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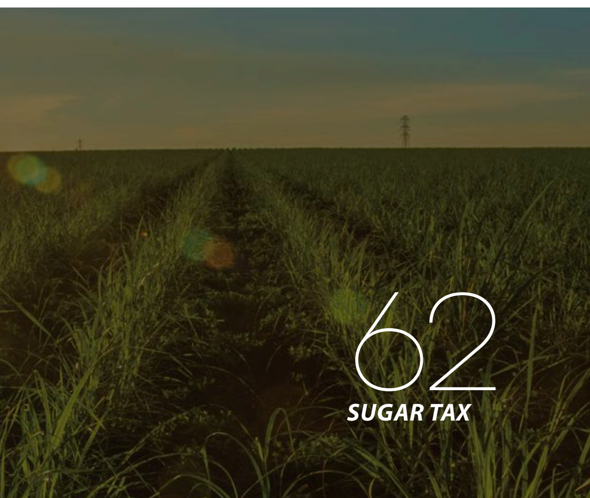

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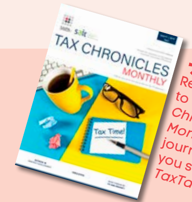

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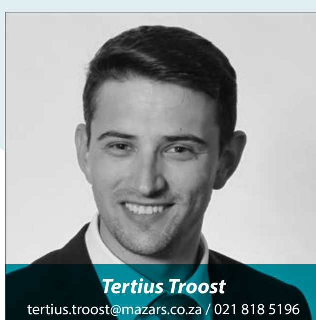

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THE BASICS OF SAVING AND INVESTING

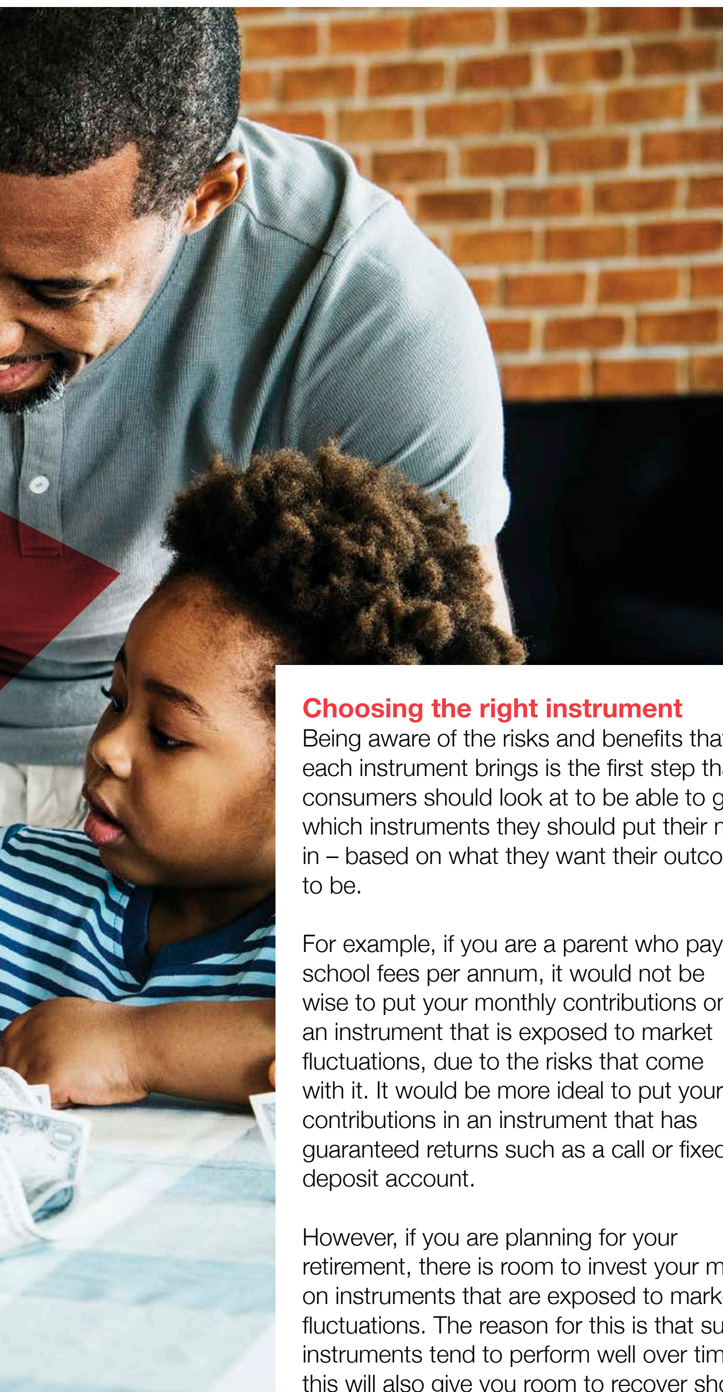
▶ **ESTER OCHSE,** financial_advisory@fnb.co.za

This article highlights the importance of knowing your goals in order to make the right choices when saving and investing.

When making financial commitments and looking at ways to secure your financial future, it is crucial that you understand the difference between saving and investing to ensure that you channel your funds to the right platforms that will help you meet your financial goals.

While saving and investing is a good indicator of financial discipline to help and guide consumers to meet their short and long-term goals, it is important to fully understand the pros and cons of each.

Saving is putting money aside for emergencies and short-term purchases such as buying a fridge or a couch. It is usually saved in an account that is easily accessible so that one can have access in case of an emergency. Investing looks at long-term gains. Investing is buying assets such as stock and bonds with a long-term view of getting a return on investment.



"If you have no savings at all, you should consider bolstering your savings to cover emergencies to avoid falling into debt should an emergency arise."

Choosing the right instrument

Being aware of the risks and benefits that each instrument brings is the first step that consumers should look at to be able to gauge which instruments they should put their money in – based on what they want their outcomes to be.

For example, if you are a parent who pays school fees per annum, it would not be wise to put your monthly contributions on an instrument that is exposed to market fluctuations, due to the risks that come with it. It would be more ideal to put your contributions in an instrument that has guaranteed returns such as a call or fixed deposit account.

However, if you are planning for your retirement, there is room to invest your money on instruments that are exposed to market fluctuations. The reason for this is that such instruments tend to perform well over time and this will also give you room to recover should your investment not do well in the short term.

Researching what is available on the market and consulting a certified financial advisor is one of the ways that could help you have a clear picture of what channels to pursue to be able to achieve your financial goals.

Not a simple choice

While choosing between saving and investing might look simple, it is not as easy it looks: it may depend on where you are in life and what you would like to achieve in the short and long term.

If you have no savings at all, you should consider bolstering your savings to cover emergencies to avoid falling into debt should an emergency arise. It is advisable to have at least three to six months of your living expenses to be able to cover any unexpected expenses such as a medical emergency or a car breaking down.

There is nothing stopping you from saving and investing at the same time. However, from a short-term perspective, it would be more beneficial to contribute more on savings than investing. Once your savings goal is achieved, you can look at investing for long-term benefits.

The best of both worlds

If you have benefits such as a provident fund or retirement annuity from your employer, this can help relieve the pressure in terms of your contributions on both saving and investing and put you in a position to achieve both your saving and investing goals simultaneously.

Consumers should consider factors such as tax when planning their financial future. For example, if you have an additional retirement fund from the one offered by your company, you may be able to benefit from a further tax deduction when you complete your annual returns. Furthermore, consumers should consider vehicles such as tax-free savings accounts as these let you save R33 000 per annum and R500 000 over a lifetime tax free.

STRIKE A BALANCE FOR SUCCESS

▶ **JANET HUGO**, janet@sterlingwealth.co.za

How to provide for short-term needs while not neglecting long-term provision for retirement. Our article provides some sage advice.

In my experience as a financial planner, one of the biggest challenges that investors face is balancing short- and long-term investments. Even highly educated professionals can find it challenging to align short-term investment decisions with a long-term goal such as having enough retirement capital. It takes a lot of discipline and self-control to get the balance right. And, as in all spheres in life, sacrifice is always critical to long-term success.

The hard truth

It may come as no surprise to you that the majority of South Africans do not invest enough for retirement. A recent survey by Sanlam revealed that a staggering 92% of South African retirees do not have an adequate amount of capital to live on. Ideally, you should have enough capital to generate at least 75% of your final paycheck as an income in retirement (escalating annually at the inflation rate). The Sanlam survey demonstrated that only 8% of South Africans achieve this and that the actual income replacement ratio is closer to 40% of final salary. It also revealed that a third of retirees could not cover their medical expenses.

