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Powering Through Instability

04 Time to give economic activity the centre stage **Mandela** and **Mbeki** gave it

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CONTENTS

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POWERING THROUGH INSTABILITY

04 Time to give economic activity the centre stage Mandela and Mbeki gave it

08 How tax is eating into inflation, failure to adjust thresholds?

12 High-net-worth individuals: How is SARS recovering the money?

14 SARS, NPA or SIU: Who should reclaim the money stolen?

18 Money laundering in South Africa in the spotlight: Where are taxpayers hiding the money?

22 South Africa's imminent greylisting: 'Sword of Damocles' or a wake-up call for our economy

26 The green measures we need to see in the February Budget

30 OECD Pillar One progress on the tax challenges arising from the digitalisation of the economy

32 Manufacturing incentive for the motoring industry: The one model of success

36 Agriculture in South Africa: Six things that need urgent attention in 2023

40 Corporate restructuring; merger and acquisition transactions: Navigating tax complexities post-COVID

04 Time to give economic activity the centre stage Mandela and Mbeki gave it

14 SARS, NPA or SIU: Who should reclaim the money stolen?

36 Agriculture in South Africa: Six things that need urgent attention in 2023

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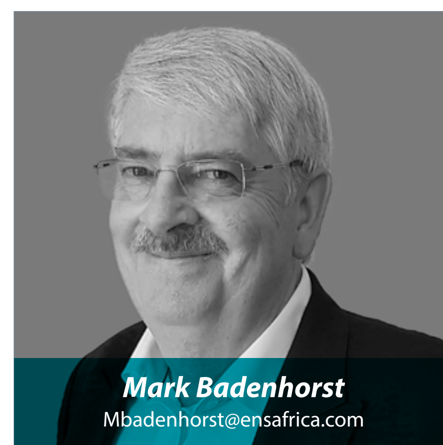

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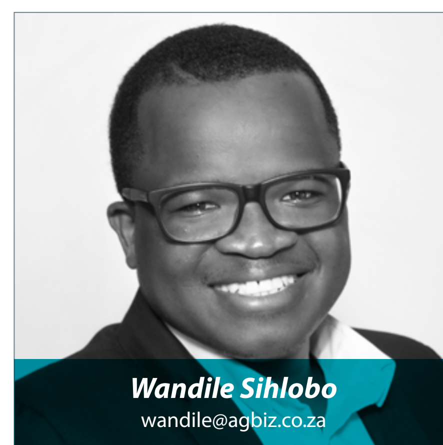

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Time to give economic activity the centre stage Mandela and Mbeki gave it

▶ **CLAUDE DE BAISSAC,** CEO at Eunomix

Government revenues are dictated by economic activity. If governments enjoy some flexibility in the short-to medium-term sources and levels of income, this flexibility reduces over time to being a function of the performance of the economy.

If temporary reductions in activity do not significantly affect long-term revenues, structural reductions do. With these, not only do revenues decrease but the flexibility horizon for revenue generation itself decreases. Options narrow, trade-offs become painful and costs rise. Failure by a government to acknowledge and adequately respond to the shift from temporary economic slowdown to structural decline, is an easy but dangerous mistake to make, because it has enormous implications.

This mistake is precisely the one that South Africa's successive governments had committed since circa 2010–11, when growth failed to recover to its pre-2008 level and, instead, began a long structural decline that remains unaddressed; in fact, it has worsened to the now dangerous. In 2019 growth had reached the 0 per cent point. It would have likely entered slightly negative territory in 2020–21. The pandemic decided otherwise and growth collapsed by seven points in 2020 before it whiplashed back to about 5 per cent in 2021. In 2022, it will, at best be half of that, signalling a return to pre-pandemic conditions—just worsened by the effect of the latter. For 2023–24, Treasury forecasts growth to remain above 1.5 per cent. Nothing to celebrate.

But the bad news does not end here. The problem is that Treasury has had it systematically wrong in the wrong way with its forecasts. Excluding 2020–21, which were truly not predictable, the department has overestimated every single year's growth by an average of over 50 per cent on its two-year forecast since 2012, ranging from 20 to 95 per cent. Treasury's forecast accuracy is lower than 25 per cent . . .

Its latest forecast sets growth to slightly below 2 per cent in 2023–24. This is improbable not only because the department's forecasts average double actual growth but because growth at that level would be twice higher than its miserly average of 0.9 of 2015–19, below the population growth rate that it bears stating. The South African Reserve Bank's (SARB's) latest forecast confirms the distance between the world according to Treasury and the world according to reality: 0.3 and 0.7 per cent for 2023–2024. This is likely closer to what will transpire, although it is probably still on the bullish side.

Indeed. Confidence is, euphemistically, subdued. Investment is at a record low. All key productive sectors are buckling under the weight of high costs, low infrastructure availability, stuttering domestic demand and broken governance. Consumption is throttled by inflation, a shrivelling middle class and high domestic debt. South Africa is one of the world's worst-performing larger economies on just about every indicator that matters. We know because we benchmark and monitor them against the rest of the world.

Otherwise stated, to demand optimism in the face of disaster (a now officially sanctioned term, following the President of this country's latest action about the electricity crisis), is to be asking for a confidence trick. There will not be silver linings until and unless government embarks on the kinds of short-term crisis management actions and long-term structural reforms that it has been promising and not delivering. Whatever green shoots exist, they will remain nestled in the small crevices which fires and floods have mercifully missed.

Eunomix expects no uptick in 2023–25 (see Figure 1). We see no cause for growth to be higher or even near its pre-pandemic level in the immediate term. We also see no cause for growth in the medium term, given the uncertainty that enshrouds the political landscape ahead of next year's elections and their consequences. The train, as the saying goes, left the station many years ago . . .

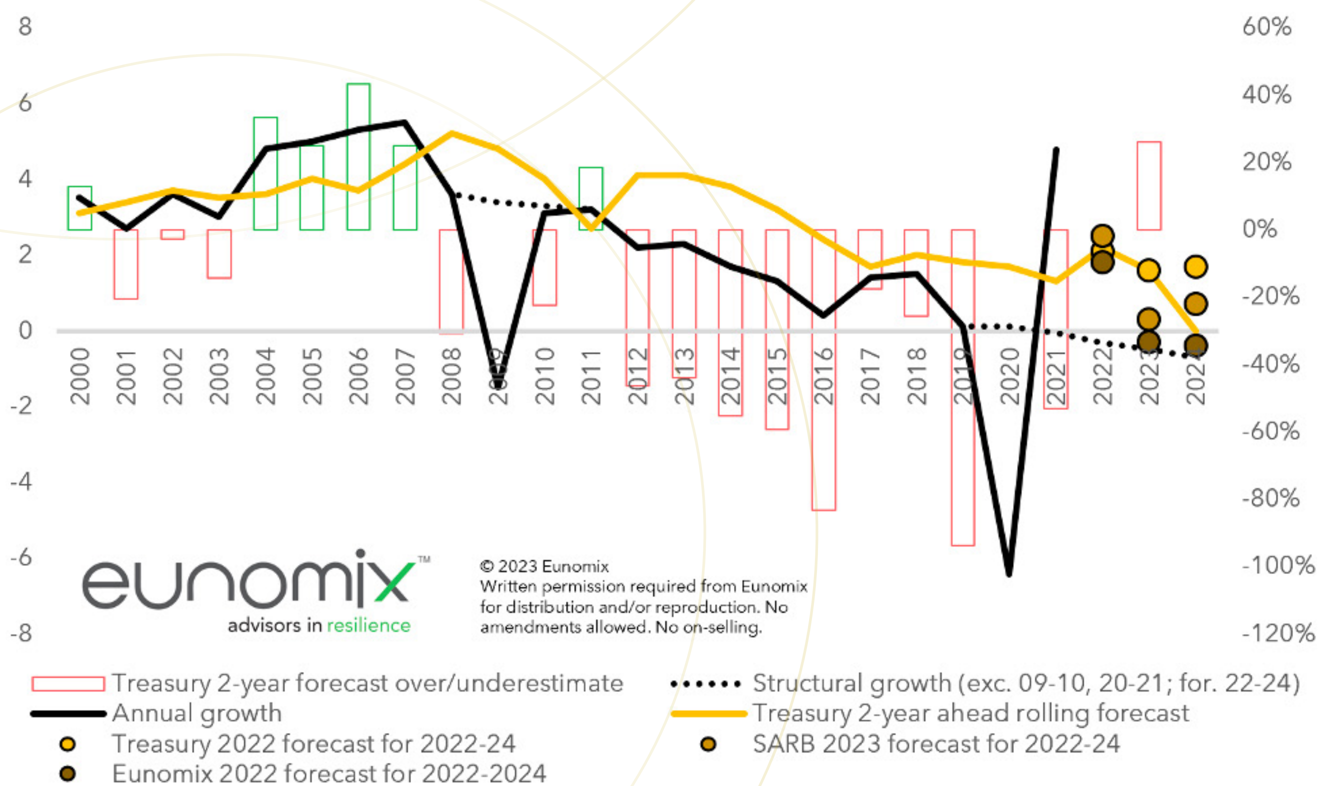

Figure 1: Chart of Eunomix's economic growth forecast for 2023–25.

The problem with Treasury's irrational exuberance is that, unlike the forecasts of Eunomix, those of the department matter enormously. Budgets are set on them; thus, expected revenues, borrowing requirements and debt repayments follow. Critically, expenditures are set on them. They hugely influence things like investor and consumer confidence. They are a key signal for future economic behaviour. They are a precious commodity whose integrity should not be trifled with.

Experience shows that governments the world over are biased towards spending more than they planned, irrespective of whether revenues have obliged. If this were somewhat forgivable in a world of near-zero interests, it is less so in one where they are above five per cent. If the latter is somewhat tolerable in growing economies, it is just about suicidal in one whose population grows faster than the economy, where the economically inactive swamp the active by a world-beating four to one and where a mere 1.5 per cent pay about 30 per cent of all tax revenues. Situations like these do not end well. Particularly, where the government sector accounts for a large share of the economy, thanks to social welfare expenditures that are as vital to sociopolitical stability as they are unaffordable without radical economic transformation in favour of private capital mobilisation.

