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EXCHANGE CONTROL
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INTERNATIONAL TAX
CHECKING YOUR TAX RESIDENCY STATUS WITH SARS

DEDUCTIONS AND ALLOWANCES
TAX DEDUCTIBILITY OF INTEREST: THE TRANSITION FROM PN31 TO SECTION 11G

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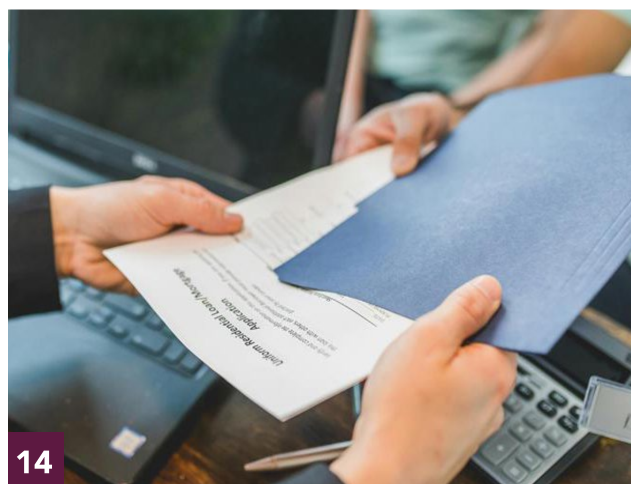

Editorial Panel:
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CARBON TAX PHASE 2

It was reported that COP29, concluded in November 2024, left many developing countries feeling frustrated and disappointed at the commitment by developed countries to provide climate finance of USD300 billion per year by 2035.

However, South Africa's Minister of Forestry, Fisheries and the Environment, Dion George, was quoted as saying that despite this, the agreement on carbon markets reached at COP29 will allow South Africa and other developing economy countries to initiate new carbon market projects. According to the Minister, this will facilitate investments in green technologies and economic opportunities.

Considering this, the upcoming implementation of phase 2 of South Africa's carbon tax regime (Phase 2) takes on greater significance. On 13 November 2024, National Treasury (NT) published the "*Carbon Tax Discussion Paper: Phase Two of the Carbon Tax*" (the Discussion Document), which proposes that Phase 2 of the carbon tax be implemented from 1 January 2026. The implementation of Phase 2 has been delayed on several occasions, at least partly due to the economic effects of the Covid-19 pandemic and concomitant lockdown.

The Discussion Document is extremely comprehensive – 66 pages – and addresses in some detail the proposed amendments to the Carbon Tax Act, 2019, in implementing Phase 2 and the rationale for these proposals.

This article touches on just two of the most important amendments proposed as part of Phase 2:

- Firstly, the proposed changes to the basic tax-free allowance, which affects all carbon taxpayers and applies to all emissions.
- Secondly, proposed changes to the carbon offset allowance, which will likely have a direct impact on the amount of carbon offsets generated by South African projects and on South Africa's carbon market. Internationally, carbon offsets are more commonly known as carbon credits.

"However, the Discussion Document proposes to reduce this allowance to 50% in 2026 and then by 2.5 percentage points every year thereafter. This means that the maximum effective carbon tax rate will increase."

BASIC TAX-FREE ALLOWANCE

Currently, this allowance is set at 60% and, as stated in the Discussion Document, it "is the only free allowance for which industry does not need to make investments to qualify for during the first phase of the carbon tax..."

The effect of this allowance is to reduce the maximum effective rate of carbon tax and it has been in place since the Carbon Tax Act came into effect in 2019. In other words, even though the carbon tax rate for 2024 was R190 per tonne CO2e above the prescribed threshold, the maximum effective rate for 2024 was R76 (R190 less 60% allowance). In other words, if a carbon taxpayer's activities resulted in 4 tonnes of greenhouse gas (GHG) emissions above the prescribed threshold, the maximum carbon tax liability will be R76 x 4 = R304. It can be reduced further if any other allowances apply, but it will not be more than this.

However, the Discussion Document proposes to reduce this allowance to 50% in 2026 and then by 2.5 percentage points every year thereafter. This means that the maximum effective carbon tax rate will increase. In terms of the Carbon Tax Act, the carbon tax rate for 2026 will be R308. If the basic tax-free allowance is reduced to 50% in 2026, the maximum effective rate would be R154 per tonne CO2e above the prescribed threshold, double the maximum effective rate of R76 for 2024.

During one of the workshops held by NT as part of the public consultation process on the 2022 Taxation Laws Amendment Bill, NT acknowledged that without this 60% allowance, the effect of the carbon tax on businesses would be devastating. This was in the context of the discussion on the proposed carbon tax rate increases from 2023 to 2030, which was hotly debated at the time. While the proposal in the Discussion Document is that the allowance be gradually reduced as opposed to being eliminated, how it affects businesses, especially those in hard-to-abate industries, remains to be seen.

A hard-to-abate sector is one where the nature of the sector's activity makes reduction of GHG emissions through technology prohibitively expensive or impossible. Examples of this are the iron, steel, chemicals and aviation industries. In the aviation context, for example, the development of and research into the use of sustainable and cleaner fuels remain ongoing.

CARBON OFFSET ALLOWANCE

This is the one that matters for South African carbon market projects and the trading of carbon offsets (carbon credits). As it stands, this allowance makes it possible for taxpayers to reduce their carbon tax liability by 5% or 10% of their total GHG emissions. As the Discussion Document explains "it enables industry to invest in mitigation projects at a lower cost to what would be achieved in their own operations . . . . . . and to incentivise mitigation in sectors . . . that are not directly covered by the tax which includes agriculture, forestry and other land use (AFOLU) and waste."

For entities in hard-to-abate sectors, the carbon offset allowance is one of the few options available to reduce their carbon tax liability in the medium to long term. In this regard, it is encouraging that the Discussion Document proposes increasing the maximum carbon offset allowance by 15 percentage points. One is inclined to agree with the Discussion Document, where it states that this proposed increase "…will provide much needed flexibility to the hard-to-abate sectors and stimulate carbon market activities in South Africa."

This proposed increase of the allowance will hopefully also increase foreign investment into carbon market projects in South Africa. Currently, the regulations on this allowance only allow for offsets generated from South African-based approved projects to qualify for the carbon offset allowance. In addition, the projects have to be approved under the Clean Development Mechanism (CDM) VERRA's Verified Carbon Standard or the Gold Standard. With respect to the CDM, one should note that the adoption of Article 6(4) of the Paris Agreement provides for a new market mechanism to replace CDM. In the 2024 Budget Review it was indicated that NT, in consultation with other government departments, would consider inclusion of the Article 6(4) mechanism as an eligible carbon offset standard. This is yet to occur. The Discussion Document adds that NT and other government departments "aim to finalise and publish the framework for implementation" of a local carbon offset standard "before the end of the financial year". This appears to refer to the end of government's 2024/2025 financial year on 31 March 2025.

WHAT'S NEXT?

The due date for comments on the Discussion Document was 13 December 2024. Any comments received will likely be considered by NT when the 2025 Budget Review is published in February 2025 along with the Budget Speech. Any proposed changes to the Carbon Tax Act will be published in draft legislation and go through a public consultation process, during which it will be possible to comment. Given that the implementation of Phase 2 has been postponed several times, it seems unlikely that there will be another postponement.

> "The effect of this allowance is to reduce the maximum effective rate of carbon tax and it has been in place since the Carbon Tax Act came into effect in 2019. In other words, even though the carbon tax rate for 2024 was R190 per tonne CO2e above the prescribed threshold, the maximum effective rate for 2024 was R76 (R190 less 60% allowance)."

Louis Botha

WTS Renmere

Acts and Bills

- Carbon Tax Act 15 of 2019;
- Taxation Laws Amendment Bill 26 of 2022.

Other documents:

- Carbon Tax Discussion Paper: Phase Two of the Carbon Tax (published by National Treasury on 13 November 2024).

Tags: COP29; carbon offset allowance; greenhouse gas (GHG) emissions.

ASSET-FOR-SHARE TRANSACTIONS

Section 42 of the Income Tax Act, 1962 (the Act) deals with asset-for-share transactions.

It provides roll-over relief for persons wishing to transfer assets to a company in exchange for an issue of shares. But how many shares must the transferee company issue in exchange for an asset or assets?

Before attempting to answer this question, it might be helpful to explain the basics of section 42 with reference to a simple example.

Example 1 – Basic asset-for-share transaction

Facts:

John owns a piece of vacant land which he acquired on 1 March 2008 at a cost of R20. The current market value of the land is R100. He wishes to transfer the land to Newco (Pty) Ltd (Newco), a resident, in return for shares in Newco. John held the land as a capital asset and it is to be acquired by Newco as a capital asset. Newco will issue 100 equity shares with a value of R100 in exchange for the land. John will be the sole shareholder of Newco after the transaction.

Result:

John is deemed to dispose of the land for proceeds equal to its base cost (section 42(2)*(a)*(i)*(aa)*, read with paragraph *(a)* of the definition of "asset-for-share transaction" in section 42(1)) and so will realise neither a capital gain nor a capital loss (R20 – R20). The market value of the land exceeds its base cost (R100 > R20) on the date of disposal and John holds a qualifying interest in Newco (at least 10% of the equity shares and voting rights) (paragraph (a)(i) of the definition of "asset-for-share transaction", read with the definition of "qualifying interest").

Under section 42(2)*(a)*(ii) John is treated as having acquired the 100 equity shares on 1 March 2008 at a cost of R20 incurred on 1 March 2008 (this aspect is the focus of this article). Under section 42(2)*(b)* Newco is treated as having acquired the land on 1 March 2008 at a cost of R20 incurred on 1 March 2008.

So far so good. John sold an asset to Newco at no gain/no loss and acquired 100 equity shares which have taken over the characteristics of the land in relation to cost, date of acquisition and date of incurral of expenditure. If he sold the shares the next day for R100, he would realise a capital gain of R80, which is the same result that would have ensued had he sold the land for R100.

But what happens when there are multiple assets disposed of in exchange for shares?

Example 2 – Multiple assets disposed of under an asset-for-share transaction

Facts:

Jill owns two post-valuation date capital assets which she wants to dispose of to Newco (Pty) Ltd (Newco) under an asset-for-share transaction in exchange for two shares. The base cost of each asset is equal to its market value. Asset X's base cost is R100 and Asset Y's base cost is R900.

Result:

The problem that arises here is that if share 1 is allocated to Asset X and share 2 to Asset Y, there will be a distortion between the base cost of each share and its market value. Assuming this is the only transaction, each share should be worth R500 (R100 + R900 = R1 000/2 = R500). If Jill were to dispose of each share the next day, there would be a capital gain of R400 on share 1 (R500 – R100) and a capital loss of R400 on share 2 (R500 – R900). If both shares are disposed of simultaneously, it would not be an issue because the aggregate base cost of both shares would equal their market value and the gain on Asset X could be set off against the loss on Asset Y, assuming the loss is not clogged under paragraph 39 of the Eighth Schedule to the Act.

"While sections 41 to 47 generally override the rest of the Act, section 41(2) specifically provides that this does not apply to section 24BA and section 40CA*(b)*."

So, what does section 42 actually require? The definition of "asset-for-share transaction"

> "means any transaction … in terms of which a person disposes of an asset … in exchange for the issue of an equity share …".

The definition, if taken literally, requires a single share to be issued for each asset.

Section 42(2)*(a)*(ii) on the other hand treats the transferor to have

> "acquired the equity shares in that company on the date that such person acquired that asset".

Thus, in this instance the provision contemplates multiple shares for a single asset.

Section 6*(b)* of the Interpretation Act, 1957, states the following:

> "In every law, unless the contrary intention appears … words in the singular number include the plural, and words in the plural number include the singular."

Given the conflicting use of the singular in the definition of "asset-for-share transaction" and the plural in section 42(2)*(a)*(ii), it would be reasonable to infer that one should not attach too much importance to the use of the plural and singular in section 42 when it comes to how many shares are required to be issued. As long as at least one share is issued for an asset or assets, the requirements of section 42 in relation to the issue of a share or shares should be met.

But this does not solve the distortion problem that arises when there are insufficient shares to match the relative market values of the assets forming part of the subject of an "asset-for-share transaction".

