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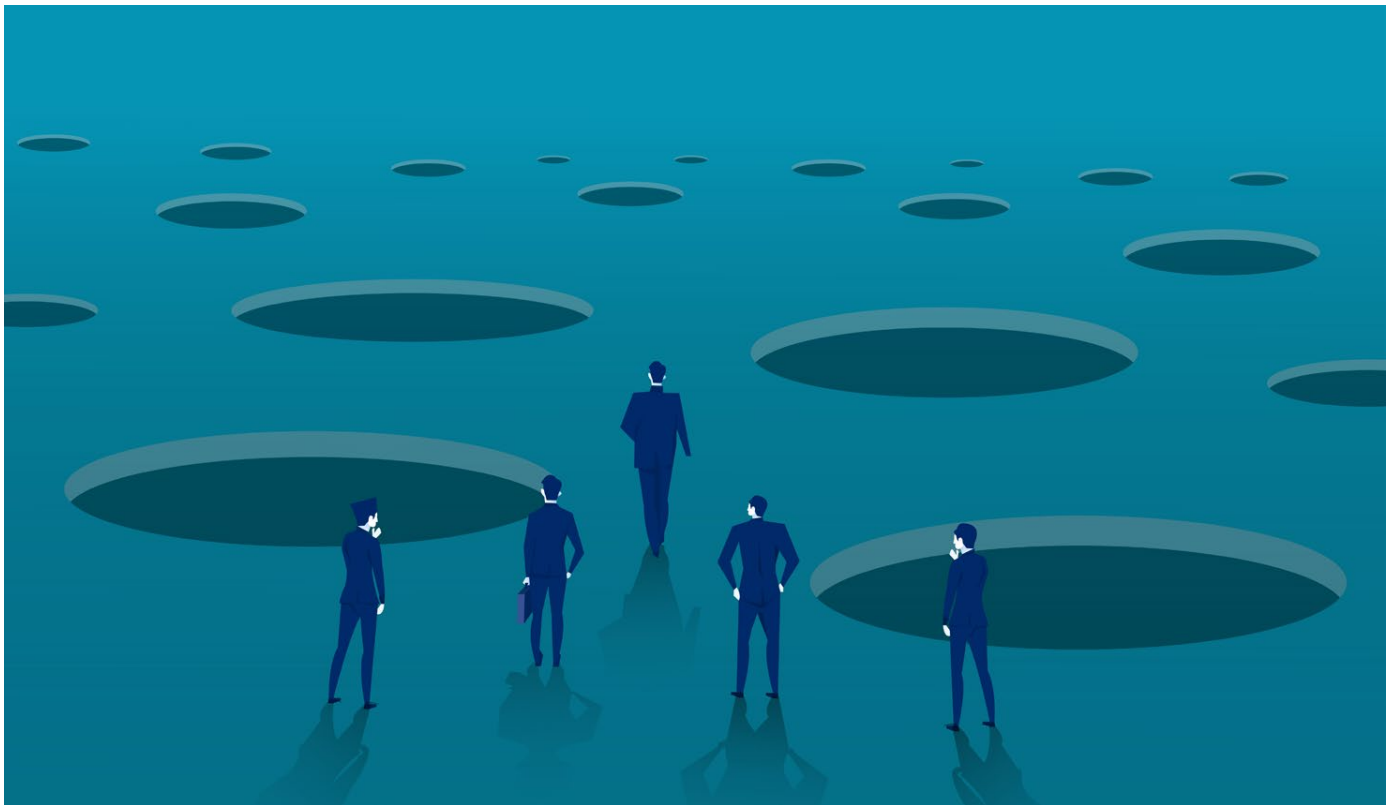

PARTNERSHIP PITFALLS

En commandite *partnerships are back in vogue as an investment vehicle for investors to take advantage of the solar incentives in sections 12B and 12BA (section 12BA remained in force until the end of February 2025) of the Income Tax Act, 1962 (the Act).*

However, if not structured properly, they may not produce the desired outcome. In some instances, the law is unclear and in others it can impose an uncommercial burden on an investor. [*Author's note*: Although section 12BA expired at the end of February 2025, *en commandite* partnerships are still being used for the purposes of section 12B, which remains in force.]

The use of *en commandite* partnerships in order to secure tax benefits for investors was very popular in the 1980s, when there was a proliferation of schemes covering a variety of asset classes, many of which ended up in lengthy tax disputes in South African courts. They included endowment policies [see *Burgess v Commissioner for Inland Revenue* [1993]], films [see *Rane Investment Trust v Commissioner, South African Revenue Service* [2003]], horses used for breeding purposes, aircraft [see *Chipkin (Natal) (Pty) Ltd v Commissioner, South African Revenue Service* [2005]] and plantations [see *ITC 1496* [1990]], to name but a few.

The promoters of some of the more aggressive schemes claimed that they resulted in a deduction of up to five times the investment. Many film schemes did not even result in films being produced. These schemes resulted in the legislature introducing section 24H into the Act in 1988. Other amendments to the Act have also addressed some of the more aggressive features of past *en commandite* partnerships such as the attempts to claim interest and other expenses up front. [*Author's note*: Section 24J spreads interest over the term of a loan on the yield to maturity basis and section 23H spreads prepaid expenditure exceeding time and quantum thresholds.] Livestock losses were ring-fenced against farming income under paragraph 8 of the First Schedule to the Act.

NATURE OF PARTNERSHIP

A partnership is a legal relationship arising from an agreement between two or more persons and is formed under South African common law.

An *en commandite* partnership is a type of partnership in which the business is carried on in the name of one partner only, that is, the general partner (GP). The remaining partners are undisclosed. The undisclosed partners or limited partners (LPs) contribute specified amounts of money and in return share in the profits and losses of the venture with the proviso that their losses are restricted to their specific contributions.

In *Joubert v Tarry & Co* [1915], De Villiers JP set out the *essentialia* of a partnership when he stated the following:

> "These essentials are fourfold. First, that each of the partners brings something into the partnership, or binds himself to bring something into it, whether it be money, or his labour or skill. The second essential is that the business should be carried on for the joint benefit of both parties. The third is that the object should be to make profit. Finally, the contract between the parties should be a legitimate contract." [1915 TPD 277 at 280–1]

In *ITC 1794* [2005], after noting the above *essentialia*, Davis J stated the following:

> "In determining whether a particular contract gives rise to a partnership, regard must be had both to the *essentialia* of the partnership as evidenced in the agreement and the intention of the parties. The fact that a contract does contain the *essentialia* of a partnership does not necessarily mean that the legal relationship created by the contract is that of a partnership. Upon a proper construction of the relationship, the true intention of the parties may well be that, notwithstanding the existence of the *essentialia* of a partnership agreement, a contract other than a partnership has been created. See LAWSA Vol 19 at para 274." [*ITC 1794* [2005] 67 SATC 262 (C) at 269]

No limit exists on the number of partners in a partnership for gain under the Companies Act, 2008. Under the now repealed section 30(1) of the Companies Act, 1973, the number of partners in a partnership for gain was limited to 20, save for partnerships in the organised professions that were designated by the Minister.

A partnership is not a separate legal entity. In *Michalow, NO v Premier Milling Co Ltd* [1960] the court summed up the common law position as follows:

> "At Common Law a partnership is not a legal entity having an existence apart from the individuals constituting it. It cannot have assets and liabilities." [1960 (2) SA 59 (W) at 61]

A partnership cannot have a taxable income because it is not a taxable entity or a taxpayer. [See *Chipkin* [2005] (5) SA 566 (SCA), at 249.] It is therefore the individual partners who must account for the income, deductions and capital gains of the partnership in their tax returns.

"A partnership is a legal relationship arising from an agreement between two or more persons and is formed under South African common law."

SECTION 24H

Section 24H(2) deems LPs to be carrying on the trade of the partnership despite their not being actively involved in the partnership business. [See *ITC 1496* above, in which the court did not accept that the passive investors were genuine partners.]

Section 24H(3) limits the amount of any allowance or deduction that a limited partner can claim to the sum of –

- the partner's contribution;
- any other amount for which the taxpayer is liable or may be held liable to any creditor of the partnership; and
- any income received by or accrued to the taxpayer from such trade or business.

Section 24H(4) then provides that any amount disallowed under section 24H(3) shall be carried forward and be deemed to be an allowance or deduction to which the taxpayer is entitled in the succeeding year of assessment.

Section 24H(3) is a cumulative test and it needs to be applied in each year of assessment.

It poses a particular difficulty in relation to the many solar *en commandite* partnerships aimed at taking advantage of the section 12BA allowance. The reason is that section 12BA grants an allowance of 125% of the cost of the qualifying solar equipment. Thus, an LP investing R100 would be entitled to a R125 allowance. But since the LP's contribution is only R100, the balance of R25 would have to be carried forward to the next year of assessment (disregarding net income). One might try to argue that this is not a sensible or businesslike result [see *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012]] but the fact remains that this is the effect of the plain wording of section 24H(3). The legislature was aware of this problem because it deleted the words "other than section 11*bis*" which followed the words "any allowance or deduction ..." in the Revenue Laws Amendment Act, 2002. Section 11*bis*, which was repealed by the same amending Act, provided a double deduction for export marketing expenditure. Clearly, it would have been absurd to expect a partner to be liable to creditors for the portion of an allowance which did not involve any outlay of expenditure. But that is precisely the problem that section 12BA poses for an LP. The LP therefore would have had to agree to be held liable to creditors for an additional amount of 25% of any contribution if any limitation under section 24H(3) is to be avoided, which is not a commercial outcome. The issue was drawn to National Treasury's attention but presumably it was not considered worthy of an amendment because of the temporary nature of the section 12BA allowance.

Section 24H(5)*(a)* deems the income of the partnership to be received by or accrued to the partners on the date it is received by or accrues to them in common. This rule was inserted to address the outcome of *Sacks v Commissioner for Inland Revenue* [1946], which held that partnership profits accrue only when the partners agree to draw up their accounts. The amount that will be received or accrue to each partner must be determined in accordance with the ratio that they agree to share profits or losses.

Section 24H(5)*(b)* then provides that partners will be entitled to a deduction or allowance based on their share of the income referred to in section 24H(5)*(a)*. This requirement can lead to some conflicting results in the context of capital allowances. Typically, the LPs contribute the capital to purchase the equipment while the GP makes a nominal contribution but takes a bigger slice of the partnership profits. For example, assume that there are 10 LPs and each contributes R100 000 and the GP contributes R1 000. However, the GP takes 20% of the profits while each LP takes 8%. How is the section 12BA allowance to be shared? If it were shared in accordance with the fractional interest of each LP in the solar equipment, each LP would be entitled to a R125 000 allowance with the GP's share being R1 250. But if section 24H(5)*(b)* is applied, the GP's share would be 20% × R1 251 250 = R250 250. Yet, section 12BA(2) states that the deduction is 125% "of the cost incurred by the taxpayer". How then can the GP claim R250 250 when incurring a cost of only R1 000? The result of section 24H(5)*(b)* would be to divert a large portion of the allowance away from the LPs, who incurred the expenditure, to the GP, who is not entitled to claim it.

Clearly, section 24H(5)*(b)* is in conflict with section 12BA. When two provisions of a statute are in conflict, the rules of interpretation require the maxim *generalia specialibus non derogant* (general provisions do not derogate from specific ones) to be applied to resolve the conflict. In ITC 79 the court stated:

> "When, therefore, there were special provisions in a statute and also general ones and the latter conflicted with the former, the special provisions were read as exceptions from the general ones." [(1927) 3 SATC 78 (U) at 80]

In this instance, section 12BA is the more specific provision and so should take precedence. If this approach is followed, each LP would be entitled to an allowance of R125 000, while the GP would be entitled to R1 250. It is possible that the sort of allowance the draftsperson had in mind in section 24H(5)*(b)* was something related to income such as an allowance for bad debts (section 11*(i)*), doubtful debts (section 11*(j)*), debtors allowance (section 24) or the allowance for future expenditure (section 24C).