Globally, governments have the unenviable task of reconciling realities that range from the merely difficult to the nearly irreconcilable. South Africa's own faces the latter situation. It has painted itself in a corner from which, under the laws of economics and politics, there is very little space to run towards and from which there is ultimately no escape. It still benefits from some of the flexibility mentioned earlier, but not much, and one that is fast vanishing. There is still some opportunity for tax optimisation; for instance, by raising duties and VAT on luxury products that are mostly imported (black cars included); and, obviously, by further raising income taxes on people and businesses. But none of these options represents anything more than, at best, managing decline and, at worst, finding itself swallowed by the above-mentioned laws. Though rising rapidly, government debt offers a handful of wiggle years until the debt turns budget-devouring and until the country finds itself confronting an increasingly plausible debt crisis. According to Treasury's own forecasts, the government's obligations are expected to hover around 75 per cent in the next two years or so. No need to say more . . .

"Indeed. Confidence is, euphemistically, subdued. Investment is at a record low. All key productive sectors are buckling under the weight of high costs, low infrastructure availability, stuttering domestic demand and broken governance"

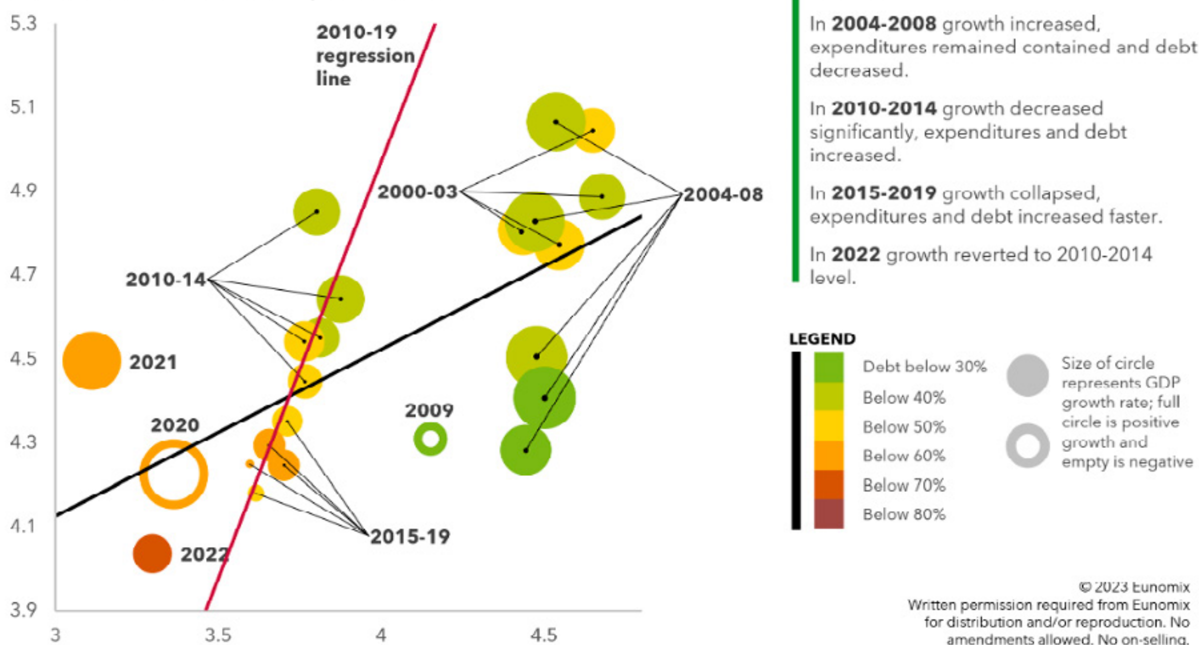

Figure 2: Chart presenting a comparison of four variables between 2000 and 2022.

South Africa's fundamental problem is not revenue generation, which is largely a dependent variable of more critical drivers. The fundamental problem is the structural mismatch between government expenditure and real economic activity. Figure 2 compares four key variables between 2000 and 2022: GDP growth (circle size), debt (circle colour), the GDP to revenues ratio (Y-axis), and the GDP to expenditure ratio (X-axis). The graph spectacularly illustrates just how 2010 represented a clear, awful break in economic policy. Between 2000 and 2008, growth increased while the GDP/ expenditure ratio remained relatively stable, while revenues rose and debt in GDP significantly declined. This represented an era of measured fiscal conservatism that, at worst, did not negatively affect growth (contrary to the tired assertions of the left) and, at best, enabled it (admittedly in the context of high commodity prices and a relatively benign global context). From 2010 to 2019, expenditures and revenues in GDP increased fast and furiously. But these were debt-funded and, at worst, decimated growth (as expected by ourselves in a 2009-article published in South African Property Owners Association (SAPOA) magazine's *The Property Developer* ominously titled 'Is the Rainbow Nation Fraying?') and, at best, failed to support it (there were commodity booms here too and periods of global growth . . .).

Stated differently, while in the first period South Africa managed to have its cake and eat it, in the following period, it ate the cake while losing it.

The 2009 crisis ushered in an era of growth-destructive profligacy in pursuit of a blatantly failed developmental state that gave the country state capture and structural load-shedding. The 2020 crisis caught the government in the nude. After an extremely short-lived recovery, 2022 put all key indicators back on the 2010–2019 trendline (see red line in Figure 2). All forecasts, from Treasury's overly optimistic, to Eunomix's somewhat less optimistic, to SARB's in-between, confirm one thing: the next few years promise to be extremely painful unless economic activity, the real driver of revenues and fiscal sustainability, is allowed to retake the centre stage that Mandela and Mbeki gave it.

Let's GEAR up!

HOW TAX IS EATING INTO INFLATION, FAILURE TO ADJUST THRESHOLDS?

▶ **NYASHA MUSVIBA,** Founder and Tax Director at SA Tax Guide

The adjustments of the tax brackets did not consider the impact of inflation, this means that individuals will owe more taxes. The tax relief announced by the government in the previous Budget Speech has since been eroded by inflation and was never enjoyed by the individual taxpayers.

How individuals are taxed

In South Africa, companies pay tax on a flat rate whereas individuals pay on a progressive scale according to tax tables. The tax year for individuals runs from the first of March of each year to the last day of February the following year. Individuals pay income tax on their earnings depending on the income tax brackets which are applicable to the aggregate income that they have received in a tax year. A progressive tax system involves tax rates that increases as taxable income increases. Low-income earners pay tax on lower tax rates and high-income earners pay tax on higher tax rates.

Every year in February, the Minister of Finance presents the National Budget, which includes, among other things, the spending programmes and the tax proposals for the coming years. Key among the tax proposals will be the individual tax rates for the following year of assessment. The tax rates are commonly known as 'income tax brackets'. Year after year, we hear the Minister of Finance announcing that the government provides tax reliefs to individuals through an adjustment in personal income tax brackets and rebates.

Adjustment in personal income tax brackets

For the tax year ending 28 February 2019, the tax brackets were adjusted by a mere 1%. The tax brackets were not adjusted for the tax year ending 29 February 2020. For the three tax years commencing 01 March 2020 to 28 February 2023, the tax bracket was adjusted by 5% in each tax year.

According to Stats SA, the annual consumer price inflation was 6,9% on average in 2022. This was 2,4 percentage points higher than the corresponding average of 4,5% in 2021. The average annual consumer price index for the past three months is 7.17% (that is, 6.9% in January 2023, 7,2% in December 2022, and 7,4% in November 2022). The consumer price index (CPI) is the most well-known indicator of inflation, it measures the percentage change in the price of a basket of goods and services consumed by households. The tax brackets adjustments must consider the changes in the cost of living.

The adjustments of the tax brackets did not consider the impact of inflation, this means that individuals will owe more taxes. The tax relief announced by the government in the previous Budget Speech has since been eroded by inflation and was never enjoyed by the individual taxpayers. For as long as the tax bracket adjustments are below the CPI, individuals will not benefit from the adjustments. The billions of tax reliefs announced by the Minister of Finance will remain on paper but it will not actually be enjoyed by the taxpayers.

Tax bracket creep

Employers usually adjust salaries by a percentage higher than the CPI figures but at the same time the government's adjustment to tax brackets is below the CPI; this causes tax bracket creep. Tax bracket creep is when inflation pushes salaries and wages into a higher tax bracket or reduces the value of tax credits and rebates. Tax bracket creep results in an increase in income taxes without an increase in real disposable income. The tax brackets adjustments done by the Minister of Finance do not avoid tax bracket creep, therefore it causes individual taxpayers to owe more in income tax due to increases in their salaries.

How to prevent bracket creep

To prevent bracket creep, tax brackets must be adjusted after considering the changes in the cost of living which are caused by inflation. Failure to properly adjust the tax brackets pushes taxpayers into higher tax brackets due to wage inflation and this results in a tax increase. For individuals to benefit from the tax reliefs that are announced by the government, the government must ensure that the individuals are not moving up the tax brackets when there is no real movement in their disposable income.

For the past three years the tax threshold and the tax rebates were adjusted upwards by 5%. The adjustments were also below the CPI, therefore they do not reduce the negative effects of tax bracket creep. The tax threshold is an amount of income that an individual can earn without paying income tax. The tax threshold for the current tax year ending 28 February 2023 is R91 250 and for 2022 tax year it was R87 300.

Failure to adjust the tax brackets benefits the government

In a progressive tax system, the tax bracket creep causes the government to collect more taxes from individual taxpayers. The collection of the revenue using tax tables announced during the Budget Speech gets distorted along the year when employers increase employees' salaries based on inflation increases. The distortion benefits the government and it may be a convenient way to collect more taxes to cover for the increased government expenditures. The government might not publicly announce that it is benefiting from bracket creeps, but the failure to adjust tax tables as per the CPI, automatically results in an increased tax burden on individuals without an increase in their real income. In between the tax brackets that have been adjusted by 5% when the inflation is higher than that adjustment, there will be unavoidable additional tax burden to individuals. However, for the government there will be additional tax revenue that was not subjected to parliamentary processes and oversight.

Inflation does not reduce the value of taxes to be collected by the fiscus

Ironically, the fiscus charges interest rates that are higher than the inflation, this ensures that the collections done by SARS will not be eroded by inflation. Currently, SARS charges interest of 9.75% on outstanding tax debt, this rate is above the inflation figures and therefore the amounts that will ultimately be paid to SARS will be cushioned from the negative effects of inflation.

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YOUR KEY TO THE TAX COMMUNITY

HIGH-NET-WORTH INDIVIDUALS: HOW IS SARS RECOVERING THE MONEY?

JASHWIN BAIJOO, Head of Strategic Engagement & Compliance at Tax Consulting SA

In 2022, the South African Revenue Service (SARS) demonstrated its increased focus on revenue collection and compliance, specifically pertaining to high-net-worth individuals (HNWIs). Their purview extends to wealthy South Africans abroad who remain tax residents of South Africa as well as those in the process of financially emigrating while retaining assets and interests in South Africa.