One way in which to solve the problem would be to issue a sufficient number of shares so that the base cost of an asset can be matched with the required number of shares. Thus, in Example 2, Newco could have issued 1 000 shares for R1 000, and allocated 100 shares to Asset X and 900 shares to Asset Y.

However, sometimes a company may not wish to issue so many shares, particularly when there are minority shareholders, as this may upset the balance of control over the company.

Another approach to this problem would be to simply allocate the aggregate base cost of all the assets to the shares issued, so that in Example 2 each share would have a base cost of R500.

There is, it is submitted, much to commend this approach as it avoids the problem of maintaining a share register in which different base costs are allocated to certain batches of shares with distinctive certificate numbers. One can only imagine the nightmare involved in tracking shares linked to thousands of assets.

One cannot help being reminded of the oft-cited passage from *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012], in which the court stated the following:

> "An interpretation will not be given that leads to impractical, unbusinesslike or oppressive consequences or that will stultify the broader operation of the legislation or contract under consideration."

PRE-VALUATION DATE ASSETS

While the aggregate base cost allocation method works well for post-valuation date assets, it does not work for pre-valuation date assets.

The problem with pre-valuation date assets is that the shares to which they are linked will also become pre-valuation date assets. There are three methods for determining the valuation date value of a pre-valuation date asset, namely, market value on 1 October 2001, the time-apportionment base cost method and the "20% of proceeds" method. If there is a record of pre-valuation date expenditure, the time-apportionment base cost method can be used. [See paragraph 26(1) of the Eighth Schedule to the Act.] This method requires the taxpayer to know the date of acquisition, the paragraph 20 expenditure and the date of incurral of the expenditure. It is highly unlikely that all the assets that are the subject of a section 42 transaction would have the same dates of acquisition and incurral and cost. In addition, the problem with time-apportionment is that it represents a constantly moving target when it comes to the determination of the valuation date value of an asset at any particular point. "T" in the time-apportionment formula (the number of years or part thereof on or after valuation date) keeps changing the longer the asset is held. [See paragraph 30(1)*(e)* of the Eighth Schedule.] Generally, the longer the asset is held after valuation date, the greater the proportion of the capital gain or loss that will have to be brought to account. What also complicates matters is that some assets involved in an asset-for-share transaction may have been improved after the valuation date, which triggers the proceeds formula [See paragraph 30(2).] or the depreciable assets formula. [See paragraph 30(3) and (4).] And when an asset has been improved in more than one year before the valuation date, "N" (the number of years or part thereof before 1 October 2001), is limited to 20. [See paragraph 30(1)*(d)*.]

Aggregating costs in these circumstances is simply not an option.

The solution to this conundrum is to allocate shares with distinctive certificate numbers to particular pre-valuation date assets based on their relative market values.

Another solution to this problem would require legislative intervention. A rule similar to that found in paragraph 76B(1) of the Eighth Schedule could be introduced, which would apply immediately before any asset-for-share transaction is entered into. Paragraph 76B(1) applies when a return of capital is received or accrued on a pre-valuation date share for the first time on or after 1 April 2012. Under this provision, the share must be converted from a pre-valuation date share having a valuation date value to a post-valuation date share having paragraph 20 expenditure. This task is achieved by treating the share as having been disposed of and reacquired at market value. Any capital loss resulting from the deemed disposal is added to the reacquisition cost, while any capital gain reduces it. The capital gain or loss arising under paragraph 76B(1) is purely for the purposes of re-establishing the base cost and is not actually brought to account as a capital gain or loss in determining the shareholder's aggregate capital gain or loss for the year of assessment.

Of course, a company could solve the problem itself by simply distributing a small amount of contributed tax capital to its shareholder, as this would trigger paragraph 76B(1) and thus convert all the pre-valuation date shares to post-valuation date shares.

Introducing a similar rule under section 42 would assist in simplifying the roll-over of the base cost of the asset to the shares issued by the transferee company. While it may be detrimental to the fiscus to freeze the base cost of a pre-valuation date share whose price is expected to rise, it would prejudice the taxpayer if the company were expected to make losses. However, the benefits of simplification are likely to outweigh any prejudice to the fiscus or the taxpayer.

VALUE FOR VALUE

While sections 41 to 47 generally override the rest of the Act, section 41(2) specifically provides that this does not apply to section 24BA and section 40CA*(b)*. Under section 24BA the value of the asset transferred must equal the value of the shares received in exchange immediately after their issue, otherwise this can result in a capital gain or dividends tax for the transferee company. Nevertheless, section 24BA(3) provides that section 24BA will not apply if –

- the transferor and transferee company are part of the same group of companies immediately after the company acquires the asset;
- the transferor holds all the shares in the company immediately after the company acquires the asset; or
- paragraph 38 of the Eighth Schedule applies.

The sale agreement should thus specify the consideration for the sale as being equal to the market value of the shares to be received and not the base cost of the assets being transferred.

CONCLUSION

The allocation of the base cost of post-valuation date assets to shares issued under section 42 on an aggregate basis offers a simple solution to the question of how many shares need to be issued. The decision can be left to practical commercial considerations in the knowledge that the aggregate basis removes any distortion of the base cost of the shares. It would give taxpayers some comfort if SARS were to issue an interpretation note on this subject.

However, when pre-valuation date assets are involved, some burdensome record-keeping may be required. It may be time for some legislative intervention to simplify matters.

The value-for-value rule in section 24BA must always be borne in mind when performing an asset-for-share transaction under section 42.

This article was first published in ASA February 2024

Duncan McAllister

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 24BA, 40CA*(b)*, 41 to 47 (specific reference to sections 41(2), 42(1) (definition of "asset-for-share transaction": Paragraph *(a)*) & 42(2)*(a)*(i)*(aa)* & (ii) & *(b)*; Eighth Schedule: Paragraphs 20, 26(1), 30 (subparagraphs (1)*(d)* & *(e)*, (2), (3), (4)), 38, 39 & 76B(1);
- Interpretation Act 33 of 1957: Section 6*(b)*.

Cases

- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA) (at 610).

Tags: asset-for-share transactions; qualifying interest; pre-valuation date share; value-for-value rule.

NEW SARS AND CIPC RULES ON BENEFICIAL OWNERSHIP

As of 16 September 2024, the South African Revenue Service (SARS) has implemented the latest iteration of the ITR14 and ITR12T income tax returns for companies and trusts, respectively, on the eFiling platform.

Although various updates to the returns have been made, the most far-reaching is arguably that it is now a strict requirement for a taxpayer to disclose the number of beneficial owners of the company or trust, as well as the personal details of every beneficial owner. This article will briefly discuss the new beneficial ownership requirements and the information that is required to be disclosed.

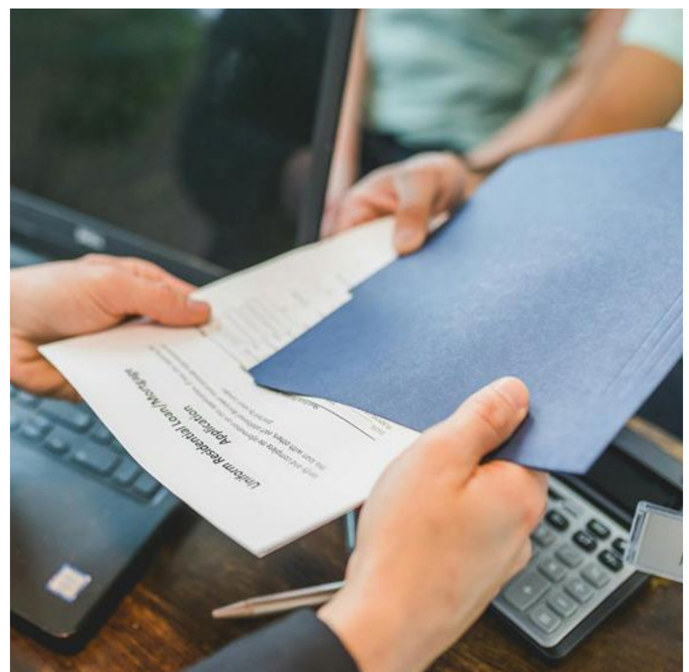
The only enterprises which are allowed to enter "0" as the number of beneficial owners are non-profit cooperations without members, cooperative societies or voluntary associations. For all other enterprises, the beneficial ownership information is mandatory, with a maximum of nine entries being allowed at present.

It is important to note that the return does not allow a taxpayer to enter the details of its holding company or ultimate holding company, but instead requires the details of all of the natural persons (so-called "warm bodies") which directly or indirectly hold a beneficial interest in the securities of the entity, exercise control over the entity or materially influence the management of the entity. This aligns with the global trend of increased financial transparency and regulatory oversight in an effort to combat financial crime and the funding of terrorist activity. In the South African context, it is informed especially by the attempt to remove South Africa from the grey list of the Financial Action Task Force.

"The only enterprises which are allowed to enter '0' as the number of beneficial owners are non-profit cooperations without members, cooperative societies or voluntary associations."

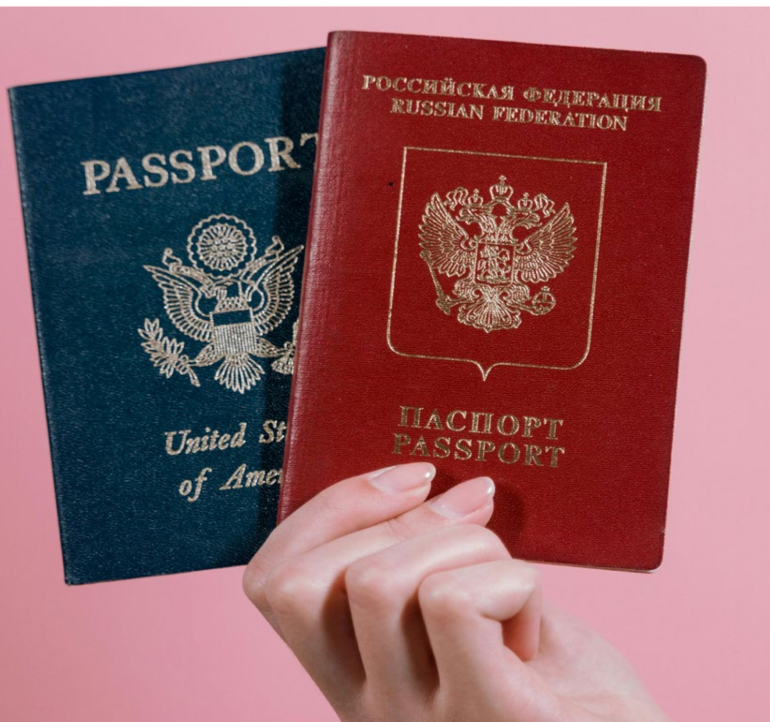
In a related development, the Companies and Intellectual Property Commission (CIPC), in a media release on 28 June 2024, announced that the filing of Annual Returns would, effective 1 July 2024, strictly require beneficial ownership declarations to be submitted, and that companies and close corporations would be precluded from filing annual returns unless an updated beneficial ownership declaration has been submitted. Failure to comply could lead to penalties for late filing, enforcement action through the issuance of a compliance notice, referral for deregistration and even final deregistration due to non-compliance. [See further: https://www.cipc.co.za/wp-content/uploads/2024/06/Media-Release-CIPC-enforces-BO-filing-with-ARs-01-July-2024.pdf]

It is important for taxpayers to note that the enhanced beneficial ownership disclosure requirements imposed by SARS and by the CIPC are here to stay, and that it is imperative for taxpayers to ensure that their beneficial ownership information is updated and complete. It is also essential for taxpayers to maintain consistency in their submissions to SARS and CIPC, as these bodies have indicated that they will be "comparing notes".



The beneficial owner section of the new income tax return requires the following information for each beneficial owner [See page 18-19: https://www.sars.gov.za/wp-content/uploads/IT-GEN-04-G01-How-to-complete-the-Income-Tax-Return-ITR14-for-Companies-External-Guide.pdf]:

- First name
- Other name
- Surname
- Initials
- Date of birth



- ID number
- Passport number, along with the passport's country of issue and issue date
- Whether the individual is registered for tax in South Africa
- Tax reference number
- Email address
- Reason for beneficial ownership

The reasons for beneficial ownership should also be indicated, with the following options to choose from on the ITR14:

A. Holding of beneficial interest in the securities of the company.

B. Exercise of or control of the exercise of the voting rights associated with securities of the company.

C. Exercise of or control of the exercise of the right to appoint or remove members of the board of directors of the company.