CLOSURE OF PARTNERSHIP

Before acquiring any solar equipment, all the LPs should be in place. If additional partners are admitted after the equipment has been acquired, the pre-existing LPs will have to dispose of a fractional interest in the partnership assets in exchange for a share in the contribution made by the incoming LP, thus triggering a recoupment of the section 12BA allowance under section 8(4)*(a)* and *(n*A). [*Author's Note*: If it is disposed of before 1 March 2026.] The fractional interest acquired by the incoming LP will be second-hand, thus disqualifying that LP from claiming the section 12BA allowance. Instead, the incoming LP will have to be satisfied with a 100% deduction under section 12B.

What would happen in the event that one of the existing partners dies or wishes to dispose of their partnership interest? If a buyer can be found, the exiting LP will suffer a recoupment and the buyer will be entitled to the section 12B allowance on the second-hand equipment. However, at least this will not have any impact on the rest of the LPs. Sometimes the GP will agree to take up the LP's share to give the LPs the peace of mind that they will have a buyer for their interest.

NEW OR SECOND-HAND

The 2025 year of assessment and the section 12BA window have already past, and the question now arises whether the equipment could have been installed on a client's premises while the investors were found. The equipment could then be sold to the LPs as a turnkey project. Caution needs to be exercised here lest the equipment is no longer regarded as new and unused. It would be best if the equipment has not been brought into use besides some preliminary testing before selling it to the LPs.

RETAINING OWNERSHIP

One of the requirements of sections 12B and 12BA is that the claimant has to be the owner or, if not, an acquirer under an instalment credit agreement. When equipment is permanently affixed to a client's premises, the maxim *superficies solo cedit* (whatever is attached to the land forms part of it) means that in the absence of a contractual arrangement to the contrary, the client becomes the owner of the equipment. [See *ITC 1467* (1989); 52 SATC 28 (C) at 31.] It is therefore essential in any agreement with the client to stipulate that the equipment remains the property of the partnership and will be removed at the end of the contract period.

BEWARE LETTING

Agreements with clients are nearly always structured as electricity purchase agreements rather than leases for good reason. Charging the client for the electricity produced is not the same as charging a rental for the equipment. While section 12BA allows a lessor to claim the allowance by permitting the equipment to be "used by that taxpayer or the lessee of that taxpayer, in the generation of electricity", section 12B by contrast, requires the equipment to be "used by that taxpayer in the generation of electricity". Thus, on the face of it, a lessor would not qualify for the allowance under section 12B(1)*(h)* and would need to default to section 11*(e)*. Regardless of whether a lessor claims an allowance under section 11*(e)*, 12B or 12BA, the allowances will be ring-fenced against the lease rentals under section 23A. For any investor in an *en commandite* partnership, that would mean that they cannot set off the allowance against other taxable income, making the investment far less attractive.

COMMERCIAL RISK

Finally, while it is satisfying to have a large tax deduction, one should not let the tax tail wag the commercial dog. Around 1991 while the author was at SARS, two promoters of a plantation scheme asked him if he would give them a ruling that their partnership agreement would not result in any limitation under section 24H(3). On reading the relevant clause, it was clear to the author that the partners' exposure was unlimited. He told them that he was happy to give them the ruling but that he personally would not touch such an arrangement with a bargepole. Subsequently, the scheme turned out to be a financial disaster because of farm mismanagement and problems with the trees. Both promoters faced sequestration.

One would like to think that solar projects are less risky than a plantation but they are not without risk. Many solar projects rely on gearing to boost the tax deduction but this also increases the risk because the debt has to be repaid with interest. Understanding the risks associated with the investment is essential. Choosing a promoter with a proven track record and the necessary expertise would be a good starting point for a successful solar venture.

This article was published in *Accountancy SA* in October 2024.

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Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 8(4)*(a)* & *(nA)*, 11*(e)*, *(i)* & *(j)*, 11*bis* (repealed by Act 74 of 2002), 12B (specific reference to subsection (1)*(h)*), 12BA (specific reference to subsection (2)), 23A, 23H, 24, 24C, 24H (specific reference to subsections (3), (4) & (5)*(a)* & *(b)*), 24J; First Schedule: Paragraph 8;
- Revenue Laws Amendment Act 74 of 2002;
- Companies Act 71 of 2008;
- Companies Act 61 of 1973: Section 30(1).

Other documents:

- LAWSA Volume 19 at paragraph 274;
- *Draft Guide on the Allowances and Deductions relating to Assets Used in the Generation of Electricity from Specified Sources of Renewable Energy*: paragraph 2.3 (released by SARS on 30 July 2024);
- *Guide on the Allowances and Deductions relating to Assets Used in the Generation of Electricity from Specified Sources of Renewable Energy* (released by SARS on 23 November 2024).

Cases

- *Burgess v Commissioner for Inland Revenue* [1993] (4) SA 161 (A), 55 SATC 185;
- *Rane Investment Trust v Commissioner, South African Revenue Service* [2003] (6) SA 332 (SCA); [2003] 3 All SA 39 (SCA), 65 SATC 333;
- *Chipkin (Natal) (Pty) Ltd v Commissioner, South African Revenue Service* [2005] (5) SA 566 (SCA); 67 SATC 243;
- *TC 1496* [1990];
- *Joubert v Tarry & Co* [1915] TPD 277 at 280–1;
- *ITC 1794* [2005] 67 SATC 262 (C) at 269;
- *Michalow, NO v Premier Milling Co Ltd* [1960] (2) SA 59 (W) at 61;
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA);
- *Sacks v Commissioner for Inland Revenue* [1946] AD 31, 13 SATC 343;
- *ITC 79* [1927] 3 SATC 78 (U) at 80;
- *ITC 1467* [1989] 52 SATC 28 (C) at 31.

Tags: *en commandite* partnerships; partnership for gain; qualifying solar equipment; instalment credit agreement.

TAX-EXEMPT GOVERNMENT GRANTS

Section 12P of the Income Tax Act, 1962, (the Act), plays a crucial role in fostering economic development by providing tax relief for certain qualifying government grants.

GOVERNMENT GRANTS

Government grants may be provided in cash or in kind (eg, assets). Key points to remember for grants in kind include:

- The value of the grant is the market value of the asset received; and
- Trading stock acquired through a grant in kind will be included in opening stock and closing stock at a cost price of zero.

UNDERSTANDING THE GOVERNMENT GRANTS EXEMPTION

Section 12P provides an income tax exemption for qualifying government grants. Its purpose is to empower businesses and individuals receiving these grants by exempting the grants from normal tax, and thereby allowing recipients to utilise the funds entirely for their intended purposes.

To qualify for exemption under section 12P, a government grant must be –

1. listed in the Eleventh Schedule to the Act;
2. identified by the Minister of Finance in a notice published in the *Government Gazette*; or
3. a grant received as part of fulfilling obligations under a public-private partnership, to fund improvements to land or buildings owned by or under servitude to the government.

ACCOUNTING FOR EXEMPT GRANTS

Grants received to acquire, improve or reimburse expenses for trading stock

The grant must be deducted from the cost price of trading stock. Any excess amount, ie, if the grant exceeds the cost price of the trading stock, will result in a reduction of other tax-deductible expenditure.

Grants received for the acquisition or improvement of an allowance asset or to fund expenditure in order to acquire or improve an allowance asset

The base cost of the asset will be reduced by the amount of the grant. Any tax allowances claimed will be on the original base cost of the asset and the tax allowance claimed will be limited to the reduced base cost. If the government grant exceeds the base cost of the asset (ie, the base cost of the asset will be reduced to a nil base cost) then that excess must be used to reduce any allowable deductions in terms of section 11 of the Act for that year of assessment.

Any excess not utilised (after the allowable expenses for that year of assessment have been reduced) will be carried forward to the subsequent year of assessment until the excess has been fully utilised.

Grants used to fund the acquisition, creation or improvement of a capital asset

Similar to allowance assets, the grant reduces the base cost of capital assets. Excess amounts will then reduce allowable deductions under section 11, and any balance carried forward to the next year of assessment.

NO DOUBLE-DIPPING

Double-dipping occurs when a taxpayer claims a tax deduction or allowance on expenses funded by a tax-exempt government grant.

To prevent this, the taxpayer should take caution not to claim deductions on expenses where the grant was exempt. If an exempt government grant is received, the corresponding expenditure funded by that the grant cannot be claimed as an income tax deduction. This expenditure must be added back for tax purposes.

For example, a government grant that is exempt in terms of section 12P may disqualify the taxpayer from claiming the 150% research and development deduction under section 11D of the Act. The portion of the research and development costs for which the government grant is not utilised may qualify for the 150% accelerated deduction.

Taxpayers must ensure compliance with these provisions to avoid penalties and non-compliance risks.

CONCLUSION

Exempting qualifying government grants from normal tax promotes effective economic development. Taxpayers should carefully consider if a government grant qualifies for exemption, and that associated expenditure is not claimed as an income tax deduction.

"Double-dipping occurs when a taxpayer claims a tax deduction or allowance on expenses funded by a tax-exempt government grant."

Mu'mina Moollagee, Elmien Theron & Walter Blake

Forvis Mazars in South Africa

Acts and Bills

- Income Tax Act 58 of 1962: Sections 11, 11D & 12P; Eleventh Schedule.

Tags: qualifying government grants; trading stock; double-dipping.

CEASING SA TAX RESIDENCE: TREATMENT OF ASSETS

For South Africans who are leaving to live overseas, it is not just a question of pack up and go, and breaking tax ties with the South African Revenue Service (SARS).

Ceasing South African tax residency to safeguard one's worldwide income from tax liability in South Africa is a significant step that comes with the stress of relocating and uncertainty around one's assets.

Questions about what happens to one's investments, properties, and policies can cause sleepless nights, because the answer is rarely straightforward. It depends on the specifics of each asset and situation.

The following concise guide can help expatriates navigate this complex process.

CAPITAL VS INCOME: UNDERSTANDING THE DISTINCTION

Proper planning starts with differentiating one's assets between capital and income. This distinction is crucial for determining how SARS and the South African Reserve Bank (the SARB) will treat them. Events like property sales and lump-sum retirement vehicle withdrawals are classified as **capital** in nature, while earnings such as rental income, dividends, or interest are classified as **income** in nature.

In addition, SARS will assess the origin and compliance of one's funds to ensure they are properly declared under a correct source. Misclassifying these can result in audits or rejected applications to cease tax residency, adding unnecessary stress to one's move.

OFFSHORE TRANSFERS: CAPITAL VS INCOME FUNDS

Keep in mind that the single discretionary allowance (SDA) of R1 million that South African residents can take out of the country in a calendar year, is not available for non-tax residents. For them, all capital offshore transfers require a SARS Approval International Transfer (AIT) Tax Compliance Status (TCS) PIN. On the other hand, income offshore transfers do not require SARS or SARB approval for amounts below R10 million. An annual Good Standing TCS PIN will be required for verification of one's tax compliance standing once a year.

Furthermore, expatriates can retain South African assets such as fixed properties, investments and policies until they are ready to transfer the proceeds offshore or for as long as they wish.

RETIREMENT AND PENSION PRODUCTS

Legislation which came into effect in March 2021 restricts the withdrawal of retirement and pension funds. Individuals must remain non-residents for at least three consecutive years post-cessation to access these funds. Authorised dealers (banks) may require further source verification documents prior to processing transfer of these funds offshore.

INHERITANCE FUNDS

Inheritance funds less than R10 million are freely transferable offshore without needing approval from SARS and the SARB once the estate is finalised. Inheritances over R10 million will require an AIT TCS PIN or a manual letter of compliance where the individual is no longer registered with SARS.

UNLISTED SHARES

As a non-resident, the SARB will allow classification of unlisted local shares as non-resident assets. The proceeds will be freely transferable offshore without the requirement to obtain an AIT TCS PIN from SARS or any SARB approval. The dividends from these shares will also be allowed to flow directly offshore without needing clearances.

The process of ceasing tax residency and transferring funds can be daunting, with numerous legal and compliance hurdles. Seeking professional assistance ensures that one's move abroad will be smooth and it will minimise unnecessary risks. Experts in expatriate tax and compliance can provide clarity and help taxpayers to focus on their new journey while they enjoy the benefit of the assets that they have acquired over time.

