs incurred by the company. UMK is one of the largest producers of manganese in the country.

The High Court ruled in favour of UMK and it was held that UMK was entitled to calculate its gross sales (in terms of subsections (2) and (3) of section 6 of the Royalty Act) in respect of manganese transferred by it in the 2010 and 2011 years of assessment by deducting: (i) any expenditure incurred by it in respect of transport, insurance and handling of the manganese after the manganese had been brought to the condition specified in Schedule 2 to the Royalty Act; as well as (ii) any expenditure incurred in respect of transport, insurance and handling to effect the disposal of the manganese, irrespective of whether any such expenditure was specifically and/or consciously considered in the determination of the company's gross sales and irrespective of whether such transport, insurance and handling costs are of a capital nature.

SARS filed an appeal against the judgment, which was heard on 13 March 2020 in the SCA.

Judge M J D Wallis, on 25 March 2020, dismissed the appeal with costs, although it was noted that "there was difficulty with the wording of the declaratory order granted by the High Court and it is necessary to alter it to reflect correctly the court's finding". The following order was granted:

> "Paragraph 1 of the order of the High Court is altered to read as follows:
>
> 'The applicant is entitled to calculate its gross sales (in terms of subsections 6(2) and 6(3) of the Mineral and Petroleum Resources Royalty Act 28 of 2008 (the Royalty Act)) in respect of manganese transferred by it in the 2010 and 2011 years of assessment, by deducting:
>
> 1.1 any expenditure incurred by it in respect of transport, insurance and handling of the manganese after the manganese had been brought to the condition specified in Schedule 2 to the Royalty Act; as well as
>
> 1.2 any expenditure incurred *by it* in respect of transport, insurance and handling to effect the disposal of the manganese; *irrespective of whether, in the price charged by it to purchasers of manganese, any amount was separately specified for expenditure incurred by it in respect of transport, insurance and handling under either of paragraphs 1.1 or 1.2.*' " (own emphasis added)

Following the *UMK* case, there was a lot of debate and uncertainty as to whether the transport, insurance and handling costs should have been separately specified, on for example invoices, in terms of which these costs are recovered from customers.

Having regard to the clarification of the wording by the SCA, the only requirements are that the relevant expenditure should have been incurred by the company seeking to adjust its gross sales. There is hence no requirement that the costs incurred should have been separately specified in order to qualify for an adjustment to gross sales under these sections of the Royalty Act.

Bowmans

Acts:

- Mineral and Petroleum Resources Royalty Act 28 of 2008: Sections 3(2) & 6(2) & (3)*(b)*; Schedule 2.

Cases:

- *United Manganese of Kalahari (Pty) Ltd v Commissioner for the South African Revenue Service* (74158/2016) [2017] ZAGPPHC 628; 2018 (2) SA 275 (GP) (3 October 2017);
- *C:SARS v United Manganese of Kalahari (Pty) Ltd* 264/2019 [2020] ZASCA 16 (25 March 2020).

Tags: equity shares; gross sales.