Although this may be a point of concern for a number of HNWIs, especially those with generational wealth, it is not an unexpected avenue from the taxman; it has been on the cards for years now. This targeted strategy encompasses lifestyle audits, which were initiated by SARS back in 2007, however, actual action earnestly began only a few years ago with the arrival of SARS Commissioner Edward Kieswetter.

Corrections or collections—SARS' veiled strategic objectives

Statistically speaking, SARS has upped its collection powers and efforts, with the 2023 Year of Assessment (01 March 2022 to 28 February 2023) having seen more than 186 691 Final Demand Notices being issued to taxpayers amid the almost one million tax debt cases; these yielded in excess of R35 billion being collected.

Over and above this, the implementation of a dedicated HNWI Unit at SARS, headed up by Ms Natasha Singh, evidences that this is not just some passing phase for the revenue authority; rather, it is a long-lasting game to be built on in the forthcoming years. This unit will serve to detect non-compliance from the wealthy and ultra-wealthy, having full access to global assets and investments for South African tax residents under the veil of assigning designated relationship managers to assist these individuals with their tax compliance.

This aligns with SARS' strategic objective of making compliance as easy and seamless as possible for non-compliant taxpayers who come forth voluntarily, while making it hard and costly for taxpayers who remain non-compliant. Unfortunately, in light of South Africa's shrinking tax base, the middle to HNWI classes are taking the largest tax hit.

Artificial intelligence and third-party data afflicting offshore interests

SARS has begun to embrace the use of technology, specifically artificial intelligence, to ease the burden of detecting non-compliance amongst taxpayers, while simultaneously making full use of the multi-jurisdictional automatic exchange of information. This development has made it near impossible for taxpayers to hold undisclosed offshore interests where, if caught, the taxpayer is subjected to a dual audit with the active participation of both SARS and the revenue authority in which the assets or investments are situated.

The ongoing investigations into South African taxpayers' offshore interests have long been on the cards with SARS; foreign asset/income disclosure notices were being issued as far back as 2020, entailing a blanket disclosure of offshore assets. The knock-on effect was seen last year with Airbnb Hosts, whereby SARS imputed a legal obligation on the Irish Revenue Authority to share taxpayer financial information. This was made possible by virtue of the provisions contained in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

What is noteworthy with the exchange of information requests, is that HNWI have historically opted for a jurisdiction such as Ireland, Mauritius or even the Virgin Islands to hold offshore investments and bank accounts in light of the favourable tax treatment. This jurisdiction choice included a number of not only investments but also trusts, held by South African tax resident HNWIs who thought that they were sheltered from tax consequences in South Africa.

This mindset should have shifted when Commissioner Kieswetter began pushing the agenda of joint audits to the point where they are now a reality, leaving nowhere to hide. This cements SARS' vision of "*aiming to become a smart, modern revenue service*".

"When it comes to compliance with the revenue authority, SARS is ever eager to delve into the historical affairs of any individual, company or trust, unearthing any past transgression, regardless of its impact and using it as leverage in the present day"

Paying for past sins

When it comes to compliance with the revenue authority, SARS is ever eager to delve into the historical affairs of any individual, company or trust, unearthing any past transgression, regardless of its impact and using it as leverage in the present day. In order to mitigate this, taxpayers should, as a first prize, engage experts in the field for the correct tax planning from the get-go. What we often see in practice, is that taxpayers make decisions based on poor or outdated advisory, necessitating that corrective measures be taken to remedy historic non compliance voluntarily.

An increased focus on HNWIs, regardless of what is declared in which jurisdiction, means there is a target placed on these taxpayers, with every move being scrutinised. It is essential to ensure both historical and current compliance, leaving no room for error and raising no red flags, which would give the taxman a basis to rip apart everything you have built, just on a hunch.

Planning your financial freedom

In order to protect yourself from falling victim to SARS' increased scrutiny, it remains the best strategy that you always ensure compliance, historically and currently, by following a tried and tested strategy and tax planning ahead.

Where you find yourself on the wrong side of SARS and its foreign counterparts, there is a first-mover advantage in seeking a remedial roadmap to ease your woes and to ensure the necessary steps are taken to protect both yourself and your hard-earned wealth from paying the price for what could be the tiniest mistake.

However, where things do go wrong, SARS must be engaged legally. We generally find them to be agreeable to the utmost where a correct tax planning strategy is followed.

SARS, NPA OR SIU: WHO SHOULD RECLAIM THE MONEY STOLEN?

CHAD THOMAS, CEO at IRS Forensic Investigations

On 6 January 2023, the National Treasury issued a media release regarding the President signing into law several important pieces of legislation primarily aimed at curbing money laundering and combating the financing of terrorism. The legislation signed into law was the General Laws (Anti-Money Laundering and Combating Terrorism Financing) Amendment Act No. 22 of 2022; and Protection of Constitutional Democracy Against Terrorism and Related Activities Amendment Act No. 23 of 2022 (*POCDATARA*).

The signing of these critical pieces of legislation adds to the arsenal of the state law enforcement and prosecutorial bodies in the war on fraud, corruption, money laundering and proceeds of crime. Moreover, the signing bolsters their effort to strike at those who have benefitted from State Capture, PPE fraud, tender fraud and the collusion that took place between public and private sector actors to plunder the public purse. The signing into law of this legislation came off the back of the imminent greylisting of South Africa by the Financial Action Task Force (FATF) based on the Mutual Evaluation Report, which was finalised and published by FATF in October 2021.

The following media release titled, 'Enactment of key anti-money laundering and combating of terror financing laws', was published on 6 January 2023:

> *"The General Laws Amendment Act and POCDATARA Amendment Act addresses 15 of the 20 deficiencies relating to the adequacy of laws and legal frameworks related to the 40 FATF recommendations that were identified in the Mutual Evaluation Report. The remaining 5 deficiencies will be or have been addressed through non-statutory initiatives. In addition, the South African authorities have completed a second round of assessments of money laundering and terrorist funding risks and developed a national strategy to address these. The South African regulators also developed policies and issued directives and guidance to further*

strengthen aspects of money laundering, terrorist financing and proliferation financing risk management by financial institutions. South African Authorities are of the view that these actions address almost all the technical compliance deficiencies that were identified in the Mutual Evaluation Report. Government will also continue to improve the effectiveness of South Africa's AML/CFT regime."

It appears that the South African government has taken cognisance of the massive financial and reputational damage that will come with greylisting by FATF and has put in place measures in the hope that the decision to greylist South Africa may be reversed.

South Africa has an abundance of legislation to combat financial crime. Although this new legislation has added more tools with which to counter money laundering and terror funding, it is critical that there is infrastructure and capacity among the state law enforcement agencies to achieve the objectives of stemming illicit financial flows and ensuring restitution of funds that were misappropriated during the State Capture era, the multiple tender frauds and the PPE fraud during the Covid pandemic.

The title of this opinion piece is a question posed by the TaxTalk publishers: "SARS, NPA or SIU: Who should reclaim the money stolen?". The answer is somewhat more challenging. Each of the aforementioned organisations play a critical role, as do many others, which will shortly be discussed. However, what we clearly need to understand is that during the State Capture 'project', many organisations tasked with investigation, enforcement, prosecution and revenue collection were effectively hollowed out by those implicated in State Capture.

Organisations that are responsible for the clawback of misappropriated funds include the Directorate for Priority Crime Investigation (DPCI) or more colloquially known as 'the Hawks'; the Investigating Directorate (ID); the Special Investigating Unit (SIU working with the Special Tribunal); the Asset Forfeiture Unit (AFU); the National Prosecuting Authority (NPA); the Financial Intelligence Centre (FIC); the South African Revenue Services (SARS); and the South African Reserve Bank (SARB). The clawback is achieved through criminal court sanctions permitted in law such as restitution in terms of the Criminal Procedures Act, judgements made by the Special Tribunal, and the forfeiture allowed for in terms of chapters five and six of the Prevention of Organised Crime Act of 1998 (POCA), which is generally heard in the High Court on a civil basis. Another option that the ID and NPA have, is that of the highly controversial recommendation that came out of the State Capture Commission of Inquiry of Deferred Prosecution Agreements.

POCA, in particular, has hard-hitting measures in the recovery of funds and assets in terms of money laundering and proceeds of crime. Chapter 5 of POCA can enable criminal forfeiture through a confiscation order, a realisation order or a restraint order. It generally requires a conviction, but the process is civil; there is the ability to have a restraint order issued early, even before criminal charges, to ensure that the funds or assets are not dissipated. Chapter 6 of POCA can enable civil forfeiture through a civil action based on evidence of a balance of probabilities and it utilises a preservation order to freeze property. Unlike chapter 5, a criminal conviction is not necessary; it just shows that the funds or assets were obtained unlawfully and that the action is directly against the property -not the person. [The reader should take note that much of this paragraph is paraphrased from a presentation made some years ago by the erstwhile Willie Hofmeyr when he was still head of the Asset Forfeiture Unit.]

Recovery of misappropriated funds cannot be the sole responsibility of the three agencies named in the title. It can only be achieved if all agencies are enlisted to set up a comprehensive war room with all the necessary infrastructure, workforce and capacity needed to enable the effective prosecution-led and intelligence-driven investigations into financial criminals with the aim of bringing misappropriated funds back into the fiscus.

Government has to consider the establishment and capacitation of an inter-agency war room that should be more like a super-complex facility which would dwarf every previous war room. It should be considered an investment and

not an expense; there is the very real possibility of a significant return on investment if the agencies can achieve the objectives of finding the misappropriated funds and having these finds returned to the treasury through effective co-operation. For this to happen, the State has to show that it is serious. When the ID was first established, the budget was a paltry R100 million (although this has subsequently been increased to R350 million for 2023/24). In 2022, South Africa's designated premier investigation agency, the Directorate for Priority Crime Investigation [writer's emphasis], was allocated just over R2 billion, which made up a mere 2% of the annual police budget. Conversely, the VIP protection division of the police received over R3 billion, which made up 3% of the annual police budget. This begs the question: where do the State's priorities lie?

South Africa has more than enough legislation and formally mandated agencies to address the serious issue of commercial and organised crime in South Africa. It just appears to be lacking when it comes to the political willpower to allow for these agencies to effectively leverage the existing and new legislation to ensure that restitution does, in fact, occur.

