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# TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

**GENERAL**
BACKDATING RISKS

**TRUSTS**
THE INTERPLAY BETWEEN SECTION 7C AND TRANSFER PRICING RULES

**GENERAL**
PROFESSIONAL MEMBERSHIP FEES

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Mr KG Karro (Chairman), Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Prof DA Tickle, Ms D Hurworth.

# CONTINUATION FUNDS

*An article written by Jutami Augustyn and published on 3 May 2024 (available here) dealt with the life cycle of a typical private equity fund and various considerations when these funds approach the exit phase.*


Upon exit, so the article provides, fund managers may be faced with investments that are performing well and exiting these investments may either have a diminishing impact on the portfolio value, or market conditions may not be conducive for an immediate exit. Jutami's article suggests, as a practical alternative, the creation of a "continuation fund".

Continuation funds are used as a vehicle to extend the term of holding investments, even when the initial vehicle has come to the end of its contractual term. The creation of a continuation fund is achieved usually by way of the dissolution of the old fund and the remaining partners rolling over their interests to a new fund.

Continuation funds offer many commercial benefits; they offer flexibility for investors to maximise their returns on well-performing assets in the fund, whilst also providing investors an opportunity to realise existing investments in the case of liquidity concerns.

This article focuses on some of the more salient taxation aspects concerning the creation of a continuation fund pursuant to the dissolution of the old fund and the distribution of the old fund's assets (which, for the purposes of this article, will be limited to shares held by the partners in the portfolio companies) to the exiting partners and their contribution to the continuation fund.

From a tax perspective, the dissolution of the old fund and the creation of a continuation fund require careful consideration.

## THE RESULTANT TAX CONSEQUENCES

The tax consequences for each partner of the fund will depend on the legal construct of the partnership concerned. Private equity funds typically take the form of an *en commandite* partnership (and this article also then focuses on this type of private equity fund, as opposed to a permanent capital vehicle).

A partnership does not enjoy a separate legal or tax *persona*. In terms of South African common law, the property of a partnership is co-owned, in an abstract sense, by the partners themselves in undivided (but not necessarily equal) shares, proportionate to their interest in the partnership and on the terms and conditions laid out in the partnership agreement.

"A 'disposal' is defined in paragraph 11 of the Eighth Schedule to the Income Tax Act, 1962 (the Act), and includes 'any event, act, forbearance or operation of law which results in the creation, variation, transfer, or extinction of an asset.'"

In terms of South African common law, the dissolution of a partnership terminates the respective partners' interests in the underlying assets. The distribution of the partnership assets to the partners will transpose the holding of a "partner interest", in the abstract sense, to a divided interest of the partnership's assets. The dissolution of a partnership will attract capital gains tax (CGT) for the respective partners if the division of the assets of the partnership constitutes a "disposal" or deemed disposal for tax purposes.

A "disposal" is defined in paragraph 11 of the Eighth Schedule to the Income Tax Act, 1962 (the Act), and includes "any event, act, forbearance or operation of law which results in the creation, variation, transfer, or extinction of an asset". The definition then provides particular inclusions with terms such as "conversion", "sale", and "exchange".

The principles underlying paragraph 11 are that a person must have disposed of an "asset" (as defined in paragraph 1 of the Eighth Schedule) in the sense of having parted with the whole or a portion of it.

## PARTNERS DISPOSING OF THEIR INTERESTS IN THE UNDERLYING PARTNERSHIP ASSETS TO THIRD PARTIES OR EXISTING PARTNERS

In the case of partners disposing of their respective interests in the underlying partnership assets in order to monetise their interests, and on the assumption that the respective partners' undivided interests in the partnership assets were held on capital account, the disposal will give rise to a CGT event for each partner.

When a partner initially makes their capital contribution to the private equity fund, the partner acquires an undivided share in the respective assets (see *Chipkin (Natal) (Pty) Ltd v Commissioner for the South African Revenue Service* [2005]) (*Chipkin*). This SCA judgment confirms that the undivided share in the asset and its "partnership interest" are mutually exclusive.

Cloete JA in *Chipkin* confirmed that when a partner disposes of their interest in the partnership, the partner, for tax purposes, disposes of their undivided share in the underlying asset. This disposal of a partnership interest, where ownership is transferred to a third party or an existing partner will, following the decision in *Chipkin*, result in a disposal of an "asset" for CGT purposes. The proceeds from a disposal of the partner's interest in the asset of the partnership are treated as having accrued to that partner at the time of disposal, as contemplated under paragraph 36 of the Eighth Schedule.

The proceeds less the base cost of the asset concerned will result in either a capital gain or a capital loss in the hands of the partner. In the instance of a partner being a South African company, the partner would be subject to CGT at an effective rate of 21.6% in the event of a gain. In the case of a loss, the capital loss may be capable of being set off against capital gains realised by the partner, provided that none of the loss limitation rules apply.

## PARTNERS "REINVESTING" THEIR INTEREST IN THE UNDERLYING ASSETS OF THE "OLD" FUND IN THE CONTINUATION FUND

The dissolution of a partnership would, at face value, constitute a "disposal" for tax purposes, and by implication attract CGT. However, as set out above, the principle underpinning a disposal is that a person must have disposed of an asset in the sense of having parted with the whole or a portion of it.

This view is corroborated in the *Comprehensive Guide to Capital Gains Tax* issued by the South African Revenue Service (Issue 9 – (*CGT Guide*)). SARS, in the *CGT Guide*, states:

> ". . . assume that the partnership assets comprise 100 shares in a single company and there are two partners A and B sharing profits equally. On dissolution partner A takes 50 shares and partner B takes 50 shares. Before dissolution each partner had a fractional interest in 50 shares and after dissolution each partner still holds 50 shares. While it could be argued that the 50 shares taken over by partner A consist of 25 shares formerly held by partner B and 25 shares formerly held by partner A it is not considered appropriate to trigger a disposal in these circumstances because each partner's bundle of rights in the shares has remained unchanged". (*CGT Guide*, page 392)

"Continuation funds are used as a vehicle to extend the term of holding investments, even when the initial vehicle has come to the end of its contractual term. The creation of a continuation fund is achieved usually by way of the dissolution of the old fund and the remaining partners rolling over their interests to a new fund."

In terms of a typical private equity fund, partners' rights and interests are established upfront by having regard to *inter alia* the profit-sharing waterfall that would be set out in the partnership agreement. Until the disposal of a partner's interest in the underlying partnership asset, the value of each partner's interest in an underlying asset typically fluctuates as one moves from the return of committed capital to any hurdle and then finally to "carry" participation. Particular to a general partner of a fund, the value fluctuates disproportionately to the general partner's initial capital contribution. But the value fluctuations arise as a result of the partnership interests established upfront, particular to the right to share profits.

A distribution of the old fund's assets on its dissolution will be according to the contractual interests of the respective partners set in the partnership agreement. Mechanically, the termination of a partnership will trigger a replacement of the abstract proportionate co-ownership of the underlying assets with actual ownership of the underlying assets in the proportion of that partner's rights in the partnership agreement. In this regard, the investor has not parted with anything, nor gained anything. The subsequent contribution of the respective assets to the continuation fund is then represented by a partnership interest in the new fund.

In the continuation fund, a partner's interest may differ from that of the old fund, although the analysis in this article assumes that the partner's interest does not differ in value. For example, the exiting partner may have been a general partner in the old fund and a limited partner in the continuation fund. In respect of the asset (shares in this instance) itself and the partner's co-ownership rights in the asset, provided that the partner does not monetise value, the partner will have parted with nothing. A limited partner in the old fund which contributes its shares to the continuation fund, as a general partner, will not give up value on the date of admission to the new partnership. This is because the value of the contribution equals the value of the shares distributed from the old fund. The profit-sharing waterfall in the continuation fund must be adjusted for value accretion or depreciation from that point on. Accordingly, a disposal for CGT purposes should not arise upon admission into the continuation fund.

The application of this view is supported in SARS Binding Private Ruling 391 (15 June 2023) (BPR 391). BPR 391 dealt with the tax consequences for the partners in an *en commandite* partnership following the termination of the old partnership and the associated distribution of partnership assets in accordance with their interests in the partnership. The partners, *via* the old partnership, held shares in a company on capital account. The old partnership was dissolved so that each partner obtained a direct investment in the underlying shares rather than holding its investment through the partnership itself. Under BPR 391, SARS confirmed that, for purposes of a distribution, there will be no change to each partner's bundle of rights/interests in the shares pre- and post-distribution.

## DEEMED DISPOSALS

Included within the "disposal" rules, is a deemed disposal referred to as a "value shifting arrangement". This means:

> "an arrangement by which a person retains an interest in a company, trust, or partnership, but following a change in the rights or entitlements of the interests in that company, trust, or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and– the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or a connected person in relation to that person acquires a direct or indirect interest in that company, trust, or partnership." (our emphasis)

The value-shifting provisions apply primarily to a movement in a partnership interest in respect of an existing partnership (the definition references "that" partnership). Accordingly, the value-shifting provisions should not apply on dissolution of a partnership as the said partnership is no longer in existence.

This view was also confirmed in BPR 391, in which SARS held that the dissolution of a partnership did not result in any change in the rights held by the partner and therefore would not constitute a "value shifting arrangement".

## CONCLUDING REMARKS

The rights/entitlements of each partner would need to be carefully considered upon dissolution of a partnership to determine whether a disposal event, for tax purposes, arises. Unless a particular partner monetises its interest in the dissolved partnership, the contribution of the co-owned interest in the underlying assets to the continuation fund, should ordinarily not result in a disposal for CGT purposes.

**Michael Rudnicki, Diwan Kamoetie & Eamonn Naidoo**

***Bowmans***

Acts and Bills

- Income Tax Act 58 of 1962: Eighth Schedule: Paragraphs 1 (definition of "asset"), 11 (definition of "disposal"), 36 & 38.

Other documents

- SARS Binding Private Ruling 391 (15 June 2023) ("Tax consequences of the termination of an *en commandite* partnership");
- *"Africa: navigating the path to exit in private equity – Continuation funds"* (article by Jutami Augustyn (3 May 2024 – https://bowmanslaw.com/insights/africa-navigating-the-path-to-exit-in-private-equity-continuation-funds/));
- *Comprehensive Guide to Capital Gains Tax* issued by the SARS, Issue 9 (5 November 2020): Specific reference to chapter 9.2.2.6.

Cases

- *Chipkin (Natal) (Pty) Ltd v Commissioner for the South African Revenue Service* (190/2004) [2005] ZASCA 45; 2005 (5) SA 566 (SCA); 67 SATC 243 (20 May 2005).

Tags: private equity fund; continuation fund; en commandite partnership; disposal; deemed disposal; value shifting arrangement.

# THE EXIT TAX FLAW

*The Coronation Constitutional Court judgment [*Coronation Investment Management SA (Pty) Limited v Commissioner for the South African Revenue Service *[2024] (handed down in June 2024)] made clear that South Africa should collect all taxes to which it is rightfully entitled, but not those to which it is not entitled. South Africa's "exit tax", however, appears to legislate for the collection of an amount of tax to which the country should* ***not*** *be entitled. Surely this is a flaw in the legislation.*

This article will deal only with natural persons ("individuals"). The flaw which is referred to borders on an apparent attempt to force individual taxpayers who have offshore immovable property in their own name (ie, those who have been compliant and not tried to structure out of South African taxes) to remain in South Africa on the basis that they essentially become "economic prisoners".

The principles behind the exit tax are sound. But, as mentioned, there appears to be a fundamental flaw.

The "exit tax", as it is known, was introduced into South Africa's tax law when capital gains tax was introduced in 2001. It was originally contained in paragraph 12(2)*(a)* of the Eighth Schedule to the Income Tax Act, 1962 (the Act), which deemed there to be a disposal in respect of most assets when a person ceased to be (tax) resident in South Africa. This provision was moved into the main body of the Act by the 2011 amending legislation and is now housed in section 9H. [See section 26 of the Taxation Laws Amendment Act, 2011 (*Government Gazette* 34927). Section 9H is effective for any person ceasing to be South African tax resident on or after 1 April 2012.]

"If a South African individual owns immovable property in a country other than South Africa and that country has CGT, when that asset is disposed of it will be subjected to CGT in that country on the full amount of its growth since acquisition."

The effect of section 9H is to deem a person who ceases to be tax resident in South Africa to have disposed of all their worldwide assets on the day before they cease to be South African tax resident for their market value on that day. This applies to all assets other than immovable property situated in South Africa, assets connected to a permanent establishment in South Africa and share incentive shares that would, in the relevant circumstances, be subject to section 8A, 8B or 8C. In 2024 any amount representing the value of the interest in any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund was added to the list of exclusions (effective 24 December 2024). The reason for the exclusion of these assets is that they are South African-sourced and thus taxable in South Africa in the hands of the individual even when they are non-resident.