D. Holding of beneficial interests in the securities, or the ability to exercise control, including through a chain of ownership or control, of a holding company of that company.

E. Ability to exercise control, including through a chain of ownership or control, of a juristic person other than a holding company of that company; a body of persons corporate or unincorporate; a person acting on behalf of a partnership; or a person acting in pursuance of the provisions of a trust agreement.

F. Ability to otherwise materially influence the management of the company.

As this disclosure will be required henceforth for all ITR14 and ITR12T returns, it is imperative that taxpayers ensure that they maintain a register that includes the relevant information of all beneficial owners so that returns are completed accurately from the outset. Importantly, to the extent that SARS may view erroneous or incomplete beneficial ownership disclosure as misrepresentation or non-disclosure of material facts, the taxpayer will risk non-prescription of returns in terms of section 99(2) of the Tax Administration Act, 2011, which would permit SARS to investigate returns and issue additional assessments beyond the ordinary prescription periods.

In conclusion, the accurate and comprehensive disclosure of beneficial ownership is not only a statutory requirement but also a critical aspect of maintaining transparency and compliance within the South African tax regime. It is recommended that taxpayers work together with their tax advisors to ensure that their beneficial ownership information is compiled as soon as possible so as to comply with the new requirements. Where taxpayers suspect that they are already in breach of these requirements, the recommendation is that advice is promptly obtained to ensure that the appropriate remedial actions can be taken.

Dr Hendri Herbst & Dewald Pieterse

WTS Renmere

Acts and Bills

- Tax Administration Act 28 of 2011: Section 99(2).

Other documents:

- ITR14 Income Tax Return for companies (latest iteration implemented by SARS on the eFiling platform on 16 September 2024);
- ITR12T Income Tax Return for trusts (latest iteration implemented by SARS on the eFiling platform on 16 September 2024);
- beneficial ownership declarations (submission required when annual tax returns are filed (wef 1 July 2024)).

Tags: beneficial ownership; natural persons; Financial Action Task Force; voting rights; beneficial interests in the securities; misrepresentation or non-disclosure of material facts.

TAX DEDUCTIBILITY OF INTEREST: THE TRANSITION FROM PN31 TO SECTION 11G

It is trite that, either in terms of section 11(a) *or section 24J(2) of the Income Tax Act, 1962 the Act), interest expenditure is deductible only where a taxpayer derived income from carrying on a trade and the interest expenditure is incurred in the production of income.*

Practice Note 31 of 1994 (PN31), however, permits a deduction of expenditure where a taxpayer incurs expenditure in the production of interest income but not in the carrying on of a trade, although such deductions are limited to the amount of interest income.

This article will delve into the specific provisions and implications of section 11G of the Act, comparing it with PN31, which will prevail until section 11G's implementation (delayed by section 67 of the Taxation Laws Amendment Act, 2024, until 1 January 2026 and applicable in respect of years of assessment commencing on or after that date). It will highlight key similarities and differences between the two, particularly focusing on the limitations and allowances for interest expenditure deductions under each of the aforesaid dispensations. Through various examples, the article will explore how these changes may impact different types of taxpayers. The aim is to equip taxpayers with an overview of the new framework to ensure that their affairs are in order when the section becomes effective.

During November 2022, the South African Revenue Service (SARS) revealed its intention to withdraw PN31 due to concerns of taxpayers misusing the concession, and to amend the tax legislation so as not to adversely affect legitimate transactions. The amendment took the form of the insertion of section 11G into the Act to govern the deduction of expenses incurred in the production of interest.

Section 11G was originally intended to be applicable for years of assessment commencing after 1 January 2025 (now, as indicated, delayed until 2026), and SARS announced on 8 July 2024 that PN31 will be withdrawn concurrently with section 11G coming into effect (this date may differ depending on the taxpayer's tax year). The original proposed wording of section 11G would have resulted in wide-reaching consequences for legitimate transactions, but fortunately many of the problematic aspects have since been amended. After an extended process of public consultation and changes resultant therefrom, the final wording of section 11G can be found in the section 14 of the Taxation Laws Amendment Act, 2023, and reads as follows:

"(1) For purposes of this section 'interest' means interest as defined in section 24J.

(2) For purposes of determining the taxable income derived by any person, there shall be allowed as a deduction from the income of that person, interest incurred by that person to the extent that the interest –

(a) is incurred in the production of interest that is included in the income of that person; and

(b) is not incurred in carrying on a trade.

(3) The amount allowed to be deducted under this section shall not exceed the amount of interest income referred to in subsection (2)*(a)*, that is received by or accrued to the person, during the year of assessment."

There are certain similarities between PN31 and section 11G. Firstly, both are applicable not only to companies but to all persons, thus including individuals and trusts. Secondly, both limit the deductible expenditure to the amount of the related interest income received by or accrued to the taxpayer such that claiming the deduction cannot give rise to a tax loss. Thirdly, with both PN31 and section 11G the interest expenditure must be directly linked to the interest income in order to be deductible. By way of example, this means that where Company A lends money to Company B and Company B on-lends that money to Company C, Company B can only deduct the interest expenditure incurred on its loan from Company A against the interest income received from Company C on the loan so on-lent, and not against other sources of income. Should Company B on-lend the full loan amount received from Company A to Company C, but at a lower interest rate, it would result in Company B's interest expenditure deduction for the interest paid to Company A being limited to the interest income received from Company C. In other words, the difference between the interest paid and the interest received will never be claimable as a tax deduction. It is important to note that the deductibility of the interest expenditure in Company B's hands is not dependent on whether Company C is allowed to deduct the interest expenditure incurred by it in turn – in other words, Company B will be allowed to deduct its interest expenditure (not exceeding the amount of the related interest income) regardless of whether or not Company C utilised the loan for a productive purpose.

"The original proposed wording of section 11G would have resulted in wide-reaching consequences for legitimate transactions, but fortunately many of the problematic aspects have since been amended."

Although section 11G expressly provides that interest deductions are only allowed to the extent that the interest is not incurred in carrying on a trade, one must remember that section 11G is a codification of PN31, which solidifies the concession afforded to taxpayers to still qualify for a tax deduction, even though the criteria in terms of section 11*(a)* or 24J, and more specifically the trade requirement, have not been complied with. To this extent, the requirement that the interest income should not be derived from carrying on a trade merely serves to limit the application of section 11G to the circumstances for which it was intended, while redirecting the deductibility of interest in all other circumstances to the general provisions under section 11*(a)* or section 24J. On the assumption that all other requirements are fulfilled, interest incurred in the carrying on of a trade should generally be deductible under section 11*(a)* or 24J, in which case it would not be limited to related interest income.

There is, however, an important and far-reaching difference between PN31 and section 11G, namely that certain expenses which are deductible under PN31 will not be deductible in terms of section 11G, due to section 11G allowing only the deduction of "interest" (as defined in section 24J) incurred in the production of interest income, whereas PN31 allowed a deduction for any expenditure incurred in the production of interest income, and not only interest expenditure. This may have significant downstream implications for certain taxpayers, which will be explored through some examples below.

Section 24J(1) provides a somewhat circular definition of "interest", namely the "gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement" (see paragraph *(a)* of the definition of "interest"). SARS' Draft Interpretation Note on the meaning of "similar finance charges", published on 27 September 2024 (Draft IN), notes that, given the circular reference in the above definition, the ordinary grammatical meaning of "interest" must apply. Referencing dictionary definitions and relevant case law, the Draft IN states that "it can be concluded that the amount which constitutes interest is the charge for the use of money borrowed and which a person receives for giving someone the use of the money".

Importantly, however, the Draft IN further notes that "finance charges" as referred to in paragraph *(a)* of the definition of "interest" in section 24J(1) must be of the same nature as interest, which results in a narrower pool of deductible expenses than was previously allowed under PN31. For example, it is typical of holding or treasury companies to advance loans to group companies. Such a holding or treasury company, however, often does not carry on a trade, and receives only dividend and interest income. Under PN31, it was typically the case that those taxpayers would deduct other finance charges associated with securing funding for capital projects. Such administrative fees, however, do not fall within paragraph *(a)* of the definition of "interest" in section 24J(1), as it cannot be said to be of a similar nature, and thus, on the assumption that the taxpayer is not otherwise carrying on a trade, these fees will no longer be deductible once section 11G comes into effect. This could result in these taxpayers experiencing adverse tax consequences when compared to the prior position. The same applies in private equity and venture capital contexts where investments are made through a special purpose vehicle which does not otherwise carry on a trade.

Turning to a different example, one often finds that a trust would borrow money and subsequently on-lend money to the trust's beneficiaries. Under section 11G, the trust will still be able to deduct the interest expenditure on the borrowed funds, limited to the interest received from beneficiaries, but will not be able to deduct other related expenditure which falls outside of the section 24J(1) "interest" definition. This is contrary to the position under PN31, in terms of which it was typical for a trust to deduct expenses such as accounting fees and administrative expenses from the interest income received; this will no longer be possible.

It is clear that while both section 11G and PN31 are a departure from the normal interest deductibility requirements and provide a concession to taxpayers who do not fulfil the trade requirement under section 11*(a)* or section 24J, the nuances in their application can lead to significant differences in tax outcomes. Taxpayers must critically evaluate their specific circumstances and consider how the transition to section 11G might affect their tax positions. Thorough planning and consultation is essential in navigating these changes effectively and in mitigating potentially negative consequences. By understanding the intricate details and limitations of section 11G, taxpayers can better optimise their tax positions within the new framework.

In conclusion, although there are many similarities between PN31 and section 11G, it is incumbent upon taxpayers to consider whether section 11G may have unforeseen downstream consequences on their tax affairs, as the potential impact of section 11G extends beyond what meets the eye upon first consideration thereof.

Dr Hendri Herbst & Dewald Pieterse

WTS Renmere

Acts and Bills

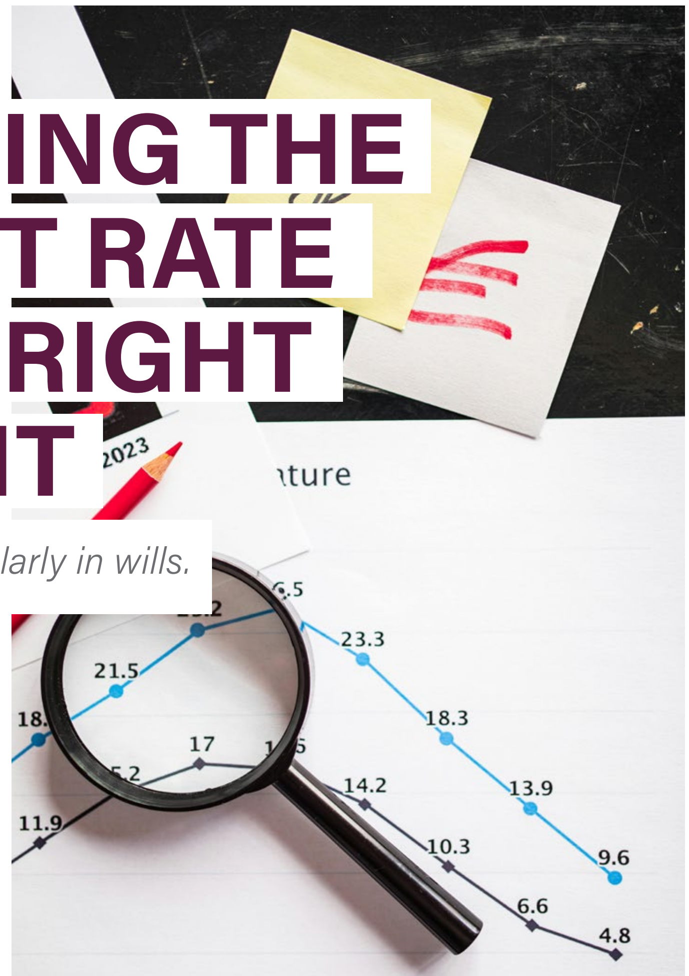
- Income Tax Act 58 of 1962: Sections 11*(a)*, 11G & 24J(1) (definition of interest: Paragraph *(a)*) & (2);
- Taxation Laws Amendment Act 17 of 2023: Section 14;
- Taxation Laws Amendment Act 42 of 2024: Section 67 (delaying of date of implementation of section11G until 1 January 2026).