In support of the opinion expressed above, the following quote from key findings in the FATF Mutual Evaluation Report of South Africa (p. 5) refers:

"South Africa has suffered from a sustained period of 'State Capture', which helped generate substantial corruption proceeds and undermined key agencies with roles to combat such activity. Government initiatives from 2018/19 were starting to address the situation as of the onsite, including by replacing key staff and increasing resources at key law enforcement and judicial agencies. The Financial Intelligence Centre effectively produces operational financial intelligence that law enforcement agencies use to help investigate predicate crimes and trace criminal assets, but the law enforcement agencies lack the skills and resources to proactively investigate money laundering or terror financing."

"South Africa has an abundance of legislation to combat financial crime. Although this new legislation has added more tools with which to counter money laundering and terror funding, it is critical that there is infrastructure and capacity among the state law enforcement agencies to achieve the objectives of stemming illicit financial flows and ensuring restitution of funds that were misappropriated during the State Capture era"

The FATF Mutual Evaluation Report further articulates something of importance in Chapter 3 titled, 'Legal systems and operational issues':

> *"The authorities also acknowledged that they struggle to investigate and prosecute cases of stand-alone and third-party money laundering. The necessary legislation is in place to tackle such activities; however, the problem appears to lie with lack of resources and expertise available to law enforcement agencies and the NPA to proactively identify the networks and money laundering syndicates operating behind the predicate offence."*

South Africa is at a turning point, the State can decide to capacitate and resource a critical inter-agency task team to run intelligence-driven and prosecutorial-led investigations into commercial and organised crime; to use the funds recovered to fund important social upliftment projects; to expand the capacity and infrastructure of state law enforcement and the NPA; or they can choose to enact more laws without the capacity to enforce such laws, thus allowing South Africa to slide closer to failed state status.

MONEY LAUNDERING IN SOUTH AFRICA IN THE SPOTLIGHT:

"WHERE ARE TAXPAYERS HIDING THE MONEY?"

▶ **STEVEN POWELL,** Director at ENSafrica & **ADRIAN ROUX,** Senior Associate at ENSafrica

Money laundering is a topic that has recently been uppermost in many minds along with a number of high-profile matters covered by the media. Additionally, deficiencies in South Africa's anti-money laundering (AML) and counter-terrorist financing (CTF) regimes have been exposed by the recent Financial Action Task Force (FATF) Mutual Evaluation Report (MER).

"The emergence of cryptocurrencies initially resulted in a regulatory gap which was exploited by criminals—cryptocurrency exchanges were often not subject to these KYC regulations and it was therefore far easier to move funds around anonymously"

The FATF is an intergovernmental organisation that develops policies to combat money laundering and terrorist financing globally. The MER has identified more than 20 weak areas in South Africa's AML and CTF frameworks. Unless drastic measures are implemented to address these weaknesses, South Africa is at risk of being placed on the FATF's list of jurisdictions under increased monitoring, also referred to as the 'greylist', which may result in dire financial consequences for our country.

What is this so-called FATF greylist?

The term 'greylisting' has received significant media attention and has left many asking: "what is greylisting?" and "so what?". Put simply, greylisting is effectively a risk rating which signifies enhanced money laundering and related risks associated with doing business in the jurisdiction to which the rating is assigned. In the event that South Africa is greylisted, there will likely be an increased administrative and cost burden on those doing business in South Africa, given the enhanced due diligence which will be required. In addition, a significant reputational knock will be taken on the global stage which, among others, may deter foreign direct investment (FDI). More specifically, according to the International Monetary Fund, a greylisted country can expect an average decline in capital influx of 7.6% of its GDP, a decrease in FDI of 3% of its GDP, and a decrease in portfolio influx of 2.9% of GDP (Powell, S. 'Grey-listing looming as South Africa rushes to meet the tight deadline'. ENSight; 11 October 2022).

What is money laundering?

Money laundering is the process of obscuring the source of funds acquired through illicit means so that such funds appear to be from a legitimate source. For example, while principally a matter involving alleged fraud, money laundering was cited among the raft of charges recently brought against Samuel Bankman-Fried, the founder of the collapsed cryptocurrency exchange, FTX Trading Ltd. In addition, in December 2022, Dankse Bank (Denmark's largest bank) pleaded guilty to bank fraud conspiracy and agreed to forfeit USD 2 billion as part of an agreement with the United States (US) to settle one of the world's largest money laundering scandals. Money laundering is clearly an issue of significant regulatory interest and will likely remain a top priority for regulators around the world in 2023.

How do criminals launder their money?

In light of the above, many are perhaps left wondering exactly how criminals are laundering their money. Money laundering is typically understood to involve a three-step process commencing with placement, followed by layering and then by integration. Placement is the process of introducing illicit funds into the financial system, e.g. by depositing funds into a bank account. Layering is the process of then moving these funds around using a variety of techniques in attempting to blur their origin. Finally, integration is the process of introducing illicit funds back into the legitimate economy, e.g. by purchasing assets such as cars, houses etc. Money laundering is usually significantly more complex than simply hiding cash under the mattress or in the furniture.

Traditional money laundering schemes

Two examples of traditional money laundering techniques include smurfing and the use of shell companies. Smurfing involves breaking large amounts of money into smaller, less conspicuous payments with the aim of avoiding threshold-based detection methods often employed by financial institutions. The use of smurfing also makes it difficult to pinpoint the source and overall quantum of such funds. Through the use of shell companies and complex corporate structures, criminals are able to store and launder illicit funds using companies, which are often designed to appear legitimate on the surface.

Criminals soon realised that cryptocurrencies provide a convenient mechanism to launder proceeds of crime

Criminals have never been shy of adopting new technology to advance their cause. In recent times, criminals have exploited the lacunae of AML controls and governance in new technologies like cryptocurrencies such as Bitcoin and others to launder criminal proceeds.

Cryptocurrencies are decentralised which makes it far more difficult for authorities to trace transactions, particularly as criminals are able to use cryptocurrencies to transfer large amounts internationally with relative ease.

Faced with this new threat, regulators are employing a combination of new and old tools in the fight against money laundering. New tools include the use of blockchain analysis tools to track transactions on the blockchain, whereas tried and tested tools include relying on Know Your Customer (KYC) regulations. In respect of the latter, institutions forming part of the centralised financial system, such as banks, have for many years been required to conduct KYC on their clients, the purpose of which is, among others, to assist authorities in identifying the persons behind particular transactions. The emergence of cryptocurrencies initially resulted in a regulatory gap which was exploited by criminals—cryptocurrency exchanges were often not subject to these KYC regulations and it was therefore far easier to move funds around anonymously.

Regulators have been forced to bring cryptocurrency within mainstream supervision

Regulators around the world have moved to address weaknesses in managing AML risks in cryptocurrencies and South Africa followed suit towards the end of 2022 with the introduction of various amendments to the Financial Intelligence Centre Act, 2001 (FICA). The effect of these amendments was to classify additional entities, such as cryptocurrency exchanges, as 'accountable institutions' which are subject to KYC and other regulations, as well as to bring cryptocurrencies under the supervision of the Financial Services Conduct Authority (FSCA).

As South Africa continues to grapple with the imminent risk of greylisting by the FATF, we are seeing far-reaching legislative changes to South Africa's AML and CTF landscape.

In this regard, President Ramaphosa assented to a raft of legislative amendments on 22 and 23 December 2023. The amendments, such as those to FICA discussed above, seek to remedy a number of the key legislative deficiencies identified by the FATF. These amendments introduce various changes to key legislation intended to enhance access to beneficial ownership information in respect of companies, trusts and non-profit organisations. Access to beneficial ownership information is generally accepted as a cornerstone in the fight against money laundering. As discussed above, convoluted corporate structures serve as a veil behind which the beneficiaries of the proceeds of crime can hide. In addition to (hopefully) assisting in staving off the threat of greylisting, these legislative amendments will be of significant assistance in the fight against money laundering and generally in conducting counterparty due diligence. Therefore, whereas it remains to be seen whether the steps adopted by South Africa will be sufficient to avoid greylisting, the positive changes brought about by these amendments are nevertheless welcomed. Criminal syndicates and money launderers will be placed under such scrutiny that concealing money under their beds may be one of the few ways left for them to hide the proceeds of crime!

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SOUTH AFRICA'S IMMINENT GREYLISTING: 'SWORD OF DAMOCLES' OR A WAKE-UP CALL FOR OUR ECONOMY?

JACQUES VAN WYK, Managing Director at JGL Forensic Services

Google the word, 'Greylist' and you will find many articles on email best practices. Unfortunately for South Africa, this term has another meaning which is potentially far more damaging.

In a few short weeks, our country will find out whether or not the Financial Action Task Force (FATF) will place us on their international Greylist. This has nothing to do with email spamming but it has everything to do with our future economic prosperity and stability. Think of it as putting a huge, illuminated sign above our country to let the international financial community know that we are simply not putting in the required effort to combat financial crime.

The listing carries huge weight because the FATF is held in high regard around the world. The FATF, a global money laundering and terrorist financing supervisory body, sets international standards to prevent these illegal activities and the societal harm that they cause. Although the FATF does not have independent enforcement powers, it works hard to generate the necessary political will to implement its recommendations.

Despite this apparent lack of 'teeth', countries who fail to comply with FATF findings face significant reputational damage that risks disrupting investment flows and access to the global financial system.

It is not hard to understand why.

Countries placed on the FATF greylist are deemed to have strategic deficiencies in their framework for anti-money laundering and for combating the financing of terrorism. In 2021, the FATF found that South Africa failed in 20 of the 40 standards and had shortcomings in all 11 steps needed to combat money laundering. They set a deadline of February this year to fix the problems.

Some of the reasons for the worrying position in which we find ourselves stem from legislative shortcomings and, admittedly, our government is trying to rectify these before the FATF reaches its final decision. Unfortunately, an arguably greater number comes from the overall weakness of our criminal justice system and the embarrassingly blatant lack of prosecution of those involved in financial crimes such as terrorism funding and money laundering.

These are not as simple or as quick to fix.

Not surprisingly then, a number of experts believe that South Africa's partial or non-compliance with a full 50% of the FATF's recommendations means there is simply too much to do in too short a time.

This is no doubt why a new research report commissioned by Business Leadership SA has found that there is an 85% probability that South Africa will land on the FATF's greylist in a couple of weeks' time.