Lovemore Ndlovu

Tax Consulting SA

Tags: tax residency; single discretionary allowance (SDA); capital offshore transfers; Approval International Transfer (AIT) Tax Compliance Status (TCS) PIN; income offshore transfers; source verification documents; inheritance funds; unlisted local shares.

SOUTH AFRICA KUWAIT DOUBLE TAX TREATY

The October 2024 ratification of the protocol amending the double taxation agreement (DTA) between South Africa and Kuwait has far-reaching implications, particularly in relation to the tax treatment of dividends paid from South Africa.

The reach of the amendment to the dividend article is not limited to Kuwait, but also extends to the Netherlands and Sweden. This article focuses on the relevant amendment introduced by the protocol, its implications for taxpayers, and the broader context of international tax treaties.

BACKGROUND AND RATIFICATION

Unless a specific exemption or reduction applies, South Africa imposes dividends tax at a statutory rate of 20% on all dividends paid by South African companies. The rate at which dividends tax is levied may, however, be reduced by virtue of the application of a DTA, provided that prescribed administrative requirements are adhered to. For example, the original DTA between South Africa and Kuwait effectively granted an exemption from dividends tax for Kuwaiti shareholders who beneficially owned dividends declared by South African companies. This exemption extended to eligible Dutch and Swedish shareholders through the so-called "most favoured nation" (MFN) clauses in South Africa's DTAs with the Netherlands and Sweden, respectively, as confirmed by the Dutch Hoge Raad and a Cape Town tax court in 2019. However, with the ratification of the new South Africa and Kuwait protocol, this position has changed.

The original DTA between South Africa and Kuwait was signed on 17 February 2004 and came into force on 25 April 2006. This agreement provided a framework for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income between the respective countries. However, over the years certain provisions, particularly those related to the taxation of dividends, became points of contention and required renegotiation.

"Interestingly, SARS never appealed the tax court judgment. In retrospect, it appears that SARS and National Treasury rather focused their efforts on getting the Kuwait protocol ratified with the aim of closing this 'loophole' and of preventing taxpayers from 'exploiting' the MFN clause."

The protocol to amend the DTA was signed by the governments of South Africa and Kuwait on 17 December 2019 and 1 April 2021, respectively. However, despite the signing thereof, the protocol required ratification by both countries to come into effect. Kuwait took its time in this regard and only ratified the protocol on 18 September 2024, which was subsequently published by the South African Revenue Service (SARS) on 22 November 2024 with the date of entry into force being 2 October 2024.

DIVIDENDS TAXATION

One of the most far-reaching changes introduced by the protocol is the modification of the dividends article. As indicated, under the original DTA, Kuwaiti shareholders effectively enjoyed a 0% dividends tax rate, a benefit extended to Dutch and Swedish shareholders through the MFN clauses in South Africa's DTAs with Sweden and the Netherlands. The protocol, however, introduces a new structure for dividends taxation, as follows:

- A 5% tax rate on the gross amount of dividends if the beneficial owner is a company holding at least 10% of the capital of the company paying the dividends.

- A 10% tax rate on all other cases.

This change effectively removes the 0% dividends tax rate previously enjoyed by Kuwaiti, Dutch and Swedish shareholders, aligning the tax treatment more closely with South Africa's broader tax policy of levying a minimum of 5% dividends tax.

RETROACTIVE APPLICATION

A particularly contentious aspect of the protocol is its retroactive application. The protocol stipulates that its provisions will have effect from the date that dividends tax came into effect in South Africa, namely 1 April 2012. This retroactive application has understandably raised significant concerns among South African companies that have relied on the previous DTA provisions to not withhold dividends tax from dividends declared to qualifying shareholders since 2012. The retroactive nature of the protocol is likely to lead to legal challenges, as it may well go against the well-established principle of non-retroactivity.

The constitutionality of retroactive legislation was addressed in *Robertson and Another v City of Cape Town and Another; Truman-Baker v City of Cape Town* [2004]. The court acknowledged the challenges retroactive legislation poses to the rule of law, especially in criminal law. Although the Constitution does not expressly prohibit retroactive legislation, it can be deemed unconstitutional if it unreasonably or unfairly impairs individuals' ability to regulate their conduct according to the law.

"With the introduction of the new dividends tax rates, Kuwaiti, Dutch and Swedish shareholders will face increased tax liabilities on dividends paid by South African subsidiary companies."

In the Constitutional Court case of *Thistle Trust v Commissioner, South African Revenue Service* [2025] (judgment on 2 October 2024), the minority judgment, authored by Bilchitz AJ, emphasised the importance that laws must be rational, capable of being followed, and provide reasonable certainty, even if not perfect lucidity.

IMPLICATIONS FOR TAXPAYERS

With the introduction of the new dividends tax rates, Kuwaiti, Dutch and Swedish shareholders will face increased tax liabilities on dividends paid by South African subsidiary companies. This change may therefore necessitate a reassessment of existing investment structures.

In addition, the absurd retroactive application of the amendments, if left unchallenged and as is, may lead to potential historical financial exposure in terms of the underpayment of dividends tax and resultant penalties and interest.

TEST COURT CASE AND FINDINGS

A notable test court case that sheds light on the interpretation of the MFN clauses in DTAs is the Cape Town Tax Court judgment of *ITC 1925* 82 SATC 144, delivered on 12 June 2019. The case involved ABC (Pty) Ltd (the Taxpayer) and SARS, where the Taxpayer sought a refund of dividends tax overpaid based on the interpretation of the MFN clause in the SA/Netherlands DTA, read with the MFN clause in the SA/Sweden DTA and the SA/Kuwait DTA.

Despite that, the original SA/Kuwait DTA provided for a 0% dividends tax rate and even though the protocol with Kuwait was not yet in force, the South African government proceeded to implement the 5% dividends tax regime with effect from 1 April 2012.

A few months earlier on 18 January 2019, the Dutch Supreme Court passed down the much-anticipated Hoge Raad Judgment (17/04584) in favour of the taxpayer. The judgment considered the interpretation of the MFN clause in the double taxation agreement between South Africa and the Netherlands, dated 10 October 2005, as amended by the protocol dated 8 July 2008 (Dutch DTA). In finding in favour of the taxpayer, the judgment concluded that to the extent that any other DTA entered into by South Africa with any other country provided a more favourable dividends withholding tax rate than the Dutch DTA, that more favourable rate must automatically apply.

The MFN clause contained in the Dutch DTA contemplated that the automatic application of a more favourable rate should apply in respect of DTAs concluded after the Dutch DTA came into effect. However, the DTA concluded with Sweden on 25 December 1995 (as amended by the protocol wef 18 March 2012) (Sweden DTA) contained wording which extended its own MFN clause to retrospectively concluded DTAs. The result was that if either the Dutch DTA or the Sweden DTA were utilised, the most favourable dividends withholding tax rate contained in the Kuwait DTA could be applied, thereby resulting in a dividend withholding tax rate of 0%.

The tax court found in favour of the Taxpayer, ordering SARS to refund the overpaid dividends tax with interest and to pay the Taxpayer's costs, including the costs of two counsel. The court's decision was based on the clear provisions of the DTAs, which stipulated that if another state received preferential treatment, the same treatment must be extended to the Netherlands and Sweden. This judgment provided significant relief to many taxpayers engaged in similar disputes with SARS and highlighted the importance of adhering to the clear terms of DTAs.

Interestingly, SARS never appealed the tax court judgment. In retrospect, it appears that SARS and National Treasury rather focused their efforts on getting the Kuwait protocol ratified with the aim of closing this "loophole" and of preventing taxpayers from "exploiting" the MFN clause.

RELEVANCE OF THE JUDGMENT FOR FUTURE CASES

The tax court judgment on this topic underscores the importance of clear and unambiguous language in DTAs and the interpretive principle that the written terms of an agreement should prevail over the intentions of the parties or extrinsic evidence. This principle will continue to guide the interpretation of DTAs in South Africa, even in light of the new protocol. However, this should be understood in the context of the widely accepted purposive approach to interpretation as developed in *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012], where Wallis JA wrote the following:

> "Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors."

Furthermore, the tax court judgment gives an indication of how South African courts may handle disputes related to the retroactive application of tax treaties. Given the contentious nature of the retroactive application of the South Africa-Kuwait protocol, it is likely that similar legal challenges will arise.

CONCLUSION

The ratification of the South Africa-Kuwait protocol represents a pivotal development in the tax relationship between the two countries. The changes introduced by the protocol, particularly those related to dividends, have far-reaching implications for Kuwaiti, Dutch and Swedish investors in South African companies. It would be prudent for businesses and investors to reassess their tax positions, ensure compliance with the new provisions, and seek professional advice to navigate the evolving tax landscape. By staying informed and proactive, taxpayers can effectively manage the impact of these changes and continue to thrive in the dynamic international tax environment.

Dr Hendri Herbst & Neethling van Heerden

WTS Renmere

Double taxation agreements

- *Agreement between the Government of the Republic of South Africa and the Government of the State of Kuwait for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income* (original agreement signed on 17 February 2004 and came into force on 25 April 2006; GN 356 published in *GG* 29815 of 20 April 2007);
- *Protocol Amending the Agreement between the Government of the Republic of South Africa and the Government of the State of Kuwait for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.* Signed by the governments of South Africa and Kuwait on 17 December 2019 and 1 April 2021, respectively; Kuwait ratified the protocol on 18 September 2024; published by the South African Revenue Service on 22 November 2024; date of entry into force is 2 October 2024;
- *Convention between the Republic of South Africa and the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital* (10 October 2005); (GN 34 published in *GG* 31797 of 21 January 2009);
- *Protocol Amending the Convention between the Republic of South Africa and the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital* (8 July 2008) (GN 32 of 2009) (GN 34 published in *GG* 31797 of 21 January 2009);
- *Convention between the Republic of South Africa and the Kingdom of Sweden for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income* (signed on 24 May 1995 (GN 1985 published in *GG* 16890 of 22 December 1995));
- *Protocol Amending the Convention between the Republic of South Africa and the Kingdom of Sweden for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income* (signed on 7 July 2010 (GN 319 published in *GG* 35268 of 23 April 2012 – entry into force: 18 March 2012)).

Cases

- *Robertson and Another v City of Cape Town and Another; Truman-Baker v City of Cape Town* [2004] (5) SA 412 (C);
- *Thistle Trust v Commissioner, South African Revenue Service* [2025] (1) SA 70 (CC); CCT 337/22 [2024] ZACC 19 (2 October 2024);
- *ITC 1925* 82 SATC 144 (Cape Town Tax Court – delivered on 12 June 2019) (*ABC Proprietary Limited v The Commissioner for the South African Revenue Service*; (Case No 14287); [2019] JDR 1292);
- *Hoge Raad Judgment* [2018] (17/04584) (The Netherlands) (case number 15/01361);
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA); [2012] ZASCA 13.

Tags: double taxation agreement (DTA); "most favoured nation" (MFN) clauses; retroactive legislation; purposive approach to interpretation.

TRANSFER OF FUNDS OFFSHORE

An unsuspecting taxpayer faced a dilemma when he had to transfer money overseas, and found SARS had cancelled his Tax Compliance Status (TCS) PIN approval, a critical component for taxpayers who need to transfer funds internationally or engage in other cross-border transactions.

Without a TCS PIN approved by SARS cross-border financial transactions can be delayed and that can potentially damage the taxpayer's reputation with stakeholders.

SARS informed the taxpayer the TCS PIN approval was cancelled due to insufficient and outdated documentation. From the SARS notice it is clear that the taxpayer could have saved himself a headache and time by submitting accurate and timely information to the tax authority for securing and maintaining tax compliance approval.

Failure to meet SARS' stringent documentation and information standards can lead to application declines and cancellations, even after initial approval; taxpayers should therefore best ensure that SARS does not find them wanting.