Other documents:

- Practice Note 31 of 1994 (*Income Tax: Interest paid on moneys borrowed*) (3 October 1994);
- Draft Interpretation Note on the meaning of "similar finance charges", published on 27 September 2024 (deadline for submissions: 8 November 2024).

Tags: interest expenditure; expenditure in the production of interest income; similar finance charges; administrative expenses.

USUFRUCTS: UNDERSTANDING THE 12% DISCOUNT RATE AND ANNUAL RIGHT OF ENJOYMENT



It is not uncommon to find usufructs, particularly in wills.

These provide one person (generally a spouse) with the use of an asset over their lifetime or a defined period and another (often a child or trust for the children) with the "bare dominium" in the asset. At the end of the usufruct period or death of the usufructuary, it falls away and the bare dominium holder has the full use of the asset. The usufruct is an asset and has to be valued, be it for capital gains tax, donations tax, estate duty, or transfer duty purposes.

The process of determining the value of a usufruct can be quite daunting for the uninitiated. The capitalisation rate of 12%, the annual right of enjoyment of 12% or lower, life expectancy tables and tables for a fixed period can all add to the confusion. This article seeks to clear up some of the fog surrounding the subject.

The following abbreviations have been used: Income Tax Act 58 of 1962 (the Act), capital gains tax (CGT), Estate Duty Act 45 of 1955 (EDA) and Transfer Duty Act 40 of 1949 (TDA).

The present value tables

Two sets of tables are available for the purposes of determining the value of a usufruct, namely:

- Table A – The Expectation of Life and the Present Value of R1 per Annum for Life Capitalised at 12 per cent over the Expectation of Life of Males and Females of Various Ages; and
- Table B – Present Value of R1 per Annum Capitalised at 12 per cent over Fixed Periods.

"Females have longer life expectancies, for example, a female aged one has a life expectancy of 72,74, which is 7,37 years longer than her male counterpart of the same age."

These tables are contained in regulations published under section 29 of the EDA and can be found in GNR 1942 in GG 2533 of 23 September 1977: *Valuation of annuities or of fiduciary, usufructuary or other limited interests in property in the estates of deceased persons.* They can also be found in the SARS *Comprehensive Guide to Capital Gains Tax* (Issue 9) in 8.35.7. A quick way to get there is to search the guide for the word "females" (without the quotation marks).

Table A

Table A is used for valuing a usufruct based on the person's life expectancy. The table shows ages from 0 to 90, life expectancies for males and females of those ages and then a present value factor which is multiplied by the annual right of enjoyment.

For example, a male with an age of zero (less than one year old) has a life expectancy of 64,74 years and a present value factor of 8,32791. But a male aged one has a longer life expectancy of 65,37 years and a factor of 8,32828. After that, it's downhill all the way until age 90, when the life expectancy is 4,3 years with a factor for a male of 3,21438. According to *Meyerowitz on Administration of Estates and their Taxation*, persons aged above 90 are to be taken as 90. This was supposed to have been included in a footnote to the *Gazette* but it was inadvertently omitted. Females have longer life expectancies, for example, a female aged one has a life expectancy of 72,74, which is 7,37 years longer than her male counterpart of the same age.

In looking up the age, it is the age next birthday that must be used. This can be tricky to work out at a specific point, but fortunately there are online calculators that can be used. [See https://www.calculator.net/age-calculator.html [Accessed 19 October 2023]] It is difficult to see under what circumstances the age of zero will ever be used because a child of three months old would have an age next birthday of 1. A conceived but unborn child does not have legal personality until born [see *Road Accident Fund v Mtati* [2005]] and cannot hold a usufruct, although it can inherit under a will. Even so, its age next birthday when born would also be one.

Table B

Table B contains the present value factors for fixed periods ranging from 1 to 100.

A usufructuary that is a juristic person such as a trust or company is treated as having a life expectancy of 50 years, [Note: CGT: paragraph 31(2)*(b)*(ii) of the Eighth Schedule to the ITA; donations tax: section 62(3) of the ITA; estate duty: section 5(3) of the EDA; Transfer duty: Based on likely period of enjoyment under section 5(7)*(a)* of the TDA] and the factor for 50 years is found in Table B (8,3045).

Determination of the present value factors in the tables

One might ask how the factors in the tables are determined. No attempt will be made to explain this for table A because the life expectancies include parts of a year, which complicates matters. But the fixed period amounts are easier to explain. The mathematical formula (a polynomial) is $1/(1 + r)^n + 1/(1 + r)^{n+1} + 1/(1 + r)^{n+2}$ and so on, in which r is the discount rate (0,12) and n is the period. Thus, for example, the present value of R1 at 12% for 1 year is $1/(1 + 0,12)^1 = 0,892857$ but the table rounds it up to 0,8929, and for two years $1/1,12 + 1/(1,12 \times 1,12) = 0,89257 + 0,797194 = 1,69005$, rounded in the table to 1,690.

Using Excel

The factors in both tables can quickly be checked using Excel using the formula:

=PV(0.12,n,-1), in which 0.12 is the discount rate, n is the number of years and -1 is the annual right of enjoyment. So, to work out the factor for a life expectancy of a male aged 90 bearing in mind 4.3 is the life expectancy:

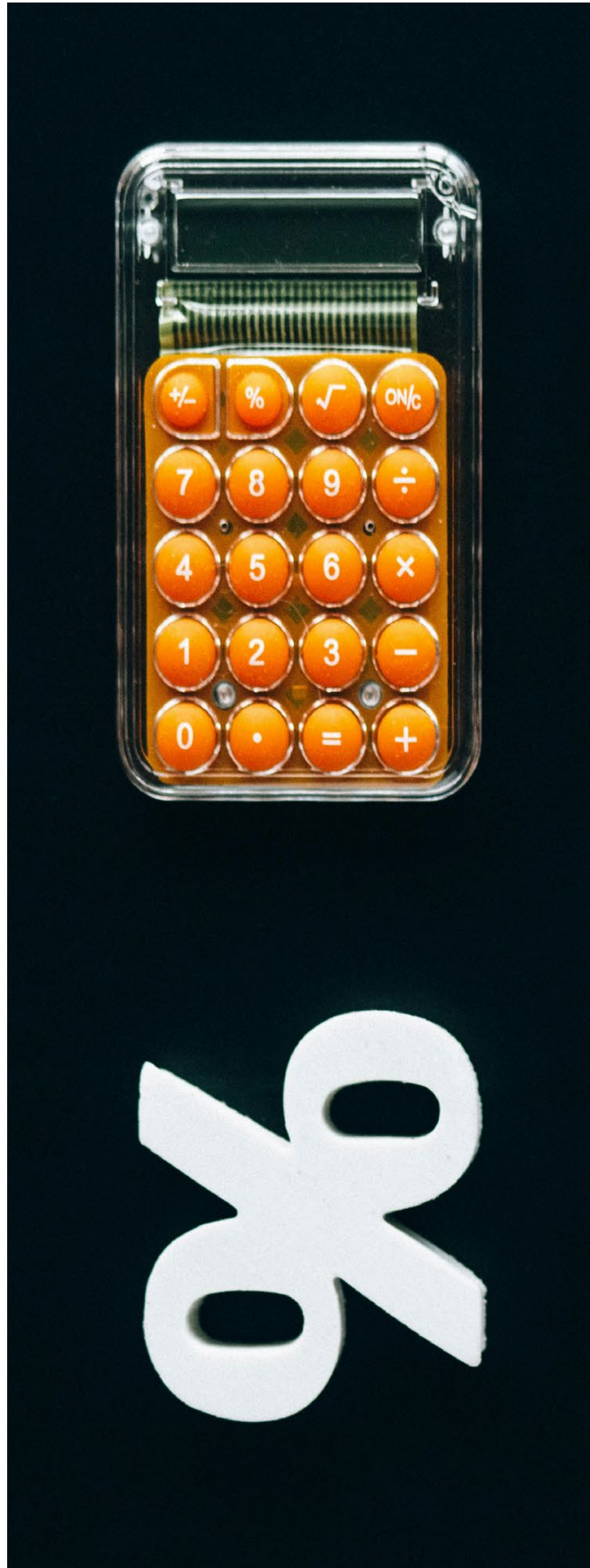
=PV(0.12,4.3,-1)

= 3,21438, which is the same as the table A figure.

In Excel you can expand the number of decimal places using the shortcut key ALT, H, 0 and reduce it with ALT, H, 9.

Annual right of enjoyment v discount rate

For CGT, donations tax, estate duty and transfer duty purposes the method for determining the value of a usufruct is the same. It involves capitalising, at 12% a year, the annual right of enjoyment of the asset over the usufructuary's life expectancy, or if the right of enjoyment is for a lesser period, over that lesser period. The annual right of enjoyment of the asset is 12% of the market value of the full ownership of the asset. If the Commissioner is satisfied that the asset cannot reasonably be expected to produce a yield of 12%, the Commissioner must prescribe the annual yield that the asset is reasonably expected to produce.



It will be observed that the rate of 12% is mentioned in two different places in the calculation and these should not be confused.

The discount rate

The discount rate is 12% and represents the rate at which the annual right of enjoyment must be discounted back to the present ("capitalised"). [*Note*: CGT: Paragraph 31(1)*(d)* of the Eighth Schedule to the Act; donations tax: Section 62(1)*(a)* of the Act; estate duty: section 5(1)*(b)* of the EDA; transfer duty: No rate specified in the TDA.] It is the equivalent of the rate of inflation or time value of money and cannot be changed by SARS or the taxpayer. Thus, the present value factors in Table A and Table B must always be used as they presume a discount rate of 12%. The rate of 12% is quite high in relation to South Africa's actual rate of inflation of around 4 to 5% and for usufructuaries wishing to dispose of their usufructs to the bare dominium holder, it reduces the annual right of enjoyment quite substantially. For example, R100 a year for two years discounted at 0% is equal to R200 but the same amounts discounted at 12% are equal to R169.

The annual right of enjoyment

The presumed annual right of enjoyment is 12% × the market value of the full ownership in the property. This valuation can be challenged in appropriate circumstances by approaching the Commissioner for a reduced percentage. [Note: CGT: Proviso to paragraph 31(2)*(a)* of the Eighth Schedule to the Act; donations tax: section 62(2) of the Act; estate duty: section 5(2) of the EDA; transfer duty: The TDA does not prescribe either a discount rate or an annual right of enjoyment, instead referring in section 5(6) and (7) to the fair value of the property. In practice, SARS applies Tables A and B (SARS *Transfer Duty Guide* (Issue 6) dated 25 July 2023 in 2.4.2).]

In *Commissioner for the South African Revenue Service v Klosser's Estate* [2000] an estate duty case, the court upheld the Commissioner's use of an annual yield of 2,5% for listed shares. The court held that the Commissioner was required to make predictions as to the future yield and that these could be based only on facts which included the yield at the time of death and in the past. The Commissioner had invited the taxpayer to provide statistics of the yield over the past three years but the taxpayer had not responded to the request. The court also rejected the taxpayer's argument that the assets could be subject to change in future because no evidence to this effect had been adduced. In the result the court upheld the Commissioner's use of an annual yield of 2,5% for the listed share portfolio.

Example 1 – Determination of value of usufruct

Facts:

Jack owned a farm currently valued at R10 million. His will provided that the bare dominium in the farm was to be left to his family trust while the usufruct was to be left to his wife, Jill. Jack passed away on 31 August 2023. Jill was born on 31 March 1960. Determine the value of the usufruct to be left to Jill.

Result:

On 31 August 2023 Jill was 63 years and five months old. Therefore, her age next birthday was 64. According to Table A, Jill's life expectancy is 15.88 years with a present value factor of 6,95537.

The annual right of enjoyment is R10 million × 12% = R1,2 million.

The value of the usufruct is therefore R1,2 million × 6,95537 = R8 346 444.

This result can be checked in Excel: =PV(0.12,15.88,-1200000), which gives R8 346 448, which differs by only R4.