The survey pinpointed some reasons behind our retirement crisis:

- We start saving too late (28 years old vs suggested 23).
- We save too little (average savings rate of 7% vs the recommended minimum of 15%).
- 62% of us do not reinvest retirement savings if we are retrenched or change jobs.
- 38% of us do not get retirement advice.
- 90% of people with pensions do not ever look at the pension options again after signing up – i.e., they do not assume any responsibility.

The immediate outlook for disposable income is not looking that great yet! Let us look at the real inflation rates of two big-ticket items:

- Medical aid contributions have increased by 3–4% above CPI since 2010 and this gap is likely to continue to widen.
- The rising cost of education also continues to outstrip inflation. The gap widened from around 2% in the early 2000s to 4% in 2018.

We are also all feeling the effects of the fuel and electricity price hikes and the ripple effect they have on many commodity prices, including food. According to the publication 'The South African', food is now more expensive in South Africa than in the UK.

"The correct asset allocation and degree of diversification for your investments is a critical decision, and it is highly recommended that you get financial advice from a qualified and experienced advisor."

Strike a balance between short- and long-term investment goals

So now more than ever, it is essential to prioritise investment goals and strike the correct balance between long-term ones including retirement, and short-term ones, such as for education and travel. Planning for retirement is a careful balancing act between providing for your own retirement security and meeting your family's needs.

The best way to start striking a balance is to start with the math and determine how much capital you need for a secure retirement. In the past, we did our retirement calculations based on the assumption that you would live for 25 years in retirement, starting at the age of 65. We now base the sums on a 30-year retirement to account for longevity, which is becoming the norm. What is more, we have had to adjust the expected growth rates of retirement funds from 6% down to 4% above inflation to factor in the changes in the markets.

The following table shows how much capital you will need at the age of 65 for 30 years in retirement for the various pre-tax monthly incomes, assuming an inflation rate of 6% and a 10% annual growth rate. (The capital required is the present value of an annuity that escalates by inflation.)

MONTHLY INCOME IN THE FIRST YEAR IN RETIREMENT	RETIREMENT CAPITAL REQUIRED
R 30 000	R 6 037 639
R 40 000	R 8 050 185
R 50 000	R 10 062 732
R 60 000	R 12 075 278
R 70 000	R 14 087 825

Once you have worked out how much retirement capital you need, subtract the amount you already have, and then work out exactly how much you need to contribute monthly to ensure that you reach your long-term goal. There is simple truth in numbers. (There are many good retirement calculators available online.)

This monthly contribution to your retirement fund is one of your top priority budget items along with other essentials such as medical aid and life cover contributions. And then, once you've accounted for your essential living expenses, you can allocate surplus income to short-term investment goals.

In my experience, one of the best ways to prioritise your short-term goals is to have a good discussion with your family and advisor and to jointly select goals that are relevant and add real meaning to your lives. There is nothing like 'group buy-in' for commitment and success.

More than only eggs in your basket

As well as striking a balance between short- and long-term investment goals, there is a need to balance the asset allocation of your investments correctly. The asset allocation for long- and short-term investments differs as they carry different expectations. You purchase a long-term investment for an expected profit, whereas you purchase a short-term investment for the relatively greater degree of principal protection it provides. Thus, cash instruments and bonds work well for short-term investments as they provide a guaranteed return, whereas equity and property work well within a long-term portfolio as they provide better returns in the long run.

The investment principle of diversification - summed up by the good old adage 'don't put all your eggs in one basket' - is important for longer term investments as it is essential to manage the risk of loss. Diversification is all about combining assets which exhibit low or negative correlation, and which move in opposing directions during investment cycles - and in doing so lowering the volatility of the performance of the overall portfolio.

The right mix of assets to hold in your portfolio depends on your personal circumstances including the time horizons for your various investment goals, and your ability to tolerate risk. The correct asset allocation and degree of diversification for your investments is a critical decision, and it is highly recommended that you get financial advice from a qualified and experienced advisor.

Horses for short and long courses

There are various investment vehicles which are suitable for short- and long-term investments. When it comes to long-term investing for retirement, it is advisable to make the most of tax-efficient investment vehicles including pension funds, retirement annuities (RAs) and tax free-savings accounts. The tax savings have a significant effect on the long-term returns which you need for a long and secure retirement.

You can now contribute up to 27.5% of your income (limited to R 350 000 annually) to pension funds and RAs and use the contribution as a tax deduction which lowers your marginal tax rate and frees up funds to invest in other retirement vehicles such as tax-free savings accounts. Contributions towards tax-free savings accounts are not tax-deductible but they do have the advantage of not being bound by Regulation 28, which allows you to assume more risk within the fund and invest in more local and offshore equity.

Tax-free savings accounts are also excellent for important short-term goals such as for education, as the funds are accessible to you before retirement, with no tax implications on withdrawal. You can only contribute up to R33 000 per year to the funds (with a R500 000 lifetime limit), but you can open up an account in each of your children's names for important goals such as education.

New generation endowment funds which allow you a choice in the selection of the underlying investments are also great investment vehicles for education. The growth within the fund is taxed at 30% which works well for high-income earners. Restrictions on access to the funds also work well for investors who may be tempted to dip into the funds (for unjustifiable reasons!).

Money market unit trusts are great investment vehicles for the essential short-term emergency fund that all investors need. Emergencies are an absolute given – a sure part of life. Money market unit trusts keep up with inflation, and you can access the funds within 2 working days.

The bottom-line

Things are not going to get much easier in South Africa in the short term. This makes planning – and balancing short- and long-term investment goals – increasingly important. It is highly likely that you will have to sacrifice some pleasures for your long-term security.

Do be wary, however, of only living for the future. Make sure your sacrifices are well thought out for a balanced and fulfilling life.

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A HOME AS AN INVESTMENT

▶ **DYLAN VERREYNE,** dylanverreynne@wellsfaber.com &
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Is buying a family home a good investment? Our article weighs the question, looking at the numbers and also taking human nature into consideration.

In a world filled with uncertainty, both politically and economically, it is no surprise that conversations in the investment universe have changed from "how do I generate larger returns?" to "how do I preserve what I have?". This is especially true for middle-income earning families in South Africa who tend to tread a fine line between surviving on what they earn and living off debt.

South Africans, in general, have a higher than average affinity towards physical bricks and mortar compared to citizens in other parts of the world. It is, therefore, no surprise that the idea of investing in a tangible asset, such as a property, is high on the list for many South Africans when we think of a "safe investment". The question facing many middle-income families is whether or not the benefits of owning their home outweigh the benefits of renting.

In dealing with this question it is important to eliminate the emotional value that we, as South Africans, place on our homes and it is for this reason that we will focus purely on the monetary value attached to owning a home versus renting a home.

The numbers

For the purpose of this analysis we assume the following for an average three bedroom starter home outside of the city:

- Purchase price of R1 500 000
- Deposit of 10% (R150 000)
- Interest rate of 10.25%
- Monthly loan repayment of R13 252 over 20 years (240 months)
- Transfer costs of R55 608
- Bond registration costs of R33 451
- Property price inflation over 20 years of 7% per annum
- CPI inflation of 6% per annum over the long term
- Average rental of three bedroom home outside of the city of R10 800
- Average utilities for a three bedroom home of R1 200 per month

The key to determining the real return for any investment is to ensure that one takes into consideration all the costs involved. Making use of the above assumptions, the cost per month of renting a home is R5 585 cheaper than owning a home in the first year as is evidenced by the table below.

	BUYING HOUSE	RENTING HOUSE
RENT/BOND	R 13 252.00	R 10 800.00
UTLITIES	R 1 200.00	R 1 200.00
RATES AND TAXES	R 1 100.00	R -
INSURANCE	R 1 200.00	R -
MAINTENANCE	R 833.00	R -
TOTAL	R 17 585.00	R 12 000.00

In keeping with the theme of eliminating emotion, we have undertaken the following study to determine the real future value of the potential investment in a property. We have compared this investment to the three most common risk profiles in the investment universe and their expected returns. The initial deposit of R150 000 was used as the initial lump sum investment whilst the surplus of R5 585 per month was used as an additional recurring contribution in the first year and proportionately decreased year on year as the rental price increased.