IMPLICATIONS OF A CANCELLED TCS PIN

A cancellation can lead to:

- **Delays in financial transactions:** A cancelled TCS PIN means that the application must be resubmitted, delaying planned transactions.
- **Increased administrative burden:** Taxpayers must recompile documentation and navigate the reapplication process, which can be time-consuming.
- **Potential financial or reputational risks:** Delays or non-compliance could have financial consequences or impact the taxpayer's reputation with stakeholders.

COMMON REASONS WHY A TCS PIN MAY BE CANCELLED

Insufficient or inaccurate documentation

Avoid submitting incomplete or outdated supporting documents as SARS requires all documentation to be current to ensure accurate assessment. For example, in the case of the application referred to above, the financial statement provided (from a financial institution) was older than 14 days.

Approval issued in error

Occasionally, SARS may identify an error in an approval issued, leading to it being revoked. While this may seem unfair, it highlights the importance of ensuring that all aspects of the application meet compliance requirements before submission.

Non-adherence to specific guidelines

Each TCS PIN application type – whether for international transfer or other purposes – has unique documentation and procedural requirements. Failing to meet these can result in rejection or cancellation.

HOW TO PREVENT A TCS PIN CANCELLATION

Ensure documents are up to date

Financial statements and other required documentation should not be older than 14 days at the time of submission. Taxpayers should regularly update their records to ensure compliance.

Understand the requirements

One should familiarise oneself with the specific requirements for a TCS PIN application type. SARS provides detailed guidelines, and professional advisors can offer additional clarity and guidance.

Conduct a pre-submission review

Double-check all documentation and information for accuracy and completeness. Address any discrepancies before submission.

Consult a tax professional

Working with a professional tax consultant or advisor can help ensure that one's application meets SARS' requirements and minimise the chances of rejection or cancellation.

WHAT TO DO IF ONE'S TCS PIN IS CANCELLED

If a TCS PIN is cancelled, one should –

- carefully review the notice from SARS to identify what went wrong;
- address any missing or outdated documents and ensure that all information is correct; and
- resubmit the application with updated documentation and a clear explanation.

CONCLUSION

A TCS PIN cancellation can be frustrating; however, it is often avoidable with proper preparation and attention to detail. Staying informed, maintaining updated records, and seeking professional advice when needed can go a long way in ensuring a smooth application process.

Tax compliance is a shared responsibility. Taking continued proactive measures can save significant time and reduce stress.

Lovemore Ndlovu

Tax Consulting SA

Tags: Tax Compliance Status (TCS) PIN; tax compliance; pre-submission review.

OBJECTING TO ADDITIONAL ASSESSMENTS

When a taxpayer is aggrieved by an assessment raised by the South African Revenue Service (SARS), the first step in disputing this is to file an objection under section 104 of the Tax Administration Act, 2011 (the TAA).

In the December 2024 case of *X and Another v Commissioner for the South African Revenue Service,* [2024], the tax court dealt with the importance of complying with the requirements of Rule 7(2)*(b)* of the dispute resolution rules promulgated under section 103 of the TAA (the Rules) in order for an objection to be valid. The tax court also clarified some of these prescribed requirements.

BACKGROUND

The taxpayers were a neurologist (Dr X) and his medical practice (Dr X Inc), of which Dr X was the public officer. Following a lengthy back and forth between the taxpayers and SARS during which SARS repeatedly requested certain financial information from the taxpayers in order to conduct an audit on the taxpayers' income tax and value-added tax affairs, SARS issued both taxpayers with estimated assessments based on the limited information which SARS had in its possession.

Although it makes for interesting reading, the minutiae of the correspondence between the taxpayers and SARS leading up to the estimated assessments are not relevant to the tax court's final decision. Suffice to say that the taxpayers ultimately did not provide the information requested by SARS. The upshot was that, in addition to the estimated tax assessed, SARS levied large understatement penalties on both taxpayers, citing intentional tax evasion and obstructive behaviour on the part of the taxpayers as the reasons for imposing the penalties.

Aggrieved by the estimated assessments, the taxpayers filed an objection with SARS. This objection was declared invalid by SARS, and a notice to this effect was provided to the taxpayers.

Although the taxpayers initially intended to challenge SARS' declaration of invalidity in the tax court, they came to an agreement with SARS that they would file a second objection. However, SARS also declared this second objection invalid for lack of compliance with Rule 7(2)*(b)* of the Rules. It is the validity of this second objection which became the subject of the dispute in the tax court.

In short, SARS' reasons for treating the taxpayers' second objection as invalid were that –

- the taxpayers' grounds of objection were contradictory and misleading;
- the taxpayers failed to provide evidence to support their reasons for why certain amounts should not be included in their gross incomes; and
- the taxpayers failed to provide the documents necessary to substantiate their grounds of objection.

It is worth noting that the documents which SARS alleged were missing from the taxpayers' second objection were the documents which SARS had originally requested from the taxpayers and which the taxpayers ultimately did not provide, leading to the imposition of understatement penalties.

Disagreeing with SARS' decision to treat their second objection as invalid, the taxpayers approached the tax court under Rule 52(2)*(b)* for an order declaring their second objection to be valid for purposes of Rule 7(2)*(b)*. It was this request by the taxpayers that the tax court was called upon to answer.

"In many instances, an additional assessment will be raised by SARS due to a factual (as opposed to legal) misunderstanding between a taxpayer and SARS, there having been no intentional tax evasion on the part of the taxpayer concerned."

REQUIREMENTS FOR A VALID OBJECTION

Section 106(1) of the TAA provides that: "SARS must consider a valid objection in the manner and within the period prescribed under this Act and the rules."

Giving further content to this section, Rule 7(2)*(b)* provides that in order for an objection to be valid, it must, *inter alia*:

> "(i) [specify] the part or specific amount of the disputed assessment objected to;
>
> (ii) [specify] which of the grounds of assessment are disputed; and
>
> (iii) [submit] the documents required to substantiate the grounds of objection that the taxpayer has not previously delivered to SARS for purposes of the disputed assessment".

In the event that SARS determines that an objection is invalid, then Rule 52(2) allows a taxpayer to:

> "apply to a tax court under this Part –:
>
> [...]
>
> *(b)* if an objection is treated as invalid under rule 7, for an order that the objection is valid".

TAX COURT DECISION

Reading section 106(1) of the TAA with Rule 7(2)*(b)*, the tax court stated that an objection which complies with the three requirements set out in Rule 7(2)*(b)* is a prerequisite for that objection being adjudicated on its merits by SARS. Given this, the tax court had to compare the taxpayers' objection in this case to those three requirements in order to assess whether it was valid or not.

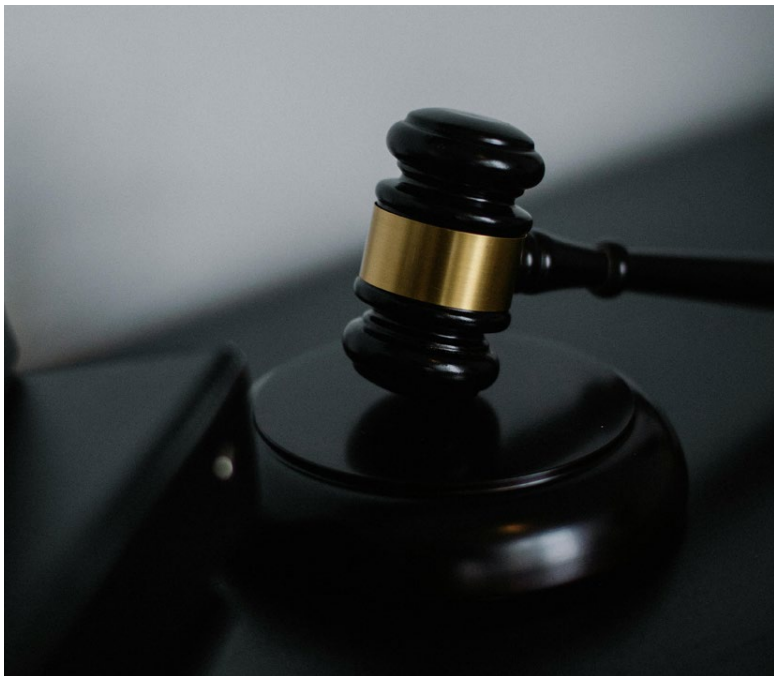
It was when considering the requirement in Rule 7(2)*(b)*(iii) that the tax court found that the taxpayers' objection became unstuck. The tax court considered that the documents submitted by the taxpayers with their objection did not support the taxpayers' grounds of objection with sufficient detail so as to be of evidentiary value. This was mainly as a result of these supporting documents being an aggregation of the taxpayers' financial information, and not the detailed records maintained by the taxpayers on their accounting system and which SARS had previously requested from the taxpayers on multiple occasions. On this basis, the tax court agreed with SARS that the taxpayers' second objection was invalid.

In coming to this conclusion, the tax court was unpersuaded by the taxpayers' arguments that the requirement in Rule 7(2)*(b)*(iii) merely means a taxpayer must submit documents which it (the taxpayer) considers necessary to support its grounds of objection, and in the event that SARS finds these documents insufficient, SARS should in any event exercise its discretion in favour of the taxpayer and find the objection to be valid. The tax court agreed with SARS that these arguments go against the ordinary meaning of the words used in Rule 7(2)*(b)*(iii).

When dealing with these arguments, however, the tax court also set out the importance of the validity requirements. The essential goal of an objection is to place SARS in a position to properly determine the merits of the objection. Therefore, where an objection is imprecise or lacks the specificity necessary for SARS to do this, then the tax court found that such an objection will be invalid.

As noted by the tax court, this is also consistent with the overall purpose of the TAA, which is to provide for the effective and efficient collection of tax. As SARS relies on public funds and acts in the general public interest, it is imperative that a taxpayer sets out their grounds of objection with sufficient specificity, and supported with the relevant documentary evidence, so that SARS can engage with, and come to a decision on, the merits of the objection without wasting resources.

"The upshot was that, in addition to the estimated tax assessed, SARS levied large understatement penalties on both taxpayers, citing intentional tax evasion and obstructive behaviour on the part of the taxpayers as the reasons for imposing the penalties."



As was clear from the tax court's decision, this reasoning must inform a taxpayer's understanding of what constitutes a valid objection. In short, it is not merely enough for supporting documents to be provided by a taxpayer when lodging an objection. Rather, these documents must evidence, in adequate detail, the facts supporting a taxpayer's grounds of objection. As the tax court put it, a taxpayer is not entitled to play possum when objecting to an assessment.

CONCLUSION

The reasoning provided by the tax court when coming to its decision in this case makes two points clear. Firstly, that it is a requirement for SARS to consider an objection on its merits for that objection to be valid, and secondly, that the determination of whether a taxpayer's objection is in fact valid does not lie within the subjective view of that taxpayer.

What is less clear from the tax court's decision is whether the discretion afforded to SARS to determine the validity of an objection is also not based on SARS' subjective view. Arguably, although the decision lies with SARS, this question of whether a taxpayer's objection is valid or not should be determined on an objective basis. Deciding otherwise may result in an abuse of the dispute resolution process by either party – if the determination lies within the taxpayer's subjective view, then it can force SARS to consider an objection on its merits without the necessary information at its disposal (as the tax court pointed out), or if the determination lies within SARS' subjective view, then it can prevent a taxpayer's dispute from reaching the tax court, thus forcing the taxpayer to waste resources on an application in terms of Rule 52(2)*(b)*.

It should be kept in mind that SARS approaches a tax dispute "blind", and it is the taxpayer that has full knowledge of the background facts. As pointed out by the tax court, this is what leads to the requirement in Rule 7(2)*(b)*(iii) being present. Therefore, when objecting to an additional assessment, it is incumbent on a taxpayer to provide SARS with the information and documents objectively necessary to establish an understanding of the factual background and to assess the grounds of objection in light thereof.

In many instances, an additional assessment will be raised by SARS due to a factual (as opposed to legal) misunderstanding between a taxpayer and SARS, there having been no intentional tax evasion on the part of the taxpayer concerned. Whether this case is one of those instances is unknown; however, it does point to the importance of providing SARS with the information and documents it will need when assessing the merits of an objection so that any areas of contention which can be easily explained are dispensed with and only the core elements of the dispute (if there are any remaining) can be dealt with.