At this stage, it is important to acknowledge that there are some areas in which South Africa has recently made good progress. We have seen arrests (though limited) and asset forfeiture related to state capture, as well as proposals to put additional controls in place over sectors not currently monitored by the Financial Intelligence Centre (FIC), such as attorneys and estate agents. The National Prosecuting Authority of South Africa (NPA) and the Hawks have also taken steps to hire more forensic accountants and investigators to help them tackle the increasing number of incidents.

All of these are commendable; sadly, it is a case of too little too late and there is still far too much to be done before the FATF's February ruling.

Stuart Theobold, chairman of Intellidex, a leading research and consulting firm that specialises in capital markets and financial services, says: "*There is still a path open to meeting the recommendations of FATF, but we think that probability is low. We believe the [outstanding] issues will be very difficult to process in time for the February FATF plenary, and that South Africa will therefore be greylisted*".

He is not alone in this prediction.

A recent statement from financial services group Klynveld Peat Marwick Goerdeler (KPMG) says that, despite the South African government's best efforts to fast-track reforms and make urgent changes to the country's financial regulations, the sheer scale of its deficiencies when it comes to the FATF's metrics means that greylisting is highly likely.

According to KPMG, the most helpful thing that our government can do now, is to stop hoping for the best and, instead, to prepare for the worst. In other words, similar to a disaster response that moves from 'rescue' to 'recovery' once it has become clear that there is no longer a chance of anyone being found alive,

"Most experts agree that, even with a lesser impact, a greylisting would significantly further impair our economy's links to the global financial system. It would also likely raise our cost of capital and create an additional disincentive for offshore companies to deal with South Africa"

South Africa should move the conversation forward from how to avoid the greylisting to what can be done to get us off the list as fast as possible.

In the meantime, however, we have to deal with the question of what being greylisted actually looks like for South African businesses. What are the consequences and effects, what can we expect and how can we prepare?

The Business Leadership SA report tells us that

> *"South African clients will become subject to enhanced due diligence, which will mean more frequent [usually annual instead of every three years] and more invasive assessments for AML [anti-money laundering] and CFT [combatting of terrorism financing measures] risks. This will mean increased costs for South African businesses and individuals that trade internationally and have bank accounts or investment accounts abroad. Costs will increase, particularly for South African banks, in managing correspondent banking relationships and relationships with global infrastructure providers such as payment systems*".

But how does this translate into the bigger-picture scenario? Is there a significant knock-on effect for South Africa as a whole?

In the absence of anything resembling a crystal ball, we can try to extrapolate a picture by looking at what has happened in other greylisted markets.

In Botswana, for example, asset managers could not transact directly with pension funds containing an offshore portfolio. Foreign direct investment in the diamond sector was also affected as the repatriation of profits from Botswana was impacted.

Pakistan, which was greylisted for 11 years, experienced cumulative real gross domestic product (GDP) losses of approximately $38 billion and saw a cut in economic growth of between 1% and 2% in just three years.

In Turkey, there was a steep decline in foreign investment, which had a ripple effect that exacerbated its existing economic problems.

As a general rule of thumb, the International Monetary Fund (IMF) says that a greylisted country can expect an average decline in capital inflow of 7.6% of GDP, a decrease in foreign direct investment of 3% of GDP, and a decrease in portfolio inflow of 2.9% of GDP. However, Momentum Investment believes the picture may not be quite as grim for South Africa, given our country's clear plan to deal with the fallout.

Nevertheless, most experts agree that even with a lesser impact, a greylisting would significantly further impair our economy's links to the global financial system. It would also likely raise the cost of capital and create an additional disincentive for offshore companies to deal with South Africa.

Bradley Preston, chief investment officer at Mergence Investment Managers in Cape Town, says: *"We would expect greylisting to be negative for the Rand, South African bonds and South African banks"*. He also highlighted findings by Investec that the currencies of greylisted countries depreciated by 4% on average in the first 150 days and 8% in 300 days. Separate research shows that cross-border bank inflows drop by around 15%.

All of this is, of course, in addition to our ongoing problems of critical energy shortages, political uncertainty and inflexible labour markets.

From KPMG's perspective, there could be any number of scenarios, ranging from 'simple' reputational damage to large-scale foreign disinvestment.

South Africa could also face restrictions imposed by other jurisdictions, which could create barriers to doing business and make investing in the country less attractive and more difficult.

Over and above this, there may be damaging international economic impacts, including:

- An increase in the regulatory burden imposed on South African entities and their foreign counterparts.
- Economic restrictions from international funders such as the IMF or the World Bank.
- Restrictions imposed by individual banks and businesses when doing business with South African entities.
- A squeeze on access to international trade and financial systems—greylisted countries are not able to trade freely with other countries.
- An increase in the cost of capital. Every extra Rand that the country pays as a result of the risk premium levied by owners of capital and other global development financial institutions (DFIs), is one Rand less going into South Africa's development. In addition, the funding needs of many state-owned enterprises are met by the global wholesale markets.

Whichever way you look at it, being greylisted would be disastrous for South Africa.

The story becomes even more depressing when you consider that, according to National Treasury, it will take a number of years for South Africa to fall off the FATF greylist; this means long-lasting and negative effects on our already embattled economy.

So, as all indications are that it is too late to avoid being greylisted, what can we do to give ourselves the best chance of never again finding ourselves in this predicament or having to ensure that we are taken off the greylist as soon as it is feasible?

The most obvious—and most likely the fastest route—out of this situation lies in significant legislative reform. The FATF conceded that South Africa does indeed have a *"solid legal framework for combatting money laundering"*. The problem, however, lies in its implementation.

In recent years, we have witnessed the distinct erosion of financial criminal prosecution. Coupled with virtually unchecked corruption, this makes the implementation of our Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) laws extremely difficult.

What we need is more efficient (and effective) policing on the part of the financial authorities, as well as greater international cooperation with other FATF-style Regional Bodies (FSRBs). These are autonomous regional organisations that assist the FATF in implementing its global AML/ CFT policy.

As always, justice does not only need to be done, but to be seen to be done. By implementing the FATF's recommendations and making a far more rigorous effort to prosecute financial crimes, South Africa would improve its investment status and the perception of this status among its people.

Obviously, the situation in which South Africa now finds itself has not crept up on us overnight. Equally so, the solution will be a time-consuming process. However, we have to start somewhere and, as tax practitioners, there is much we can do to help.

In one of his many speeches focusing on state capture, President Cyril Ramaphosa said: *"The Accounting Officer is the most important figure in South Africa's system of accountability for the use of public funds"*.

At the Finance Indaba 2022, Tsakani Maluleke, Auditor-General of South Africa said: *"Our role as finance professionals is to directly influence the lives of people, institutions, nations, and the future. This comes with huge responsibility, and we dare not excuse ourselves from showing up less than who and what we represent"*.

She continued: *"We must acknowledge that mismanagement of funds, corruption, and nefarious activities will not take place or be prevalent if accountants are visible, alert, and we do the right thing to protect institutions, companies, and the country. We should be ready to do better"*.

Some suggestions on how tax practitioners and other finance professionals can change the narrative include:

Be the change

Always ensure that you act with integrity, professional competence, objectivity, confidentiality and due care. Make sure you do not become an enabling force for corruption.

Lead by example

1. Adopt the International Code of Ethics for Professional Accountants and encourage everyone on your team to do the same.
2. Start an ethics or anti-corruption compliance programme in your organisation.
3. Create an environment in which whistle-blowers feel safe reporting any wrongdoings.
4. Speak out against noncompliance and misconduct, and become a voice in building a strong ethical culture and behaviour in your workplace.

Use technology to encourage transparency

1. Push for data integrity and improved access to information.
2. Make processes digital to enhance accessibility, efficiency and transparency.
3. Advocate for the digital transformation of your company's processes and systems. This helps to ensure the accuracy of any data captured which, in turn, leads to improved decision-making.

We will very shortly know whether or not the FATF plans to greylist South Africa or not. If the experts are to be believed, it is pretty much a foregone conclusion. So, if this is indeed the case and it is too late for us to change the situation, let us do everything in our collective power to make sure that we respond to the situation positively, ethically and responsibly, because we all know that a prolonged stay on the greylist would be more detrimental to South Africa than the initial inclusion.

THE GREEN MEASURES WE NEED TO SEE IN THE FEBRUARY BUDGET

▶ **DUANE NEWMAN,** partner at EY

The Conference of the Parties (COP 27) climate change conference in Sharm el-Sheikh, Egypt, held in November 2022, sent a clear message to both developed and developing countries that everyone must play a part in helping to meet climate change targets.

This, in turn, has increased pressure for more funding for the developing world to support new green measures.

The biggest development at the climate summit was an agreement on compensation for what has been termed—or broken infrastructure caused by climate change.

It is going to take a while for such funds to be set up, for rules to be agreed upon and for any funding to start to trickle to SA.

This is regrettable; we saw during recent flooding in South Africa's KwaZulu-Natal Province that the maintenance of municipal infrastructure has been neglected. It will be a real struggle to speedily repair all the damage caused by the floods.

However, structures will soon be in place for the processing of the USD8.5bn that was pledged at the previous COP 26 climate change conference in Glasgow to support South African measures to reduce the country's reliance on coal.

The Presidential Climate Commission is close to finalising the logistics for these funds to be dispersed and we should see some movement in 2023.

Effectively, money from overseas Development Finance Institutions (DFIs) will flow into the local banking system to be deployed to both government and the private sector.

Ernst & Young (EY) believes that it is vital for businesses to be following all the developments resulting from these crucial COP meetings. They should be engaging with their bankers to understand how to gain access to cheaper funding with longer payback periods that will soon be on offer for green projects.

This is especially the case for intensive energy users in mining and manufacturing. The biggest challenges that both sectors face are energy security and energy pricing. We have observed that most intensive energy users are investigating alternative sources because they can no longer rely on the Electricity Supply Commission (Eskom), the state electricity utility. The COP green funding, which I have outlined earlier, will assist with this.

In another development, export-focused businesses are coming under threat from carbon pricing mechanisms such as the carbon border adjustment mechanism of the European Union (EU). We can expect other jurisdictions to implement similar mechanisms.

Therefore, even if Eskom's high tariffs and unreliability were not a problem, export-orientated businesses such as producers of aluminium, steel and automotive, would in any case need to be looking at alternative energy sources due to Eskom's heavy reliance on coal.

If they continue to depend highly on Eskom's electricity, this will keep their carbon footprints high; it would mean that they incur higher border taxes on their exports.

Looking forward to the February Budget, it is important that the Minister of Finance creates new (and extends existing) carrots and sticks to support the move to a lower carbon economy. In the recent State of the Nation address, the President did announce that there would be a tax incentive for households who install solar systems.