The principle behind the exit tax is that a person has lived, as a tax resident, in South Africa and benefitted from the public goods provided to them, up until the point that they cease their tax residence, which requires that they move their permanent home away from South Africa. They must thus pay tax in South Africa on their worldwide income and gains up to that point. They will pay tax in South Africa only on their South African-sourced income after exit.

Whilst resident, they will also have benefited from the growth in the value of their assets but will not necessarily dispose of those assets on "departure" from South Africa. Thus, in order to "balance the scales", when they leave South Africa, they should pay tax on the growth of those assets up to that point as if they have disposed of them.

This makes perfect sense, particularly since, on arriving in a new country of tax residence, that country, if it has a CGT regime, will require the base cost of those assets to be recorded as the market value of the assets on the date of the individual's arrival there as a tax resident. In this way, the individual will not pay CGT on the amount subjected to CGT on departure from South Africa in their new country of tax residence.

Or will they? And this is where the punch comes.

If a South African individual owns immovable property in a country other than South Africa and that country has CGT, when that asset is disposed of it will be subjected to CGT in that country on the full amount of its growth since acquisition. Fair enough. If the individual is South African tax resident, they will be able to claim a foreign tax credit (FTC) either through South Africa's domestic FTC regime as set out in section 6*quat* or through the mechanism of a double tax treaty (DTT) if there is one between that country and South Africa.

Section 6*quat*(1)*(e)*, which applies only to South African tax residents, specifically refers to a capital gain from a non-South African source and provides for the individual to offset the foreign tax that can be proved to have been paid against the South Africa CGT payable on that gain (FTC). Similarly, Article 13(1) of the DTTs

[see 2017 OECD Model Tax Convention] indicates that the country where immovable property is located also has the right to tax the gains on disposal of such property. Article 23 then provides that the country of residence of the individual will be required to exempt the gain from tax, or provide a credit in respect of the tax paid in the country where the immovable property is located (ie, where the gain is sourced). Generally, when immovable property is concerned, an FTC will be provided.

Thus, were the individual to have sold the immovable property, they would not pay the full amount of CGT in South Africa on the gain (proceeds less base cost) because of the availability of the FTC under the relevant DTT or section 6*quat*. However, where the immovable property has not actually been sold, but is deemed to have been disposed of owing to the person ceasing to be tax resident (section 9H), the full CGT is payable in South Africa.

The problem with this scenario is that when the immovable property in the other country is actually sold, CGT will be payable on the full difference between the proceeds (market value at that point) and the original base cost, this time in the country in which it is located. This means that, following disposal of the immovable property at some point after the individual has ceased to be South African tax resident, CGT will have been paid twice on the difference between the market value on the day before ceasing to be resident and the base cost.

By way of example, assume a South African tax resident individual owns immovable property in Country A which, for illustration purposes, imposes CGT in the same way as South Africa. Assume also that the exchange rate of the Country A dollar is R1=$1. The base cost of the property is $100 000 and the market value on 31 July 2024 is $400 000. The MV is still $400 000 on 31 July 2028. Assume also that the individual pays income tax in South Africa and in Country A at a rate of 45%, has used up the relevant annual exclusion in both countries and both countries have the same inclusion rate of 40%. The individual ceased to be South African tax resident on 1 August 2024 and takes up residence in Country C.

If the person actually sold the property on 31 July 2024, they would have paid tax of $54 000 CGT thereon in Country A ($300 000 × 40% × 45%) and R54 000 CGT will be due in South Africa. However, the person will qualify for an FTC of R54 000 in South Africa and will thus not pay any tax in South Africa.

If, on the other hand, they do not actually sell the property but cease to be resident on 1 August 2024, they will pay tax on the deemed disposal of the property under section 9H and will thus pay CGT of R54 000 in South Africa. There will be no tax in Country A at this point, since the property has not been disposed of, so no FTC.

If the individual then settles outside South Africa and disposes of the property on 31 July 2028, $54 000 will be payable as CGT in Country A.

In total then, because section 9H does not cater for the local taxes that will be paid in the country of location of immovable property, on its actual disposal, the individual who ceased South Africa tax residence will pay CGT twice and will suffer tax in South Africa that would not ordinarily have been payable had they not ceased to be resident. This is surely a flaw in the legislation.

So, why can section 6*quat* or the relevant DTT not assist the taxpayer to reduce the tax in South Africa when they cease to be resident? This is because, firstly, section 9H deems the disposal to be made on the day before the person ceases to be resident and thus South Africa still has taxing rights over the individual.

Secondly, since there is no actual disposal on the day before the individual ceases to be tax resident in South Africa, no tax is paid in the other country at the point the exit tax is payable and thus there is no amount to treat as an FTC.

Thus, ultimately, more tax than would ever have been payable by the individual had they remained resident and disposed of the asset in the ordinary course of events, will have been paid to the South African fiscus. This is clearly not in line with the intention of the "exit tax" provision and effectively penalises the individual for leaving South Africa as a taxpayer.

It is submitted that this flaw in the legislation should be rectified through an amendment which provides a deemed credit to the taxpayer ceasing to be South African tax resident to the extent that tax would have been payable had they actually sold the immovable property in the relevant country in which it is located. This would mean that if the country has no CGT there would be no deemed credit, but if it does have CGT the taxpayer will not be taxed any more than they would have been had they remained resident and actually sold the property at the relevant market value on the day before they cease to be South African tax resident.

Clearly, unless the legislature is changed, departing South African taxpayers need to be aware of this flaw and its implications for them.

**Adjunct Associate Professor Deborah Tickle**

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 6*quat*(1)*(e)*, 8A, 8B, 8C & 9H; Eighth Schedule: Paragraph 12(2)*(a)*;
- Taxation Laws Amendment Act 24 of 2011: Section 26.

Other documents

- *Government Gazette* 34927;
- 2017 OECD Model Tax Convention on Income and on Capital 2017: Articles 13(1) and 23.

Cases

- *Commissioner, South African Revenue Service v ABC* [2023] (6) SA 477 (GP).

Tags: natural persons; immovable property; permanent establishment; tax resident; foreign tax credit (FTC); exit tax.

# CTC AND SECTION 42

*In tax practitioner circles the acronym CTC is understood to mean "contributed tax capital". But laypersons would probably think it more aptly means "Complex Tax Concept".*

The complexity of tax legislation is such these days that the latter phrase could apply to any number of areas of tax law – the "corporate rules" [see sections 41 to 47 of the Income Tax Act, 1962 (the Act)] provide another clear example of complex tax concepts, among many more. This article will stick to CTC meaning "contributed tax capital" as set out in section 1(1) of the Income Tax Act, 1962) (the Act).

It will address one tiny aspect of the definition of CTC and how the concept is applied to the situation when an asset (share) for share transaction is undertaken by two private companies, which are both South African tax residents. The scenario will address the situation in which the transaction qualifies for the application of section 42 of the "corporate rules" in the Act, followed, at some point, by a share buy-back by the transferee.

Firstly, though, the focus will be on what the definition of CTC tells us. CTC is a concept that exists only for tax purposes and, although in many instances the two may be equal, the CTC has no actual relationship to the share capital in the annual financial statements (accounts/accounting) of the company. Here again only a South African tax-resident company is considered.

Essentially, as its name suggests, the CTC is the amount which a shareholder contributes to the company in the form of share capital after 1 January 2011 reduced by any amount transferred to a shareholder, which, by the date of transfer, the directors of the company have indicated is CTC (there are special rules for determining the position on 1 January 2011, which are not explored here). The directors clearly cannot indicate an amount to be CTC if such CTC does not exist. However, if the directors fail to indicate that an amount is CTC, it will be deemed to be a dividend (regardless of the existence or extent of accounting reserves).

Over the years various amendments have been made to the definition of CTC such that it is required that the CTC of each class or type of shares is ring-fenced to that particular class or type. In addition, despite that shareholders of the same class may contribute different amounts, the CTC per share must be calculated so as to attribute an equal amount of CTC to each share in that class.

The most recent amendment (proviso) relevant to this article, which became effective on 1 January 2023, requires that if CTC is paid to shareholders of a private company, they must each physically be paid CTC in proportion to their shareholdings and the CTC available in respect of that class of shares. This is regardless of the amount they have contributed. Thus, if there is R1 000 of CTC and two shareholders each hold 50% of the equity shares and voting rights, even though one may have contributed R600 and the other R400, if there is a share buy-back, reduction or return of capital, each shareholder must receive R500.

Things, however, become really interesting when it comes to combining this definition with section 42.

As is now well understood by most tax practitioners, the effect of the corporate rules is to defer triggering any tax impact for an asset transferred in terms of the relevant provision, until such asset completely leaves the "domain" of the transferor. In a section 42 transaction (asset for share) involving, here, two South African tax resident companies, the "domain" is determined by the "qualifying interest" (QI) definition.

The QI definition includes, amongst other things, the situation in which the transferor of the asset holds at least 10% of the equity shares and voting rights of the transferee at the end of the day of the transaction (the assumption is that both parties are private companies). Only this aspect of the QI definition will be dealt with here and it will be assumed that the transferor will not hold 20% or more of the equity shares, ie, it will not be "connected" to the transferee after the transaction. However, a scenario where they are connected at that point could lead to further interesting tax implications and thus may warrant a further article.

So, the assumption is that Company A (Co A) transfers shares it holds in its 100%-held subsidiary (S1) to Company B (Co B) in return for 10% of the equity shares and voting rights (shares) issued by Co B. The market value of the shares in S1 is R100 000 and the base cost in Co A's hands is R1 000 (thus market value exceeds base cost, as is required for section 42 to apply). Co B's shares are issued to Co A with a market value of R100 000 and Co A will hold 10% of Co B's shares at the end of the day of the section 42 share-for-share transaction. The total value of Co B at the end of the transaction is thus R1 million and it is assumed that there is only one other shareholder in Co B and that shareholder has invested R900 000 and now holds 90% of the shares. Since the transaction is undertaken at market value, neither section 24BA, nor the value-shifting provisions of the Eighth Schedule (applicable only if Co A and the other shareholder are connected, in any event) nor section 40CA will apply. [*Note*: The term "value shifting arrangement" is defined in paragraph 1 of the Eighth Schedule to the Act and dealt with under paragraph 11(1)*(g)*.]

By virtue of section 42, Co B's base cost of the S1 shares will be R1 000 (as transferred from Co A). This amount will bear no relation to the cost of the shares reflected in the company's accounts, which would be R100 000. Similarly, Co A's base cost for the shares in Co B will be R1 000 (again, notwithstanding their accounting cost of R100 000). The share capital of B will equally have increased by R100 000 for accounting purposes, but the CTC will, under section 42(3A), also be R1 000. It can thus be seen that section 42 introduces complex tax concepts that bear no relation to the accounting position.

By virtue of the transaction having qualified under section 42, no securities transfer tax (STT) will have been payable [see section 8(1)*(a)* of the Securities Transfer Tax Act, 2007 (the STT Act)].

Thus, no tax will thus have been payable up to this point, in respect of the transaction, by Co A, Co B or S1.

Now, what would happen if Co B were to buy back all its shares held by Co A at their market value of R100 000?