A taxpayer engaging experienced advisors from early on in the tax dispute process can assist with this, as these advisors can help the taxpayer when making submissions to SARS. This will ensure the dispute is dealt with in the most efficient manner possible. Moreover, in the event the dispute moves to the tax court, this will ensure the taxpayer's case has a solid grounding and only the core issues remain in dispute.

Nicholas Carroll

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 103, 104 & 106(1).

Other documents:

- Rules 7 (emphasis on subrule (2) & (2)*(b)*(iii)) & 52(2)*(b)* ((iii)) of the dispute resolution rules promulgated under section 103 of the Tax Administration Act, 2011.

Cases

- *X and Another v Commissioner for the South African Revenue Service* (52/2023) [2024] ZATC 12 (2 December 2024).

Tags: dispute resolution rules; estimated assessments; intentional tax evasion; declaration of invalidity; valid objection.

THE IMPORTANCE OF PRESCRIPTION PERIODS

The South Africa Revenue Service (SARS) has the ability to issue revised assessments in terms of the Tax Administration Act, 2011 (the TAA). In this regard, SARS is bound by provisions with regard to the period in which SARS can issue revised assessments. This period is referred to as the "period of limitations for issuance of assessments" or the so-called "prescription period".

WHAT IS A PRESCRIPTION PERIOD?

The Oxford English Dictionary defines a "prescription period" as the period of *"...a recommendation that is authoritatively put forward..."*, and in this instance, the period of time after which an assessment has been issued, in which SARS can issue a revised assessment in respect of an original, reduced or additional assessment.

Section 99(1) of the TAA prescribes the relevant prescription periods that are applicable.

An assessment may not be made in terms of Chapter 8 of the TAA:

- Three years after the date of assessment of an original assessment;
- Five years after the date of assessment of an original assessment if made by way of self-assessment by the taxpayer or if no return is received by SARS;
- Five years from the date of the last payment of tax for the tax period, or effective date if no payment was made in respect of the tax for the tax period, in the case of a self-assessment for which no return is required;
- In the case of:
  - An additional assessment, if the tax which should have been assessed was not assessed;
  - A reduced assessment if the preceding assessment was made in accordance with the practice generally prevailing at the date of that assessment;

- A tax for which no return is required, if the payment was made in accordance with the practice generally prevailing at the date of that payment; or

- In respect of a dispute that has been resolved under Chapter 9 (Dispute resolution) of the TAA.

The prescription periods above will not apply to the extent to which section 99(2) applies. In this regard, specific reference is made to section 99(2)*(c)*, which states that section 99(1) will not apply where SARS and a taxpayer so agree prior to the expiry of the limitation period.

"Taxpayers should remember that SARS only has a certain period in which a revised assessment can be issued. Where a taxpayer reaches an agreement with SARS that the prescription period will not apply, the agreement will be valid even if it is not in writing or signed by the parties to the agreement."

INTERPRETATIVE GUIDANCE

In *South African Custodial Services (Louis Trichardt) (Pty) Ltd v Commissioner for the South African Revenue Service* (A291/2022), two issues were raised. The first issue was whether SARS is bound by the contractual Anti-Prescription Agreement (the agreement) it had concluded with the appellant. The agreement entitled SARS to issue reduced assessments in respect of the 2013 to 2016 years of assessment on the same basis that Cloete J had ordered in respect of the 2005 to 2012 years of assessment. SARS contended this was the "Final Decision" as contemplated in section 100 of the TAA.

The agreement required the parties to comply with section 99(2)*(c)*. In this instance, the agreement required both parties to give prior written consent to any further extensions. With regard to the agreement with SARS, the conclusion reached was that an agreement need not be signed and in writing; there merely needs to be an agreement prior to the expiry of the limitation period.

The second issue is whether the period of limitation for the issuance of assessments contained in section 99(1)*(a)* expired in relation to the 2013 to 2016 years of assessment.

It was held that the final order granted by Cloete J in the High Court Case constituted a "Final Decision" as contemplated in the agreement. In terms of the agreement, the parties need to comply with section 99(2)*(c)*, which required the parties to agree and not that the agreement be signed and in writing.

South African Custodial Services (Louis Trichardt) (Pty) Ltd's argument that it is entitled to "immunity" from additional assessments as the agreement was signed by SARS after the limitation period is, therefore, invalid. This means that the provisions of section 99(2)*(c)* were complied with as SARS did not reject the pre-signed agreement. As a result, the appeal was upheld and SARS had to pay the appellant's costs, including the costs of two counsel.

CONCLUSION

It is important to take note of the date on which an assessment is issued. This date triggers the commencement of the prescription period.

Taxpayers should remember that SARS only has a certain period in which a revised assessment can be issued. Where a taxpayer reaches an agreement with SARS that the prescription period will not apply, the agreement will be valid even if it is not in writing or signed by the parties to the agreement. There merely needs to be an agreement prior to the expiry of the limitation period.

Jean-Jacques Blignaut, Elmien Theron & Walter Blake

Forvis Mazars in South Africa

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 99(1) & (2)*(c)* & 100.

Other documents:

- Oxford English Dictionary: Definition of "prescription period".

Cases

- *South African Custodial Services (Louis Trichardt) (Pty) Ltd v Commissioner for the South African Revenue Service* (A291/2022) [2024] JDR 4867 (GP).

Tags: prescription period; self-assessment; additional assessment; reduced assessment; practice generally prevailing.

VDP AGREEMENTS: THE *MEDTRONIC* DECISION

The South African Revenue Service (SARS) has issued several media releases encouraging taxpayers to voluntarily comply with their tax obligations. As part of this messaging, SARS has often encouraged taxpayers to also declare past undeclared income, using the voluntary disclosure programme (VDP).

An example towards the end of 2024 was where SARS encouraged crypto asset traders and investors to declare their undeclared investment and trading income under the VDP.

While a successful VDP will result in the remission of understatement penalties (USPs), subject to some exceptions, and the remission of administrative non-compliance penalties that would normally be imposed, amongst other things, VDP relief does not extend to the remission of interest. In other words, when a taxpayer's VDP application is approved, the taxpayer will be liable for tax on the undeclared income, plus interest. Pursuant to the approval of a VDP application, a taxpayer and SARS would conclude a VDP agreement (VDA). As part of the VDP process, SARS would usually also issue additional assessments, to give effect to a VDA, reflecting the additional tax and interest payable. However, as both income tax and value-added tax (VAT) legislation contain separate provisions regarding the remission of interest, an interesting question arose – can the interest imposed pursuant to the granting of VDP approval, be remitted under these separate provisions?

"A taxpayer who enters into a VDA does so with full awareness that interest on late VAT payments is mandatory and non-negotiable under section 39(1)*(a)*(ii) of the VAT Act."

In *Commissioner, South African Revenue Service v Medtronic International Trading S.A.R.L.* [2025] *(Medtronic)*, decided by the Constitutional Court (CC) on 20 December 2024, this question was answered in SARS' favour, in the context of VAT. The central question was whether a taxpayer who had concluded a VDA with SARS could seek remission of interest in terms of section 39(7) of the Value-Added Tax Act, 1991 (the VAT Act), after that taxpayer had agreed to pay the interest in terms of the VDA.

FACTS

Medtronic, a Swiss company, fell victim over the course of many years to a substantial scheme of embezzlement at the hands of an employee. This resulted in significant underpayments of VAT to SARS. Upon discovery of the scheme, Medtronic lodged a VDP application with SARS' VDP Unit.

During negotiations, Medtronic requested a waiver of interest arising from the VAT underpayments. SARS responded that it lacked the power to waive interest under the VDP, as such power was not provided by the VDP provisions in the Tax Administration Act, 2011 (the TAA). Electing to continue pursuit of the VDP relief, Medtronic agreed to pay approximately R457 million in terms of the VDA concluded with SARS. The amount included interest that was not remitted.

After concluding the VDA with SARS, Medtronic approached SARS requesting remission of the interest under section 39(7) of the VAT Act, which provides for the remission of interest on VAT underpayments in certain circumstances. SARS refused to consider the request, stating that section 39(7) of the VAT Act did not apply to VDAs. The rules of the VDP are set out in sections 225 to 233 of the TAA.

HIGH COURT AND SUPREME COURT OF APPEAL (SCA) DECISIONS

In response to SARS' decision, Medtronic brought a successful application in the Gauteng Division of the High Court, Pretoria, seeking –

- a declarator that sections 225 to 233 of the TAA do not prohibit a request for interest remission in terms of section 39(7) of the VAT Act; and
- an order reviewing and setting aside SARS' refusal to consider Medtronic's request.

On appeal to the SCA, the three-to-two majority took the view that it was not called upon to determine "the issue whether section 39(7) finds application in circumstances where SARS and a taxpayer have concluded a [VDA]", but that "all we are called upon to decide is whether SARS was justified in law to refuse even to consider Medtronic's request by virtue of such request having been made subsequent to the conclusion and implementation of the [VDA]."

The majority held that "SARS was required to entertain the application for remission and to consider and adjudicate it on its merits", thereby dismissing SARS' appeal.

The minority judgment of the SCA, however, took a more interpretative approach, which would be subsequently echoed in the unanimous judgment of the Constitutional Court. The SCA's minority judgment noted, amongst other things, the following three purposes of the VDP:

- The principal purpose of the VDP is to have an agreement whose obligations are enforceable in the ordinary course like any other contractual obligations.
- The second purpose is that the VDA obviates the need for SARS to engage in investigation and auditing processes in order to raise an assessment.
- The third purpose is to incentivise disclosure by taxpayers of defaults otherwise unknown to SARS by assuring taxpayers that SARS will be bound by the outcome of the process.

The SCA minority held that the VDA is the centrepiece of the VDP, and to permit a taxpayer to seek remission of interest which was already incorporated in the tax debt due agreed upon in the VDA would undermine the legal consequences that attach to the conclusion of a VDA.

THE CONSTITUTIONAL COURT'S JUDGMENT

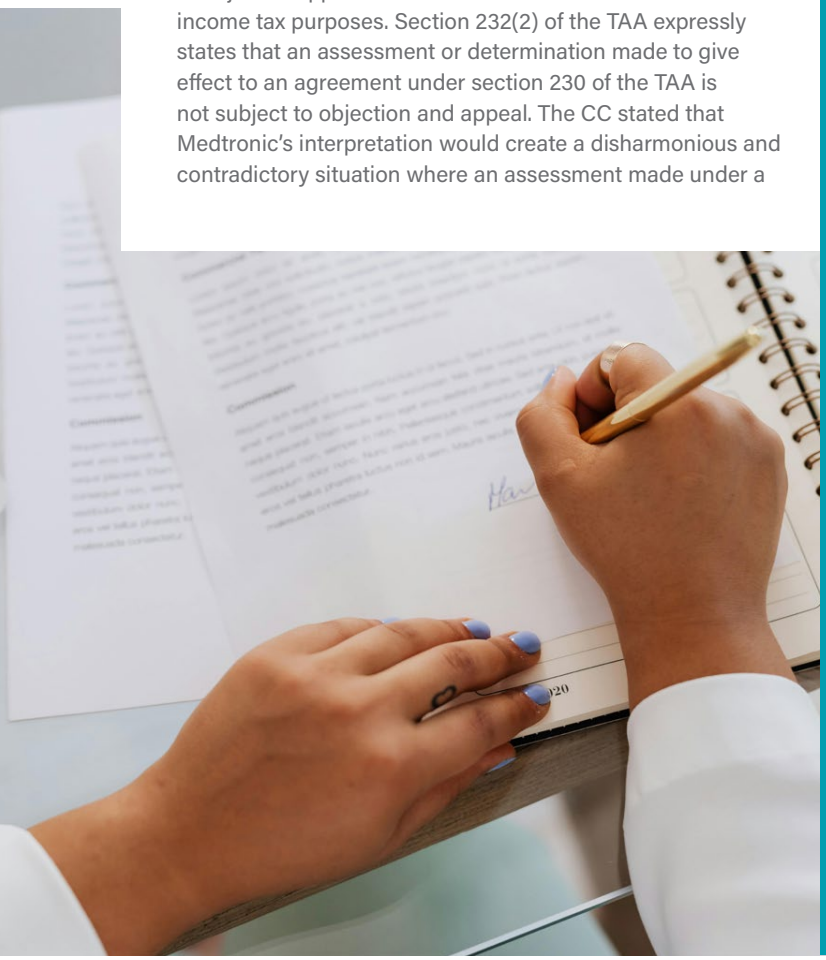
The CC disagreed with and overturned the SCA majority's decision. It disagreed that the issue for decision was whether SARS could in law not even consider Medtronic's request for remission after conclusion of a VDA.