"The process of determining the value of a usufruct can be quite daunting for the uninitiated. The capitalisation rate of 12%, the annual right of enjoyment of 12% or lower, life expectancy tables and tables for a fixed period can all add to the confusion."

Example 2 – Usufruct for a fixed period

Facts:

John owns a piece of land valued at R1 million. On 30 November 2023 he granted his brother, Harry, a usufruct for 10 years. Harry was born on 31 July 1980. Determine the value of Harry's usufruct on 30 November 2023.

Result:

Harry's age next birthday is 44 years. According to Table A, his life expectancy is 26,20 years. Since the period of the usufruct is for a lesser period of 10 years, Table B applies. The factor for a fixed period of 10 years is 5,6502. The annual right of enjoyment at 12% is R1 million × 12% = R120 000. The value of the usufruct is R120 000 × 5,6502 = R678 024.

Check with Excel:

=PV(0.12,10,-120000)

= R678 026, a difference of R2.

Example 3 – Annual right of enjoyment producing a yield of less than 12%

Facts:

Siya owns a share portfolio which has produced a dividend yield of 3% a year over the past three years. He wishes to grant a usufruct to his son Alfred aged 25 for 10 years. He applied to the Commissioner to use the 3% yield instead of 12% as prescribed, and the Commissioner approved the lower yield. The market value of the portfolio is R10 million.

Result:

It is clear, given Alfred's age, that the fixed period of 10 years is less than his life expectancy. Therefore, the factor in Table B for 10 years must be used (5,6502).

The annual right of enjoyment is R10 million × 3% = R300 000.

The value of the usufruct is thus R300 000 × 5,6502 = R1 695 060.

Check using Excel:

=PV(0.12,10,-300000)

= R1 695 067, a difference of R7.

Note: Had a 12% right of enjoyment been used, the usufruct would have been valued at R6 780 240.

This article was first published in ASA December 2023

Duncan McAllister

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Section 62(1)*(a)*, (2) & (3); Eighth Schedule: Paragraph 31(1)*(d)* & (2)*(a)* (proviso to item *(a)*) & *(b)*(ii);
- Estate Duty Act 45 of 1955: Sections 5(1)*(b)*, (2) & (3) & 29;
- Transfer Duty Act 40 of 1949: Section 5(6) & (7)*(a)*.

Other documents:

- Tables available for the purposes of determining the value of a usufruct: Table A (life expectancy tables) and Table B (fixed period tables) (GNR 1942 in *GG* 2533 of 23 September 1977 – published under section 29 of the Estate Duty Act);
- *Government Gazette* 2533 of 23 September 1977: GNR 1942 (*Valuation of annuities or of fiduciary, usufructuary or other limited interests in property in the estates of deceased persons*) (Tables available for the purposes of determining the value of a usufruct (life expectancy tables and fixed period tables));
- [SARS'] *Comprehensive Guide to Capital Gains Tax* (Issue 9): Item 8.35.7 (life expectancy tables and fixed period tables);
- [SARS'] *Transfer Duty Guide* (Issue 6) dated 25 July 2023 [in 2.4.2];
- *Meyerowitz on Administration of Estates and their Taxation* [D Meyerowitz 2010 ed [online] Jutastat e-publications].

Cases

- *Road Accident Fund v Mtati* [2005] (6) SA 215 (SCA);
- *Commissioner for the South African Revenue Service v Klosser's Estate* [2000] (4) SA 993 (C); 63 SATC 93.

Tags: bare dominium holder; life expectancies for males and females; juristic person; annual right of enjoyment.

CRYPTOCURRENCY TRADING

Cryptocurrency traders in South Africa have focused on understanding the tax implications of their transactions relative to the Income Tax Act, 1962.

This has proved challenging, as SARS has merely stated that "the normal rules apply" without providing authoritative guidance concerning the various cryptocurrency-related transactions and when profits are considered capital or income.

However, exchange control regulations are equally important for traders, especially those using foreign cryptocurrency exchange platforms, as the South African Reserve Bank (SARB) is now paying close attention.

ARBITRAGE OPPORTUNITIES AND EXCHANGE CONTROL REGULATIONS

Some South African natural persons have leveraged cryptocurrency arbitrage opportunities using their R1 million Single Discretionary Allowance (SDA) and R10 million Foreign Investment Allowance (FIA). These opportunities arise because the Exchange Control Regulations, 1961, limit the amount of South African assets natural persons can externalise annually, creating price differences between local and international cryptocurrency markets. The SARB monitors these externalisation events, requiring natural persons to apply for their FIA through SARS eFiling.

Arbitrage traders use their SDA, FIA, and South African rands (ZAR) to purchase foreign currencies like US dollars (USD) through brokers. They send the USD to foreign cryptocurrency exchanges to buy digital assets like Bitcoin (BTC) or US-dollar-backed stablecoins. These digital assets are then returned to South Africa via the respective blockchains, which are not governed or controlled by any international intermediary, and are liquidated in the local market for profit.

PASSIVE AND BOT TRADING

Apart from these arbitrage opportunities, many engage in passive trading between local and international exchanges, exploiting price differences in various cryptocurrency markets. Investors also use techniques like high-frequency bot trading, where automated software executes high-volume trades based on predefined criteria, identifying opportunities and executing trades faster than humans.

> "Arbitrage traders use their SDA, FIA, and South African rands (ZAR) to purchase foreign currencies like US dollars (USD) through brokers."

REGULATORY GAPS AND IMPLICATIONS

The SARB's oversight of blockchain-based digital assets has been limited as it does not oversee, supervise, or regulate crypto assets, as it is not considered legal tender. Despite the Financial Sector Conduct Authority regulating crypto asset service providers, no dedicated laws govern cryptocurrency use in South Africa. Consequently, natural and non-natural persons can legally move digital assets from local to foreign exchanges or self-custody solutions without restrictions, as local exchanges do not limit the transfer of digital assets to other sources. This allows natural and non-natural persons to "externalise" an unlimited value of digital assets beyond the restrictions imposed by the SARB. However, issues arise when investors buy foreign currency using these "externalised" digital assets.

CHALLENGES IN MONITORING AND COMPLIANCE

Concerns emerge when traders buy BTC locally using ZAR, send it to a foreign exchange, and then use it to purchase foreign currency. This triggers an externalisation event under exchange control regulations, contributing to why local exchanges do not facilitate liquidating digital assets into foreign currencies.

Possible contraventions of exchange control regulations occur when natural persons exceed their annual SDA and FIA allowances through arbitrage trading and conduct trading between crypto and foreign currencies or when natural or non-natural persons purchase foreign currency on foreign cryptocurrency exchange platforms without the required approval.

However, traders can circumvent triggering this externalisation event by swapping BTC for a USD-backed stablecoin if this does not affect the profitability of the trade, as these asset-backed cryptocurrencies do not fall within the definition of foreign currency, irrespective of the fact that they are linked to the value of a specific foreign currency.

FUTURE CONSIDERATIONS FOR SARB

The SARB faces significant challenges in accurately monitoring and restricting the "externalisation" of blockchain-based digital assets, as it cannot effortlessly request transactional data from foreign cryptocurrency exchanges. To address this, the SARB may need to mandate local cryptocurrency exchanges to monitor and limit the value of assets "externalised" to foreign platforms within the allowed thresholds for natural persons.

A critical consideration is how the SARB will handle cryptocurrency returning to South Africa amid high-volume trades between local and foreign exchanges. With foreign currency, these inflow and outflow movements cannot be netted against each other in relation to the allowed thresholds. If similar rules are applied to digital assets, it could severely impact these trading activities.

Additionally, the SARB must determine how to treat the transfer of cryptocurrencies from local exchanges to self-custody solutions, such as hardware wallets. These devices, which can be easily transported and used abroad, allow digital assets to be offloaded and exchanged for foreign currency without the SARB's knowledge. The SARB will likely consider the movement of digital assets to a self-custody solution as an externalisation of assets, necessitating stringent monitoring and regulation to prevent unauthorised externalisation events.

Finally, the ability to externalise assets within the allowed thresholds applies to natural persons only, raising the question of whether the SARB will disallow non-natural persons, such as trusts and companies, to purchase cryptocurrencies on local exchanges and move these assets to self-custody solutions or send these blockchain-based digital assets to a foreign source as means of payment.

Wiehann Olivier

Forvis Mazars in South Africa

Acts and Bills

- Income Tax Act 58 of 1962;
- Currency and Exchanges Act 9 of 1933: Section 9.

Other documents:

- Exchange Control Regulations, 1961 (made in terms of section 9 of the Currency and Exchanges Act 9 of 1933).

Tags: cryptocurrency-related transactions; Single Discretionary Allowance (SDA); Foreign Investment Allowance (FIA); foreign cryptocurrency exchanges; blockchains; high-frequency bot trading; blockchain-based digital assets; exchange control regulations.

TAX AMENDMENTS – 2024

INTRODUCTION

On 23 October 2024, when the Minister of Finance presented his Medium-term Budget Policy Statement to Parliament, he also tabled various fiscal Bills, which have since been enacted. This article only deals with the Taxation Laws Amendment Act, 2024, and the Tax Administration Laws Amendment Act, 2024.

As has been the trend for several years, the number of significant amendments has decreased substantially. The majority in number of the amendments are of a highly technical or esoteric nature, and many of these are more of interest to tax professionals than to the business community in general.

Accordingly, the discussion below is limited to the amendments that are likely to be of interest in the general business environment.

FOREIGN EXCHANGE GAINS AND LOSSES

Most of the deductions claimable under the Income Tax Act, 1962 (the Act), require that a taxpayer must be carrying on a "trade", as defined in section 1(1) of the Act. An exemption to this rule is section 24I of the Act, dealing with foreign exchange gains and losses, whereby a loss is deductible even in the absence of trade.

A difficulty has been noted in that a company might derive a foreign currency loss in circumstances where it has ceased to trade, eg, because it is insolvent and is being wound up, and the company incurs a foreign exchange loss, or its foreign exchange losses exceed its exchange gains. Another example might be a non-trading holding company that derives foreign exchange gains or incurs foreign exchange losses.

Unlike individuals and trusts, an assessed loss may only be brought forward from the previous year by a company and used to shelter the current year's profit if it is carrying on a trade. Where the company has ceased trading operations and is being wound up, there might be no trade in the current year, but nevertheless a (net) exchange loss could be incurred that could be carried forward to, but not claimed in, the subsequent year owing to the absence of trade. On the other hand, there could be exchange gains in the following year, with nothing to shelter these gains. To resolve this problem, section 24I has been amended to provide that, in the case of a company that is not carrying on trade –

- it will be taxable on the excess of the foreign exchange gains (including premiums or like consideration in relation to foreign currency option contracts) over the foreign exchange losses (including premiums or like consideration in relation to foreign currency option contracts); or
- if the losses exceed the gains, then the net loss is deemed to be an exchange loss of the company in the immediately succeeding year.

The effect is the same as if the loss had been carried forward but which, owing to the lack of trade, would not have been available to shelter foreign gains in the following year.

This amendment came into operation on 1 January 2025 and applies in respect of tax years commencing on or after that date.

INTEREST LIMITATION RULES

There are two interest limitation rules in the Act, being sections 23M and 23N. The former relates to the limitation on a deduction for interest primarily when it is paid to a foreign party that meets certain relationship tests, in which case the amount of interest claimable is limited to 30% of, what is colloquially referred to as, tax EBITDA.

The other section, section 23N, applies where there are group restructurings undertaken on essentially a tax-free basis but where interest-bearing loans are used to fund the acquisition, and the interest is claimable as a deduction. Section 23N also limits the amount of the interest that can be deducted.

Up until now the calculation of the percentage of tax EBITDA was determined in terms of a formula that was, in brief, linked to the Reserve Bank's repo rate. The higher the repo rate the greater the percentage, and therefore the greater the amount of deductible interest.

The section has been amended to bring it into line with section 23M, so that the interest allowable will be limited to 30% of tax EBITDA.

This amendment comes into operation on 1 January 2027 and applies in respect of tax years commencing on or after that date. This does allow for effectively a two-year phase-out period that might be sufficient in a number of cases where there will be adequate profits and/or adequate reductions in the debt, so that companies will not be affected too adversely in relation to existing loans.