The assumed returns per annum for the above four options are as follows:

- House price inflation averaging at 7% per annum over the 20-year period.
- Averaged annual return on a cautious portfolio of 7% per annum.
- Averaged annual return on a moderate portfolio of 10% per annum.
- Averaged annual return on an aggressive portfolio of 12% per annum.

INVESTMENT	HOUSE	CAUTIOUS	MODERATE	AGGRESSIVE
LUMPSUM	R 150 000.00	R 150 000.00	R 150 000.00	R 150 000.00
MONTHLY (240 MONTHS)	R 17 585.00	R 5 585.00	R 5 585.00	R 5 585.00
FUTURE VALUE	R 5 804 526.69	R 3 515 186.22	R 5 340 285.99	R 7 158 874.26
CAPITAL CONTRIBUTION	R 1 500 000.00	R 1 490 400.00	R 1 490 400.00	R 1 490 400.00
INTEREST & OTHER	R 2 870 400.00	R -	R -	R -
EFFECTIVE RETURN	**R 1 434 126.69**	**R 2 024 786.22**	**R 3 849 885.99**	**R 5 668 474.26**
TAX OWED	R 398 784.18	R 364 461.52	R 692 979.48	R 1 020 325.37
RETURN AFTER TAX	**R 1 035 342.51**	**R 1 660 324.70**	**R 3 156 906.52**	**R 4 648 148.90**

Tax

All of the above scenarios will be subject to capital gains tax on eventual disposal of the asset. The capital gain will be calculated as the difference between the proceeds (usually the selling price) and the base cost of the asset. For the investment(s), the base cost would amount to the expenses actually incurred to acquire the asset. Based on the above figures this will amount to the line item named "contribution".

The disposal of a primary residence will be subject to similar principles, but certain aspects should be borne in mind with regard to the base cost and net capital gain on the disposal of a primary residence. The base cost of the property would include other specific costs in order to acquire the property (e.g., transfer duty, legal costs). In addition, certain selling costs may also be included in the base cost of the property. However, borrowing costs are specifically excluded from the base cost of an asset.

The Income Tax Act also provides specific relief for the disposal of a primary residence. Currently, in terms of paragraph 45 of the Eighth Schedule to the Income Tax Act, a natural person must disregard up to R2 million of the capital gain determined in respect of the disposal of the primary residence. It should be noted that the primary residence exclusion should be apportioned if the property was not utilised as a primary residence for the entire period the person resided in the house, or if the person conducted a trade from the property.

To buy or not to buy

As evidenced by the numbers above, the appeal of purchasing a house for the conservative investor is warranted. Ultimately, the value of property in South Africa increases at a higher rate than inflation over the long run and therefore owning a home could be seen as a hedge against inflation.

From a pure investment perspective, it is important to understand that each individual has their own risk profile. As a wealth manager, one of the first steps I take when assisting a client to build their portfolio is assisting them to understand their real affinity for risk and the real returns that they should strive to achieve at their prescribed level of risk. As illustrated by the numbers, an investor with an aggressive risk profile would be better suited to investing in a high equity portfolio with the long-term objective of earning a return of 12% per annum. Whereas a cautious investor who is focused on capital preservation, will be happy to beat inflation with the added benefit of owning an appreciating asset.

Incorporating human nature

In a perfect world with perfect economic competition, the above scenario would always work. The opportunity cost of investing in a traditional portfolio is giving up the opportunity to own their home. The above scenario is therefore based on the assumption that individuals have the discipline to invest all the extra cash that they have.

When analysing the numbers above it is important to take into consideration the fact that most households will not invest or save the total amount that they save by renting their home. The nature of the current economic climate dictates that the extra disposable income owned by a middle-income household will be used to fund living expenses. Most families that fall within this income level live their lives on the edge of debt, which means that they are often required to forego certain "unnecessary" expenses. The extra disposable income will therefore most likely be used towards additional living expenses rather than a voluntary investment.

It is for this very reason that we can conclude, for the most part, an investment in a home does not only serve as a hedge against inflation in the long term but servicing a bond can also deter individuals from spending unnecessarily. The most important piece of advice for any individual grappling with the choice of purchasing a home or investing the cash saved by renting is knowing exactly what each scenario will cost, their appetite for risk and their ability to remain disciplined enough to make the most out of their decision to rent.

REAL ESTATE INVESTMENT TRUSTS

ESTIENNE DE KLERK, edeklerk@growthpoint.co.za

We provide a background to the position of real estate investment trusts in South Africa, explain how this has improved in a short time and also look at future issues.

The introduction of a real estate investment trust (REIT) structure in South Africa has been a catalyst for a world-class real estate sector. The sector has become a major contributor to our country's GDP, a significant preserver of wealth, and an enabler of economic growth in other sectors, in its own development and expansion. SA REITs play a material role in improving the prosperity of South Africans over the long term.

What is an SA REIT?

SA REITs remain the cheapest, easiest, quickest and safest way to invest in property.

All SA REITs own income-producing property. Most SA REITs own several kinds of commercial properties like shopping centres, office buildings, factories, warehouses, hotels, hospitals and even residential properties and student accommodation, in cities and towns across the country. Some, however, specialise in one subsector. Others even invest in properties in other countries.

They offer investors the ability to invest in quality property investments that would otherwise be difficult to access. The entry cost for a REIT investment is the price of a single share.

REITs provide liquidity for real estate markets. Investors can also buy or sell shares in SA REITs at any time, without the costs and delays involved with physical property ownership. SA REITs provide a lower-risk property investment model because investors are exposed to a diversified portfolio of properties.

An investment in an SA REIT is underpinned by lease agreements with tenants in property assets. Importantly, most rentals escalate at a predetermined rate annually, creating sustainable growth and relatively predictable earnings.

Management of SA REITs is undertaken by companies which have strict governance requirements and are performance driven and entrepreneurial. This means they are driven to get the best sustainable performance from property assets. They bring good governance, transparency and accountability to the real estate sector. Listed property has outperformed physical property due to professional focused management and access to cheaper capital.

SA REITs offer investors the best of both worlds: a reoccurring cash distribution yield like a bond as well as growth in income like equity.

A unique asset class

The development of the REIT sector globally has been so significant that the FTSE recently provided real estate its own sector classification, separate from the financial sector. This recognises the independently unique nature of investment in real estate, which is not correlated to other asset classes such as cash, bond and equity, including the financial sector.

Who invests in SA REITs?

In a recent study, the Property Sector Charter Council analysed the ownership in the REIT market and noted that institutional ownership in the various REITs ranged from 40% to as much as 85% in the larger REITs. International institutions varied from nil to as high as 25% of these institutional holdings. The balance of the 60% to 15% shareholdings was dominated by BEE shareholders, retail or private shareholders and REIT staff and management.

How to invest in REITs

There are several ways of investing in REITs listed on the JSE. This includes direct ownership of REIT shares, investing in a property unit trust fund and buying shares in a property index tracker fund. Your bank, stockbroker or financial advisor may be able to help you with these options.

Background to the SA REIT tax dispensation

In 2006, the local listed property sector was facing specific tax challenges and the listed property sector began engaging with the South African National Treasury to promote the concept of the REIT, which at the time was a fast-growing best-practice tax dispensation.

The combined skills around the table were a recipe for success. The publicly listed real estate sector was represented by Andrew Brooking of Java Capital and myself, supported by some of the country's best tax attorneys. Treasury's then chief director of tax policy, Keith Engel, had been a technical adviser to the US Treasury and tax attorney at the US Inland Revenue Service and quickly understood what was needed for SA REITs. Several SARS representatives also ably assisted. At the JSE, Tania Wimberley swiftly articulated this into a regulatory framework.

Treasury formally published the REIT tax legislation for South Africa on 25 October 2012 in the 2012 Taxation Laws Amendment Bill. This took the form of a new section (section 25BB) in the Income Tax Act. Bringing South Africa's publicly traded property sector in line with international standards, the JSE published new Listing Requirements on 28 March 2013 facilitating the SA REIT.

Most qualifying South African listed property entities applied to the JSE to become a REIT. By the end of September 2013, the JSE had approved REIT status for 24 entities.