The CC observed that "[i]f there is no power to decide the request for remission of interest under section 39(7) of the VAT Act post conclusion of a VDA, there is no point in considering the request."

It followed that "the real question can only be whether SARS enjoys the section 39(7) remission power post conclusion of a VDA".

The CC found that allowing an interest remission after the conclusion of a VDA in terms of which interest is payable would be glaringly absurd, for several reasons, including the following:

- A taxpayer who enters into a VDA does so with full awareness that interest on late VAT payments is mandatory and non-negotiable under section 39(1)*(a)*(ii) of the VAT Act.
- The TAA's silence on remission of interest in terms of section 39(7) of the VAT Act does not mean that interest remission post conclusion of the VDA is permitted.
- VDAs are legally binding agreements that must be honoured by both parties thereto in accordance with the trite principle of *pacta sunt servanda*. As the agreement to pay interest is an integral component of a VDA, permitting a remission of interest after a VDA has been concluded would undermine the legal consequences attaching to the VDA as a whole.
- Examining the legislative history of the VDP, and with specific reference to the Memorandum on the Objects of the Tax Administration Bill, 2011, the CC contrasted the previous and current VDP dispensations. The current dispensation's silence on interest remission as opposed to the prior dispensation does not necessarily mean that interest remission is now governed by section 39(7) of the VAT Act (as contended by Medtronic). Rather, it means that the legislature intentionally and explicitly excluded the possibility of relief in respect of interest within the VDP framework.
- Section 89*quat*(3) of the Income Tax Act, 1962 (the Act), relates to the remission of interest in the context of income tax. With reference to this provision, the CC held that if Medtronic's interpretation was correct, a taxpayer could bypass the finality of a VDA, as laid out in section 232(2) of the TAA, by using section 89*quat*(3) of the Act to object or appeal a decision on interest remission for income tax purposes. Section 232(2) of the TAA expressly states that an assessment or determination made to give effect to an agreement under section 230 of the TAA is not subject to objection and appeal. The CC stated that Medtronic's interpretation would create a disharmonious and contradictory situation where an assessment made under a VDA could not be appealed, but a decision on remission of interest from that assessment could be.



CONCLUSION

While the CC's decision is clear and well-reasoned, it highlights the limitations offered by the VDP. The unfortunate outcome is that there is no relief from interest payable, irrespective of the facts. In *Medtronic*, the amount of approximately R457 million was payable to SARS due to the intentional unlawful conduct of one employee, including a substantial amount of interest that was not remitted. Although the capital VAT would have still been payable were it not for the employee's conduct, no interest would have been payable. The judgment notes that the amount of R457 million also includes USPs, but does not indicate whether all USPs were remitted or whether some USPs were payable. The prejudice suffered by *Medtronic* due to one employee's conduct is thus likely to be substantial.

The judgment in *Medtronic* makes it clear that once a VDA is concluded, it constitutes a final agreement, and taxpayers cannot seek to renegotiate the terms thereof through subsequent requests. In coming to its conclusion, the CC provided several reasons. The decision also underscores the importance of harmonious interpretation of tax legislation and reinforces the principle of *pacta sunt servanda*, that is, agreements must be adhered to.

Taxpayers must carefully consider all aspects of their tax liability, including interest, before applying for VDP relief and entering into a VDA. The ruling serves as a reminder for tax professionals to thoroughly advise their clients on the implications of the VDP.

Dewald Pieterse & Louis Botha

WTS Renmere

Acts and Bills

- Income Tax Act 58 of 1962: Section 89*quat*(3);
- Value-Added Tax Act 89 of 1991: Section 39(1)*(a)*(ii) & (7);
- Tax Administration Act 28 of 2011: Sections 225 to 233 (voluntary disclosure programme (VDP) provisions) – specific reference to sections 230 and 232(2).

Other documents:

- Memorandum on the Objects of the Tax Administration Bill 11B of 2011.

Cases

- *Commissioner, South African Revenue Service v Medtronic International Trading S.A.R.L.* [2025] (2) SA 337 (CC); [2024] ZACC 26 (decided by the Constitutional Court on 20 December 2024).

Tags: voluntary disclosure programme (VDP); understatement penalties (USPs); undeclared income; additional assessments; remission of interest.

DIMINUTION IN THE VALUE OF CLOSING STOCK

In the world of tax compliance, accurately valuing closing stock is crucial, especially for businesses dealing in inventory that may lose value over time.

Section 22(1)*(a)* of the Income Tax Act, 1962 (the Act), addresses this by allowing businesses to reduce the value of closing stock for tax purposes when the value has declined. This reduction, known as "diminution in value", generally allows for a fair reflection of unrealised inventory losses, though it is tightly regulated to avoid tax manipulation.

SARS issued a Draft Interpretation Note on the Diminution in the Value of Closing Stock on 22 November 2024 (the Draft Note), which, once finalised, will replace Practice Note 36 and provide further guidance on SARS' interpretation of this important topic.

WHAT IS MEANT BY DIMINUTION IN THE VALUE OF CLOSING STOCK?

Closing stock refers to any unsold inventory held by a business at the end of a tax year, which must be included in the calculation of taxable income for that year. Section 22(1)*(a)* enables businesses (other than farmers) to adjust the cost of closing stock if the value of the closing stock (not being financial instruments, which are included in taxable income at cost) has diminished below cost due to specific reasons, such as:

- **Physical damage:** When goods are physically damaged, their utility and market appeal decrease, often requiring a reduced valuation. Common causes include damage during transportation or exposure to harmful elements.
- **Deterioration:** Some inventory may decline in condition or quality over time, such as food products nearing their expiration dates. This can lower the market value.
- **Fashion and trends:** Goods that follow seasonal fluctuations or technological innovation, like clothing or electronics, may quickly lose value as newer models emerge. In these cases, businesses can claim a diminution if they demonstrate that unsold stock is no longer as marketable as it was originally.
- **Market value decrease:** Economic forces may sometimes lower the value of items, as with currency fluctuations affecting imported goods or an oversupply situation. If these market changes result in a reduction of the value to below cost, a business may claim the diminution.

Importantly, any diminution below cost must be documented and substantiated to the satisfaction of the Commissioner, to show that it reflects a just and reasonable "loss".

KEY CRITERIA FOR CLAIMING DIMINUTION

The Act does not allow businesses to freely undervalue stock. SARS confirms in the Draft Note that an item-by-item or category-based approach is required, where each instance of reduction in value must be supported by clear documentation. The Draft Note also sets out key timing and disclosure guidelines:

- **Timing of diminution:** Only events affecting stock's value that have already occurred by year-end or events that are reasonably certain to occur in the following tax year, may be used to justify diminution. This backward-looking approach is designed to prevent speculative deductions.

- **Disclosure requirements:** Full transparency is required for any diminution claims. This includes providing details of the diminished stock, valuation methods and reasons for the reduction in value in the relevant tax return. This information helps the Commissioner exercise his discretion in respect of each claim.

LEGAL PRECEDENTS AND INTERPRETATIONS

The Supreme Court of Appeal (SCA) in *Commissioner, South African Revenue Service v Volkswagen South Africa (Pty) Ltd* [2019] and in *Commissioner, South African Revenue Service v Atlas Copco South Africa (Pty) Ltd* [2020] reiterated the principles underlying section 22(1)*(a)*. In these cases, the SCA emphasised that cost – rather than anticipated market value or net realisable value (NRV) used in accounting – serves as the benchmark for determining any diminution. These cases further clarified that diminution claims should be based only on reductions in value that have occurred or are reasonably certain to occur by year-end, eliminating the option to factor in speculative future losses.

PRACTICAL IMPLICATIONS FOR BUSINESSES

Businesses that carry substantial inventories – particularly those in industries prone to seasonal shifts, technological advancements or frequent handling – should be particularly mindful of how they approach stock valuation for tax purposes. By rigorously documenting stock conditions and market factors affecting value, businesses can make valid diminution claims without inviting tax disputes.

In summary, section 22(1)*(a)* offers a balanced approach to valuing closing stock in a way that reflects the commercial reality of a business while maintaining the integrity of the tax base. This provision allows businesses to reduce closing stock values in certain cases, provided that the Commissioner can be satisfied that a diminution in value has occurred.

Taxpayers should be mindful of the unique disclosure requirements of such claims (in addition to the *onus* of proof generally resting on them).

"SARS issued a Draft Interpretation Note on the Diminution in the Value of Closing Stock on 22 November 2024 (the Draft Note), which, once finalised, will replace Practice Note 36 and provide further guidance on SARS' interpretation of this important topic."

Vuyolwethu Langa

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 22(1)*(a)*.

Other documents:

- Draft Interpretation Note on the Diminution in the Value of Closing Stock (issued on 22 November 2024);
- Practice Note 36 (Income Tax: Valuation of trading stock (13 January 1995)).

Cases

- *Commissioner, South African Revenue Service v Volkswagen South Africa (Pty) Ltd* [2019] (2) SA 362 (SCA); [2018] ZASCA 116); 81 SATC 24;
- *Commissioner, South African Revenue Service v Atlas Copco South Africa (Pty) Ltd* [2020] (4) SA 61 (SCA); 82 SATC 116 (SCA).

Tags: tax compliance; diminution in value; closing stock.

BENEFICIARIES WITH VESTED RIGHTS TRUST AND THE CONDUIT PRINCIPLE

From an income tax point of view, a trust is a conduit with respect to income derived by the trustees.

A 2023 amendment to the Income Tax Act, 1962, added a further limitation to the conduit principle, and this article considers the impact of this amendment on trusts where beneficiaries have vested rights to income. [*Editorial note*: This article was first published in ASA (September 2024).]

INTRODUCTION

Section 25B of the Income Tax Act, 1962 (the Act), governs the taxation of trusts and beneficiaries of those trusts. It is generally accepted that this provision contains the codification of the conduit-pipe principle that applies to the taxation of trust income. Section 25B(1) applies to all amounts (other than an amount of a capital nature which is not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule) "received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust."

Prior to its amendment in 2023, the deeming effect was:

> "... to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust."

In 2023, this was amended as follows by section 29(1)*(a)* of Act 17 of 2023:

> "... to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary, who is a resident and has a vested right to that amount during that year, be deemed to be ..."

It was explained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2023 that the purpose of the amendment was to limit the flow-through principle only to beneficiaries who are resident in South Africa. This raises various concerns: one is whether this restriction also applies to non-resident beneficiaries of trusts who acquired a vested right to income many years ago, for example in a testamentary trust. Another concern is whether it applies to trusts that are used as investment vehicles where beneficiaries, as investors, acquire vested rights to the trust's assets and its income in exchange for contributing capital to the trust. The trustees do not have any discretion with regard to income or capital. If the limitation indeed applies to these investment vehicles, it may significantly distort the investment yields for all investors involved if any beneficiaries are non-resident investors. This is the question that is considered in this article.

NATURE OF A TRUST

It is common cause that where a trust owns property, the trustee does not personally hold (or own) the property, but it is held in trust for the benefit of the beneficiaries of the trust. The same applies when a trustee receives income; the receipt will then be for the benefit of the beneficiaries of the trust. It was this relationship that prompted Chief Justice Stratford, in *Armstrong v Commissioner for Inland Revenue* [1938], to describe the relationship between a trustee who held shares in a company and the beneficiary of the trust as follows:

> "... it is manifest that in the truest sense the beneficiary derives his income from the company, for that income fluctuates with the fortunes of the company and the trustee can neither increase nor diminish it, he is a mere 'conduit pipe'."