FOREIGN TAX CREDITS

Section 6*quat* of the Act provides for the situation where a resident of South Africa derives foreign income and capital gains and the foreign country has imposed a tax thereon. The section allows the resident to claim the foreign tax paid as a credit against the South African tax payable, but only to the extent that the foreign income falls into taxable income.

In the case of capital gains natural persons are taxable on 40% of the gain (which is why one speaks of an effective CGT rate of 18%, which is really 45% of 40%) and companies and trusts are taxable on 80% of the gains (for companies 80% of 27% is 21.6%, and for trusts 80% of 45% is 36%).

It follows that if a foreign country imposed a tax on a foreign capital gain, under section 6*quat* the taxpayer could claim only 40% or 80%, as the case may be, of the foreign tax paid.

The amendment has the effect of allowing the full foreign tax paid to be claimed as a credit.

This amendment came into operation on 1 January 2025 and applies in respect of tax years commencing on or after that date.

TAX ADMINISTRATION

When a taxpayer wishes to dispute an assessment raised by SARS, the first step is to lodge an objection. If the objection is disallowed (in whole or in part) the taxpayer is entitled to lodge an appeal, in which case the matter will proceed to be heard in the tax court (or the tax board if the amount of tax in dispute does not exceed R1 million).

Before the appeal procedures commence (essentially being the equivalent of exchanging pleadings) the taxpayer is entitled to request alternative dispute resolution (ADR). Under ADR the taxpayer and SARS meet informally and on a without prejudice basis, often mediated by a suitable SARS official (or it could be an independent party) and the taxpayer and SARS attempt to reach a meeting of minds. Obviously, the taxpayer would seek to persuade SARS to accept the taxpayer's version, and SARS will do likewise in relation to its own position.

It does sometimes happen that a taxpayer manages to persuade SARS to concede the matter. More often than not, however, the best that the taxpayer will be able to do is propose and reach a settlement with SARS that will result in a lesser amount of tax (and penalties and interest) having to be paid. If the settlement proposal is agreed to by SARS, the settlement is embodied in a written agreement to which SARS must give effect by issuing reduced assessments, and the taxpayer must pay what has been agreed.

The 2024 amending legislation alters this so that SARS and the taxpayer may, by mutual agreement, attempt to resolve the dispute through ADR at the objection stage, and potentially prior to an objection even having been lodged. (The exact details of how the process will work will only be clear once the Rules on objection and appeal have been updated.)

In such case the objection procedures are suspended while the ADR procedure is ongoing (so, for example, the obligation to lodge objection within 80 business days of the date of the assessment is suspended).

This change would facilitate an earlier resolution and/or settlement and would also save costs for the taxpayer and reduce the relevant resources that must be dedicated to the matter by SARS.

This amendment comes into operation on a date to be notified by the Minister of Finance in a notice published in the *Government Gazette*. It is thus, unfortunately not yet effective.

"It does sometimes happen that a taxpayer manages to persuade SARS to concede the matter. More often than not, however, the best that the taxpayer will be able to do is propose and reach a settlement with SARS that will result in a lesser amount of tax (and penalties and interest) having to be paid."

Ernest Mazansky

Werksmans Attorneys

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "trade"), 6*quat*, 23M, 23N & 24I;
- Taxation Laws Amendment Act 42 of 2024;
- Tax Administration Laws Amendment Act 43 of 2024.

Tags: trade; foreign exchange gains; foreign exchange losses; interest limitation rules; tax EBITDA; appeal procedures; objection procedures.

CHECKING YOUR TAX RESIDENCY STATUS WITH SARS

South Africans working and residing overseas, even those who left decades ago, may find they are literally not on the same page as the South African Revenue Service (SARS) when it comes to their tax residency status, and that can come with serious tax implications.

After recent system changes at the office of SARS involving the declaration of tax residency status, many South African expatriates are discovering that the SARS eFiling platform regards them as South African tax residents, despite their having formalised their emigration previously.

Some even have the SARS Notice of Non-Resident Tax Status Letter confirming they have ceased to be South African tax residents, but eFiling tells another story.

This contradicting information mainly affects expatriates who formalised their emigration through the South African Reserve Bank (SARB) pre-2021, those who completed tax emigration through SARS lately, as well as expats who left the country before the residency tax-based system was introduced in 2001.

Affected expatriates must take note of possible huge tax implications if SARS sees one as a tax resident while in fact one is a non-resident, because the two are treated differently. South African tax residents working abroad are taxed on their worldwide income, while non-residents are only taxed on their South African sourced income.

Incorrect tax residency status on the eFiling platform followed after SARS introduced a 2023-update to the *Registration, Amendments, and Verification Form (RAV01)*, which taxpayers use to update personal and tax-related information. The new RAV01 version includes a dedicated section for tax residency status changes. This update is a direct response to the growing need for regulatory compliance and reflects SARS' intention to centralise residency declarations in line with international tax standards.

It seems previous declarations of being a non-tax resident where expats just ticked a box on their annual tax return as to this status, did not necessarily achieve the same result when the updated form was introduced. It could be that information on prior years' auto-assessments incorrectly reverted some taxpayers' status back to that of tax resident on eFiling.

DON'T ASSUME ALL IS IN ORDER

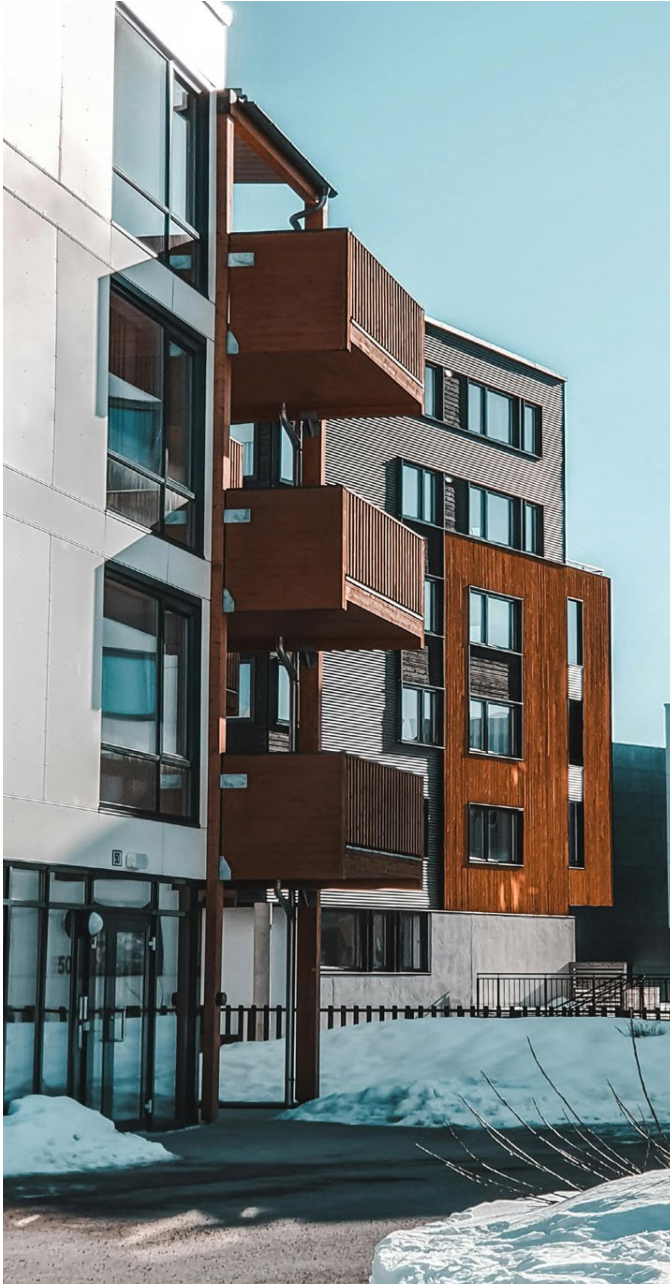
All expatriates should verify their status and cessation date of tax residency on SARS eFiling to confirm that they are formally recognised as non-tax residents, avoiding ongoing obligations, taxation of their foreign-sourced income, and potential penalties. This will mean undergoing a fresh review of residency status and providing additional information to SARS as required by the updated RAV01 verification and audit process.

Although a once-off check is supposed to suffice, non-tax residents are advised to check their status at least a few months before the opening of the tax filing season each year. This will allow enough time to rectify any incorrect information with the tax authority.

"Although a once-off check is supposed to suffice, non-tax residents are advised to check their status at least a few months before the opening of the tax filing season each year."

THE RAV01 UPDATE: SIMPLIFYING BUT STRENGTHENING COMPLIANCE

With the RAV01 update, SARS has simplified the process for expatriates to notify the tax authority of their change in residency status. This tax residency declaration section makes it easier for SARS to monitor taxpayers' status and detect inconsistencies in residency declarations. Before submitting this form, expats must ensure that all their tax filings are accurate and up to date, as discrepancies could trigger audits, penalties, or even denial of non-residency status until rectified.



The RAV01's residency audit and verification include questions on the expatriate's physical presence, family ties, and financial interests, which help SARS assess the taxpayer's intent regarding residency. By asking these targeted questions, SARS aims to identify "accidental residents" or those who might misinterpret their residency status or tax obligations.

ALL UNDER SARS' PURVIEW NOW

Understanding the distinctions between financial and tax emigration is essential for expatriates looking to formalise their status, avoid double taxation, and comply with South African tax laws.

Previously, financial emigration with SARB was sufficient for expatriates to transfer certain assets abroad, but the Reserve Bank no longer recognises financial emigration as a separate process.

Since March 2021 the responsibility shifted to SARS. Now, expatriates must go through SARS to establish non-residency status for tax purposes, encompassing both tax and exchange control implications.

EXPATS NOT FREE FROM ALL COMPLIANCE OBLIGATIONS

Even though taxpayers have ceased tax residency in South Africa, they may still have to submit an annual tax return to SARS. Tax emigration does not necessarily free expatriates from all compliance obligations as they may have ongoing requirements – for income derived from South Africa.

To become a non-resident for tax purposes can be a complex process involving documentation, compliance checks, and potential exit taxes on certain global assets.

PRACTICAL STEPS FOR EXPATRIATES

Evaluate one's tax residency: Review SARS' criteria for tax residency, particularly if one's physical presence and financial ties are mixed across South Africa and other countries. Professional advice will help clarify whether one meets non-residency requirements.

Understand the exit tax: Be prepared for the exit tax implications of declaring non-residency, which can affect global assets and one's financial planning. Proper planning can mitigate some of the costs of this once-off deemed capital gains tax. The exit tax applies to certain categories of assets, such as global investments, and reflects as a "deemed sale" on the day prior to the taxpayer's exit date.

Update the RAV01 carefully: This form should be used to declare one's tax residency status accurately. One should ensure that all supporting documentation aligns with one's declared status to avoid potential discrepancies or penalties.

The evolving process of ceasing tax residency in South Africa highlights the need for expatriates to approach tax emigration thoughtfully, armed with accurate information and professional guidance. With the right support, South Africans abroad can navigate this complex terrain confidently, ensuring that their tax affairs align with their residency status and long-term financial goals.