SA REIT tax regulations

Listed SA REITs are regulated by the JSE, specifically its listing requirements. Besides meeting all the normal listing rules for companies, an SA REIT must comply with six extra criteria in section 13 of the JSE listing requirements. An SA REIT must:

- Own at least R300 million of property
- Keep its debt below 60% of its gross asset value
- Earn 75% of its income from rental or from property owned or investment income from indirect property ownership
- Have a committee to monitor risk
- Not enter into derivative instruments that are not in the ordinary course of business
- Pay at least 75% of its taxable earnings available for distribution to its investors each year

Only after the JSE grants a listed entity SA REIT status does section 25BB of the Income Tax act apply to it.

Tax implications for REITs and investors

It is a myth that REITs are not taxed. REITs are taxpayers and submit tax returns. However, section 25BB allows an SA REIT to deduct all distributions paid to shareholders as an expense on a see-through basis. The REIT becomes a conduit for net property rental income and provides investors an investment alike to direct ownership of the underlying property.

All distributions paid to investors are taxable at each investor's applicable marginal income tax rate when they include it in their taxable income. This avoids double taxation and is one of the cornerstones of the South African pensions, retirement and savings industry. If invested in SA REITs as part of a retirement annuity or pension, provident or preservation fund, investors effectively pay no tax on dividends until they receive their pension payments for the funds. Also, shareholders of an SA REIT do not pay securities transfer tax (STT) on buying or selling SA REIT shares.

The benefit of section 25BB to an SA REIT is that when it sells a property it does not have to pay capital gains tax (CGT) on any profit from the sale.

In the Income Tax Act, the rental definition is broadly applied to investments in property companies where the assets are at least 80% property investments. Property owning subsidiaries of REITs also benefit from the section 25BB tax dispensation.

Foreign shareholders of SA REITs are levied a dividend withholding post tax at the current rate of 20%, but this can be reduced in terms of the rates set by the applicable double tax agreement between South Africa and the domiciled country of the investor.

Future matters

While agreement was originally reached on most elements of the regulation and taxation of REITs, there were a handful of outstanding matters.

Since then, as the sector has evolved, various other technical issues have arisen in applying the Act, specifically related to the sector's growing international investment. The SA REIT Association has made various submissions to National Treasury on several issues relating to section 25BB and is actively working to clarify these issues. It has also over the past five years been promoting to Treasury the expansion of SA REIT status to the unlisted sector. However, progress has been slow.

Best practice in reporting

In January 2016 the SA REIT Association published the first edition of the *Best Practice Recommendation (BPR) for reporting for REITs*. It sought to improve the consistency and transparency among all the REITs listed on the JSE. This publication was hailed by investors and endorsed by the JSE and the Accounting Standards body in South Africa. The SA REIT Association is currently working toward reviewing and improving the BPR in a broad consultative process with the sector and its major stakeholders to address areas that are not currently covered or require improvement. This will further drive quality in the governance of REITs via natural market forces.

Growth in a supportive regulatory and tax environment

South Africa's REIT legislation has provided a level of policy certainty for the sector and eliminated double taxes for sector investors. Since the introduction of REIT legislation in 2013, the South African REIT sector has grown significantly. The sector has been well supported by local and, importantly, international investors, even though the domestic economy continued to deteriorate.

"Since the introduction of REIT legislation in 2013, the South African REIT sector has grown significantly."

The SA REIT sector is now the ninth largest REIT sector globally. From 24 listed REITs in 2013, the sector has grown to 33 REITs over the past five years.

The market capitalisation of the SA Property index has continued to increase from R335 billion in April 2013 to roughly R652 billion today. SA REITs make up R341 billion of this value listed and the number of property entities coming to list on the market continues to increase.

The assets owned by SA REITs have increased to R590 billion. The sector has also expanded into several foreign jurisdictions, including other countries in Africa, Australia, Central Eastern Europe, UK and USA, earning our country much needed foreign currency and diversifying the investor's risk.

There have also been 26 new listings in the property boards on the JSE in the last five years, making it the most active sector on the JSE in this time. The growth of the REIT sector has supported commercial real estate development in retail, office, industrial, hospitality, student housing and residential markets.

6 THINGS you always wanted to know about investing in private equity and venture capital

▶ **PETER NURCOMBE-THORNE,** peter@rosebankwealthgroup.com

Our article explores the somewhat unknown areas of private equity and venture capital investing by means of six simple questions.

1 What is the difference between private equity and venture capital?

Both private equity firms and venture capital firms aim to raise money from the same pool of investors with the intention of investing in private companies, increasing their value, and in due course, selling at a profit. The sale could be to another private firm or by listing on a stock exchange. However, venture capital firms invest in early stage companies while private equity firms generally invest in more mature companies. The company that raises the money, chooses new investments and manages the turnaround of the target investment is called the general partner. Investors who commit capital are called limited partners.

2 Who are the investors?

In South Africa, limited partners generally consist of insurance companies, pension funds, banks, investment holding companies, government agencies and wealthy individuals. The high minimums and sophistication required to manage committed capital, capital calls and the like make it more complex for ordinary investors to invest in private equity.

In recent years, governments around the world have become keen promoters of private equity (in particular its younger sibling venture capital) and have introduced tax breaks for small companies and those who invest in them.

3 Why do they invest?

Below are a few reasons for investing in private equity and venture capital.

Possible outperformance

The chief investment premise of investing in a private equity or venture capital is to catch the upward growth of a promising business and/or the 'value-add' of a talented private equity firm. The 2018 SAVCA Private Equity Industry Survey, released in February 2019 by the industry body, the Southern African Venture Capital and Private Equity Association, reported that the private equity industry delivered a ten-year internal rate of return of 11.6% compared to the 10.7% from the JSE All Share Total Return Index over the same period.

Internationally, the private equity/venture capital returns, relative to public investments, have been more compelling. The *Asia-Pacific Private Equity Report 2019*, published by management consultancy firm Bain and Co, reported that the pooled internal rate of return for Asia-Pacific-focused funds with a five-year investment horizon was 14%, compared with 8% for Asia-Pacific public markets. The internal rate of return for a 10-year investment horizon was 11% versus 6% for comparative Asian public markets.

The liquidity premium

The private equity industry is particularly attractive to investors who have a long-term horizon. By sacrificing liquidity, an investor gives a private equity manager time to make meaningful changes or for a new idea to gain traction, which has a greater chance of yielding greater returns over time.

On the other hand, unfortunate investors can be locked into loss-making investments and have no way of getting out. There is an old joke that a private equity relationship is generally longer than the average marriage in the United States, which is eight years.

Uncorrelated returns

Private equity returns tend to be uncorrelated to listed equity returns. This makes them popular with institutional investors looking for diversification, reduced portfolio risk and lower portfolio volatility. Returns in private equity are less volatile because they are not priced as frequently as public equities are. Both private equities and public equities are exposed to the same broad macro-economic conditions, the difference being that the valuation of private equities is not affected by the same investor sentiment and stock price volatility which is normally associated with publicly traded markets.

The investment horizon of private equity investment is well suited to the long-term horizon of pension funds. From 2011, South African pension funds have been allowed to invest up to 15% into alternative investments: a grouping that includes private equity funds, hedge funds and other derivative or pooled vehicles.

Social returns

Research has shown that the small to medium enterprise sector plays a vital role in job creation, particularly for those with low skills and out of the mainstream. The private equity investment structure lends itself to creating opportunities for black management and BEE beneficiaries.

Alignment

In private equity funds, the tradition of a general partner commitment ensures that there is full alignment between the interests of the private equity or venture capital firm, the management team and the limited partners. Everyone has skin in the game.

4 What are the disadvantages of investing in private equity?

Investing in private equity and venture capital comes with its fair share of risks. Investors essentially agree to invest large sums of money, for long periods, for no guaranteed outcomes, with no regulatory protection other than the law of contract.

First of all, relative to listed companies, the target companies are higher on the risk curve due to the fact that they are either small with untested ideas or have been identified as a target for a turn-around, which can be a long and difficult process.

Returns in private equity investments are notoriously uneven; there is a significant return disparity of top performing private equity firms versus industry laggards. Manager selection is a key determinant of success in private equity investing and, unlike most investing, past performance and a strong track record is a stronger indicator of future performance, a proud hallmark of private equity.

Like many other investments, timing of the entry point is crucial to investment success in private equity/venture capital investment. The returns enjoyed by investors are a direct product of the environment in which they are invested; big winners and losers tend to emerge during periods of turbulence and volatility, on both the upside and the downside.