This relationship remains intact in the Trust Property Control Act, 1988, which codified the common law understanding of a trust into law. It defines a "trust" as –

> "... the arrangement through which the ownership in property of one person [the founder of the trust or the donor] is by virtue of a trust instrument made over or bequeathed –
>
> *(a)* to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument [the trust deed] for the benefit of the person or class of persons [the beneficiary or beneficiaries] designated in the trust instrument [the trust deed] ..."

Simply put, a trust is a written arrangement whereby property is held by the trustees of the trust for the benefit of the beneficiaries of the trust.

"Simply put, a trust is a written arrangement whereby property is held by the trustees of the trust for the benefit of the beneficiaries of the trust."

DEVELOPMENT OF THE CONDUIT-PIPE PRINCIPLE

The conduit-pipe principle has been part and parcel of the taxation of trusts since the *Armstrong* case. In November 2022, Judge Hughes, in *Commissioner, South African Revenue Service v The Thistle Trust* [2022], said that in "*Armstrong* ... the conduit-pipe principle was discussed for the first time. The principle became entrenched in our law in ... *Rosen* ...".

The conduit principle was, however, initially not dealt with in the tax legislation.

As indicated earlier, it was Chief Justice Stratford who in April 1938 in *Armstrong* said that a trustee is a mere "conduit pipe". [*Authors' note*: Judges De Villiers, De Wet, Tindall and Feetham concurred. This was long before the current Income Tax Act took effect.]

The facts in the *Armstrong* case were relatively complex, with Mrs Armstrong initially having a vested right to all the income in the estate of her late husband, subsequently ceding that right to her three daughters, who in turn ceded the right to a trust in terms of which Mrs *Armstrong* then was entitled to receive an annuity and other income from the trust. It is not all that clear from the facts, but it appears that the daughters' rights to income were conditional. The judgment suggests that applying, in that case, exemptions on a basis other than considering who the person beneficially entitled to the income (ie, without regard to the conduit-pipe principle) would render results such as double taxation, which does not accord with the scheme of the Act.

In *Secretary for Inland Revenue v Rosen* [1971] the issue before the court was whether dividends were received by or accrued to or in favour of a beneficiary for purposes of an exemption from normal tax. In this instance the beneficiaries did not have an unconditional right to the income. Judge Trollip said that "*Armstrong's* case in my view authoritatively established the conduit principle for general application in our system of taxation in appropriate circumstances". He then explained the conduit principle as follows:

> "... a trust deed may endow the trustee with a discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think ... that the dividends might then lose their identity and character as dividends, so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit-pipe had turned itself off at the relevant time. But if he decides on the former, i.e. to pass the dividends on to the beneficiary, the condition suspending the beneficiary's entitlement thereto is fulfilled, and they would constitute dividends in his hands in the same way as if he had been originally entitled to them unconditionally under the trust deed, i.e. as if the conduit-pipe had always been open ..."

As to the reasoning for the conduit-pipe principle, Judge Trollip said:

> "The principle rests upon sound and robust common sense; for, by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends."

It is safe to conclude from the *Rosen* case that where the beneficiaries have a vested right to income of a trust, the conduit principle applied, and the mere fact that the income was received initially by the trustees is irrelevant.

Whilst the judge said that the receipt by trustees retained its nature, this was really a consequence of the conduit principle.

INTRODUCTION OF SECTION 25B

At common law, a trust is not a person. [*Authors' note*: A trust is not included as a person in the definition of "person" in section 2 of the Interpretation Act 33 of 1957.] Until the early 1990s, a trust was also not a person for purposes of the normal (or income) tax. From a tax point of view, a trust (or the trustees of the trust) was seen as a flow-through entity and the principle was, to the extent that income flowed through the trust (or vested in the beneficiaries), that the trust must be tax neutral.

Where the income was retained in the trust, the trustees, as representative taxpayers, were taxed on the income of the trust. This practice (of taxing the trustees) was successfully challenged, and it resulted in no tax payable on income retained in a discretionary trust. [See *Commissioner for Inland Revenue v Friedman and Others NNO* [1993].] This prompted an amendment to allow for this income to be taxed in the trust. The definition of a "person" in section 1(1) of the Act was then amended to include a trust; and the definitions of "trust" and "trustee" were added:

> "In this Act, unless the context otherwise indicates–
>
> ...

> '**trust**' means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person;
>
> '**trustee**', in addition to every person appointed or constituted as such by act of parties, by will, by order or declaration of court or by operation of law, includes ... any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interest or acting in any fiduciary capacity . . ."

The fact that a trust became a person for purposes of tax necessitated the codification of the conduit-pipe principle into the tax law. This was explained as follows in the Explanatory Memorandum on the Income Tax Bill 1991:

> "In order to restore the taxing rights of the Commissioner in this regard, the definition of 'person' in section 1 of the principal Act is therefore amended to include a trust fund. The amendments introduced by clause 27 merely confirm the conduit principle without affecting the Commissioner's taxing rights in terms of section 7."

Section 27 of the Income Tax Act, 1991, introduced section 25B into the Act. It was in section 25B of the Act where the taxing rights of Inland Revenue (of the undistributed income) were restored. The provision applied to any amount received by or accrued to or in favour of any person during any year of assessment in their capacity as the trustee of a trust and deemed the amount to have accrued to either the beneficiary or the trust.

The deemed accrual rules were made subject to the attribution rules, which apply where the income in question was derived by reason of a settlement, donation or other disposition in circumstances when the anti-avoidance rules in section 7 of the Act apply.

From the onset, the so-called discretionary trusts were treated separately by stating (in section 25B(2)):

> ""Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) *in consequence of the exercise by the trustee of a discretion* vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary." (own emphasis)

This implies that the amounts contemplated in section 25B(1) were vested rights acquired otherwise than through the exercise of a trustee's discretion, which section 25B(2) deals with. No indication was given (in the Explanatory Memorandum) why it was necessary to deal with beneficiaries with vested rights, in section 25B.

The Supreme Court of Appeal (SCA) considered the distinction between section 25B(1) and section 25B(2) in *Commissioner, South African Revenue Service v Airworld CC and Another* [2008], a case that dealt with STC [secondary tax on companies] on interest-free loans from two companies to a trust. In that case, it seems that counsel for SARS argued that when it came to taxing income, the legislature, in section 25B, distinguished between beneficiaries with vested rights and those without.]

Judge Combrink, writing for the minority and with reference to SARS' argument, said that section 25B(1) did not characterise beneficiaries. Instead: "All it does is to confirm that income which is derived for the immediate or future benefit of the beneficiary with a vested right to such income accrues to such person. Similarly, it distinguishes a situation where the income is deemed to accrue to a trust."

Section 25B(2), on the other hand "deals with the position where a beneficiary becomes such as a consequence of the trustee exercising his discretion and confirms, as submitted by counsel for respondents, the established 'conduit pipe principle' namely that where income is awarded to a beneficiary by virtue of the exercise of the trustee's discretion in the same year in which the income arises, such income is regarded as accruing directly to such beneficiary." It is submitted that this does not really explain why section 25B(1) was required in the first place.

The question, therefore, remains why section 25B dealt with beneficiaries with vested rights and other beneficiaries separately, or whether there should, in principle, be a difference in the tax treatment of beneficiaries with different rights. Essentially: did section 25B(1) codify the conduit-pipe principle with respect to beneficiaries with a vested right to income?

APPLICATION TO VESTED RIGHT TRUSTS

It is submitted that this requires an interpretation of the following words in section 25B(1):

> "... received by or accrued to or in favour of any person during any year of assessment *in his or her capacity as the trustee of a trust* ..." (own emphasis)

Generally, when a person receives an amount but does not do so for their own benefit, this amount is not included in their gross income. In *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* [1955] (3) SA 293 (A) at 301E-F Judge Schreiner said:

> "It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as ... trustee for another, the former has not received it as his income."

Similarly, in *Commissioner, South African Revenue Service v Executor, Frith's Estate* [2001], Judge Plewman, in paragraph [5], said:

> " 'Accrue' is a familiar word often encountered in our law – particularly, in the law of succession and in taxation legislation where it is usually encountered in a disjunctive sense in phrases such as 'receipts or accruals'. The *Shorter Oxford English Dictionary* gives (in the sense appropriate to the context in which we find the word) the meaning 'to come as an accession or advantage'."

This would be the position in law for a trustee who receives amounts for the benefit of the trust's beneficiaries. In *South Atlantic Jazz Festival (Pty) Ltd v The Commissioner, South African Revenue Service* [2015] Judge Binns-Ward said:

> "A cognizable legal context, such as the establishment of a trust, the terms of a will, or the existence of a principal-agent relationship, is necessary to give the segregation of the funds the effect of putting them outside the holder's estate, avoiding the ordinary incidence of *commixtio*."

The receipt or accrual contemplated in section 25B(1) is, however, qualified by the phrase in italics. The latter phrase is further qualified by the following phrase: "to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary". The provision, therefore, applies to receipts and accruals by a trustee, despite the fact that they do not receive these amounts for their own benefit (or the benefit of the trust).

All amounts that accrue to a trust that are administered by a trustee(s) are therefore subject to section 25B(1).

Section 25B(1) does not appear to make any reference to or distinction based on how a beneficiary acquired the vested right to an amount. In light of this, section 25B(2) arguably only serves the purpose of confirming that section 25B(1) applies where a beneficiary acquired the vested right if a trustee(s) exercises their discretion under the trust deed.

If this interpretation is correct, income that accrues to a trust to which non-resident beneficiaries have vested rights that they acquired when they contributed capital to the trust (or otherwise in terms of the trust deed) is subject to section 25B(1) and must be deemed to have accrued to the trust. Suspending the conduit pipe principle in the case of vested right trusts used as investment vehicles has a number of adverse implications. Firstly, all beneficiaries (investors) bear the tax cost on the income that accrues to non-resident beneficiaries, while resident beneficiaries (investors) also bear the full tax liability on the income to which they have a vested right. This significantly distorts the economic yields from the investments made by investors. Secondly, as Chief Justice Stratford alluded to in the *Armstrong* case in 1938, not imposing tax on the true beneficial owner of the income could result in double taxation. In the case of trust income to which a non-resident beneficiary has a vested right, this double taxation is likely to arise when the beneficiary's home jurisdiction taxes the vested income (as it should, seeing that the income truly accrued to the beneficiary from an investment made). Since the beneficiary did not incur the South African tax themselves, they will probably not qualify for relief in their home jurisdiction in respect of the tax payable on the income by the trust in South Africa.

CONCLUSION

The conduit principle does not apply to income of a South African trust to beneficiaries who are not South African residents who have a vested right, irrespective of how this vested right was acquired. This position could perhaps be affected if the beneficiary is resident in a treaty country and the beneficiary is the beneficial owner of dividends, or interest or royalties, paid for the benefit of a non-resident person. Non-resident beneficiaries of South African trusts would be well advised to seek professional assistance with respect to the tax consequences of income to which they have a vested right.

Piet Nel & Pieter van der Zwan

[First published in ASA (September 2024)]

Acts and Bills

- Income Tax Act 58 of 1962: Sections; 1(1) (definitions of "person", "trust" & "trustee"), 7, 25B (specific emphasis on subsections (1) & (2)); Second Schedule: Paragraph 3B;
- Taxation Laws Amendment Act 17 of 2023: Section 29(1)*(a)*;
- Trust Property Control Act 57 of 1988: Section 1 (definition of "trust");
- Interpretation Act 33 of 1957: Section 2 (definition of "person");
- Income Tax Bill, 1991: clause 27;
- Income Tax Act 129 of 1991: Section 27.

Other documents:

- Explanatory Memorandum on the Taxation Laws Amendment Bill, 2023;
- Explanatory Memorandum on the Income Tax Bill, 1991;
- *Shorter Oxford English Dictionary*: Definition of "accrual".