We already have a tax allowance, namely the Section 12L (S12L) energy efficiency incentive, which will be in place until 2025.

However, the reality is that large energy-reduction projects need certainty. The Minister of Finance should consider extending S12L to 2030, as large capital projects take a few years to develop and it could take some time before energy savings materialise.

Also of relevance, is the Critical Infrastructure Programme (CIP) of the Department of Trade, Industry and Competition (DTIC). This programme provides a 10% to 30% capital grant for a qualifying renewable project.

We have seen a huge increase in applications by companies installing solar or going off-grid in other ways. The CIP incentive caters for these projects but it is seriously underfunded.

The Minister of Finance needs to seriously think about making a significant increase in the CIP budget allocation a priority, as this would help many businesses to reduce their carbon footprint.

The DTIC Minister also needs to finalise the support package for the so-called 'new energy' vehicles to be made in South Africa. Electric and battery vehicles are part of the low carbon future.

Then there are carbon offsets, which fall within the SA carbon tax system. These provide a reduction in their carbon tax liability, if a firm invests in a green project (a carbon reduction project) outside its carbon tax boundary. Currently, there is quite a significant shortage of projects, so we recommend that businesses look at carbon offsets more seriously.

The carbon tax reduction can be over a 7-to-21-year period and this could have a beneficial impact on any carbon reduction capital project.

There has been much talk about increasing the South African nominal carbon tax rate and this has been announced. However, there must be certainty about timing and the effective carbon tax that will be paid. A business may disagree with the size of the tax but it is important to have certainty. The biggest flaw in the carbon tax system is the failure to finalise all the allowances for its second phase which begins in 2026.

"There has been much talk about increasing the South African nominal carbon tax rate and this has been announced. However, there must be certainty about timing and the eåffective carbon tax that will be paid. A business may disagree with the size of the tax but it is important to have certainty"

- The Minister of Finance needs to make an announcement in the budget on any changes to allowances such as the benchmark performance allowance the trade exposure allowance, the carbon offset allowance, and—most importantly—the basic allowance.

  Businesses need to know which of these are going to be phased down or out as such changes will have an impact on a company's effective carbon tax rate; therefore, the incentive to reduce greenhouse gas emissions.

  There is an argument which is gaining momentum, namely if South Africa does not significantly increase its effective carbon tax rate closer to the rate levied in Europe, it might effectively export some tax revenue to Europe. The carbon border tax incurred would be higher unless South Africa's own carbon tax was better aligned with the level imposed in the European Union.

  Therefore, SA must look carefully at its main trading partners and levy carbon taxes at similar rates. If we do not, we will be at a competitive disadvantage and we will see a high potential tax loss to South Africa.

  There is little doubt that as the environment becomes a more significant topic, green taxes and incentive measures will become increasingly important elements in every budget.

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OECD PILLAR ONE

PROGRESS ON THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY

▶ **MARK BADENHORST**, Executive Consultant at ENSafrica

On 6 October 2022, the OECD released its progress report for comment as part of the ongoing work of the OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS) to implement the Two-Pillar solution for addressing the tax challenges arising from the digitalisation of the economy.

Background

The report was prepared to obtain further input from stakeholders on the administration and tax certainty aspects of Amount A. Amount A of Pillar One has been developed as part of the Two-Pillar Solution for addressing the tax challenges arising from the digitalisation of the economy. Pillar One provides jurisdictions in which consumers and users are located 'market jurisdictions'— a new taxing right over a portion of the residual profits of the largest and most profitable multinational enterprises (MNEs) in the world. Comments were requested about the processes and rules contained in this document. The comments were required by no later than 11 November 2022.

Significant progress has been made in developing the comprehensive technical rules for the new taxing right (Amount A) for market jurisdictions established under Pillar One. It is recognised that the substance of these rules must be stabilised before the development and completion of a Multilateral Convention (MLC), which will be signed and ratified by IF members.

The MLC will establish the legal obligations of the parties to implement Amount A in a coordinated and consistent manner. This will include binding rules on all aspects of implementing Amount A, including:

- the allocation of Amount A to market jurisdictions;
- the elimination of double taxation;
- a marketing and distribution profits safe harbour;
- the simplified administration process;
- the exchange of information; and
- the tax certainty process.

Work has already commenced on the overall design and framing of the individual provisions of the MLC, pending the finalisation of the substantive rules.

In addition to the operative provisions of Amount A, the MLC will also contain provisions requiring the withdrawal of all existing digital service taxes and relevant similar measures with respect to all companies. A commitment not to enter into such measures in future will also be required.

The MLC will enter into force if it is ratified by a critical mass of countries that will include the residence jurisdictions of the ultimate parent entities of a substantial majority of in-scope companies. The profits of these companies will be subject to the Amount A taxing right as well as the additional key jurisdictions that will be allocated the obligation to eliminate double taxation otherwise arising as a result of the Amount A tax. Work in relation to Amount B was scheduled to be delivered by the end of 2022.

The progress report contains the different building blocks relating to the new taxing right under Amount A.

Amount A

It is a new taxing right that applies to a portion of the residual profit of large and highly profitable enterprises for the benefit of jurisdictions in which goods or services are supplied or consumers are located. These are known as 'market jurisdictions'.

It operates as an overlay to the existing profit allocation rules and therefore includes a mechanism to reconcile the respective different profit allocation systems and prevent double taxation.

It includes improved tax certainty processes that bring increased certainty for enterprises on Amount A and related matters.

Rules for Amount A

There are five different types of rules relating to Amount A. These are:

Scope rules, which contain thresholds that are designed to ensure that Amount A only applies to large and highly profitable groups and have been drafted to apply in a quantitative and objective manner in order to be easy to administer and provide certainty as to whether a taxpayer is within scope.

A special purpose nexus rule, which identifies market jurisdictions that are eligible to receive Amount A. The nexus rule contains quantitative thresholds based on the amount of revenue a group generates in the market jurisdiction. A lower nexus threshold will apply to smaller market jurisdictions to ensure that these are able to benefit from Amount A as well. The nexus rule is supported by detailed revenue sourcing rules, which provide a methodology for determining where the revenues of the group are generated based on reliable indicators or allocation keys.

> *"The rules envisaged by the OECD progress report Amount A will go a long way to ensure that the tax challenges, which have come about as a result of the increased digitalisation of the global economy, are effectively addressed"*

- The tax base rules provide the steps to calculate the profit (or loss) of a group that will be used for calculating Amount A. It is the profit of the group that forms the basis for the partial reallocation. The consolidated financial statements of a group, which are prepared according to acceptable financial accounting standards, form the starting point for the tax base determination. The rules include a limited number of book-to-tax adjustments and a framework allowing groups to carry forward losses.
- The profit allocation rules are based on a formula which allocates 25% of a group's profits in excess of 10% of the group's revenues to eligible market jurisdictions. These profits will be allocated to market jurisdictions in proportion to the amount of revenue that the group generates in that jurisdiction and will be subject to any adjustment arising from the Marketing and Distribution Profits Safe Harbour.
- The elimination of double taxation rules will apply to eliminate any double taxation that arises from applying Amount A as an overlay to the existing profit allocation system. The rules will apply on a quantitative and jurisdictional basis to identify relieving jurisdictions that will be responsible for the elimination of double taxation.

The rules envisaged by the OECD progress report on Amount A will go a long way to ensure that the tax challenges, which have come about as a result of the increased digitalisation of the global economy, are effectively addressed.

MANUFACTURING INCENTIVE FOR THE MOTORING INDUSTRY: **THE ONE MODEL OF SUCCESS**

▶ **JO-ANNE BALCORTA,** Assistant Manager - Grants and Tax Incentives at Catalyst Solutions

Introduction to the automotive landscape

South Africa's automotive industry continues to follow a robust recovery despite the fact that 2022 was a year characterised by multinational and international economic headwinds.

According to the National Association of Automobile Manufacturers of South Africa (NAAMSA), South Africa's new vehicle sales statistics, which are regarded as good indicators of the economy's performance, show a year-on-year increase of 13.9% amid the despondency of global supply chain disruptions, along with the impact of the devastating KwaZulu-Natal (KZN) floods, rising interest rates, elevated inflation, record-high fuel prices, as well as frequent load shedding.

Contribution of the automotive industry to the South African economy

According to NAAMSA's latest media release, the automotive sector plays an instrumental role in South Africa's economy by contributing 4.3% to South Africa's gross domestic product (GDP) and it accounts for 17.3% of the country's manufacturing output. South Africa has a well-established production base for products to be exported on a global scale, with vehicle exports yielding an increase of 17,9% in 2022 compared to the previous year. The automotive manufacturing segment improves the country's unemployment crisis and makes an essential contribution to the upliftment of society. NAAMSA also notes that the automotive sector currently employs approximately 110 000 people across various tiers of activity. In combination with its strong multiplier effect, it is responsible for 457 000 jobs across the economy's formal sector.

The automotive sector has a key role to play in localisation, which could lead to increased resilience of local supply chains by reducing their dependency on foreign suppliers, making these stakeholders less vulnerable to global supply chain challenges.

Need for incentives in this sector

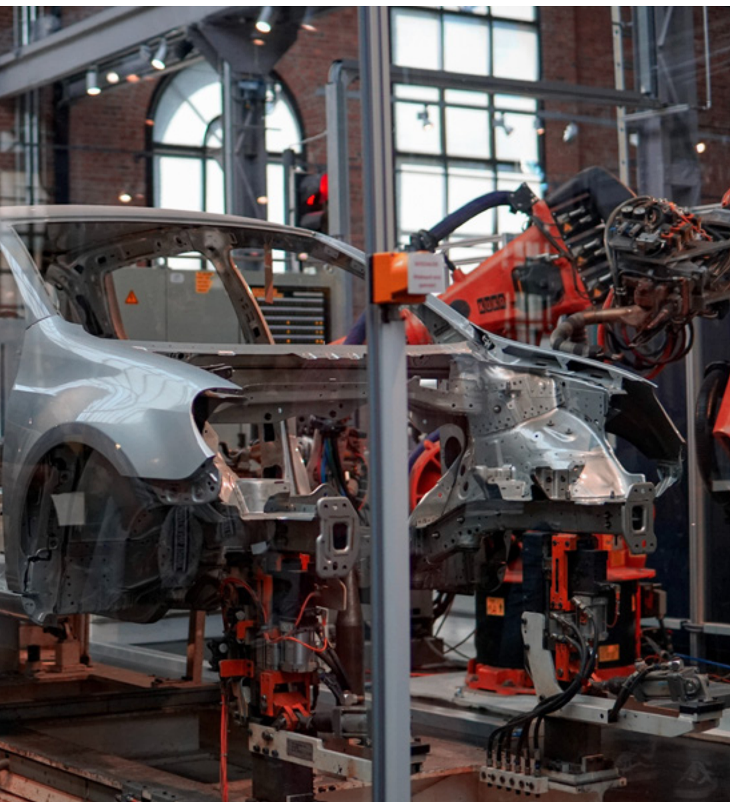
The automotive industry continues to be a significant focus of industrialisation efforts; consequently, continued support is vital to help revitalise and restore supply chain disruptions. The automotive industry requires government assistance to meet the South African Automotive Masterplan (SAAM) objectives of doubling its annual production and increasing localisation from 39% to 60% by 2035. According to the 2021/2022 Department of Trade, Industry and Competition (dtic) annual report, the automotive master plan attracted an estimated R70 billion in investments and the dtic disbursed an allocated R4.4 billion to beneficiaries in the automotive, black industrialist and agro-processing sectors.