Lovemore Ndlovu

Tax Consulting SA

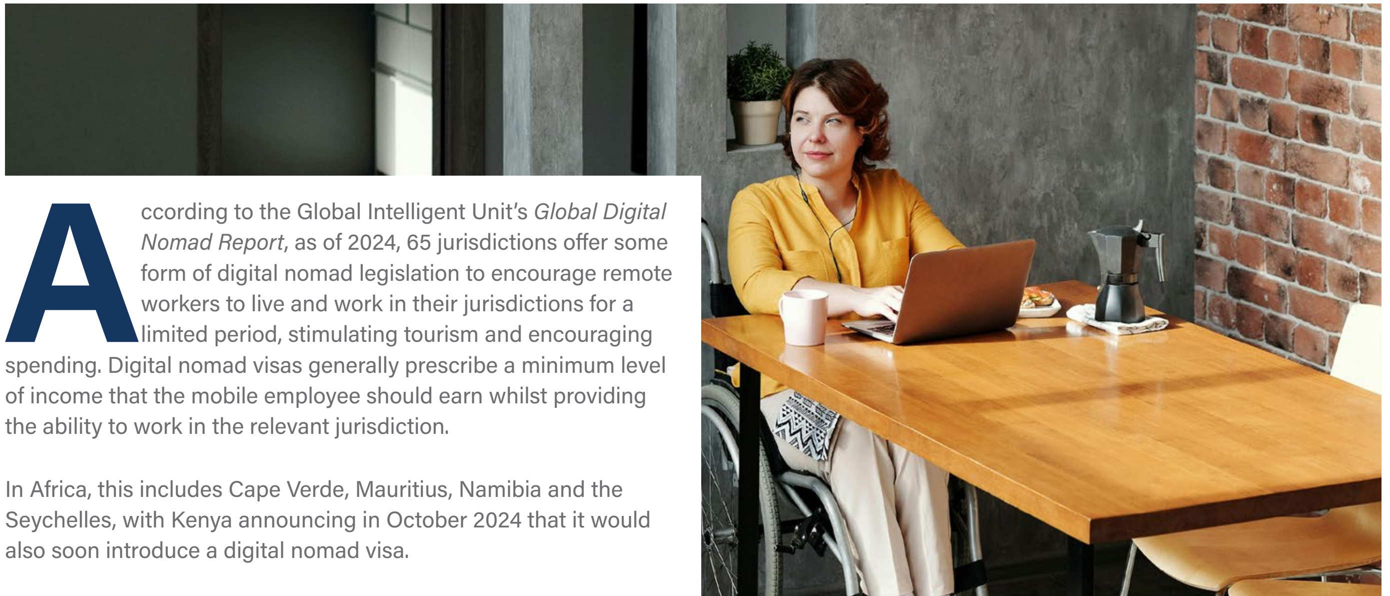
Other documents:

- Registration, Amendments, and Verification Form (RAV01) (on SARS eFiling platform).

Tags: tax residency status; non-tax resident; foreign-sourced income.

REMOTE WORKING AND GLOBAL MOBILITY

Since the Covid-19 pandemic, new ways of working have forced employers and employees to re-evaluate their typical remuneration and mobility policies. Remote and hybrid working arrangements have now become a common and accepted means of acquiring key talent.



According to the Global Intelligent Unit's *Global Digital Nomad Report*, as of 2024, 65 jurisdictions offer some form of digital nomad legislation to encourage remote workers to live and work in their jurisdictions for a limited period, stimulating tourism and encouraging spending. Digital nomad visas generally prescribe a minimum level of income that the mobile employee should earn whilst providing the ability to work in the relevant jurisdiction.

In Africa, this includes Cape Verde, Mauritius, Namibia and the Seychelles, with Kenya announcing in October 2024 that it would also soon introduce a digital nomad visa.

South Africa introduced its digital nomad visa by way of amendments to the Immigration Regulations, 2014, which initially came into operation with effect from 28 March 2024 (*Second Amendment of the Immigration Regulations*). Shortly thereafter, on 12 April, the Minister of Home Affairs withdrew these regulations, informing the public that he had been "ill advised" to publish them prematurely.

The amendments to the Immigration Regulations were then republished (as the *Second Amendment of the Immigration Regulations*), with some changes, including those related to the definition of remote work, the period in which remote workers would be exempt from registering with the South African Revenue Service for tax purposes, and compliance with South African employment law.

In October 2024, the Home Affairs Minister gazetted further reforms to the country's digital nomad visa requirements (*Third Amendment of the Immigration Regulations*). The amendments include changes to the qualification criteria, namely that, to qualify for a remote worker visa, the applicant must show financial means in the form of proof of earnings of not less than the equivalent of R650 976 per annum.

Tax considerations related to remote working are also addressed in the amendments, specifically the requirements for residents of countries with double taxation agreements (DTAs) with South Africa and those from countries without DTAs.

CHALLENGES

South Africa faces specific challenges that have hindered developments in the area of remote working and global mobility for both employees and employers. Some of the considerations limiting the attraction of global talent and the move to mobile employment arrangements are:

- The skills shortage crisis;
- Delays in obtaining critical skills and other visas, making it difficult for companies to recruit scarce skills from other jurisdictions (it is noted that the Home Affairs Minister is actively tackling this issue by addressing backlogs in applications and introducing reforms relating to how applications are assessed);
- Labour and regulatory complexity in South Africa; and
- Recent amendments to the tax legislation, effective 22 December 2023, which require non-resident employers with a permanent establishment in South Africa, to register for and withhold employees' tax, UIF and SDL contributions for employees in South Africa, regardless of whether the foreign employer has an office or subsidiary in South Africa.

> "With the advent of flexibility as a key part of the employee value proposition, many skilled employees have been looking offshore for lucrative job opportunities, either remaining in South Africa or relocating to foreign jurisdictions."

With the advent of flexibility as a key part of the employee value proposition, many skilled employees have been looking offshore for lucrative job opportunities, either remaining in South Africa or relocating to foreign jurisdictions.

South Africa is a very attractive remote working proposition for those with flexibility, offering a relatively low cost of living and fair weather while earning income in a comparatively stronger foreign currency such as US dollars or British pounds. The imposition of new tax regulations may, however, negatively affect this.

Aside from the impediments above, South African employers would benefit from keeping pace with developments in this increasingly mobile and competitive global labour environment to ensure they attract and retain the correct talent to further company and shareholder objectives.

In this regard, a quietly emerging trend in South Africa, particularly amongst multinationals, has been to consider the adoption of a global mobility policy. The contents of these policies vary, but they consider the tax, legal and regulatory implications of remote working and global appointments.

They may also include policy decisions on the "softer" elements such as quality of life and mental well-being. One of the more important considerations for companies wishing to consider employing global talent, seconding talent to offshore entities, or allowing employees to work remotely from other jurisdictions, is the company's remuneration policy around these global or flexible arrangements.

The following are some key questions that an organisation could ask when preparing a global mobility policy and aligning its remuneration policy to global mobility trends whilst ensuring equity within the workforce:

- How does a company determine the level of remuneration for two employees performing the same job in two different jurisdictions?
- Would a cost-of-living adjustment be included, and would this position remain the same if the move was initiated by the employee as opposed to the employer?
- Would the company consider allowing employees to work remotely on a permanent basis and continue to remunerate them from South Africa, and how would the tax and regulatory implications of this decision impact the level of remuneration provided?
- Would the position differ when considering the retention of scarce and critical skills and would the employees' families be accommodated? How does this affect the variable remuneration of the particular employee when benchmarking their position?
- How will variable remuneration be structured for flexible or mobile employees and how would these incentives be benchmarked?
- What are the tax implications of long-term incentives where employees are not employed in the same location throughout the vesting period?

These are relatively unchartered waters for South African employers, but policy around global mobility is developing at a steady pace.

This article was first published by Global Mobility Lawyer.

Chloë Loubser & Danielle Botha

Bowmans

Acts and Bills

- Immigration Act 13 of 2002: Section 7.

Other documents:

- Global Intelligent Unit's *Global Digital Nomad Report*, as of 2024;
- *Immigration Regulations, 2014* (published in terms of section 7 of the Immigration Act 13 of 2002);
- *Second Amendment of the Immigration Regulations* (published in *Government Gazette* on 28 March 2024 and withdrawn on 12 April 2024);
- *Second Amendment of the Immigration Regulations* (republished in *Government Gazette* 50675 on 20 May 2024);
- *Third Amendment of the Immigration Regulations* (published in *Government Gazette* 51366 on 9 October 2024).

Tags: digital nomad legislation; digital nomad visa; double taxation agreements (DTAs); global mobility policy; variable remuneration.

UNDERSTATEMENT PENALTIES

SARS has traditionally taken a narrow approach in interpreting the term bona fide *inadvertent error, the existence of which allows taxpayers to escape understatement penalties, ranging between 10% and 200% of the understatement of tax.*

This took a turn in 2022 when SARS reportedly conceded before the Supreme Court of Appeal (SCA) in *Commissioner, South African Revenue Service v the Thistle Trust* [2023] that the Trust's reliance on a tax opinion gave rise to a *bona fide* inadvertent error. The Constitutional Court (CC) has now also had its say on understatement penalties and although coming from a different angle, the pronouncements were, once again, taxpayer-friendly.

It is questionable whether the judgment in the *Thistle* case handed down by the SCA in 2022 created legally binding precedent on the meaning of the term *bona fide* inadvertent error, since SARS' reported concession meant that the matter was not argued before the court. Nevertheless, the SCA gave its stamp of approval to SARS' concession by stating that it was "correctly" made. Whether legally binding or not, this casts serious doubt on the correctness of SARS' prior stance in its *Guide to Understatement Penalties* (Issue 2, dated 18 April 2018), that *bona fide* inadvertent errors are limited to certain typographical errors and can never arise where a taxpayer acts deliberately in adopting a certain position.

The penalty debate progressed in 2023 when the SCA in *Commissioner, South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] excused Coronation from all penalties on the basis that its reliance on expert advice gave rise to a *bona fide* inadvertent error, even though Coronation did not disclose the content of the advice to SARS or the court.

The SCA judgments in both *Thistle* and *Coronation* were on appeal to the CC – the judgments of the CC in both appeals have now been delivered.

In a judgment handed down on 21 June 2024, the CC in *Coronation Investment Management SA (Pty) Ltd v Commissioner, South African Revenue Service* [2024] found in Coronation's favour on the merits and SARS' cross-appeal in respect of understatement penalties therefore did not come up for consideration. Given that the understatement and underestimation penalties which SARS sought to impose on Coronation would have been substantial, it is worth considering the history of the litigation between the parties:

- The Cape Town Tax Court found in Coronation's favour on the merits (in short, that the foreign business establishment (FBE) exemption applied to a controlled foreign company (CFC) of Coronation) (*Coronation Investment Management SA (Pty) Ltd v The Commissioner for the South African Revenue Service,* [2021]);
- The SCA found the opposite (in short, that the FBE exemption could not apply as the CFC sought to outsource what the SCA interpreted as the CFC's primary business); and finally
- The CC turned the matter back around by finding in Coronation's favour (in short, that the FBE exemption indeed applied, based on the CC's interpretation of the nature of the CFC's business).

It is perhaps understandable that even the highest courts may differ when interpreting complex legislation such as the CFC provisions found in section 9D of the Income Tax Act, 1962. However, when taxpayers, sometimes on expert advice, interpret complex legislation in a different manner to SARS, SARS often levies understatement penalties (that can be up to double the quantum of the underlying tax) in terms of a penalty table contained in section 223 of the Tax Administration Act, 2011 (the TAA). This provision prescribes penalties that differ in severity, with most of the penalty categories based on the "blameworthiness" of the taxpayer's behaviour. These categories are: "substantial understatement", reasonable care not taken in completing return, no reasonable grounds for "tax position" taken, "impermissible avoidance arrangement", gross negligence and intentional tax evasion.

Since the CC judgment in *Coronation* did not take the penalty debate any further, all eyes were on the CC's judgment in *The Thistle Trust v Commissioner for South African Revenue Service* [2024], which was handed down on 2 October 2024.

Although the tax court had found in the Thistle Trust's favour on the merits (the matter concerned the application of the "conduit pipe" principle to the taxation of capital gains distributed to beneficiaries through multiple trusts in a tiered trust structure), this was overturned by the SCA, where the Trust lost on the merits. In the CC, the majority agreed with the SCA by holding in SARS' favour that the conduit pipe principle did not apply, with two out of eight judges dissenting.

SARS had applied for leave to cross-appeal the penalty issue to the CC if the Trust lost on the merits. In a surprising turn of events, SARS denied ever having made the concession before the SCA that the Trust's reliance on expert advice was a *bona fide* inadvertent error, although SARS accepted that its counsel did not argue the point before the SCA.

Despite the interpretation of the penalty provisions being a matter of great public importance, the CC dismissed SARS' application for leave to cross-appeal as not being in the interests of justice. This was because the CC would have been sitting as the court of first and last instance in interpreting the term *bona fide* inadvertent error (since the tax court did not reach the penalty issue and the point had not been argued before the SCA) and SARS had no sustainable case for imposing the penalties (therefore the cross-appeal would ultimately fail).