Cases

- *Armstrong v Commissioner for Inland Revenue* [1938] AD 343, 10 SATC 1;
- *Commissioner, South African Revenue Service v The Thistle Trust* (516/2021) [2022] ZASCA 153; [2023] (2) SA 120 (SCA); 85 SATC 347, 7 November 2022;
- *Secretary for Inland Revenue v Rosen* [1971] (1) SA 172 (A);
- *Commissioner for Inland Revenue v Friedman and Others NNO* (14/91) [1992] ZASCA 190; [1993] (1) SA 353 (A); [1993] 1 All SA 306 (A), 5 November 1992;
- *Commissioner, South African Revenue Service v Airworld CC and Another* [2008] (3) SA 335 (SCA);
- *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* [1955] (3) SA 293 (A) at 301E-F;
- *Commissioner, South African Revenue Service v Executor, Frith's Estate* [2001] (2) SA 261 (SCA) (Case number (404/99), 29 November 2000): Paragraph [5];
- *South Atlantic Jazz Festival (Pty) Ltd v The Commissioner, South African Revenue Service* [2015] (6) SA 78 (WCC).

Tags: conduit-pipe principle; flow-through principle; beneficiaries of the trust; interest-free loans; non-resident beneficiaries.

THE ROLES OF FOUNDERS, TRUSTEES AND PROTECTORS

INTRODUCTION

The concept of trusts was introduced to South Africa during the British occupation. Soon after, the courts began to rule on cases involving the use of trusts, leading to the gradual development of South African trust law. Over time, many original trust concepts and doctrines were found to be incompatible with the local legal system and were either disregarded or modified. Later, the legislator codified certain aspects, resulting in the establishment of a uniquely South African trust regime.

As one delves deeper into the intricacies of South African trust law, one encounters the enigmatic figures of enforcers and protectors. Who are these mysterious guardians, and what is their role in the trust arrangement? Are they merely an unnecessary accessory, a third wheel disrupting the harmony, or a welcome evolution that fortifies the framework of the trust? This article aims to provide an overview of the roles and responsibilities of the various parties involved in trusts. It will explore the foundational elements established by the founder, the critical fiduciary duties of the trustee, and the rights and expectations of the beneficiaries. Each section will shed light on the unique legal framework that governs trusts in South Africa, ensuring a comprehensive grasp of how this system operates and its significant implications.

THE FOUNDER

In South Africa, the founder of a trust is the individual or entity that establishes the trust. Trusts can have co-founders, and founders can either be natural persons or juristic persons, provided that they have the necessary capacity to act. The founder is responsible for creating the trust deed, which outlines all the terms, guidelines, and conditions of the trust. Typically, the founder also provides the initial property for the trust. It is essential that the founder transfers control of this property to the trustee. The founder may also serve as a trustee and/or a beneficiary, with the only restriction being that they cannot be the sole trustee and the sole beneficiary simultaneously.

THE TRUSTEE

Trustees play a critical role in the administration of trusts, and their actions are heavily regulated to ensure the proper execution of their duties. According to the Trust Property Control Act, 1988 (the TPCA), any person appointed as a trustee must be authorised in writing by the Master. This stipulation has been interpreted to mean that any juristic act conducted by a trustee without such authorisation is null and void and cannot be subsequently ratified or validated. This requirement extends to the initiation of legal proceedings on behalf of the trust, as an unauthorised trustee lacks the necessary legal standing, rendering any such actions invalid.

The fiduciary nature of trusteeship often necessitates that security be provided to ensure the proper administration of the trust. This obligation, akin to those imposed on curators, tutors, or executors, can be waived by the trust instrument, the Master, or the court. The Master possesses wide discretion regarding the provision of security, including the ability to exempt a trustee or adjust the level of required security.

In South Africa, the office of trusteeship is well regulated. As a point of departure, there is no set limit on the maximum number of trustees. Moreover, it is a requirement that a trust must have an independent trustee. This ensures that the separation between control and enjoyment is maintained. Where there is no independent trustee, the trust will not be invalid on that basis, but the courts may well regard the trust as the alter ego of the founder. This means that the trust structure will be disregarded in its entirety. This is especially paramount where the parties to the trust are related, such as in a family trust scenario.

THE BENEFICIARY

Beneficiaries are the individuals or entities who directly benefit from the trust. In South Africa, beneficiaries can be specified by name, degree of consanguinity, membership of a specific class, or even as an impersonal object. There are no restrictions on who may be a beneficiary; this decision rests solely with the founder. The nature and extent of a beneficiary's rights depend on the type of trust and the specific provisions outlined in the trust instrument. Beneficiaries are typically categorised as either income or capital beneficiaries or as both.

Beneficiaries' rights can be vested or contingent. Vested rights are immediately enforceable and are not subject to any conditions or contingencies, thus forming part of the beneficiary's estate and being transferable or attachable. Conversely, contingent rights are realised only when all specified conditions are fulfilled. In discretionary trusts, the beneficiaries' benefits are contingent upon the trustees exercising their discretion in favour of the beneficiaries. This means no right exists for the beneficiaries until the trustees act in their favour. The determination of when and how vesting occurs is dictated by the trust instrument.

THE PROTECTOR AND ENFORCER

In some jurisdictions, particularly tax haven jurisdictions, the roles of protector and enforcer are included in trusts to retain greater control over trust assets by the founder. The protector's office, which can be held by a natural or juristic person, has a fiduciary duty to advise and supervise the trustees. The protector's decisions are typically governed by a majority rule if multiple protectors exist and can include founders, trustees, or beneficiaries. The enforcer, on the other hand, must ensure that the trust's terms and purposes are adhered to, fulfilling their fiduciary duties by accessing necessary documents and records and acting independently from the trustees.

However, the concepts of protector and enforcer are not recognised in South African law, as the TPCA makes no reference to them. Despite this, there is no outright prohibition against including such roles in a South African trust. The extent to which courts will accept and recognise these provisions remains uncertain and may depend on the specific powers and duties assigned to the protector or enforcer. The inclusion of a protector or enforcer could blur the fundamental distinction between ownership and enjoyment inherent in South African trusts, potentially allowing the founder to control the trust indirectly. This is undesirable, as one key requirement is the founder's relinquishment of all control over trust property.

While protectors and enforcers could enhance trust administration by ensuring adherence to the trust deed and founder's wishes, the risk of abuse necessitates stringent regulation. One potential regulatory measure could be the requirement that protectors and enforcers be independent, having no connections to the founder, trustees, or beneficiaries, thereby mitigating abuse risks while promoting positive outcomes.

CONCLUSION

The roles of founders, trustees, and beneficiaries are well-defined within South African trust law, ensuring a clear framework for the administration and benefit of trusts. The introduction of protectors and enforcers, while not traditionally recognised, presents an opportunity for enhanced trust governance, provided that stringent regulations are in place to prevent abuse. Understanding these roles and their implications is crucial for all stakeholders involved in trust administration, ensuring that trusts are managed effectively and in accordance with the founder's intentions.

By navigating the complexities of these roles, one can better appreciate the unique legal landscape of South African trusts and the importance of maintaining a balance between control and benefit. This balance is essential for the integrity and success of the trust structure, ultimately serving the best interests of all parties involved.

"In some jurisdictions, particularly tax haven jurisdictions, the roles of protector and enforcer are included in trusts to retain greater control over trust assets by the founder."

Dr Hendri Herbst

WTS Renmere

Acts and Bills

- Trust Property Control Act 57 of 1988.

Tags: independent trustee; protector; enforcer; founders; trustees; beneficiaries.

SUPREME COURT OF APPEAL ACQUITS TAX PRACTITIONER IN VAT FRAUD CASE

In the October 2024 judgment of Naraidu v The State *[2024], the Supreme Court of Appeal (SCA) overturned the conviction of Mr Seshin Naraidu (Naraidu), a tax practitioner, on charges of fraud and statutory contraventions under the Value-Added Tax Act, 1991 (VAT Act), and the Tax Administration Act, 2011 (TAA). The case highlights the risks for tax practitioners when failing to exercise due diligence in handling their clients' tax matters.*

BACKGROUND

Naraidu, together with Serghony's Shoes Fashion CC (SSF) and its sole member, a Mr Mbom (Mbom), were charged with three counts of fraud and three alternative charges under the VAT Act and section 269(6) of the TAA. The allegations centred on an attempt to defraud SARS by misrepresenting expenses that purportedly entitled SSF to VAT refunds, knowing that the claim was false.

With Naraidu's assistance, SSF submitted a VAT refund claim amounting to R2,748,038, supported by fictitious invoices. A subsequent investigation by SARS revealed that the invoices supporting the VAT claim were false.

At trial, Mbom and Naraidu were both convicted of fraud in the Regional Court. Mbom, who failed to return for sentencing, remains unapprehended, while Naraidu was sentenced to six years in prison without the option of a fine. Naraidu appealed his conviction to the High Court, which upheld the Regional Court's ruling. He was then granted special leave to appeal to the SCA.

SUPREME COURT OF APPEAL

The key issue before the SCA was whether the State had proved beyond a reasonable doubt that Naraidu had knowingly participated in SSF's scheme to defraud SARS through a fictitious VAT refund claim.

The State contended that numerous emails sent by Naraidu to SARS, enquiring about the VAT refund status, demonstrated that he had sight of and access to the fraudulent documents. However, the witnesses called by SARS could not confirm who had lodged the claim on the eFiling system. Nevertheless, Naraidu's emails indicated that he had access to the system and, at the very least, had resubmitted the documents.

Naraidu argued that he was unaware of the fraudulent nature of the VAT refund claim and only acted as an intermediary on behalf of SSF. He testified that in October 2013 he was a financial adviser for Liberty Life and that a client had given him a referral list to call persons there listed to try to sell Liberty policies. On the list was a person he described as the owner of SSF. Naraidu met this presumed owner of SSF at a restaurant in Midrand in October 2013. The presumed owner showed Naraidu his driver's licence and the registration papers of SSF. The presumed owner then sought the assistance of Naraidu, as a tax practitioner, to pursue a VAT refund claim with SARS on behalf of SSF. He agreed to do so. In one of the emails that he then wrote to SARS, Naraidu stated: "I have just said that I had no knowledge of what was happening. I was enquiring and hoping the client once it was resolved would sign a policy . . . that is how I ran my Liberty business."

Naraidu's version was thus that he wrote the emails to prompt SARS to pay the VAT refund, but that he had no knowledge of the basis upon which the claim had been made. His incentive was to assist the presumed owner in order to sell him a Liberty policy. The emails were the primary source of the State's evidence against him.

The SCA acknowledged that there was a great deal that was unsatisfactory about Naraidu's evidence, including how he came to be retained, his willingness to engage with SARS on behalf of a client he knew little about and his actions in submitting documents without a proper mandate.

While the court found these actions indicative of a reckless disregard for his duties as a tax practitioner, it emphasised that this was not the charge he was facing.

The critical question was whether he had knowingly participated in the fraud perpetrated on SARS.

The SCA emphasised that establishing fraud requires proof of intent. While Naraidu's actions may have been reckless in that he submitted the fraudulent documents, there was no conclusive evidence to prove that he knew the documents were fraudulent. The court clarified that recklessness is not sufficient to establish the intent necessary for a conviction of fraud.

The court raised doubts about the validity of the alternative charges under the VAT Act and the TAA, since the statutory provisions cited had been repealed at the time of the alleged offences. More importantly, the prosecution had failed to meet its burden of proving that Naraidu had intentionally submitted a claim knowing that SSF was not entitled to the refund.

Considering the lack of evidence proving intent beyond a reasonable doubt, the SCA set aside the convictions and acquitted Naraidu of all charges.

IMPLICATIONS

This ruling reinforces the principle that criminal liability in fraud cases requires proof of intent, rather than mere recklessness. For tax practitioners, the judgment serves as a stark reminder of the importance of exercising caution and due diligence when handling clients' tax matters. It is worrying that the matter went all the way to the SCA before Nairadu's eventual acquittal, given the apparent lack of evidence supporting the legal requirement of intent.

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Acts and Bills

- Tax Administration Act 28 of 2011: Section 269(6);
- Value-Added Tax Act 89 of 1991.

Cases

- *Naraidu v The State* [2024] ZASCA 139; (894/2023) (16 October 2024).

Tags: VAT refund claim; VAT refund status; fraudulent documents.

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