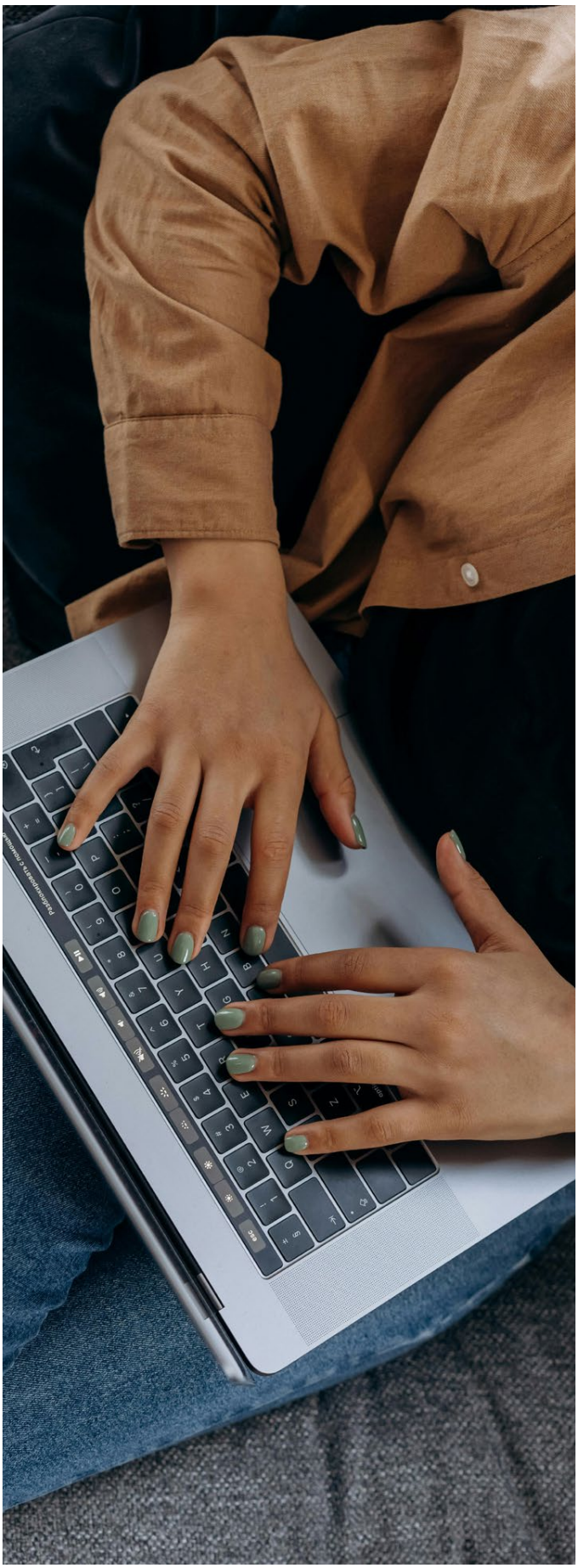
Firstly, one must consider whether the shares held by Co A in Co B would be treated as capital or revenue in nature. Despite S1 being held by Co A as a capital asset, section 42(2)*(a)*(ii) caters for the situation in which the Co B shares acquired by Co A in return for S1's shares could be viewed as being capital in nature or trading stock, based on the normal rules relating to capital, revenue and trading stock. If it is the intention of Co A to acquire the Co B shares for the purposes of disposal at a profit shortly after acquisition, the "proceeds" may be viewed as revenue in nature and thus the Co B shares could be considered to be trading stock. However, in the absence of such an intention, they would likely be capital in nature.

So, what are the tax consequences of the share buy-back? The share buy-back will entail Co B acquiring its shares from Co A and those shares being extinguished and restored to the status of authorised capital. [See section 35(5)*(a)* of the Companies Act, 2008.] Since Co B will not be wound up at that stage, there will be STT, at a rate of 0.25%, on the buy-back and cancellation, based on the market value of the shares immediately prior to the buy-back, ie, 0.25% of R100 000.

As indicated above, the total CTC of Co B will be equal to the base cost of the shares in S1 held by Co A on transfer to Co B (R1 000) plus the amount of R900 000 invested as CTC by Co B's other shareholder. ie, a total of R901 000. It is reiterated that this applies, albeit that for accounting purposes the Co B's accounts will reflect that it has issued share capital of R1 million.

Again, as indicated above, ordinarily on buy-back of Co A's shares in Co B, the directors will need to indicate in a resolution the extent to which this represents CTC and any difference will constitute a dividend (regardless of the availability of reserves). However, where different amounts of CTC have been contributed by different shareholders of the same class of shares (as in the current example) and a reduction of CTC (here through the buy-back) is to be made in respect of only one of the shareholders, the provisos to the definition of CTC, indicated above, are applicable.

"CTC is a concept that exists only for tax purposes and, although in many instances the two may be equal, the CTC has no actual relationship to the share capital in the annual financial statements (accounts/ accounting) of the company."



The first proviso to the CTC definition requires that the reduction of CTC is limited to an amount which bears to the total CTC (R901 000) immediately before the payment, the same ratio as the number of shares held by that person (say, 10) to the total number of shares (say, 100). In this example the ratio would thus be 10/100 × R901 000, ie, R90 100. Thus, if 10% of the shares are repurchased for R100 000, in terms of the first proviso, the balance (R100 000 less R90 100) will be a dividend and not a return of CTC even if the Directors resolved for it to be CTC. The difference between the base cost of the shares held by Co A in Co B (R1 000) and R90 100 would, per the application of the legislation to this point, be subject to capital gains tax (CGT) (or income tax, if held as trading stock) in Co A.

The second proviso reinforces the first proviso by specifying that an amount will comprise CTC under a share buy-back only to the extent that the shares in the class being bought back are each transferred an equal amount of CTC. Thus, each of the 10 shares must receive R90 100 /10 = R9 010. It also requires that no share being bought back can receive more than R901 000/100 = R9 010.

Readers using The SARS *Comprehensive Guide to Dividends Tax* (Issue 5) dated 22 May 2022 should bear in mind that it reflects the law according to the Taxation Laws Amendment Act 20 of 2021. This amending Act reflected an earlier version of the second proviso which does not reflect the current law. Its effect was to prevent shareholders whose shares are bought back from being transferred CTC unless all shareholders in the class of shares participate equally in the buy-back (see the note at the end of Example 3 on page 24 of the guide which needs to be updated). The second proviso was substituted by the Taxation Laws Amendment Act 20 of 2022 and now restricts the equal participation requirement to the shares being bought back.

For a detailed review of the amendments giving rise to the second proviso, see Duncan McAllister's article in the June 2023 issue of ASA "Contributed Tax Capital and the Provisos". As an equal amount of CTC is applied in return of Co A's shares in Co B, the amount of R90 100 will be a return of capital and only the balance will be a dividend (no tax). A capital gain of R89 100 will result (proceeds under paragraph 35 of R90 100 less the base cost of R1 000).

Before ending the enquiry, however, especially if the full amount received on the buy-back has been treated as a dividend with no dividends tax or CGT, the question then arises whether any of the relevant anti-avoidance provisions give rise to any taxes on the buy-back.

The specific anti-avoidance provisions in section 42 will be considered first.

Section 42(6) applies if Co A ceases to hold a QI (ie, its shareholding drops below 10%) *within 18 months* of the date of the section 42 transaction. Even though Co A will cease to hold any of the shares following the share buy-back, ie, cease to hold a "qualifying interest", section 42(6) of the Act will not apply as the section results in the deemed disposal and reacquisition of shares that *remain* after the qualifying interest reduction and the section is triggered. Since Co A will no longer have any shares in Co B there will be no remaining shares to be deemed sold and reacquired.

If Co A were, however, to retain any of the shares, section 42(6) would deem the remaining shares to immediately be disposed of at their market value at the date the shares are sold with the effect that they remove the QI and to be reacquired at that same amount. (Section 42(6) does not mention CTC, so the CTC of Co B will not change,)

Section 42(5) must also be considered. The section ordinarily applies if the shares are held as trading stock (see above), to include in income any amount to the extent that the proceeds are less than the market value of the shares acquired in terms of a section 42 transaction, at the date of the section 42 transaction. Since the Co B shares will have actually been acquired at their market value of R100 000, if the buyback for R100 000 still represents market value, the section should not apply.

Next, other specific anti-avoidance provisions will be considered.

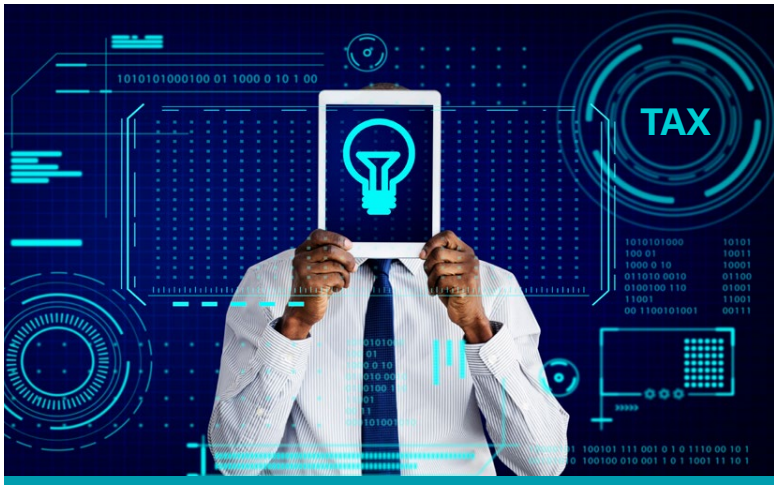
If the Co B shares held by Co A are capital in nature, any shift in value from the other shareholder of Co B to Co A would need to be considered in the context of paragraph 11(1)*(g)* of the Eighth Schedule to the Act, which pertains to "value shifting arrangements", as defined. However, as it has been assumed that Co A is not connected to the other shareholder and, furthermore, that Co A will not retain any interest in Co B, the buyback transaction will not qualify as a value shifting arrangement.

Paragraph 43A of the Eighth Schedule also requires consideration, particularly as there is a deemed dividend which applies to the share buy-back by Co B, and Co A and Co B are both companies. However, for paragraph 43A to apply, Co A must hold a "qualifying interest" in Co B. This term is defined in subparagraph (1) of that paragraph to require Co A to hold 50% of the equity shares in Co B, or 20% if no other person holds the majority of equity shares or voting rights. As Co A holds only 10% (and in any event, the other shareholder holds 90% (the majority) of the Co B shares), a qualifying interest for purposes of paragraph 43A will not exist and thus the paragraph cannot be applied.

Paragraph 19 of the Eighth Schedule is applicable where a capital loss arises as a consequence of the disposal (including the buy-back of a share) and an extraordinary dividend has been received within 18 months. An extraordinary dividend is one which exceeds 15% of the proceeds received for the shares (and paragraph 43A has not already been applied). Thus, Co A will potentially experience a capital loss (zero less R1 000 base cost) in respect of the base cost of its shares in Co B when it receives the deemed dividend from Co B. This loss must be disregarded in terms of paragraph 19.

The General Anti Avoidance Provisions (GAAR) (sections 80A–80L of the Act) (these are not excluded by the corporate rules) would also require consideration as it would appear that the example results in the shares in S1 having been transferred to Co B (and ultimately its original 100% shareholder) and removed from Co A's domain without any tax having been payable, ie, there will have been a "tax benefit" as contemplated by the GAAR (no tax on R100 000 less R1 000). However, for the section to apply, this must have been the purpose of the transactions and it would thus be important to establish the purpose before applying these provisions.

This article has been designed to highlight the complexity of tax concepts, especially where they bear no relation to the accounting position and the need to look very carefully at the outcomes. The question is also raised as to whether the increasing divergence of tax concepts from accounting concepts mean that companies might be wise to maintain a separate set of accounts based purely on tax legislation, so as to keep track of the tax values of their assets and CTC, amongst other things.




**Adjunct Associate Professor Deborah Tickle**

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "contributed tax capital") & 40CA; Sections 41 to 47 (specific emphasis on section 42(2)*(a)*(ii), (3A) & (6)) & 80A–80L; Eighth Schedule: Paragraphs 1 (definition of "value shifting arrangement"), 11(1)*(g)*, 19 & 43A;
- Taxation Laws Amendment Act 20 of 2021;
- Taxation Laws Amendment Act 20 of 2022;
- Securities Transfer Tax Act 25 of 2007: Section 8(1)*(a)*;
- Companies Act 71 of 2008: Section 35(5)*(a)*.

Other documents

- SARS *Comprehensive Guide to Dividends Tax* (Issue 5) (dated 22 May 2022): (Example 3 on page 24);
- "Contributed Tax Capital and the Provisos" – Article by Duncan McAllister in ASA of June 2023. [http://magazine.accountancysa.org.za/asa-june-2023?m=52861&i=793291&view=articleBrowser&article_id=4588838&ver=html5 [Accessed 5 May 2024].]

Tags: corporate rules; contributed tax capital; asset (share) for share transaction; South African tax resident companies; share buy-back; anti-avoidance provisions; General Anti Avoidance Provisions (GAAR).

# BACKDATING RISKS

*The question of backdating frequently arises in practice and it is important to understand when it is acceptable and when it is not.*

## FRAUD

When documents such as minutes of meetings, contracts, and invoices are backdated purely to avoid tax or to take advantage of tax benefits by portraying a set of facts that never happened, one is dealing with the crime of fraud. The tax cases reports do not seem to contain any examples of the crime of backdating, and the only example found was one reported in Special Board Decision 95 heard on 22 July 1998. [SBD 95 (1998) 3 TBDR 54 (N).] It so happened that the author of this article represented SARS at the tax board hearing which was chaired by Peter Olsen SC who later went on to become an acting judge in the SCA.

Secondary tax on companies (STC) was introduced on 17 March 1993 and applied to any dividend declared and paid on or after that date. It was replaced by dividends tax from 1 April 2012. The financial statements of the appellant close corporation for the year ended 28 February 1994 reflected that all the capital profits of the close corporation which had arisen in 1985 had been declared by way of a dividend of R30 000 on 1 March 1993 and credited to the member's loan account on that date. The fact that all this happened conveniently 17 days before the introduction of STC seemed too good to be true. The declaration of capital profits as a dividend seemed imprudent given the close corporation's financial position, which reflected net current liabilities. It was also the first dividend declared by the company since its inception ten years earlier. The date of 1 March 1993 was unusual because it did not coincide with any date on which financial statements were prepared and the minutes provided no reason for the declaration of the dividend.