Incentives in the form of cash grants and import duty rebates are able to materially offset the large upfront investments required by manufacturing facilities to mitigate risks and/or to reduce future operating costs, thus lowering the cost of doing business. The automotive sector is one of the largest manufacturing sectors in the country's economy and a key player in South Africa's industrialisation landscape. Therefore, it is important for government to provide continued support to the industry and its broader value chain to ensure the ongoing growth of this sector.

Overview of Automotive Investment Scheme (AIS)

The automotive sector is a coordinated effort between Government, industry bodies (such as NAAMSA and NAACAM), original equipment manufacturers (OEMs) and component manufacturers; it is the one manufacturing sector which still shows signs of life. This achievement is mainly supported by the success of the manufacturing incentive, the Automotive Investment Scheme (AIS) administered by the dtic.

The South African government continues to provide support for an incentive programme aimed at achieving key industry objectives and targets outlined in SAAM. The AIS is one of South Africa's long-term plans to grow and develop the automotive industry by 2035 through boosting local vehicle production output, local procurement, employment creation, transformation, value addition and export promotion through investment into new, upgraded and expanded automotive production facilities in the country.



The AIS provides a non-taxable reimbursive cash grant between 20% to 30% in respect of qualifying investment in manufacturing assets; 20% towards OEMs; 25% towards component and tooling manufacturers; and 30% towards New Energy Vehicle (NEVs), energy efficient (EE) vehicles and component manufacturers. Component manufacturers and tooling companies can further receive a benefit of up to R1 million for costs incurred on activities to enhance its competitiveness. Examples include costs incurred to introduce new processes, improving product efficiency or production techniques, obtaining a certification or accreditation, skills development, energy or resource efficiency improvements and/or acquisition of IT systems. The incentive scheme incentivises manufacturers and, as a result, benefits smaller players in the supply chain by adding to the competitiveness of the automotive sector as a whole.

"Commitment from Government to reach 2035 targets demonstrates long-term support for the growth of the automotive industry. The incentives should help attract new entrants into the market and increase investor confidence despite the present economic conditions"

The incentive administration process is efficiently managed by the dtic AIS department. The effectiveness of the AIS administration process encourages investor confidence by providing more certainty to investors in comparison to some of the other programmes with stringent criteria and longer lead times. Project claims must be submitted according to the milestones specified in the approval letter issued by the dtic. Owing to the successful management of the programme, grant payments are disbursed up to three months after asset verifications have been conducted. Claims are disbursed over three years, subject to the project(s) having met the mandatory requirements and economic benefit criteria where applicable.

- A key priority focus of the South African government in 2023 is to finalise the support framework for NEVs. This is also supported by the amended AIS guidelines published by the dtic. These guidelines have widened the scope of support to include NEV manufacturers and EE vehicle manufacturers in an effort to take major leaps towards green transportation in South Africa.

Other industry-specific support measures

Government provides other industry-specific support measures to incentivise local manufactures such as the revised Automotive Production Development Programme: Phase 2 (APDP2) regulations, which are legislated in Schedule No.3 of the Customs and Excise Act. The recently revised APDP2 was issued in 2021 and will run to 2035. The programme provides import duty rebates for the duties raised by the South African Revenue Service (SARS) on the importation of vehicles and components for completely knock-down (CKD) assembly. The APDP2 forms part of South Africa's masterplan to significantly grow automotive production volumes and to substantially grow value addition in the country.

The revised volume assembly localisation allowance (VALA) and the production incentive (PI) under the new APDP2 is, according to global standards, still strong with the support of a lucrative cash incentive (the AIS), to supplement the changes.

Conclusion

Ongoing support measures for the automotive industry is a necessary tool for the advancement of South Africa's economic development strategy. It promotes current investments in the automotive industry and contributes to the growth of the entire motor vehicle value chain which, in turn, accelerates the economic growth of the country. The one model of success, the AIS, has proven to encourage local investment, to strengthen and diversify the sector while increasing local production volumes and sustaining employment levels. Commitment from Government to reach 2035 targets demonstrates long-term support for the growth of the automotive industry. The incentives should help attract new entrants into the market and increase investor confidence despite the present economic conditions. The automotive support package in South Africa is a model that demonstrates success in attracting investment and increasing exports which have benefited the industry significantly. The model showcases the economic rewards of industry support measures and highlights the need for the South African Government to focus on offering targeted industry support measures. Our view is that the South African Government could learn from the implementation of industry-specific support measures in the automotive sector and consider implementing similar targeted support measures in other sectors in the economy.

AGRICULTURE IN SOUTH AFRICA: SIX THINGS THAT NEED URGENT ATTENTION IN 2023

WANDILE SIHLOBO, Chief Economist at the Agricultural Business Chamber of SA

South Africa's agriculture remains an important sector of the economy and holds great potential to reduce poverty. It is also central to the political economy of the country, as evident in the governing African National Congress's (ANC's) recent policy documents.

The ANC acknowledges that agriculture *"holds the potential to uplift many poor South Africans out of poverty through increased food production, vibrant economic activity, and job creation."*

This is not a misplaced view. There is compelling evidence that, on average, growth in agriculture is more poverty-reducing than an equivalent amount of growth outside agriculture. This brings home the need to invest in and expand agricultural production, particularly for the benefit of poor, rural communities.

This is a view that many have held since the publication of South Africa's National Development Plan in 2012. The plan argued for the expansion of agricultural production and agro-processing and advertised the prospect of nearly a million jobs that could be created. But year after year, challenges have distracted the country from its agricultural expansion goals.

The year 2023 will be no different. There are six key themes that are likely to underpin the sector, particularly in the first half of this year.

These are:

- the impact of energy shortages and associated costs to businesses and consumers after the severest power outages that the country has ever seen;
- the expansion of exports;
- land reform;
- the fallout from collapsing local administrations;
- a lack of progress on key regulations;
- the financing of the sector.

Unless these challenges are addressed, the country's agricultural sector will not achieve the growth and the job creation prospects of which it is capable.

The impact of power cuts

The country can expect intensified discussion about the impact of energy shortages on the production of agriculture, food, fibre and beverages.

South Africa's persistent power cuts are a significant challenge across the economy. At the end of 2022, the South African Reserve Bank highlighted the risks that persistent power cuts represent to the growth prospects of the country's economy in 2023.

The agricultural sector and food producers have not always been as vocal about the impact on their businesses as, for example, the mining industry. This is likely to change this year. Power outages have started to disrupt the production of even essential food items. This includes potato chip processing, milling and poultry meat processing. At primary production, farmers using irrigation systems face production difficulties in the current environment.

There are also disruptions across a range of food value chains. Importantly, this also brings extra costs to food companies and farmers, some of which could be transferred to the consumer over time. Consumer food price inflation is already elevated and estimated to have averaged approximately 9% in 2022 (from 6,5% in 2021), driven mainly by global agricultural commodity challenges.

Export expansion

Expect a major focus on the need for the expansion of agricultural export markets.

South Africa's agricultural sector is export-oriented, exporting roughly half of its products by value. Organised agriculture groups are pushing to expand exports.

This is not a new discussion, but it is likely to gain momentum in 2023 as the growth in domestic production necessitates that South Africa reaches new markets. The priority countries should be China, South Korea, Japan, the USA, Vietnam, Taiwan, India, Saudi Arabia, Mexico, the Philippines and Bangladesh. All have sizeable populations and large imports of agricultural products, specifically fruits, wine, beef and grains.

Land reform

Land reform will be back at the top of the agricultural agenda as the drive for inclusion of black farmers in the sector is highlighted in the Agriculture and Agro-processing Master Plan.

However, the discussion is likely to focus on redistribution, rather than land restitution and tenure. The focus could be on the launch of the Agricultural Development and Land Reform Agency. For much of 2021 and 2022, the agency was mentioned on various occasions by South African president Cyril Ramaphosa and the Minister of Agriculture, Thoko Didiza.

Working with the private sector and redistributing some state-owned land, the agency is expected to accelerate land redistribution.

Deteriorating municipalities

The threat of deteriorating municipal service delivery, corruption in public offices and failures in the network industries such as roads, rail, water, electricity and ports have occupied agribusiness leaders for some time.
These inefficiencies have:

- increased the cost of doing business;
- taken investment away from productive agribusiness activities to maintain roads and other infrastructure;
- constrained expansion; and
- made conditions even more challenging for new entrants.

This year, the country's organised agriculture groupings are likely be more vocal about these challenges as they continue to constrain the agricultural sector expansion and make conditions even more challenging for new entrants.

Slow progress in fixing regulations

There are likely to be signs of growing unease about the slow progress in agricultural regulations.

The country's agricultural sector faces regulatory constraints, such as the dysfunctional State Veterinary Service. This dysfunction negatively affects the production of key vaccines. There is also a need to modernise the Fertilizers, Farm Feeds, Seeds and Remedies Act 36 of 1947. This is key in enabling the importation and registration of agrochemicals that are essential for boosting productivity of the agricultural sector.

For an extended period, South Africa has embraced science and led the continent in agricultural productivity, benefiting from the adoption of critical agrochemicals, seeds and livestock remedies. But there has been a drift away from this positive path. The country now lags behind its competitors due to delays and large backlogs

in the office of the Registrar of Agricultural remedy. The result has been that crucial productivity-enhancing inputs have not been released to the agricultural industry. Failures in national vaccine production also remain an issue.