While most private equity investments have a pre-planned exit arrangement these plans can go awry. In difficult economic environments, private equity firms tend to defer planned listings until investor appetite is deemed ready, further locking in limited partner money.

5 How are private equity investments and venture capital investments taxed in South Africa?

Private equity investments

Private equity investments are generally set up as limited partnerships and investors are taxed as if they own the underlying assets directly, according to the tax profile of each individual investor. A limited partnership is also not a separate legal person or taxpayer; each partner is taxed on his or her share of the partnership profits.

Private equity investors are thus exposed to limited liability (up to the amount of their capital contributions or contractual commitment to the fund) provided they do not become involved in the management of the partnership. Limited partnerships are ideal vehicles for the typical private equity investor, like pension funds, which pay no tax.

In other words, the main tax advantage of a limited partnership is that it is a flow-through entity. The partnership itself pays no taxes on its income. Limited partners receive income in the form of distributions or dividends and normal dividend payment rules apply.

Approved venture capital investments

In 2009 SARS, on instruction from National Treasury, created a tax incentive through section 12J of the Income Tax Act, with the purpose of stimulating growth and creating jobs.

Section 12J offers individuals, trusts and companies that are resident in South Africa a tax rebate on investments (up to 45% for individuals and trusts and 28% for companies), if made through an approved VCC. Rules and regulations for investors about qualifying venture capital companies are available in a document published by SARS on their website, 'External Guide Venture Capital Companies', which explains the legislative requirements and the obligations of approved VCCs.

Fast forward to March 2019: according to the SARS website, after a few tweaks to the original legislation, there are about 145 qualifying venture capital companies licensed by the Financial Services Conduct Authority and SARS. Industry sources have it that about R3.5 billion has been invested since the launch of the programme.

This legislative change has provided the general public with a more accessible and better entry into an asset class which has largely been off limits to them until now. Minimum investments in approved section 12J VCCs range from R100 000 to R1 million, and the only proviso is that in order for the tax rebate to apply, the investor must hold the investment for at least five years from the date of investment.

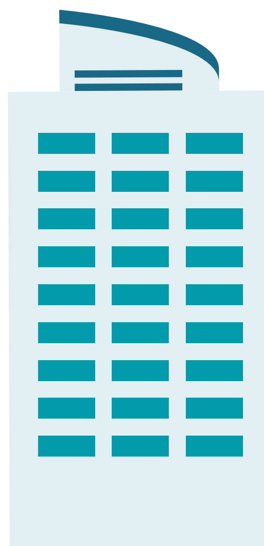
6 What is the South African context for private equity and venture capital investing?

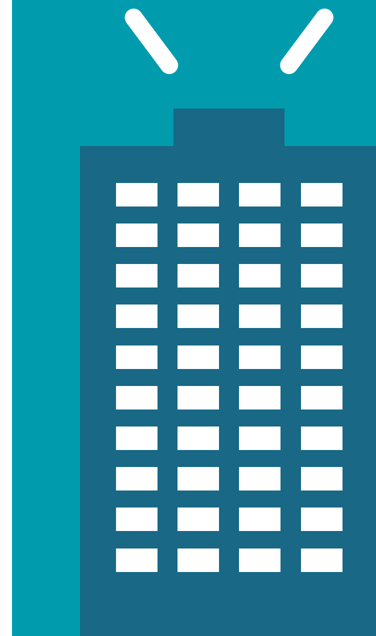
Over the last ten years, the combination of low interest rates and a recovering global economy has created an environment conducive to private equity/ venture capital firms. As of 2019, competition for these opportunities has increased and private equity/ venture capital returns may well diminish in this bubble-type scenario.

However, in South Africa, the trend could not be more different. We have relatively higher real interest rates and an underperforming equity market, where arguably the environments for both listed equities and unlisted private equity funds are offering better upside at lower risk.

Private equity is still largely underrepresented in portfolios across the spectrum, from individuals to pension funds. In addition, legislation in the form of section 12J will make private equity/venture capital investing more accessible and bring it into the main stream.

"In recent years, governments around the world have become keen promotors of private equity (in particular its younger sibling venture capital) and have introduced tax breaks for small companies and those who invest in them."





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WHAT IS A HEDGE FUND AND HOW IS IT TAXED?

▶ **MAGDA SNYCKERS,** msnyckers@ensafrica.com

Ever wondered what a hedge fund is and whether you should invest in one? Our article examines the nature of these funds and tax considerations for investors and the funds themselves.

Broadly speaking, a hedge fund is a portfolio that follows an investment strategy that may result in the portfolio incurring losses in excess of its aggregate market value. The investment strategy may include leverage or short positions.

The regulatory framework

A hedge fund that invites or permits members of the public to invest is subject to the provisions of the Collective Investment Schemes Control Act and as such, is regulated as a collective investment scheme. Such a hedge fund may either be constituted as a trust or a partnership.

The tax angle

In terms of the Income Tax Act, a collective investment scheme constitutes a person for tax purposes. Therefore, a portfolio of a hedge fund collective investment scheme that is regulated in terms of the Collective Investment Schemes Control Act (a hedge fund) will constitute a person and a taxpayer in its own right for income tax purposes.

In terms of paragraph 61(3) of the Eighth Schedule to the Income Tax Act, any capital gain or capital loss in respect of the disposal of an asset by a hedge fund is disregarded for purposes of capital gains tax. On this basis, the hedge fund is effectively exempt from CGT.

Income tax

From an income tax perspective, the provisions in section 25BA of the Income Tax Act are relevant to hedge funds and investors in hedge funds, i.e., holders of participatory interests in a hedge fund. Section 25BA contains deeming provisions that apply to a hedge fund and the holders of participatory interests in the hedge fund.

In particular, section 25BA(1) deems an amount, other than an amount of a capital nature, that is received by or accrues to a hedge fund and is distributed by that hedge fund to its holders of participatory interests within 12 months after its accrual to directly accrue to the holder of the participatory interests. An amount of interest is also deemed to accrue directly to the holder of participatory interests if the distribution is made within 12 months of receipt of the interest by the portfolio. Therefore, provided the hedge fund distributes all amounts of a revenue nature that accrue to it within 12 months of accrual, or within 12 months of its receipt in the case of interest, then the hedge fund will effectively be a tax transparent entity for income tax purposes.

However, to the extent that the hedge fund does not on-distribute amounts of a revenue nature within 12 months of accrual thereof or within 12 months of receipt in the case of interest, then the hedge fund itself is subject to tax on the revenue amounts. The hedge fund is entitled to deduct expenses against its income provided the expenses comply with the specific provisions of the Income Tax Act that deal with the deduction of expenses. If the hedge fund is constituted as a trust, it suffers tax on its taxable income at the rate of 45%.

A hedge fund that is constituted as a partnership is in terms of section 25BA(2) treated, for purposes of section 25BA(1), to have distributed an amount to the partners of the hedge fund if the amount is allocated to the partners.

In order to determine if an amount falls within the provisions of section 25BA(1), it is important to determine whether an amount constitutes income or capital from a tax perspective.

In this regard, section 9C of the Income Tax Act and the normal principles distilled from case law are relevant. Section 9C(2) deems any amount, other than a dividend or foreign dividend, received or accrued in respect of certain equity shares which have been held for at least three years to be capital.

Absent the application of section 9C, in terms of case law, the test to determine if an amount is of a capital or revenue nature is whether the taxpayer is engaged in a scheme of profit-making or whether it constitutes the realisation of a capital asset acquired for purposes other than such a profit-making scheme (see *Commissioner for Inland Revenue v Strathmore Consolidated Investments Ltd* [1959 (1) SA 469 (AD)]). If an asset is bought as a long-term investment to produce dividend income the profit is

likely to be of a capital nature (*CIR v Middelman 52 SATC* 323, 1989 [C]). But if an asset is bought for the purpose of resale at a profit, the profit will be of a revenue nature (*Californian Copper Syndicate [Limited and Reduced] v Harris [Surveyor of Taxes]* 41 Sc LR 694, 5 TC 159).