It was obvious from these factors and several others that both the minutes and the crediting of the member's loan account had been backdated to 1 March 1993, and the appellant's representative conceded as much at the hearing. He, however, sought to argue that the search for the truth or the facts concerning a company's conduct and affairs begins and ends in the books of the company. In response, the chairman of the special board (later changed to the tax board) stated the following:

> "in my view, and notwithstanding general practice, the purpose of books of account of a company or close corporation is to reflect the affairs of that company or close corporation. The 'affairs' of such an entity are constituted by what it did and what was done to it, ie what actually happened. In saying this I am mindful of the fact that accounts are required 'fairly' to represent the affairs of a company, and that the use of the word 'fairly' recognises the 'fact that in respect of many of the matters to be reflected in the accounts there is no absolute truth, or no truth which is ascertainable with certainty.'" (See *Novick and Another v Comair Holdings Ltd and Others* [1979] (2) SA 116 (W) at 140).
>
> "However this principle does not imply a licence deliberately to record falsehoods".

"Sometimes taxpayers try to have the tax consequences of a transaction cancelled or brought into account in a previous year of assessment retrospectively."

In the result, the appeal was dismissed. The appellant and its representatives can count themselves fortunate that SARS did not institute criminal proceedings.

In the United States case of *US v Micke* [859 F.2d 473, 1988], the defendant, Norman Micke, a tax advisor and business consultant, was less fortunate. In preparing his client's tax return for the year ending 31 December 1982 he claimed certain allowances for the purchase and leasing of equipment. The purchase and lease agreements, and cheques for the purchase of the equipment and for consulting services were dated 28 December 1982, but it was conceded that these documents were executed only in late January 1983. Micke's counsel argued that the documents merely memorialised a verbal agreement entered into in December 1982 but this was contradicted by the evidence from the taxpayer, Charles Quirt, who confirmed that he had not signed any documents in 1982. Micke was convicted of one count of willfully aiding and assisting in the preparation of the false and fraudulent 1982 income tax return of Charles and Judith Quirt and sentenced to three years imprisonment.

The reason why there are so few reported cases on backdating is probably because it tends to go undetected and can be difficult to prove.

Another case the author came across during his time at SARS was one in which the promoters of an *en commandite* farming partnership were still recruiting partners in August 1988 when the partnership agreement was dated February 1988, no doubt to avoid paragraph 8 of the First Schedule – this was introduced from the commencement of years of assessment ended or ending on or after 31 May 1988 and it ring-fenced livestock losses against farming income. A further matter involved a taxpayer who had been carrying on a trade and when caught for not declaring the income in his personal tax returns, claimed that the income actually accrued to a dormant company which had not yet submitted its tax returns. It appeared that the minutes of the company had been backdated, having been modified with Tippex, but this was difficult to prove.

An area where backdating is, at least anecdotally, rife is in the field of trusts. When the trust accounts are drawn up and the income for the year has been established, the minutes of the trustees' meeting are backdated to reflect that the income was vested in the beneficiaries before the end of the year of assessment, so as to take advantage of section 25B(1), which deems the income to accrue to the beneficiary rather than the trust. Backdating minutes in these circumstances is fraudulent, since any vesting has to be done in real time. Some tax practitioners avoid backdating by passing a resolution before year end stipulating that "all net income for the year of assessment as eventually determined is hereby vested in the beneficiaries in [specified proportions]".

With the section 12BA allowance for renewable energy assets that expired on 28 February 2025, SARS is sure to be on the lookout for taxpayers who have backdated their claims.

## RECTIFICATION AND RECORDING

During his time at SARS the author saw that SARS often received requests from taxpayers to allow the submission of revised financial statements for a variety of reasons. The usual one was that a company had forgotten to charge interest on a loan to a shareholder, which resulted in the loan being deemed to be a dividend under section 64C(2)*(g)* and subject to STC. Unless there was a written loan agreement providing for such interest, SARS would not accept such a request as it was simply a case of trying to backdate a transaction which had never happened. But if it could be shown that the financial statements were incorrect, there would be no problem with accepting the revised accounts.

There is also no difficulty in preparing minutes of a meeting after the event as long as the meeting actually happened. But it is best to prepare the minutes as soon as possible after the meeting in order to discharge the onus resting on the taxpayer under section 102 of the Tax Administration Act, 2011.

How does one prove that a document was actually in existence on a specified date? One way would be to have the document stamped by a commissioner of oaths. With computer-generated documents, the metadata showing when the file was created and by whom may be of assistance.

## EFFECTIVE DATES

It is common in contracts for the sale of a business to have an effective date when the transaction will take place. The SARS *Comprehensive Guide to Capital Gains Tax* (Issue 9) notes in 6.3.4 that such an effective date does not determine the time of disposal of an asset, which is determined under paragraph 13 of the Eighth Schedule. Unless the sale is subject to a suspensive condition, the time of disposal is when the contract is concluded.

*Tax is an annual event*

Sometimes taxpayers try to have the tax consequences of a transaction cancelled or brought into account in a previous year of assessment retrospectively. The law in this regard was set out in *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* [1975], in which Botha JA stated:

> "income tax is assessed on an annual basis in respect of the taxable income received by or accrued to any person during the period of assessment, and determined in accordance with the provisions of the Act. … It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment".

He continued [at SATC 15]:

> "What is clear, I think, is that events which may have an effect upon a taxpayer's liability to normal tax are relevant only in determining his tax liability in respect of the fiscal year in which they occur, and cannot be relied upon to redetermine such liability in respect of a fiscal year in the past."

In *New Adventure Shelf 122 (Pty) Ltd v Commissioner, South African Revenue Service* [2017] the appellant company had sold immovable property in the 2007 year of assessment. When the agreement was cancelled in the 2012 year of assessment, the company sought to have the 2007 assessment reopened to redetermine the capital gain. Based on the *Caltex* case the court dismissed the company's appeal.

With effect from 1 January 2016, the Eighth Schedule was amended to provide specific rules dealing with the cancellation of contracts. Taxpayers that cancel a contract in the same year of assessment can disregard the original disposal under paragraph 11(2)*(o)* as long as the parties are restored to their original position. When the cancellation relates to a transaction in a previous year of assessment, any earlier capital gain or loss is reversed in the year of cancellation and the base cost is restored under paragraph 20(4).

In *Matla Coal Ltd v Commissioner for Inland Revenue* [1987] the appellant had entered into a contract for the sale of coal rights and payment was received on 20 February 1980. However, the contract underwent novation resulting in the payment becoming consideration for a restraint of trade. The question was how the amount should be treated in Matla's year of assessment ending 30 June 1980. The court considered that the matter should be determined either at the time of payment (*Mooi v Secretary for Inland Revenue* [1972]) or at the end of the year of assessment (*Caltex Oil (SA) Ltd v Secretary for Inland Revenue* [1975]). Since both dates fell within the same year of assessment, the sale was treated as being for the sale of coal rights.

## PRE-INCORPORATION CONTRACTS

Section 21 of the Companies Act, 2008, enables a person to enter into a contract for a company to be formed. Upon ratification by the company, the agreement is as enforceable against the company as if the company had been a party to the agreement when it was made. [Section 21(6)*(a)*.]

*Silke on South African Income Tax* [in § 13.15] notes that section 21(6) does not have the effect that profits earned from the date of the contract to the date of ratification are taxable in the company. Instead, Silke maintains that the vendor is taxable on such profits. Silke states that SARS, by contrast, taxes the trustee on the pre-incorporation profits.

The basis for not recognising the profits retrospectively in the company is the principle established in *Commissioner for Inland Revenue v Witwatersrand Association of Racing Clubs* [1960] that income cannot be disposed of after accrual.

Another way of dealing with pre-incorporation profits and profits earned before a partnership is formed is through a contract for the benefit of a third party (*stipulatio alterii*). Again, the textbook writers seem to be unanimous that pre-formation profits are not taxable in the company or partnership. But *Broomberg on Tax Strategy* [Des Kruger and Wouter Scholz] notes that these arguments are "a little thin" and that "there are more than interesting arguments to support a view that at least as long as the period of retrospectivity does not cross over the end of any year of assessment, income tax law should recognise the retrospective effect of a contract". The learned author does not say what these arguments are, but it is submitted that they are based on the fact that the Caltex case emphasised that

> "It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment".

In *Minister of Home Affairs and Another v American Ninja IV Partnership and Another* [1993] the SCA recognised the registration of two films for subsidy purposes and had no difficulty with a contract entered into on behalf of the partnerships to be formed.

There could be harsh consequences if SARS were to tax both the vendor or trustee as well as the company or partnership on the pre-formation profits, since this would amount to economic double taxation. As David Clegg noted in his 1985 article titled *Retroactive Contracts*, [(July 1985) 1 *Tax Planning* 42] such contracts are best avoided.

This article was first published in ASA September 2024

**Duncan McAllister**

***Webber Wentzel***

Acts and Bills

- Income Tax Act 58 of 1962: Sections 12BA, 25B(1) & 64C(2)*(g)*; First Schedule: Paragraph 8; Eighth Schedule: Paragraphs 11(2)*(o)*, 13 & 20(4);
- Tax Administration Act 28 of 2011: Section 102;
- Companies Act 71 of 2008: Section 21 (special emphasis on subsection (6)*(a)*).

Other documents

- Special Board Decision 95 heard on 22 July 1998 [SBD 95 (1998) 3 TBDR 54 (N)];
- *SARS Comprehensive Guide to Capital Gains Tax* (Issue 9) [6.3.4];
- *Silke on South African Income Tax* [In § 13.15];
- *Broomberg on Tax Strategy* [Des Kruger and Wouter Scholz 4 ed (2003) LexisNexis Butterworths, Durban: in paragraph 2.4.];
- Retroactive Contracts (article by David Clegg) [(July 1985) 1 *Tax Planning* 42].

Cases

- *Novick and Another v Comair Holdings Ltd and Others* [1979] (2) SA 116 (W) at 140;
- *US v Micke* [(859 F.2d 473, 1988)] (United States case);
- *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* [1975] (1) SA 665 (A); 37 SATC 1 at 11; SATC 15;
- *New Adventure Shelf 122 (Pty) Ltd v Commissioner, South African Revenue Service* [2017] (5) SA 94 (SCA); [2017] 2 All SA 784 (SCA), 79 SATC 233;
- *Matla Coal Ltd v Commissioner for Inland Revenue* [1987] (1) SA 108 (A), 48 SATC 223;
- *Commissioner for Inland Revenue v Witwatersrand Association of Racing Clubs* [1960 (3) SA 291 (A), 23 SATC 380];
- *Minister of Home Affairs and Another v American Ninja IV Partnership and Another* [1993] (1) SA 257 (A); [1993] 1 All SA 222 (A).

Tags: backdating; Secondary tax on companies (STC); dividends tax; section 12BA allowance for renewable energy assets; written loan agreement; a contract for the benefit of a third party (*stipulatio alterii*).

# INVESTING AND TRADE

*For expenditure to qualify as a deduction for tax purposes under the general deduction formula (section 11(a)), it must, amongst other things, be incurred "for the purposes of trade". This requirement is reiterated in section 23(g). But whether an investment activity qualifies as a trade has been the subject of many cases over the years, demonstrating that the answer is far from clear.*

In the *Unitrans Holdings Ltd v Commissioner for the South African Revenue Service* [2023] case, the question of whether the company in that case was "trading" was not dealt with in detail. Judge Adams, with Judge Strydom agreeing, disposed of the question upfront when, in the first sentence of the judgment, he stated that Unitrans Holdings "trades as an investment and holding company". This was an interesting conclusion when one considers it against the background of cases that specifically consider what a trade is.

The first port of call when trying to determine the meaning of any term in legislation is to have regard to the legislation's own definitions. In this instance, the Income Tax Act, 1962 (the Act) includes a very broad definition of "trade" being any "profession, trade, business, employment, calling, occupation or venture, including the letting of any property……". The definition is somewhat circular in that it includes "trade" as one of its components. However, what becomes clear when seeing this definition applied in case law is that it contemplates some sort of "activity".

Many would suggest that the activity must be designed to generate a profit, but case law has also shown that this is not always the situation even though it would generally be – "Of course, the attainment of a profit is not necessarily the hallmark of a trading transaction" [*De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* [1986]] and "It is doubtless true to say that, in general, a trader embarks upon trade with the intention of making a profit, but it cannot be said that if this intention is lacking there is no carrying on of a trade. A trade may be carried on with the knowledge that losses will result" [*ITC 1274* [1977], quoting from *Umtali Finance (Pvt) Ltd v Commissioner of Taxes* [1962]].