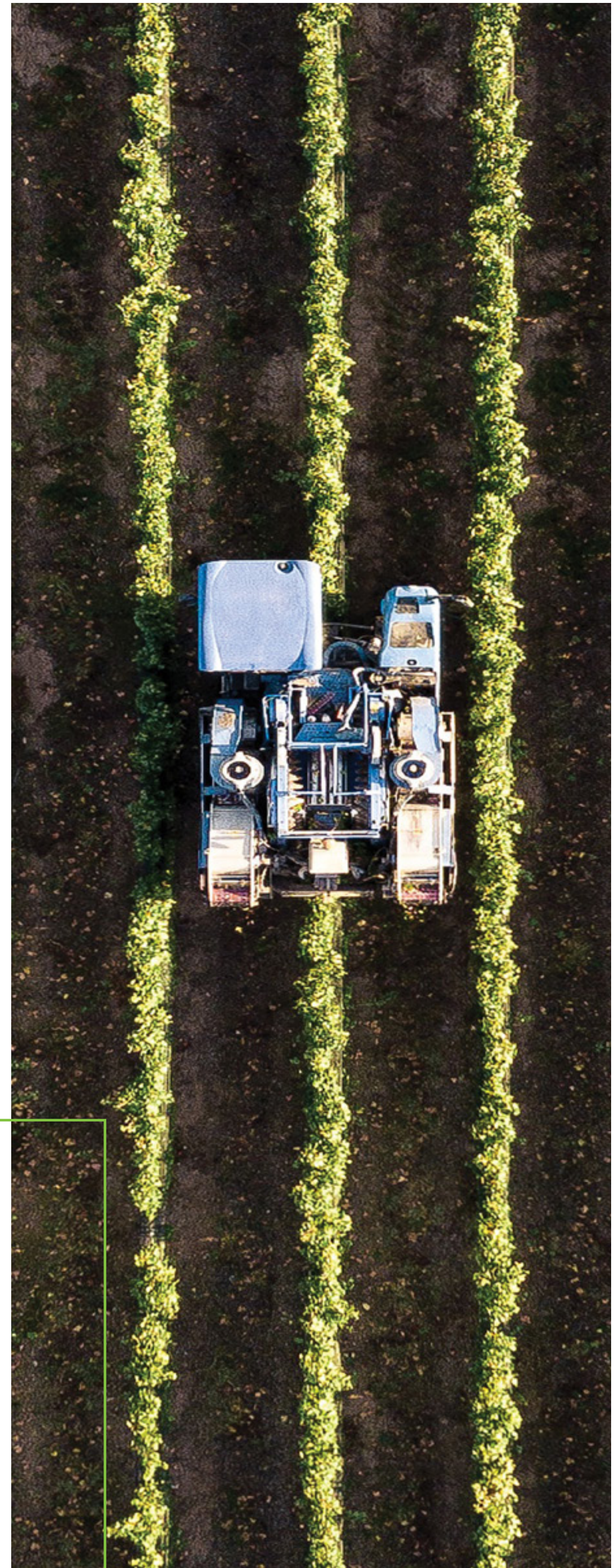
The pressure will intensify to resolve all of these issues, especially as they are part of the legislative points that the Agriculture and Agro-processing Master Plan should address. The plan seeks to address key hindrances to growth at a commodity level. Notably, the master plan is a social, compact approach. It has already been given the support of major role players in the agricultural private sector.

Finance

The need for agricultural finance, particularly developmental finance for new farmers, has not been given enough attention.

At the end of 2022, the focus was on the blended finance instrument by the Department of Agriculture, Land Reform and Rural Development and the Land Bank. The instrument will contribute positively to the sector's growth and to serving the needs of some new farmers.

In 2023, there will be a drive for the Department of Agriculture, Land Reform and Rural Development to broaden the blended finance instrument to accommodate more financial institutions and to increase its scale in order to reach more farmers.



"South Africa's persistent power cuts are a significant challenge across the economy. At the end of 2022, the South African Reserve Bank highlighted the risks that persistent power cuts represent to the growth prospects of the country's economy in 2023"

CORPORATE RESTRUCTURING;

merger and acquisition transactions: Navigating tax complexities post-COVID

▸ **ITUMELENG NKADIMENG**, Partner (Director) at KPMG Services

The COVID-19 pandemic has experienced an unprecedented change in how organisations operate. Many organisations, especially corporate entities that are still dealing with the impact of the pandemic at various levels, have become remarkably adept and flexible at responding to market changes and needs. In South Africa, organisations have also had to deal with capacity and infrastructure constraints such as rolling blackouts of electricity supply, high unemployment rates and restricted economic growth.

The resultant impact has been that organisations have had to undergo corporate restructures, including having to implement and consider changes in their operational strategies to address the risks as significantly and speedily as possible. Moreover, they had to reimagine the way in which their operational and financial positions had to be structured. Accordingly, organisations had to review and reshape their product portfolios, consider divestments from businesses as part of streamlining their portfolios to achieve operational efficiencies; and direct their focus to stabilise core assets or distressed business sales.

Against this backdrop, the changes in the operational, financial and commercial objectives of organisations have triggered market activity in the merger and acquisition (M&A) transaction space.

Why is this even relevant?

Well, the importance of M&A in the current economic climate is that "*. . . M&A [activity] enables growth in a no-growth environment . . .* "[1] organisations on the buy-side of corporate restructures can and have utilised M&A transactions to, *inter alia*, enter new markets through the establishment or acquisition of new investments or assets, consider new opportunities in new emerging products, consolidate investments, acquire new capabilities, etc. Moreover, M&A activity not only serves as a response to ambitious strategic goals but it also responds to transforming operating models and digital capabilities that can take companies to a new frontier.

To bring this closer to home, the most recent edition of the 2022 South Africa Chief Executive Officer (CEO) Outlook Report, presented by Klynveld Peat Marwick Goerdeler (KPMG), that has examined the global pandemic, inflationary pressures and geopolitical tensions, reveals that over the next three years, M&A appetite is moderate but still on the rise as compared to 2020/2021; with a lower percentage of CEOs likely to undertake significant acquisitions as compared to their global counterparts. The survey further reveals that "*. . . six out of 10 local executives believe the most important growth objectives over the next three years are organic growth (i.e. innovation, Research and Development R&D), capital investments, new products, and recruitment) as well as strategic alliances with third parties . . .*".
Whilst this is an indicator of the type of M&A activity that markets can expect during this period, it is fair to deduce from this that the way in which such M&A activity is to be carried out is likely to be more complex

This ever-changing and complex business environment can create uncertainty and challenges for many taxpayers; these challenges are exacerbated in the context of organisations that are managing and sustaining profit margins in the aftermath of a global health pandemic. It is important to note that taxpayers are therefore cautioned to critically evaluate the tax consequences arising from acquisition or disposal transactions in the context of a corporate restructuring or M&A deal.

"This ever-changing and complex business environment can create uncertainty and challenges for many taxpayers, which challenges are exacerbated in the context of organisations managing and sustaining profit margins in the aftermath of a global health pandemic"

[1] KPMG 2022 United States CEO Outlook survey features insights from more than 1 300 CEOs at large companies globally; it was released amid a business environment marred by high inflation, geopolitical tensions and fears of a recession

From a tax perspective, the transfer of an asset is likely to trigger a taxing event, whether it is at an equity level or whether it is a transfer of the individual underlying assets held within an organisation. This is because, upon the transfer of assets for a consideration (either by way of sale, exchange, etc.) from one person to another, the question will arise whether the profits or proceeds derived from such transfer are subject to normal tax in the hands of the person disposing of such assets owing to the proceeds constituting gross income (which triggers tax liability at the current corporate tax rate of 28%)[2] or whether they are subject to capital gains tax (CGT) (which triggers tax liability at an effective corporate rate of 22.4%)[3] because the proceeds constitute receipts or accruals of a capital nature. The answer to this question turns on a further enquiry:

- whether the transfer of ownership of the assets amounted to the realisation of a capital asset; or
- whether such transfer was made in the course of carrying on a business or in pursuance of a profit-making scheme.

Moreover, depending on the nature of the transaction, other tax transaction costs may occur. For example, a corporate restructuring or an M&A transaction that results in a change of ownership at an equity level may result in securities transfer tax costs. Securities transfer tax is levied and must be paid in respect of the transfer of any share issued by a company incorporated, established or formed inside South Africa at a rate of 0.25% on the taxable amount of that share.[4]

The tax considerations of corporate restructuring and M&A transactions are not limited to the consequences of the transfer of assets. Taxpayers also need to consider, among other things:

(i) the tax implications of the funding elements of the transaction (including cross-jurisdictional elements);
(ii) the impact of historical tax positions adopted; and
(iii) in respect of local transactions within a South African group context allows for transactions to be tax-neutral (i.e. tax costs deferred and triggered only in respect of a disposal of assets outside of the group).

The significance of this is that, in critically evaluating the tax implications that relate to a corporate restructuring and an M&A deal, taxpayers are not only able to reconcile the tax positions adopted against the commercial rationale of that specific transaction but are also able to structure their tax affairs in a tax efficient manner (i.e. tax optimisation while achieving synergies from both a legal and commercial perspective) and accurately disclosing or reporting on these.

Therefore, although a changing business environment can create opportunities for taxpayers to restructure and review the tax operational and risk framework; it is clear from the above that taxpayers need to apply due care in arriving at their adopted tax positions and at the manner in which they handle their tax affairs—particularly, in tracking the tax cash and non-cash flow steps of each step to the overall transaction.

In conclusion, as organisations continue to monitor and adjust their approach to corporate restructuring and M&A activities, it is essential that the tax impact of any proposed transaction is considered at each point in the corporate restructuring or M&A deal cycle, to ensure that taxpayers are optimising and realising efficiencies as part of managing their tax obligations in a complex deal environment.

[2]The corporate income tax rate will reduce from 28% to 27% with effect from years of assessment ending on or after 31 March 2023.
[3]The reduction of the corporate income tax rate from 28% to 27% with effect from years of assessment ending on or after 31 March 2023 means that the effective CGT rate will reduce from 22,4% (28% corporate income tax rate multiplied by the CGT inclusion rate of 80%) to 21,6% (27% corporate income tax rate multiplied by the CGT inclusion rate of 80%).
[4] For the sake of completeness, it must be noted that a transaction that does not result in a change in beneficial ownership, the issuing of a share and the cancellation or redemption of a share, which came about as a result of the company that issued the share being liquidated, deregistered or wound up etc. should not result in any securities transfer tax costs.

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