In determining whether a scheme of profit-making has been engaged in, our courts have indicated that this is "fundamentally a question of intention" (see *Secretary for Inland Revenue v The Trust Bank of Africa Ltd* [37 SATC 87]). However, although the intention with which the investments were acquired is of the utmost importance, it is not necessarily decisive. In determining whether proceeds are of a capital or revenue nature, all the relevant facts and all the circumstances of the case have to be considered. The courts recognise that intention, being a subjective test, is tested against the objective facts: The actual activities and the manner in which those activities are implemented and the conduct of the taxpayer are considered before coming to a conclusion as to the nature of the income. Based on case law, the courts consider, inter alia, the following factors:

- The intention of the owner, both at the time of buying the asset and when selling it
- The activities in relation to the asset up to the time of the decision to sell or realise it and the light which such activities throw on the owner's ipse dixit as to intention
- The frequency of the transactions
- The existence of an income flow from holding the asset
- The reason for selling the asset

Based on the above, the hedge fund manager should consider whether the amounts that accrue to it or are received by it are capital or revenue in nature. It should be noted that the classification of an amount as capital or revenue for tax purposes may differ from the classification of income for purposes of the distribution policy of the hedge fund.

Proposed changes to the regime

Following statements in the 2018 Budget Review, which noted that the current rules will be clarified to provide certainty on the treatment of trading profits in the context of collective investment schemes, certain amendments were proposed to the Act. However, after public comments on the proposed amendments, it was announced that further time is required in order to find solutions that will not negatively impact on the relevant parties. As such, the proposed amendments were withdrawn. The 2019 Budget Review noted that a study is proposed for the 2019 legislative cycle.

Withholding taxes

In addition to the above, a hedge fund is a regulated intermediary for dividends tax purposes. This means it must withhold dividends tax (which is levied at the rate of 20%) in respect of dividends that the hedge fund on-pays to the holders of participatory interest in instances where the dividends are distributed by the hedge fund within 12 months of accrual thereof.

A hedge fund is further required to withhold a withholding tax on interest (levied at the rate of 15%) if it on-distributes interest to a non-resident holder of the participatory interest within 12 months of receipt of the interest.

"It should be noted that the classification of an amount as capital or revenue for tax purposes may differ from the classification of income for purposes of the distribution policy of the hedge fund."

Securities transfer tax

A hedge fund is not exempt from securities transfer tax. As such, if it acquires a share that is listed on an exchange in South Africa or issued by a company incorporated in South Africa, the transfer of the share to the hedge fund is subject to securities transfer tax. However, in some instances, the hedge fund may rely on an exemption from securities transfer tax, for example, if the hedge fund borrowed shares and it qualifies for the "lending arrangement" exemption from securities transfer tax.

Prior considerations

In the light of the above, potential investors should carefully consider the investment strategy and the mandate of the hedge fund before investing in it. Potential investors should furthermore be mindful of the fact that the hedge fund is a taxpayer in its own right and to the extent that the hedge fund does not on-distribute amounts, there may be tax implications for the hedge fund.

Furthermore, depending on the findings of the study which has been proposed in the 2019 Budget Review, future law changes may impact on the tax implications of a hedge fund.

RAND-HEDGED LOCAL INVESTMENTS

▸ **WOUTER FOURIE**, wouter@ascor.co.za

Want to learn how to protect your hard-earned Rands from creeping devaluation against other currencies? Our article explains it all.

Half the man you used to be?

When planning an overseas holiday or business trip, you quickly realise that our local rand currency does not buy you half the travel benefits you got 10 years ago. Unfortunately, this has a much bigger impact than just holiday planning, for the value of your wealth (including retirement savings) has also halved over the past 10 years in dollar terms and you will realise that you are half the person you used to be in dollar value. In fact, we are slowly becoming poorer and poorer, and the decline of our currency against international currencies will also put more pressure on inflation going forward.

The difference between two countries' inflation rates is also a good long-term indication of how one country's currency will weaken or strengthen over time. If the USA's inflation rate is 2 per cent and South Africa's inflation rate is 6 per cent, then South Africa's currency should depreciate by 4 per cent per year against the US dollar. This is a well-known concept called "Purchase Price Parity" and confirms that the past decline of the value of our currency will continue over the long term. Until we kick-start our economy, create more jobs, start exporting and bring down our inflation rate, we will have a depreciating currency.

So, how do you protect yourself against this long-term currency depreciating "cholesterol" build-up in your wealth creation?

By including international investments, you will protect yourself against currency depreciation and also gain access to industries not well presented locally. You are spreading your investment risk by "not putting all your eggs in one basket".

There are two major options when investing internationally: rand hedging and offshore investing. In this article we will focus only on rand-hedge investing.

What is rand hedging?

Rand hedging means protecting your investment against a weaker currency over time. Pure rand hedging can be achieved through investing in our local companies that sell products and services outside South Africa or have big foreign operations. These companies can be private or public listed companies on the JSE and/or any of the new exchanges: ZAR X, 4AX and A2X. As an investment planner, I prefer investing in listed companies that provide transparent financial reporting, liquidity and strict reporting standards and therefore prefer investments in listed public companies compared to private companies.

What are the rand-hedge options for local investors and how do you go about making such an investment?

Access to investing in companies that provide you with rand-hedging options can be obtained through a private share portfolio or as part of a unit trust. Both options can be part of your pension fund investments, as well as non-pension funds.

The new generation linked investment platforms (LISPs) like Glacier from Sanlam, Momentum Wealth, Investec and Old Mutual Wealth allow you to have access to both private share portfolios and unit trusts within your pension funds. Non-pension fund investments have no limitations and you have access to both shares and unit trusts.

Most of us who invest in pension, provident and retirement annuities will already have an exposure to rand-hedge funds. This is obtained by the fund managers investing in companies on the JSE that provide rand hedging. Companies like Naspers, which now ranks as the biggest company in Africa (and top 100 in the world) by market capitalisation, with operations in more than 130 countries, is only one of many companies that provide us with offshore rand-hedge income.

What are the limitations, if any, to invest in rand-hedge companies?

Regulation 28 in terms of the Pension Funds Act regulates how much exposure pension, provident and retirement annuities can have to offshore investments. Current regulations limit offshore exposure to 30% plus another 10% to Africa. Rand-hedge companies do not form part of this limitation, thereby allowing investors to benefit from offshore exposure plus rand-hedge exposure within these kinds of investments.

Investments that are not regulated by Regulation 28 have no limitation on offshore exposure or rand-hedge exposure.

In constructing an investment portfolio, you need to take care that your offshore plus rand-hedge exposure does not increase your overall risk to currency volatility, especially where you need to draw down on the portfolio. Consult with an investment specialist, preferably an independent certified financial planner, to guide you in constructing the optimal portfolio.

Are there (unforeseen) tax implications?

The tax implications of investing in rand-hedge companies will depend on the investment vehicle used.

Pension fund investments

In the build-up to retirement, you can invest in rand-hedge companies using a share portfolio and/or unit trusts within your pension fund, provident fund and/or retirement annuity. You will then be subject to the "five fund approach" as specified by section 29A(3) of the Income

Tax Act. In terms of the “five fund approach”, the retirement investments will fall in the “untaxed policyholder fund” and there will be no income tax or capital gains tax payable on the growth within the fund. So, you benefit from tax-deductible contributions and no tax payable on the investment growth in pension funds. When you retire, after age 55, you can receive up to R500 000 tax free and will be subject to income tax at your marginal tax rate on the monthly income you withdraw. Pension fund investments are still one of the most tax-efficient wealth creation investment options available in South Africa.

Non-pension investments
Here, you also have the option of investing in a direct share portfolio and/or unit trust to obtain rand-hedge exposure.

A private share portfolio will be more effective in constructing greater exposure to rand-hedge companies, seeing that you can choose exactly what you would like to include. Within a unit trust the unit trust manager will make the choice.

A unit trust or private share portfolio will be subject to tax on any interest earned and dividends received. The first R23 800 (R34 500 if older than 65) of your annual interest income is exempt. The interest could be paid out or be reinvested and added to your base cost. You will also incur a 20% withholding tax on your unit trust or share dividend income. The dividend could also be paid out or reinvested and can again be added to your base cost. If you sell your share or unit trust, you would pay capital gains tax on the difference between your realised value and the base cost.

If your marginal tax rate is higher than 30%, you might consider using an endowment ‘life wrapper’ as your investment vehicle. Endowment tax on income is at a flat rate of 30% as opposed to the higher rate of 45%. Capital gains tax is an effective rate of 12% compared to an 18% effective rate for individuals in the higher income bracket and 36% for trusts.