The *Pick 'n Pay Wholesalers* case [*Commissioner for Inland Revenue v Pick 'n Pay Wholesalers (Pty) Ltd* 1987 (3) SA 453 (A), 49 SATC 132] makes it clear that expenses incurred for a purely philanthropic endeavour would not be considered a trade. Strictly private expenses would also not be considered incurred for purposes of a trade.

So, taking these aspects into account, the question arises: when would a person who is investing be considered to be trading?

*Silke on South African Income Tax* in paragraph 7.2 provides a good summary of the principles, even if these are not necessarily simple to apply:

> "A person who accumulates his savings and invests them in interest-bearing securities or shares held as assets of a capital nature does not derive the income from carrying on any trade.
>
> Nevertheless, the scale and nature of the investment in securities or shares held as assets of a capital nature may, it is submitted, be such as to amount to the carrying on of a trade.
>
> A business of speculation in securities or shares held as assets of a revenue nature constitutes the carrying on of a trade".

The first point is supported by *ITC 1275* [1978], in which an individual claimed office expenses, entertainment and travelling expenses as well as bank charges against his income from public listed shares, debentures, bonds and loans as well as a number of tax-free investments. The taxpayer did not claim to be dealing or trading in investments and a review of the investments indicated that many had been held for a considerable time. However, he argued that he had to incur the expenses claimed to oversee the various investments. The court concluded that the taxpayer was not carrying on a trade or a business of investing in securities and

> "The law does not allow a taxpayer who derives a portion of his income from investments to deduct from his income expenses he incurs in watching over those investments, however wisely those expenses may be."

Contrast this with the *Burgess* case [*Burgess v Commissioner For Inland Revenue* [1993], in which the taxpayer borrowed money from the bank to invest in an insurance product for one to two years. The taxpayer expected this investment to appreciate in value (a good return was indicated but only a minimal amount guaranteed) – it also carried certain tax advantages, although it was determined that these were not the main purpose of the investment.

"It is thus imperative that tax practitioners are clear in their minds as to what is sufficient to constitute a trade. The case law helps to provide us with these rules."

The scheme required Burgess to invest through an *en commandite* partnership and he was at risk for an interest cost differential should the expected profits not materialise. Unfortunately, the October 1987 market "crash" meant that Burgess did not realise the profit he anticipated and had to pay the interest differential. He sought to claim the costs and the Commissioner disallowed these on the basis that Burgess had merely made a passive investment and was thus not "trading".

The Judge, Grosskopf, laid specific emphasis on Burgess' state of mind in becoming involved in the scheme – that he foresaw "a short-term gain". He referred to *ITC 770* [1953], in which it was indicated that it is well-established that the definition of "trade" is "obviously intended to include any profitable activity" and should be given a wide interpretation.

Grosskopf J concluded that the scheme Burgess had embarked upon constituted a "venture", a term which appears in the definition of "trade".

He referred to *ITC 1476* [1989] (at 148) and the definitions of "venture" set out therein:

> "The Oxford English Dictionary (Compact Edition) defines the word as a noun as follows – 'An act or occasion of trying one's chance or fortune: a course or proceeding the outcome of which is uncertain but which is attended by the danger of risk or loss: an enterprise, operation or undertaking of a hazardous or risky nature.' Webster's New Universal Unabridged Dictionary (Jean L. McKechnie Edition) defines the noun 'venture' as –'1 A risky or dangerous undertaking; a business enterprise in which there is danger of loss as well as chance for profit.' As a verb Webster quotes – 'To do or go at some risk – to dare.' "

He said that the scheme Burgess had embarked upon "was a speculative enterprise par excellence".

Of additional importance is that, although in the Burgess scenario emphasis was placed on the fact that the venture was risky, Judge Grosskopf made the *obiter* (and thus not binding) comment that because "venture" (and thus "trade") is such a broad concept

> "a person who borrowed money at a low rate of interest and invested it at a higher rate, would be engaged in a trade even if his investment was a safe one".

If the Burgess case thus sets such a low bar, then one has to ask: why, other than when incurred for philanthropic and private expenses, or to determine when a trade commences or ceases, "trade" is ever the subject of debate in respect of expenditure? This includes when incurred in respect of investments (that generate taxable rather than exempt income – not deductible under (section 23*(f)*). The Judge's upfront confirmation that the company was trading in the *Unitrans* case appears to support this question.

There must, however, be a "venture" and case law has shown the importance of this. In *ITC 1476* [above at 147] the judge referred to *ITC 777* [1953]:

> "The ratio of Neser J's judgment is that the mere intention to carry out some business activity or a particular transaction is insufficient to amount to the carrying on of a trade – there had to be an actual endeavour so to do. That there must at least be such an active step is trite".

*ITC 1476* dealt with a holding company which had previously received management fees, dividends and interest from companies it invested in, which companies invested, speculatively, in property. In the year under review, it received none of these forms of income (only a small amount of interest from deposits in its bank account) and it attempted to offset an assessed loss brought forward (to do this the company must have been trading in the current year, per section 20 of the Act). The Judge (Kirk-Cohen J) indicated that a company could trade in one year but cease in another and resume again in a later year.

The Judge stated:

> "In my view the carrying on of a trade involves an active step – something far more than merely watching over existing investments which are not, and are not intended or expected to be, income producing during the year in question".

Having analysed the evidence and evaluating the nature of the expenses, he concluded:

> "that the appellant was totally inactive in the sense that it held shares and had investments made in years prior to the 1987 year of assessment which needed little, if any, supervision as no dividend or interest was to accrue".

Hence, the company was not trading and the assessed loss could not be offset.

In *ITC 1222* [1974] the taxpayer bought and sold shares on a systematic basis, but realised a loss in the year concerned. The court determined that speculative ventures were being undertaken and these were held to be trade.

Thus, where there is speculative investment trading (also see the finding in *Nussbaum's* case [*Commissioner for Inland Revenue v Nussbaum* [1996]] the proceeds from the sales of shares (or other financial instruments) will be included in gross income and the expenses incurred to generate that income will be deductible. In that case significant profits were realised during the year and the taxpayer tried to argue that his shares were not his "stock-in-trade".

There is thus motive for the taxpayer to argue that he is not trading when profits that would result in taxable income arise, but that he is trading where he has expenses but not profits that could result in taxable income. The converse applies for SARS.

It is thus imperative that tax practitioners are clear in their minds as to what is sufficient to constitute a trade. The case law helps to provide us with these rules.

[*Editors' note:* For more discussion on the concept of trade from the SARS perspective, readers are referred to IN 33, which deals with the requirements of income and trade for purposes of determining the continuation of assessed losses.]

**Adjunct Associate Professor Deborah Tickle**

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "trade"), 11*(a)*, 20 & 23*(f)* & *(g)*;
- Tax Administration Act 28 of 2011.

Other documents

- *Silke on South African Income Tax* in paragraph 7.2;
- *Oxford English Dictionary (Compact Edition): Definition of "venture"* (noun);
- *Webster's New Universal Unabridged Dictionary (Jean L McKechnie Edition): Definition of "venture"* (noun and verb).

Cases

- *Commissioner, South African Revenue Service v ABC* [2023] (6) SA 477 (GP);
- *Unitrans Holdings Ltd v Commissioner for the South African Revenue Service* (A3094/2022) [2023] ZAGP JHC;
- *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* [1986] (1) SA 8 (A), 47 SATC 229;
- *Umtali Finance (Pvt) Ltd v Commissioner of Taxes* [1962] (1) SA 251 (SR), 24 SATC 398;
- *Commissioner for Inland Revenue v Pick 'n Pay Wholesalers (Pty) Ltd* [1987] (3) SA 453 (A), 49 SATC 132;
- *Burgess v Commissioner for Inland Revenue* [1996], 55 SATC 185;
- *Commissioner for Inland Revenue v Nussbaum* [1996] (4) SA 1156 (A), 58 SATC 283;
- *ITC 1274* (1977) 40 SATC 185 (T);
- *ITC 1275* [(1978) 40 SATC 197 (C)];
- *ITC 770* [(1953) 19 SATC 216 (T)];
- ITC *1476* [(1989) 52 SATC 141(T) at 148];
- *ITC 777* [(1953) 19 SATC 320 (T)];
- *ITC 1222* [(1974) 37 SATC 17 (C)].

Tags: general deduction formula (section 11*(a)*); investment and holding company; trade; interest-bearing securities; en commandite partnership; speculative investment trading.

# PROFESSIONAL MEMBERSHIP FEES

## INTRODUCTION:

SAIT membership fees were due in early 2025 and tax practitioners are raising concerns about the income tax and VAT implications associated with paying these fees.

To determine the income tax and VAT implications of SAIT membership fees, it is crucial to address the following considerations:

## KEY CONSIDERATIONS

1. **Who pays the membership fees:**
    - Is it the employer or the employee who is a member of SAIT?
2. **Perspective of the question:**
    - Is the analysis from the company's perspective or the individual SAIT member's perspective?
3. **Tax implications:**
    - Both income tax and VAT implications are analysed.

## BREAKDOWN OF SCENARIOS

1. ***If the employer pays the SAIT membership fee***

*Company's perspective:*

- If SAIT membership is a condition of employment, the company can deduct the membership fees (including VAT) from its taxable income for income tax purposes.
- However, as the company is not the member, it cannot claim the VAT on the fees as input tax when completing its VAT 201 return.
- The full cost, including VAT, is a tax-deductible expense for the company when completing the ITR14.

*Employee's perspective:*

- When the employer covers the membership fee, it constitutes a **nil-value fringe benefit** under paragraph 13(2)*(b)* of the Seventh Schedule to the Income Tax Act, 1962 (the Act), resulting in no income tax implications for the employee.
- The employee cannot claim an input VAT deduction because the fee is paid by the employer.

2. ***If the employee pays the SAIT membership fee***

*Individual's perspective:*

a. For registered VAT vendors (eg, sole proprietors): VAT implications

- A member who is a registered vendor can claim the VAT as input VAT only if the expense is incurred for the purposes of making taxable supplies in the course of conducting an enterprise, as per the definition of "input tax" in section 1(1) of the Value-Added Tax Act, 1991 (the VAT Act).
- If the member is not a vendor or does not incur the expense for the purposes of making taxable supplies in the course of its enterprise, the input VAT cannot be claimed.

b. For non-vendors or employees: Income tax implications

- Under section 23*(m)* of the Act, employees are prohibited from deducting membership fees paid to professional bodies.
- As a result, this field is greyed out in the ITR12 tax return.
- Section 23*(m)* limits deductible expenses for employees to specific categories, such as contributions to retirement funds, legal expenses, wear-and-tear allowances, bad debts, and doubtful debts.
- A SAIT tax practitioner employed by a company therefore cannot deduct SAIT membership fees against taxable income when completing the ITR12.
- Where the member is not an employee, but a sole proprietor, the amount would be deductible for income tax purposes.

**Summary of deductibility**

1. **For vendors:**
    - Input VAT can be claimed if the member is a vendor conducting an enterprise and the expense is incurred for the purposes of making taxable supplies.
2. **For non-vendors (employees):**
    - Membership fees are **not deductible** against taxable income, even if employed as a SAIT tax practitioner.

**OPTIMAL TAX STRATEGY** [The Seventh Schedule to the Act: paragraph 13(2)*(b)*]

To optimise the tax treatment, the employment contract should explicitly state that membership to a professional body is **mandatory** and a **condition of employment**.

- **Employer's role:**
    - The employer pays the membership fees directly to the professional body.
    - While the employer, as a vendor, cannot claim input VAT, the payment can be treated as a deductible expense against taxable income.
- **Employee's perspective:**
    - When the employer pays the membership fee, it is treated as a **nil-value fringe benefit**, with no income tax consequences for the employee.

[*Editors' note*: Although this article refers to SAIT membership fees the principles apply equally to the membership fees of other professional bodies.]

"When the employer covers the membership fee, it constitutes a **nil-value fringe benefit** under paragraph 13(2)*(b)* of the Seventh Schedule to the Income Tax Act, 1962 (the Act), resulting in no income tax implications for the employee."

**Mahomed Kamdar**

Acts and Bills

- Income Tax Act 58 of 1962: Section 23*(m)*; Seventh Schedule: Paragraph 13(2)*(b)*;
- Value-Added Tax Act 89 of 1991: Section 1(1): definition of "enterprise".

Other documents

- VAT 201 form;
- ITR12;
- ITR14.

Tags: tax-deductible expense; registered vendor; deductible expenses; taxable supplies; nil-value fringe benefit.