However, the CC made instructive remarks regarding the two blameworthy behaviour categories, at least one of which SARS argued should apply, in holding that SARS had no reasonable prospects of discharging the *onus* of proving the facts that would bring the Thistle Trust's conduct within either of these categories:

- In relation to "[n]o reasonable grounds for 'tax position' taken", the CC held that there were indeed reasonable grounds for the tax position taken by the Trust which was not only based on legal advice but upheld by the tax court in a reasoned judgment; and
- In relation to "[r]easonable care not taken in completing return", the CC rejected SARS' argument that the Trust failed to take reasonable care in completing its return by not following the stated SARS position (which was considered and rejected in the advice relied on by the Trust).

The dissenting judges in *Thistle* agreed with the majority's reasoning on the penalty issue, therefore these remarks were effectively unanimous by no less than eight judges of the CC. It was clearly the view of the bench in *Thistle* that a taxpayer who adopts a position contrary to SARS' position is not automatically liable for understatement penalties – rather, to discharge the onus resting on it, SARS must prove the facts which bring the taxpayer's conduct within the chosen behaviour category, amongst other things.

If based on a "substantial understatement", SARS must remit the understatement penalty if the taxpayer made full disclosure of the arrangement to SARS and was, by the time the relevant return was due, in possession of an opinion by an independent registered tax practitioner that satisfied the requirements of section 223(3) of the TAA. One of these requirements is that the opinion must be based on a full disclosure of the facts and circumstances of the arrangement that gave rise to the prejudice to SARS or the fiscus and another is that the opinion must confirm that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court. Although "substantial understatement" is only one of the available categories, where a taxpayer was in possession of such an opinion which considered the available SARS guidance on an issue and submitted its tax returns based on the advice contained in the opinion, the taxpayer's behaviour could hardly constitute reasonable care not taken in completing return, no reasonable grounds for "tax position" taken or gross negligence (this view would seem to be supported by the CC's remarks in *Thistle*). It would also seem that the behaviour of the taxpayer would not fall into the "intentional tax evasion" category, unless there was some sort of collusion between the taxpayer and the tax practitioner who issued the opinion. In these circumstances, SARS would only be able to levy an understatement penalty if it was able to show that the "arrangement" in question constituted an "impermissible avoidance arrangement" (an arrangement to which the general anti-avoidance provisions applied).

Especially since the CC in *Thistle* declined to comment on the meaning of a *bona fide* inadvertent error, the SCA's pronouncements on the meaning of this term remain instructive. In view of these pronouncements of the SCA, SARS' prior narrow view of the term *bona fide* inadvertent error seems to require an update. Moreover, in the case of taxpayers acting on reasoned expert advice and given the CC's remarks in *Thistle*, SARS will not easily discharge the *onus* of proving the facts which bring the taxpayer's behaviour into one of the categories required to successfully impose understatement penalties. The value of tax opinions that comply with the requirements of section 223 should thus not be underestimated.

Esther van Schalkwyk

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 9D;
- Tax Administration Act 28 of 2011: Section 223 (specific emphasis on subsection (3)).

Other documents:

- Guide to Understatement Penalties (Issue 2) – dated 18 April 2018.

Cases

- *The Thistle Trust v Commissioner for South African Revenue Service* [2024] CCT 337/22 (2 October 2024); 2024 JDR 4267 (CC); [2024] ZACC 19;
- *Commissioner, South African Revenue Service v the Thistle Trust* [2023] (2) SA 120 (SCA); 85 SATC 347;
- *Commissioner, South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] (3) SA 404 (SCA); 2023 (2) All SA 44 (SCA); 85 SATC 413;
- *Coronation Investment Management SA (Pty) Ltd v Commissioner, South African Revenue Service* [2024] (6) SA 310 (CC); [2024] ZACC 11 (CC);
- *Coronation Investment Management SA (Pty) Ltd v The Commissioner for the South African Revenue Service,* unreported judgment of the Tax Court of South Africa, Cape Town, Case No 24596 (17 September 2021).

Tags: *bona fide* inadvertent error; understatement penalties; underestimation penalties; substantial understatement; impermissible avoidance arrangement; gross negligence; intentional tax evasion; "conduit pipe" principle.

LOANS TO OFFSHORE TRUSTS

The 2024 Taxation Laws Amendment Act (TLA Act 2024) introduces amendments specifically addressing the interaction between section 7C and section 31 of the Income Tax Act, 1962.

Section 7C deals with interest-free or low-interest loans to trusts, and section 31 governs transfer pricing in cross-border transactions. The aim is to provide clarity and ensure that lending to offshore trusts is treated correctly from both a transfer pricing and section 7C perspective.

THE CURRENT STATE OF AFFAIRS

Section 7C aims to curb tax avoidance through interest-free and / or low-interest loans, advances and credit arrangements to local and foreign trusts. This is achieved by regarding discounted interest rates on these loans and credit arrangements as a deemed donation.

Prior to the implementation of section 7C, trusts were often used to lessen the tax impact of estate duty upon the death of an individual, thereby allowing the transfer of wealth to the next generation with minimal tax impact. This was mainly achieved by an individual disposing of assets to a trust, with the purchase price remaining outstanding on an interest-free loan account.

If section 7C applies, the charging section in subsection (3) takes effect. Section 7C(3) states that if a trust or company incurs interest in respect of a loan at a rate lower than the official rate of interest, an amount equal to the difference between the interest amount incurred by the trust or company and the interest amount that would have been incurred at the official rate of interest (as defined) must be deemed to be a donation. The deemed donation is subject to donations tax at a rate of 20% in the case of donations not exceeding R30 million in value, and 25% thereafter.

Section 31, on the other hand, applies to cross-border transactions between connected persons, ensuring that such transactions (including loans) are in alignment with the arm's length principle. The arm's length principle mandates that the terms of these transactions reflect those that would have been agreed upon by independent parties under similar circumstances. If not, transfer pricing adjustments can be made, resulting in additional tax liabilities.

THE MISALIGNMENT CONUNDRUM

Since the introduction of section 7C, there were concerns regarding the interaction between section 7C and transfer pricing, specifically regarding loans to foreign trusts. Transfer pricing rules, designed to prevent profit-shifting and base erosion, mandate that cross-border transactions between connected persons be conducted at arm's length. This is achieved by increasing income tax through a primary adjustment, and a secondary adjustment which deems a donation of the same amount to have been made. The deemed donation may be subject to donations tax. However, the focus of section 7C was predominantly on preserving individuals' wealth, and not on the cross-border pricing concerns that are the subject of transfer pricing rules.

For example, assume a resident individual provides an interest-free loan to a connected non-resident trust of R20 million. If the non-resident trust borrowed a similar amount from an independent financial institution, the non-resident trust would be charged interest at an interest rate of 8% (R20 million x 8% = R1.6 million). Because the transaction is with a non-resident connected person, the section 31 transfer pricing rules will apply. This will result in a primary adjustment for the resident individual of R1.6 million in terms of section 31(2). A deemed donation of R1.6 million would also be raised in terms of section 31(3) as a secondary adjustment, which will be subject to a 20% donations tax. Similarly, if the resident were to be a company, a deemed dividend would be raised, which will be subject to a 20% dividends tax.

Assuming an official rate of interest of 10%, an amount of R2 million (R20 million x 10%) would be regarded as a deemed donation in terms of section 7C(3). However, section 7C(5) lists various transactions which are exempt from section 7C(3). In this example, the exemption contained in section 7C(5)*(e)* applies. This provision stated that section 7C(3) does

> "not apply in respect of any amount owing by a trust . . . during a year of assessment in respect of a loan . . . if that loan . . . constitutes an affected transaction as defined in section 31(1) that is subject to the provisions of that section."

The difference of R400 000 (R1.6 million in terms of section 31 and R2 million in terms of section 7C), creates unintended structuring opportunities, which could lead to the erosion of the tax base.

THE IMPACT OF THE PROPOSED CHANGES

The TLA Act 2024 changes the exemption in section 7C(5)*(e)* so that it only applies in respect of the interest which is subject to a transfer pricing adjustment (ie, R1.6 million in the example above). The remaining interest (ie, R400 000 in the example above) will then be subject to section 7C donations tax.

For South Africans with foreign trusts, these changes will impact estate planning and tax structuring strategies. Loans to foreign trusts, which previously enjoyed more lenient treatment, will now be subject to closer scrutiny from both a section 7C and a transfer pricing perspective.

This dual approach reflects South Africa's commitment to adhering to OECD guidelines on base erosion and profit-shifting, ensuring that cross-border transactions do not erode the country's tax base. Taxpayers with foreign trusts will now need to re-evaluate their structures to ensure that they are compliant with both domestic and international tax principles.

"For South Africans with foreign trusts, these changes will impact estate planning and tax structuring strategies. Loans to foreign trusts, which previously enjoyed more lenient treatment, will now be subject to closer scrutiny from both a section 7C and a transfer pricing perspective."

Nadine Smit & Charl Hall

Forvis Mazars in South Africa

Acts and Bills

- Income Tax Act 58 of 1962: Sections 7C (emphasis on subsection (5)*(e)*) and section 31 (emphasis on subsections (1), (2) & (3));
- Taxation Laws Amendment Act 42 of 2024.

Tags: low-interest loans; official rate of interest; interest-free loan; connected non-resident trust; transfer pricing adjustment.

VAT ESTIMATED ASSESSMENTS

On 11 December 2023, the South African Revenue Service (SARS) introduced the issuance of estimated assessments in respect of value-added tax.

WHEN IS AN ESTIMATED ASSESSMENT RAISED?

SARS is entitled to request relevant material to verify particulars disclosed in a vendor's VAT201 return. If, despite more than one request sent by SARS, the vendor does not respond to a SARS verification request or provides relevant material that is considered to be inadequate, SARS is entitled to proceed to raise an estimated assessment in terms of section 95(1)*(c)* of the Tax Administration Act, 2011 (the TAA).

According to SARS, the aim of this process is to enhance tax compliance, streamline the VAT system and strike a compromise between the interests of vendors and SARS.

HOW DOES IT WORK?

The estimated assessment is raised by SARS issuing a VAT 217 assessment (VAT 217). Once the VAT 217 is raised, vendors are required to submit the relevant material within 40 business days if they disagree with the estimated assessment.

Vendors can submit relevant material via the SARS Online Query System, at a SARS branch, or on SARS eFiling.

If the vendor is unable to submit the relevant material within 40 business days, the vendor may request an extension from SARS, prior to the end of the 40 business days. An extension will be granted if there are reasonable grounds for the extension.

If a vendor does not submit the relevant material within the required timeframe, the estimated assessment will be final, and the vendor will not be entitled to object to the estimated assessment.

A vendor may only object to the estimated assessment if the required relevant material was submitted, and if the vendor, after SARS has had time to consider the impact of the relevant material on the assessment, is still aggrieved by the outcome.

PRACTICAL CHALLENGES

Some vendors have experienced that the regular link supplied on SARS eFiling for the submission of relevant material subsequent to the VAT 217 being raised, does not function properly. Vendors are thus unable to use this functionality to submit the required relevant material.

It is advisable to rather access the *submit document functionality* on the estimated assessment letter issued by SARS. This then provides access to SARS eFiling, which allows the vendor to submit the relevant material via this link.

Once SARS has reviewed the supporting documents and finalised or revised the assessment raised in respect of the tax period, there are instances where remitted penalties and interest in the revised estimated assessment do not align with the VAT Statement of Account (VAT SOA). In other words, the VAT SOA does not reflect the fact that the penalties and interest have been remitted. Should one experience this issue, it is advisable to contact SARS to procure a resolution.

CONCLUSION

Ideally, vendors should not ignore requests for relevant material and implement controls to ensure that these requests are attended to timeously.

In the unfortunate event that SARS does issue an estimated assessment due to non-submission of relevant material or inadequate relevant material, vendors only have 40 business days to comply. Non-compliance will result in the estimated assessment becoming final, which may significantly impact the financial position of the vendor.

It is advisable to get in touch with a registered tax advisor where one is not sure how to respond to an estimated assessment, or where practical difficulties in submitting the required relevant material are experienced.

Leila Wright & Sindisiwe Zinyongo

Forvis Mazars in South Africa

Acts and Bills

- Tax Administration Act 28 of 2011: Section 95(1)*(c)*.

Other documents:

- VAT201 return;
- VAT 217 assessment;
- VAT Statement of Account.

Tags: estimated assessment (VAT); VAT 217 assessment; VAT Statement of Account.

sait South African Institute of Taxation