> *"By including international investments, you will protect yourself against currency depreciation and also gain access to industries not well presented locally."*

Other benefits of using an endowment include:

- Simplified tax administration as tax is recovered within the endowment and is taken care of on behalf of the investor.
- Insolvency protection – the entire value of the policy will be protected against creditors from three years after inception until five years after maturity, or upon termination of the policy.
- Beneficiary nomination can lead to potential savings on executor’s fees (up to 4.025% of fund value). Where a beneficiary has been nominated, payment of the death benefit does not depend on the winding up of the estate and beneficiaries will receive the proceeds relatively quickly.
- Liquidity is created in the estate as payment of the death benefit does not depend on the winding up of the estate and beneficiaries will receive the proceeds fairly quickly.

Investing in rand-hedge companies provides excellent protection against the devaluation of our currency because of political risks and low domestic (internal) economic growth.

The Tax Faculty

PROFESSIONAL CERTIFICATE IN TAXATION

The course is designed to empower course participants with applied working and practical knowledge of the fundamentals of taxation that will secure the course participant the license to practice as a registered tax practitioner with SARS and professional membership with the South African Institute of Tax Professionals (SAIT).

The course covers the entire field of taxation (including value-added tax), excluding certain specialised areas and will enable the course participant to calculate the tax of individuals including farmers, partnerships, sole traders as well as the taxation of companies, close corporations and trusts. This course will benefit beginners as well as practitioners who need to update their knowledge on the fundamentals of taxation

COURSE DELIVERY

This short learning programme is delivered by The Tax Faculty through the virtual campus and webinar platforms.

The knowledge and practical skills gained in this programme will provide you with the foundational knowledge and practical skills to perform SARS tax compliance functions and services, including the preparation and submission of tax returns for individuals, corporate, farmers, partnerships, sole traders, companies, close corporations and trusts. This certificate is built upon practical simulations, ensuring the learning environment simulates reality in a tax practice.

The purpose of the simulation is to ensure theoretical knowledge can be practically applied in the completion and submission of tax returns without errors.

DURATION OF THE COURSE

12 months – 1 calendar year.

LANGUAGE

The teaching medium is English.

REGISTRATION

The Course in Taxation commences on 4th July 2019.
Registrations must be submitted before 28th June 2019.

REGISTRATION REQUIREMENTS

A senior certificate or equivalent qualification or appropriate experience in Tax.

FEES

Payment option 1: Once-off payment
R21 950.00 (incl. VAT)
Payment option 2: Debit order
First payment: R3 975.00
12 Instalments: R1 600.00 per month
Bursary students (SAIT Members in Good Standing):
First payment: R3 975.00
12 Instalments: R700.00 per month
SAIT members in Good standing qualify for the bursary of R10975.00 (Once Off)

TWO SIDES TO EVERY (BIT)COIN

▶ **NATASHA WILKINSON**, natasha@taxconsulting.co.za

Our article gets behind what Bitcoin is and describes the tax implications to be taken into account when transacting in it.

What is Bitcoin?

Bitcoin is an online currency which, despite not being legal tender in South Africa, derives value and is a mechanism for trading goods (or services), in exchange for the virtual currency in what is called "blockchain" by cryptocurrency traders. The result of this online trading in Bitcoin is that the Bitcoin holder either generates an overall profit or incurs an overall loss.

In addition to this, some individuals simply purchase Bitcoin for the purpose of long-term holdings as investments. In the case of miners, when computers add a block to the blockchain ("the ledger"), they are rewarded with cryptocurrency and mine Bitcoin.

From the below graphical depiction (obtained from https://www.coindesk.com/price/bitcoin), it is, however, clear that Bitcoin has experienced a steady decline from 6 April 2018 to 12 March 2019 and the majority of Bitcoin holders would have experienced a loss.

Who should invest in Bitcoin?

There is no ideal Bitcoin investor. Any person with access to the internet can trade on an exchange, a platform that facilitates the sale and purchase of not only Bitcoin, but a wide array of other cryptocurrencies.

Miners, on the other hand, would not necessarily suffer any losses, given that they do not physically purchase Bitcoin. They simply create it. A miner of Bitcoin would still, however, have a tax exposure due to there being a gain, with no loss incurred.

How is it taxed?

A media release by SARS on 6 April 2018 confirms that SARS "will continue to apply normal income tax rules to cryptocurrencies and expect affected taxpayers to declare cryptocurrency gains and losses as part of their taxable income". Accordingly, following normal income tax principles, cryptocurrency may either be held as a capital asset or revenue in the hands of the taxpayer.

While normal income tax principles apply, certain tax amendments have been introduced in the Taxation Laws Amendment Act, No. 23 of 2018, with the aim to prevent abuse and/or tax evasion following the compulsory disclosure of Bitcoin earnings by taxpayers.

Section 20A(2)(b)

Section 20A(2)(b) of the Income Tax Act applies to revenue and sets out trades which are subject to automatic ring-fencing on the basis of these trades being classified as "suspect trades". The aim of section 20A is to prevent expenditure and losses associated with suspect trades from being used as a means to reduce a taxpayer's taxable income.

With effect from 17 January 2019, section 20A(2)(b) of the Income Tax Act was amended by the Taxation Laws Amendment Act of 2018. The result of this amendment is that

"Any person with access to the internet can trade on an exchange, a platform that facilitates the sale and purchase of not only Bitcoin, but a wide array of other cryptocurrencies."

both the acquisition and disposal of any cryptocurrencies by a natural person will be listed as a suspect trade on which any assessed losses are automatically ring-fenced. It is only where the circumstances enunciated in section 20A(3) of the Income Tax Act (commonly referred to as the "facts and circumstances" test) are met, that this ring-fencing falls away; thereby allowing for any assessed loss to be set off against a taxpayer's income in terms of section 20 of the Act.

"Financial instrument"

Under the 2018 Amendment Act, the definition of "financial instrument" in section 1 of the Income Tax Act is extended to include "any cryptocurrency". Where the cryptocurrency is held as capital, taxpayers should bear in mind the anti-avoidance provision in paragraph 42 of the Eighth Schedule to that Act. Where there is a disposal of the cryptocurrency within 12 months of its acquisition and an amount is received or accrues from a portfolio of a collective investment scheme, a proposed section 25BA(3) will apply if and when a proposed amendment of the Income Tax Act is promulgated sometime in the future.

Paragraph 42 of the Eighth Schedule to the Act

Where any cryptocurrency is held as a capital asset and: (a) the cryptocurrency is disposed of towards the end of a year of assessment in order to realise a capital loss (to be offset against any capital gains made during that same year of assessment); and (b) similar cryptocurrency is reacquired within a certain period, the anti-avoidance rule in paragraph 42 of the Eighth Schedule to the Act is activated.

The result of this anti-avoidance rule is that the person (or a connected person, where the cryptocurrency is reacquired by the connected person) is treated as not having realised a capital loss, because the proceeds are deemed to equal their base cost.

Section 25BA(3) of the Act

In the Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2018 (published on 16 July 2018), National Treasury indicated that Parliament had the intention to add a new subsection (3) to section 25BA of the Income Tax Act, with effect from 1 March 2019. This amendment to the Act was, however, not contained in the 2018 Taxation Laws Amendment Act passed by Parliament. Currently it is unclear if and when this amendment will become law.

Once section 25BA(3) of the Act is eventually promulgated into law, the effect will be that any amount received or accrued from a portfolio of a collective investment scheme is deemed to be revenue in nature, where a "financial instrument" is disposed of within 12 months of acquisition. Accordingly, where a portfolio, for example, sells cryptocurrency (a financial instrument) within 12 months from the date of acquisition, it is automatically deemed to be revenue received by the taxpayer.

As it is deemed to be revenue, where the disposal occurs within 12 months of the acquisition of the cryptocurrency, the consequence is that the cryptocurrency will be considered a "suspect trade", and any assessed loss associated with it will be made subject to section 20A(2)(b) of the Act.

Value-added tax

In addition to the above, the 2018 Taxation Laws Amendment Act goes a step further and adds section 2(1)(n) to the Value-Added Tax Act, with effect from 1 April 2019. The result of this is that, where a vendor (taxpayer) issues, acquires, collects, buys, sells, or transfers ownership of any cryptocurrency, this supply by the vendor is deemed to be a supply of a financial service. Accordingly, this financial service is an exempt supply, envisaged in section 12(1)(a) of the VAT Act and accordingly the vendor may not charge VAT on its outputs. The result of this is that, unless the supply of this financial service qualifies for zero-rating under section 11 of the VAT Act, no input tax may be claimed on any expenses incurred by the vendor on such exempt supply.