# GLOBAL MINIMUM TAX ACT

*The introduction of the Global Minimum Tax Act, 2024 (the GMT Act), into South African law (promulgated in* Government Gazette *51830 on 24 December 2024) has created significant buzz in the tax world.*

[The GMT Act was introduced alongside with the Global Minimum Tax Administration Act, 2024, which sets out the South Africa's specific administrative provisions. Both these Acts are deemed to have come into operation on 1 January 2024 and apply to fiscal years beginning on or after that date.] The GMT Act is designed to ensure that large multinational enterprises (MNEs) pay a minimum level of tax on their income in each jurisdiction in which they operate, aligning South Africa with international efforts to combat tax base erosion.

This development follows the formalisation of South Africa's collaboration with the OECD on 16 July 2023, when both parties signed a Memorandum of Understanding for their inaugural Joint Work Programme. This five-year initiative is set to deepen South Africa's cooperation with the OECD, laying the groundwork for enhanced alignment on global tax policies.

Developed under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS), the GMT Act reflects the principles of the Pillar 2 proposals by setting an effective minimum tax rate of 15% for MNE Groups with annual revenues of at least €750 million (see Article 1.1 of the OECD Model Rules ("Scope of the GLoBE Rules")). South Africa's adoption of this framework underscores its role as an active participant in shaping equitable international tax standards.

## WHO DOES NOT NEED TO WORRY ABOUT THE GLOBAL MINIMUM TAX ACT?

Multinationals with a South African presence have been preparing for worldwide changes as well as the South African impact of the GMT Act, with discussions largely focused on compliance, international competitiveness, and economic impacts. However, for many businesses and individuals, this legislation may not be as relevant as it seems – at least for now.

While the GMT Act aims to curb profit shifting to low-tax jurisdictions and erosion of the tax base by ensuring that a fair share of taxes are paid, the Act specifically targets MNEs with annual revenues of at least €750 million. This means that unless a taxpayer's business operates on a global scale and meets the revenue threshold, the GMT Act likely does not directly affect that taxpayer.

In addition to the group annual revenue threshold, a list follows of those who do not need to lose sleep over the GMT Act:

1. Governmental entities;
2. International organisations;
3. Non-profit organisations;
4. Pension funds;
5. An investment fund that is an ultimate parent entity;
6. A real estate investment vehicle that is an ultimate parent entity; or
7. Entities owned or partially owned by the aforementioned entities in certain circumstances.

## THE REAL TAX ISSUES ON WHICH ONE SHOULD FOCUS

While the GMT Act is grabbing headlines, many other tax issues remain more critical and immediate for most South African businesses with cross-border activities earning revenue. These include:

- **Permanent establishment (PE) risks:** Where one's company has a business presence, employees, offices, etc, in another country through which its business is wholly or partly carried on, it can be considered as having a permanent establishment in that foreign country, exposing one's business to income tax liabilities in that country and the risk of double taxation in South Africa.

- **Transfer pricing compliance:** If one's business involves a group of companies where companies within the group are operating in different jurisdictions, transfer pricing regulations should be at the top of one's compliance checklist. Many taxpayers fall foul of the transfer pricing provisions, allowing SARS to make an adjustment to taxable income and thereby increasing their income tax liability.

"When engaging in cross-border transactions, it is essential to understand the VAT implications that arise, as different countries have varying rules regarding VAT on international sales."

However, with proper planning and specialised guidance, compliance with these provisions can be effectively achieved. In the case of *ABD Limited v Commissioner for the South African Revenue Service* (IT14302 – judgment handed down in February 2024), dealing with transfer pricing, the court found in favour of the taxpayer, who licensed its intellectual property to foreign subsidiaries at a small 1% mark up, based on the computation method used.

- **Controlled foreign company (CFC) rules: In th**e event that South African resident shareholders collectively hold more than 50% of the total participation rights or voting rights in a foreign company, the resident shareholders should ensure they are aware of the CFC imposition rules, which can result in foreign company income being imputed to resident shareholders.

It is possible to navigate the negative effects of CFC imposition rules by qualifying for the exemption afforded to foreign business establishments, the high tax exemption or headquarter company exclusion. In the Constitutional Court case of *Coronation Investment Management SA (Pty) Ltd v Commissioner, South African Revenue Service* [2024], the court had to consider whether the net income of the CFC should be included in the taxable income of its parent company, which is resident in South Africa. The court found in favour of Coronation on the basis that all the requirements of a foreign business establishment were met under section 9D of the Income Tax Act, 1962.

- **Cross-border withholding taxes:** Ensuring compliance with withholding tax obligations under the taxation laws of foreign countries is crucial, especially when making payments to foreign entities or receiving cross-border income, whether in the form of dividends, interest or management fees. However, taxpayers should take note that cross-border withholding taxes can often be reduced under the relevant double taxation agreement, providing valuable relief and opportunities to optimise tax efficiency.

- **Value-added tax (VAT):** When engaging in cross-border transactions, it is essential to understand the VAT implications that arise, as different countries have varying rules regarding VAT on international sales. Proper documentation and compliance with the VAT registration requirements in both the exporting and importing countries are crucial to avoid penalties and ensure smooth transactions. Failure to account for specific rules, such as South Africa's imported services VAT provision, can result in costly repercussions, with SARS potentially deducting the VAT portion from the payment made for services – ultimately reducing the income received by the South African entity.

- **Exchange control:** Whilst not a tax rule, exchange control goes hand in hand with tax where money is flowing across borders. For South African businesses, navigating these regulations is important, as the Reserve Bank continues to enforce them despite a gradual relaxation of certain rules in recent years. These controls govern the flow of funds across borders, with specific approvals often required for significant payments or transactions involving restricted jurisdictions. Ignoring these requirements is not just risky – it could lead to penalties or even the reversal of transactions. Staying informed and proactive ensures businesses can move funds efficiently while avoiding unnecessary complications.

## CONCLUSION: FOCUS ON WHAT MATTERS NOW

The GMT Act may be an important step in international tax reform; however, whilst National Treasury and SARS will be incorporating the changes happening at OECD level into South African law, for many businesses, it remains a distant issue. Instead of being caught up in the hype, businesses should concentrate on more pressing tax challenges, such as **permanent establishment risks, transfer pricing, cross-border compliance** and **VAT requirements**.

By focusing on these critical areas and staying informed, one will ensure that one's business is well-positioned to handle today's tax environment – and whatever changes the future may bring.

**Darren Britz & Anelmari Truter**

***Tax Consulting SA***

AActs and Bills

- Income Tax Act 58 of 1962: Section 9D;
- Global Minimum Tax Act 46 of 2024 (promulgated on 24 December 2024 – *Government Gazette* 51830);
- Global Minimum Tax Administration Act 47 of 2024 (promulgated on 9 January 2025 – *Government Gazette* 51884).

Other documents

- OECD (2021), Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, OECD Publishing, Paris, https://doi.org/10.1787/782bac33-en [Article 1.1 of the Rules ("Scope of the GLoBE Rules")];
- Memorandum of Understanding between South Africa and the OECD for their inaugural Joint Work Programme;
- OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

Cases

- *ABD Limited v Commissioner for the South African Revenue Service* [2024] (IT14302);
- *Coronation Investment Management SA (Pty) Ltd v Commissioner, South African Revenue Service* [2024] (6) SA 310 (CC).

Tags: multinational enterprises (MNEs); profit shifting; withholding tax obligations; cross-border withholding taxes.

# *MEDTRONIC* JUDGMENT AND VDP

*The Constitutional Court judgment handed down on 20 December 2024 in* Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L. *[2024] has significant implications for taxpayers navigating the South African tax compliance landscape.*

At its core, the decision confirmed that once an agreement in terms of the voluntary disclosure programme (VDP) has been concluded, interest on outstanding tax liabilities cannot be remitted. This ruling has sparked a debate on whether the VDP remains the most financially beneficial route for taxpayers seeking to address historic non-compliance.

## BACKGROUND

Medtronic International Trading S.A.R.L. (Medtronic) was defrauded by a former employee who embezzled funds and submitted fraudulent VAT returns to SARS over several years [*Medtronic* at paragraph 3]. Upon discovering the fraud, Medtronic applied for relief under VDP and disclosed the VAT underpayments [*Medtronic* at paragraph 5]. During VDP negotiations Medtronic requested SARS to waive the interest in relation to the default. SARS subsequently informed Medtronic that it lacked authority to waive interest under VDP and presented it with the following two options [*Medtronic* at paragraph 6]:

1. Proceed with the conclusion of the VDP process and pay the full agreed amount (including interest); or

2. Withdraw the VDP application, following which the ordinary statutory enforcement processes would ensue.

Medtronic elected to proceed under the VDP, entering into a written voluntary disclosure agreement (VDA) with SARS. However, after the conclusion of the VDA, Medtronic submitted a request for remission of interest, citing section 39(7) of the Value-Added Tax Act, 1991 (the VAT Act) [*Medtronic* at paragraph 8], which request SARS declined to consider.

The question whether the Tax Administration Act, 2011 (the TAA) allows for the remission of interest post conclusion of the VDA, was settled by the Constitutional Court where it was unanimously held that the conclusion of a VDA precludes any further negotiation or adjustment of interest [*Medtronic* at paragraph 49].

It follows that while the VDP offers significant benefits, such as reduced penalties and immunity from criminal prosecution, it also locks taxpayers into the terms agreed upon during the application process. This rigidity, particularly regarding interest, may reduce the overall attractiveness of the VDP for some taxpayers.

This begs the question, as to whether it could potentially be more beneficial for taxpayers to address historic non-compliance outside the VDP (ie, filing-corrected or outstanding returns)?

## DISCLOSURE OUTSIDE VDP

Naturally, if a taxpayer declares historic non-compliance in the ordinary course, they will fall subject to understatement penalties, administrative non-compliance penalties as well as interest, of which the understatement penalties would arguably be the most difficult to dispute. Or would they?

*Understatement penalties*

Understatement penalties are imposed under Chapter 16 of the TAA in circumstances where a taxpayer has made an "understatement" as defined that is not the result of a "*bona fide* inadvertent error". In other words, there can be no understatement penalty levied if the taxpayer's "understatement" is the result of a "*bona fide* inadvertent error".

The term "*bona fide* inadvertent error" is not defined in the TAA and there is a large degree of uncertainty regarding its meaning. This uncertainty is compounded by the divergence between SARS' interpretation of the phrase and the interpretation which appears to be adopted by the courts. [*Editorial note:* Further developments to clarify this issue are likely.]

While SARS adopts a very narrow view, which is that an error can never be inadvertent if the taxpayer consciously adopted a tax position, the courts have adopted a much more lenient interpretation, as summarised below:

- In *ITC 1890* [2016] the tax court held that the term referred to "an innocent misstatement by a taxpayer on his or her return, resulting in an understatement, while acting in good faith and without the intention to deceive." [*ITC 1890* at paragraph 45]

- In *ITC 1788* [2023] the court found that the fact that VAT returns prepared by personnel were scrutinised by various levels of management together with the fact that the taxpayer's external auditors did not raise any concerns regarding the input VAT claimed, meant that any understatement must be the result of a *bona fide* inadvertent error and that the understatement was not done with the intention to deceive. [*ITC 1788* at paragraphs 44–48]

- In *Commissioner, South African Revenue Service v The Thistle Trust* [2022] (*Thistle*) the SCA held that the taxpayer had made a *bona fide* inadvertent error since it relied on a tax opinion, and it made a mistake in good faith without acting intentionally. [*Author's note*: The decision reached by the SCA in *Thistle* was partly based on a concession made by counsel for SARS, which was not ventilated further in the Constitutional Court, but the SCA still held that counsel for SARS "correctly conceded". This could be interpreted to mean the court agreed with the perceived concession and as such this judgment still carries persuasive value.]

"One needs the necessary facts to conclude on Medtronic's prospect of success in remitting the administrative penalties outside VDP; however, the point remains that not following the VDP route could end up being more beneficial for taxpayers."

- In *Commissioner, South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] (*Coronation*), with reference to the judgment handed down in *Thistle*, the SCA also concluded that the taxpayer's reliance on a tax opinion together with the fact that it submitted its tax returns under the guidance of an audit firm were indicative of a "*bona fide* error". Furthermore, the court noted that the mere fact that the taxpayer did not disclose the opinion was not sufficient to indicate "*mala fides*". [*Coronation* at paragraph 60 – 64] The conclusion in *Coronation* was based on the earlier judgment in *Thistle*, which in turn was based on the incorrect understanding that SARS had conceded; the court in *Coronation* nevertheless also pointed out that the taxpayer had relied on professional advice.]

- *Thistle* was taken on appeal to the Constitutional Court [*Thistle Trust v Commissioner, South African Revenue Service* [2024]], where it was held that the issue of what constitutes a "*bona fide* inadvertent error" does not engage its jurisdiction. However, the court made several important observations, including that SARS had no sustainable grounds to impose understatement penalties based on either "no reasonable grounds for tax position taken" or "reasonable care not taken in completing return". The court explained that SARS bears the onus of proving the fact that would bring the understatement of the taxpayer within either of these categories and in the circumstances where the taxpayer was in possession of a well-reasoned legal opinion, SARS had no reasonable prospects of discharging this onus.

Therefore, if a taxpayer's position is supported by a legal opinion or if the taxpayer engaged a suitable professional to assist in filing their returns, the understatement penalties could still be disputed (outside VDP) by way of objection on the basis that the understatement is the result of a "*bona fide* inadvertent error" or, alternatively, that it does not fall under the specified categories of behaviours.

It is submitted that it is not inconceivable that a company of Medtronic's magnitude might have the necessary checks and balances in place to prevent non-compliance and ensure accuracy of returns and certainly had external auditors. On this basis it could be argued that it was a *bona fide* inadvertent error.

Absent a VDA, the taxpayer will also be free to dispute any administrative penalties which may have been imposed as well as request the remission of interest in terms of the applicable section of the relevant underlying tax Act (ie, section 39(7) of the VAT Act or section 89*quat* of the Income Tax Act, 1962).

*Remission of interest*

- Section 39(7) of the VAT Act, for example, provides that the Commissioner may remit the interest if he is satisfied that the taxpayer's failure to make timeous payment was due to circumstances beyond the control of the taxpayer.

- Section 187(7) of the TAA limits the type of circumstances that would qualify as "beyond the taxpayer's control" to natural or human-made disasters, civil disturbance, or disruption of services; or a serious illness or accident.

- In the case of *Medtronic*, the embezzlement by the employee of the taxpayer would likely not fall within one of these categories; however, that is not to say that the possibility to make out an argument for remittance of interest may exist for other taxpayers with historic tax defaults.

*Remission of administrative penalties*

Administrative penalties may be remitted in terms of section 217(3) of the TAA, if SARS is satisfied that the following requirements are satisfied:

- The penalty has been imposed in respect of a "first incidence" of non-compliance, or involved an amount of less than R2 000;

- Reasonable grounds for the relevant non-compliance exist; and

- The non-compliance in question has since been remedied.

In the above context "first incidence" of non-compliance means that no administrative penalties have been imposed on the same taxpayer in terms of a penalty assessment during the preceding 36 months.

The second requirement imposes the standard of reasonableness, which tests whether the default occurred notwithstanding that the taxpayer had acted reasonably. The question of what is considered "reasonable" in any particular circumstances must be assessed on a case-by-case basis. In the case of *Peri Framework Scaffolding Engineering (Pty) Ltd v The Commissioner for the South African Revenue Service* [2021] the court held that the taxpayer, who in that case made every effort to comply, but nevertheless failed to comply, had acted reasonably.

The last requirement simply means that the taxpayer has rectified the default in question, in other words the underestimation and late payment have been remedied.

One needs the necessary facts to conclude on Medtronic's prospect of success in remitting the administrative penalties outside VDP; however, the point remains that not following the VDP route could end up being more beneficial for taxpayers.

> "Section 39(7) of the VAT Act, for example, provides that the Commissioner may remit the interest if he is satisfied that the taxpayer's failure to make timeous payment was due to circumstances beyond the control of the taxpayer."

## CONCLUSION

The judgment handed down in *Medtronic* unequivocally confirms that taxpayers effectively forfeit the possibility to remit interest when historic non-compliance is disclosed to SARS under the VDP. The reason for this is that SARS is not empowered to waive interest under VDP and once the VDA is concluded, the agreement must be honoured.

In light of this judgment, it may be worthwhile for taxpayers to consider the true benefit of the VDP and whether they would not perhaps be able to achieve a better result by disclosing non-compliance outside the VDP and disputing the penalties and interest separately. Although this avenue potentially carries a greater risk for the taxpayer and it must be considered on a case-by-case basis, it may be a risk worth taking in the appropriate circumstances.

**Jana de Clerk**

***Unicus Tax Specialists SA***

Acts and Bills

- Income Tax Act 58 of 1962: Section 89*quat*;
- Tax Administration Act 28 of 2011: Sections 187(7) & 217(3);
- Value-Added Tax Act 89 of 1991: Section 39(7).

Cases

- *Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L.* [CCT 79/23 [2024] ZACC 26; [2024] JDR 5301 (CC): Paragraphs 3, 5, 6, 8 & 49;
- I*TC 1890*; 79 SATC 62 at paragraph 45;
- *Commissioner, South African Revenue Service v The Thistle Trust* [2023] (2) SA 120 (SCA); (516/2021) [2022] ZASCA 153 (7 November 2022): Paragraphs 28–29;
- *Thistle Trust v Commissioner, South African Revenue Service* [2025] (1) SA 70 (CC); CCT 337/22 [2024] ZACC 19 at 87-90;
- *ITC 1788* [2023]: Paragraphs 44–48;
- *Commissioner, South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] (3) SA 404 (SCA) (paragraphs 60–64;
- *CCT 337/22* [2024] ZACC 19 at 87–90;
- *Peri Framework Scaffolding Engineering (Pty) Ltd v The Commissioner for the South African Revenue Service* (A67/2020) [2021] ZAWWCHC 153 (23 August 2021); [2021] JDR 1908 (WCC).

Tags: voluntary disclosure programme (VDP); voluntary disclosure agreement (VDA); historic non-compliance; understatement penalties; *bona fide* inadvertent error; innocent misstatement; *mala fides*.

# RISKS OF NON-DISCLOSURE

*When it comes to keeping secrets, the taxman might just be the ultimate detective. In today's world of sophisticated information exchange networks and robust international cooperation, the era of "hiding" assets or income is effectively over.*

Tax authorities now have unprecedented access to data, thanks to agreements like double taxation agreements (DTAs), automatic exchange of information (AEOI), the Common Reporting Standard (CRS), and the Foreign Account Tax Compliance Act (FATCA). These will be explored below.

## 1. DOUBLE TAXATION AGREEMENTS (DTAs): THE FOUNDATION OF TAX TRANSPARENCY

DTAs are bilateral agreements designed to prevent double taxation of income that crosses borders. While their primary purpose is to eliminate double taxation and encourage international trade and investment, they also include exchange of information (EOI) clauses.

***How DTAs facilitate tax transparency:***

- (Exchange on request EoR): Tax authorities in one country can request information from another country about a taxpayer, provided there is a justified reason.
- Focus on specific information: This might include bank account details, business records, or property ownership.

***Global reach:***

Over 3,000 DTAs are currently in force worldwide, involving most countries. As these agreements evolve, they are increasingly including clauses that require both sides to exchange information automatically, a step beyond the traditional "on-request" model.

## 2. AUTOMATIC EXCHANGE OF INFORMATION (AEOI): SHARING DATA WITHOUT WAITING

AEOI takes tax transparency to the next level. Instead of waiting for a request, tax authorities in participating jurisdictions automatically share financial information annually.

***How it works:***

- Financial institutions collect details of foreign account holders, generally including their balances, interest, dividends, and proceeds from sales, depending on the relevant treaty agreement.
- This information is then shared with the tax authorities of the account holder's home country.

***Scale of participation:***

The AEOI framework is supported by over 120 jurisdictions globally. These include countries that were once considered tax havens, marking a shift in the global tax landscape.

## 3. COMMON REPORTING STANDARD (CRS): THE OECD'S GAME-CHANGER

Developed by the Organisation for Economic Co-operation and Development (OECD), the CRS standardises AEOI globally, ensuring that tax authorities can seamlessly exchange data.

***What CRS covers:***

- Financial institutions in participating countries must identify and report on accounts held by foreign residents.
- The information includes not just balances but also earnings, proceeds, and even ownership structures of entities and trusts.

***Scope and impact:***

- Adopted by more than 110 jurisdictions, CRS creates a vast web of tax transparency.
- Key adopters include European Union countries, Australia, South Africa, Mauritius and Singapore.
- In 2022 alone, CRS facilitated the exchange of data on 111 million financial accounts, with total reported assets exceeding €11 trillion.

## 4. FATCA: THE U.S. POWER PLAY

The Foreign Account Tax Compliance Act (FATCA) was introduced by the United States in 2010 to combat tax evasion by U.S. persons holding assets abroad. Unlike CRS, FATCA is a unilateral U.S. initiative that requires foreign financial institutions to report directly to the U.S. Internal Revenue Service (IRS).

***How FATCA operates:***

- Financial institutions worldwide must identify and report accounts held by U.S. taxpayers or entities with substantial U.S. ownership.
- Non-compliant institutions face a 30% withholding tax on U.S.-sourced income.

***Global adoption:***

Over 113 jurisdictions have signed Intergovernmental Agreements (IGAs) with the U.S. to facilitate FATCA compliance, including many major financial hubs.

***What does this mean for taxpayers?***

The message is clear: there is nowhere to hide. The combination of DTAs, AEOI, CRS and FATCA creates an interconnected global tax network, leaving little room for tax evasion.

**KEY POINTS**

- Transparency is the new normal. The data shared is not limited to income – it includes ownership structures, asset movements, and even minor financial transactions.
- Compliance is non-negotiable. Failing to disclose assets can lead to severe penalties, including heavy fines and even criminal prosecution.
- Proactive planning is essential. Taxpayers should work with advisors to ensure full compliance while optimising their tax positions within the bounds of the law.
- As the taxman's reach continues to expand, it is more important than ever to be transparent.

It is important to be on the right side of compliance.

"AEOI takes tax transparency to the next level. Instead of waiting for a request, tax authorities in participating jurisdictions automatically share financial information annually."

**Caoilfhionn van der Walt**

***Regan van Rooy***

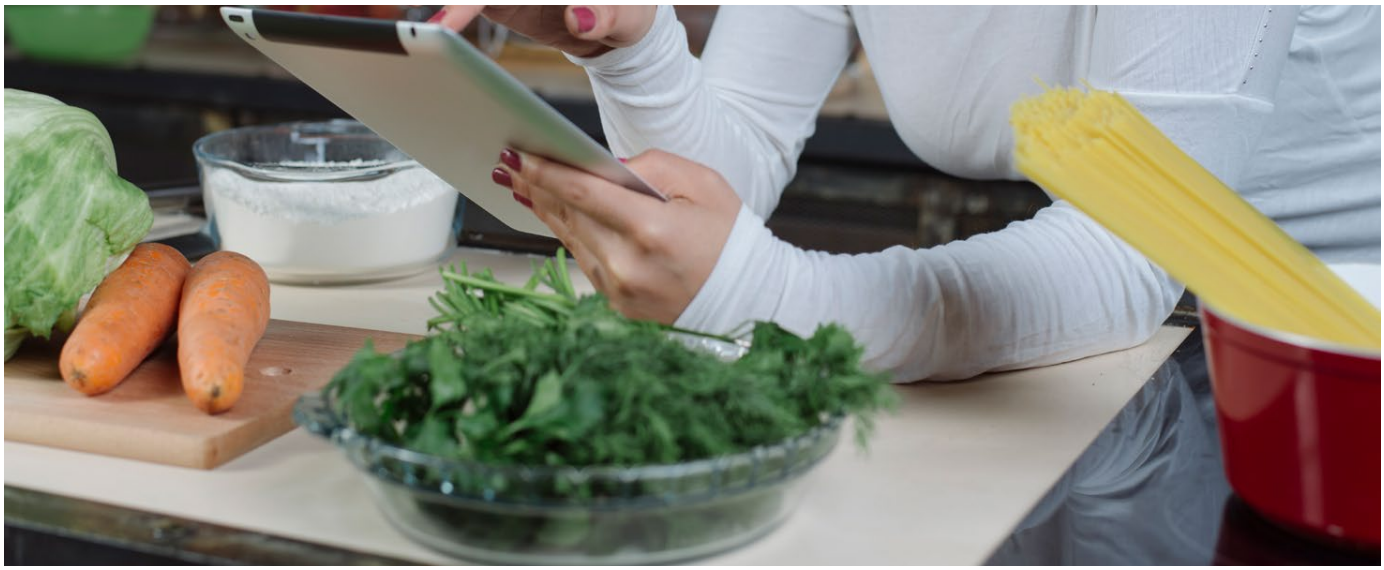
Acts and Bills

- Foreign Account Tax Compliance Act (FATCA) (USA).

Tags: double taxation agreements (DTAs); automatic exchange of information (AEOI); Common Reporting Standard (CRS); Foreign Account Tax Compliance Act (FATCA); double taxation; (Exchange on request EoR); Organisation for Economic Co-operation and Development (OECD).

# OUTSTANDING TAX RETURNS

*After years of threatening non-compliant trusts with administrative penalties for non- or late submission of annual income tax returns as required by law, the South Africa Revenue Service's (SARS') leniency in imposing these penalties seems to be coming to an end.*



It is expected that from April 2025 SARS will start introducing administrative penalties for trusts for non-submission of trust income tax returns retrospectively, and going forward, for non-submission of trust IT3(t) third party data returns. The expected penalties for non-submission underscore the urgency for trusts to ensure that their systems and information align with SARS' requirements.

SARS will have discussions with recognised controlling bodies about administrative penalties, but it is difficult to see why the Revenue Service will be graceful and put off imposing penalties for much longer.

SARS apparently sees a concerningly high level of non-compliance among trusts regarding registration, filing, declarations and payment.

All trusts, operational or not, must submit an annual tax return. This has been a requirement for more than two decades. If a trust has fallen behind, it is very important for the trust to catch up with the filing of such returns. All trusts must be registered with SARS, and not just with the Master of the High Court. Data analysis, however, shows that it takes trusts on average two and a half years after registering with the Master, to register with SARS.

Further to this, SARS has warned trusts to file accurate tax returns on time as delays or inaccuracies can lead to punitive measures which can be costly for trust taxpayers.

Although it is believed that SARS will not impose penalties for the current year of assessment for non-submission of required trust IT3(t) returns, submission is strongly encouraged to establish a compliant track record.

The topic of administrative penalties for non-compliant trusts is often given little attention. Many have not taken trust compliance as seriously as they should. For years, SARS has warned trusts about administrative penalties but has refrained from enforcing them. This inaction may have led trusts to underestimate the seriousness of these warnings. However, this is now expected to change.

Even if April 2025 is not "D-day" for trusts who fail to submit annual tax returns, tax practitioners and trustees are nearing the end of SARS' grace pertaining to administrative penalties. The massive trust reform over the past two years should tell taxpayers that SARS means business. Trustees should have recognised the growing focus of SARS on the tax compliance of the trusts under their care. The formal implementation of administrative penalties is now a key step in SARS' strategy to enforce trust tax compliance.

There is also important advice for trusts that see themselves as dormant or passive and therefore have not bothered to submit trust tax returns for many years. In SARS' view there is actually no such thing as a dormant trust because it has assets (eg, lifestyle assets such as plots, flats or exotic cars), and liabilities, including interest-free loans and other funding methods (eg, donations).

A nil return does not equate to dormancy if any income, expenses or liabilities exist. A passive trust must be passive for the entire tax year to be viewed as such, but even passive trusts must submit beneficial ownership details.

SARS aims to record all beneficial owners of registered trusts to ensure compliance with the Financial Action Task Force (FATF) requirements. FATF identified several action items to be addressed before South Africa can exit the grey list. Countries on the grey list are subject to stricter monitoring of financial institutions to prevent terrorism financing and money laundering. The stricter monitoring brings additional costs for financial institutions.

SARS' stringent requirements for trusts when submitting tax returns are part of expanded trust reporting. SARS now requires the submission of minimum compulsory supporting documents as part of a trust tax return.

SARS does not consider the tax return as filed if any of the following documents are not submitted as well:

- Trust annual financial statements or trust administration statements;
- Minutes of trustee meetings and resolutions passed by trustees;
- Trust instrument (will or trust deed);
- Beneficial ownership document; and
- Letter of authority.

SARS may also require additional supporting documentation over and above the abovementioned documents as part of a SARS verification of the trust return. The scope of the verification requests as per SARS communication, comes down to unprecedented scrutiny with up to 15 separate points to address in each verification letter.

The questions can relate to foreign investments and foreign tax credits (with seeking the precise name of the tax and foreign country and name of the law under which the tax was imposed); beneficiary information such as income tax numbers, ID numbers or residency status; requests for trust bank account information and comprehensive details on the funding of the trust (loan agreements and trustee resolutions authorising the funding structures of the trust).

Considering this, SARS is of the view that the office of trustee should not be taken up lightly. It is an office of importance and trustees should not look to abdicate their authority, responsibilities and other requirements laid down by the law.

"A nil return does not equate to dormancy if any income, expenses or liabilities exist."

***CPD Consortium***

Tags: administrative penalties; trust income tax returns; trust IT3(t) third party data returns; interest-free loans; beneficial ownership.

# THE INTERPLAY BETWEEN SECTION 7C AND TRANSFER PRICING RULES

*Many South Africans use foreign trust structures for tax-efficient asset protection and estate planning.*

Consequently, the January 2025 amendment to section 7C of the Income Tax Act, 1962 (the Act), in the context of low-interest or interest-free loans to a foreign trust by a connected person, is critical to ensuring that such trusts achieve their intended objectives without contravening the trust anti-avoidance provisions.

Section 7C is a trust anti-avoidance provision aimed at limiting the tax-free transfer of wealth to trusts using low-interest or interest-free loans, advances or credit arrangements, including cross-border loan arrangements. Since its inception, section 7C has been plagued by uncertainties that have led to multiple amendments aimed at clarifying and expanding the ambit of its application.

As indicated above, the most recent amendment to section 7C took effect on 1 January 2025 and was introduced by section 4(1)*(b)* of the Taxation Laws Amendment Act, 2024, with the objective of limiting the exclusion of an "affected transaction" as defined under section 31(1) of the Act from the scope of section 7C.

Before dealing with what the amendment entails and the implications for taxpayers, it is useful to recap the anti-avoidance measures contained in sections 7C and 31 of the Act.

## SECTION 7C AND ITS ANTI-AVOIDANCE OBJECTIVE

In terms of section 7C, when a South African resident who is a connected person in relation to a trust makes a loan (including a cross-border loan) to that trust and either does not charge interest or charges interest at a rate that is lower than the official rate of interest, the shortfall amount of interest that would have been applied as per the official rate of interest will be deemed to be an ongoing annual donation to the trust by the resident lender. This deemed donation is subject to South African donations tax as may be applicable from time to time.

The official rate of interest is defined in the Act to mean:

- in the case of a debt denominated in the currency of the Republic, a rate of interest equal to the South African repurchase rate plus 1%; or


- in the case of a debt denominated in any other currency, a rate of interest that is the equivalent of the South African repurchase rate in that currency plus 1%.

For example, consider a situation where a loan of GBP1 million is made by a South African resident to a connected person foreign trust (on an arm's length basis) with an interest rate of 4,75%. If the prevailing official interest rate were 5,75% (eg, based on the Bank of England base rate of 4,75% plus 1%), the difference of GBP10 000, representing the forgone interest, would be deemed to be a donation under section 7C. At an exchange rate of GBP1 = ZAR23, this amounts to ZAR 230 000, which would be subject to donations tax.

## SECTION 31 TRANSFER PRICING ADJUSTMENTS

Section 31 of the Act contains anti-avoidance measures (also known as the transfer pricing rules) that apply to certain "affected transactions", which include but are not limited to cross-border loan arrangements between connected persons.

In terms of section 31, if an "affected transaction" has terms and conditions that deviate from those that would exist in an "arm's length" agreement between independent parties and a consequent tax benefit exists, certain transfer pricing adjustments must be made, which in turn may result in an increased tax liability in the hands of the South African residents.

For purposes of this article only cross-border loan arrangements that would qualify as "affected transactions" under the transfer pricing rules are considered. In such instances, the provisions of section 31 would require the following transfer pricing adjustments to be made:

- **primary adjustment (section 31(2)):** the lender must include the difference between the arm's length interest rate and the actual interest charged (if any) in its taxable income; and
- **secondary adjustment (section 31(3)):**
  - where the lender is a company, the amount of the primary adjustment is deemed to be a dividend consisting of an asset *in specie* declared and paid by the resident lender to the non-resident borrower; or
  - where the lender is a natural person, the amount of the primary adjustment is deemed to be a donation made by the resident lender to the borrower, thereby potentially incurring a donations tax liability at the donations tax rate as may be applicable from time to time.

## HISTORICAL INTERACTION BETWEEN SECTIONS 7C AND 31 OF THE ACT

Previously, to avoid double taxation in instances where the application of sections 7C and 31 intersect, section 7C(5)*(e)* excluded cross-border loans classified as "affected transactions" under section 31 from the ambit of section 7C.

The 2024 budget announcement highlighted the concern that the 7C(5)*(e)* exclusion (as then worded) inadvertently created a loophole allowing for the avoidance of donations tax where the arm's length interest rate determined in terms of section 31 was lower than the official rate of interest under section 7C.

For instance, imagine Y, a South African resident, advanced an interest-free loan of R5 million to a connected non-resident trust. The arm's length interest rate (market-related rate) was 6%, resulting in interest of R300 000, while the official interest rate applicable under section 7C was 8,75%, equating to R437 500.

As this is a cross-border loan between connected persons, it falls within the scope of section 31's transfer pricing rules and accordingly would have been excluded from section 7C (under the previous wording of section 7C(5)*(e)*). Under the transfer pricing rules, Y would have been required to make:

- a primary adjustment by including the difference between the arm's length interest (R300 000) and the actual interest charged (R0) in their taxable income; and
- a secondary adjustment: if Y was a company, the R300 000 would have been deemed to be a dividend *in specie* and subject to South African dividends tax. If Y was a natural person, the R300 000 would have been deemed to be a donation and subject to donations tax.

Previously, section 7C(5)*(e)* excluded cross-border loans subject to section 31, creating a loophole where only the shortfall between the arm's length and actual interest rate was taxed – while any further shortfall to the official rate escaped donations tax.

For example, if a South African resident advanced an interest-free loan of R5 million to a non-resident trust, and the arm's length interest rate was 6% (R300,000) while the official rate was 8.75% (R437,500), only R300,000 was taxed and subjected to donations tax under section 31, leaving R137,500 not subject to donations tax. The amendment closes this gap by subjecting the remaining shortfall to donations tax under section 7C.

In the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2024, National Treasury relied on a similar example and referred to the loophole as an "unintended anomaly in the interaction between the trust anti-avoidance measures and transfer pricing rules", which inadvertently created structuring opportunities that had the potential to lead to the erosion of the tax base.

## THE AMENDMENT

The section 7C(5)*(e)* exemption was duly amended and now reads as follows:

> "...*(e)* that loan, advance or credit constitutes an affected transaction as defined in section 31(1) **to the extent of an adjustment made in terms of section 31(2)**". (own emphasis added)

Practically, this amendment introduces a "further section 7C adjustment" in as far as qualifying cross-border loan arrangements are concerned.

The exemption under section 7C(5)*(e)* now only applies to interest subject to a section 31(2) adjustment. Where the arm's length interest rate under section 31(2) is lower than the official rate, the difference is no longer excluded from section 7C, leading to an additional donations tax liability.

Using the earlier example, the implications of the amendment are illustrated in terms of Y's tax liabilities as follows:

- **primary adjustment (section 31(2))**: Y is required to include the R300 000 of forgone interest in their taxable income;

- **secondary adjustment (section 31(3)):**
    - if Y is a company, the amount of the primary adjustment (R300 000) is deemed to be dividend *in specie*; or
    - if Y is a natural person, the amount of the primary adjustment (R300 000) is deemed to be a donation; and
- **a further 7C adjustment:** the balance of the interest up to the official rate of interest (R137 000) is deemed to be a further donation under section 7C.

The report of the Standing Committee on Finance on the Taxation Laws Amendment Bill, 2024, dated 19 November 2024, indicates that numerous submissions called for exclusions for arm's length transactions with lower interest rates from the ambit of section 7C. National Treasury, however, dismissed these proposals, citing the anti-avoidance purpose of section 7C and asserting that the new amendment adequately addresses the gaps in the interaction between the trust anti-avoidance provisions and transfer pricing rules.

This amendment to section 7C(5)*(e)* therefore underscores the legislature's commitment to ensuring that anti-avoidance measures are robust and effective. Taxpayers engaging in cross-border trust structures must carefully evaluate their compliance with the amended provision, as they may now face anti-avoidance tax liabilities under both sections 31 and 7C.

**Emil Brincker & Mariska Delport**

***Cliffe Dekker Hofmeyr***

Acts and Bills

- Income Tax Act 58 of 1962: Sections 7C(5)*(e)* & 31(1) (definition of "affected transaction"), (2) & (3);
- Taxation Laws Amendment Act 42 of 2024: Section 4(1)*(b)*.

Other documents

- Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2024.

Tags: low-interest or interest-free loans; trust anti-avoidance provisions; cross-border loan arrangements; repurchase rate; connected person foreign trust; affected transaction; transfer pricing rules; arm's length interest rate; official rate of interest; connected non-resident trust; dividend *in specie*.

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