Where to now?

Trading in Bitcoin online has become relatively simple and merely requires an interested party to buy Bitcoin in order to commence trading or investing, or the mining of Bitcoin for either purpose. However, with the recent decline in the value of Bitcoin, the recent tax amendments show that government is anticipating abuse by taxpayers when losses are declared from trading.

To ensure that taxpayers have correctly disclosed their Bitcoin earnings, it is recommended that taxpayers engage with tax professionals who are familiar with the amendments that have been promulgated.

T

MANAGING THE RISING COSTS OF HEALTHCARE PROVISION

LARA WARBURTON, lara.warburton@integralwealth.co.za

Price rises in medical aid and medical costs can be potholes in the road to investing for the future. Find out how to manage these.

Planning for medical costs is an important part of a financial plan. Many of the assumptions when planning also used to apply to planning for medical costs, but that linkage has started to break down in recent years, with medical inflation breaking away and rising more than CPI each year. Part of this rising inflation is seen in the annual medical aid price increases, but in addition to that each year brings an adjustment of what the scheme covers and what it does not, leading to additional costs for members. Surveys undertaken by Alexander Forbes in December 2017 and by Grant Thornton Capital in 2018 estimated this cost to be 2-3% higher than CPI, and 3.4% higher than CPI, respectively, over the long term.

Basic options when buying medical aid

Most open medical aids (not restricted to employees only but open to the public) offer a range of medical aid options, to cater to different budgets. Medical aid, like life assurance, is a purchase made on "what ifs". Many healthy members are not too concerned about day-to-day cover, but want to know the big costs will be covered in the event of a hospital admission.

Medical aid legislation in SA at present does not allow medical schemes to age-rate or health-rate, meaning they cannot charge older people or sick people any more than they charge young healthy members. As a result, they use the only options available to penalise new joiners if they can – applying waiting periods for pre-existing conditions, and applying a late joiner penalty if there has been a break in medical aid scheme membership based on certain rules.

As the cost of the various plans rises, many of the young and healthy, as well as some older poorer members, prefer to choose a hospital plan only, where they are only covered for in-hospital procedures. Many hospital plans limit cover to 100% or 200% of medical aid rates, and the member needs to make co-payments to cover the shortfalls.

It is a known fact that given the shortage of specialist doctors in SA, many of them charge fees way in excess of medical aid rates – in some instances 500% to 700% of medical aid rates if their skills are in short supply. In addition, as medical advances are made, new treatments, technologies and types of expensive equipment push costs up further. Prescribed minimum benefits (PMBs) are a set of defined benefits ensuring all medical scheme members have access to certain minimum health services regardless of the chosen benefit option. Each year new benefits are added, causing costs to rise. The Rand/Dollar exchange rate (machinery and medicine imports), professional indemnity insurance taken out by doctors, the VAT hike last year to 15%, as well as fraud in the industry all contribute to the rise in costs.

These are some of the reasons why Gap Cover is attracting a lot of attention, and many people are taking out this form of short-term insurance to cover any medical aid shortfalls in hospital. It is relatively inexpensive to insure a family.

Some medical schemes have tried to counter these rising costs by establishing networks of contracted-in doctors and specialists who charge lower rates in exchange for client referrals from the schemes. This is not always ideal as in many instances doctors are advised how to diagnose and treat patients to meet the scheme requirements.

Tax relief for medical aid costs, and the elderly

In the past, medical aid contributions were tax deductible. Given that only 16.9% of the population (Stats SA General Household Survey 2017) are members or dependants of medical aids, it is unsurprising that this tax concession was revised, and a medical scheme fees tax credit was introduced instead. The taxpayer can claim R310 for him/herself and the first dependant, and R209 for subsequent dependants each month. In the February 2019 budget, the increase in these amounts was less than 2.5%, nowhere near the medical aid inflationary increase of just under 10% across most schemes.

There is an additional medical expense tax credit that can be claimed by members under age 65 and members over age 65, in addition to the credit that can be claimed if the taxpayer or immediate family member has a disability. "Qualifying medical expenses" and "disability" are defined in section 6B of the Income Tax Act.

How will the NHI work?

Since 2005, all medical aids have run a risk equalisation fund, whereby they have notionally accrued funds that would be paid to fund a National Health Insurance scheme. The risk equalisation funding model involved better funded medical aids making higher notional contributions to the risk equalisation fund, and schemes with older or more ill members contributed less.

The NHI Bill was released in June 2018. The objective of the NHI is to ensure that in a country as unequal as SA, all citizens are afforded the right to quality healthcare. The notion is a noble one, and one that we should all support, knowing that a healthy nation is a productive nation. The concern for most is the detail, and given the fraud and corruption that is being exposed daily in our news, the devil in the NHI will be in the detail and the implementation.

Proposed funding will be as follows:

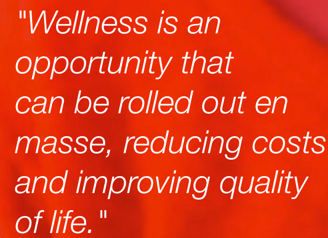
- The current Government Healthcare Budget
- Medical scheme member tax subsidies which will be stopped
- Contributions from people who are members of medical aid schemes (the risk equalisation funds that medical aids have been tracking notionally)
- Contributions from high earners who do not belong to medical aids – a wealth tax

The NHI proposes to contract out to existing public and private hospitals and service providers, and an independent body called the Office of Health Standards Compliance will be established to monitor quality of facilities and care provided. All citizens will receive the same health care, and it will be free. It is hoped that the bulk purchasing power of the NHI, as well as low administrative fees, will result in cost savings. All doctors, be they public or private, will be paid the same amounts for the services they provide.

NHI Bill proposals

There are 10 proposed changes to the current medical environment which will be debated now that the draft bill has been released:

1. No co-payments.
2. No brokers or advisors to earn fees.
3. PMBs to be replaced with comprehensive service benefits.
4. Registrar of Council of Medical Schemes (CMS) must approve all benefits which must be offered to all.
5. It is an offence to label one's business a medical scheme if it is not (must be registered to provide benefits).
6. Create a central beneficiary registry to collect data.



7. Income cross-subsidisation – rich pay for poor, young pay for old, healthy pay for sick, urban pay for rural.
8. Medical aids must pass back any realised savings to consumer – designated service providers.
9. Cancellation of member penalties like the late joiner penalty and waiting periods.
10. Tighter governance requirements for medical aids – board and CEO minimum qualification criteria.

Other potential implications of the NHI

Clearly there are many social positives that can result from a well-run NHI scheme, and in a socialist society such a scheme would be well supported.

For many South Africans, there are immediate concerns about the quality of care that the State can hope to provide, given its revenue opportunities.

- A limited State budget which has a rising deficit.
- A limited medical aid membership base (only 9,3m people covered in a population close to 55m – StatsSA General Household Survey 2019) that is already feeling squeezed financially, and is soon to lose the medical scheme fees tax credit.
- A small high net worth tax base.

In addition, there could be other implications including:

- Our small and shrinking base of medical professionals, many of whom are leaving the country to earn more elsewhere.
- Members giving up their medical aids as medical inflation continues to rise faster than salaries.
- Government inability to keep pace with medical enhancements – machinery, technology, medicines, know-how – resulting in sub-par medical care for all.
- The wealthier taxpayers leaving the country, or opting out of the tax base if they are able to.

What's to be done?

In closing I would like to end with a positive thought. I recently heard Adrian Gore, CEO of Discovery, speaking at an event where he said that Discovery (the largest open medical aid in South Africa) supports NHI and is willing to work with Government. Many South African entrepreneurs have built globally successful businesses, finding opportunities that others cannot see. NHI will bring its own set of opportunities, and potentially products and services not yet thought of. Wellness is an opportunity that can be rolled out en masse, reducing costs and improving quality of life. Any attempts to reduce inequality in South Africa give us all a brighter future – less to lose and more to gain for all citizens in a thriving, growing economy – a win-win. What can we do to steer it?

OFFSHORE TRUSTS

This five-part article looks at offshore trusts and basic considerations, tax emigration, the dividend participation exemption, funding a foreign trust and new substance rules.

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page 40 CHANGES TO THE DIVIDEND PARTICIPATION EXEMPTION

page 42 FUNDING A FOREIGN TRUST

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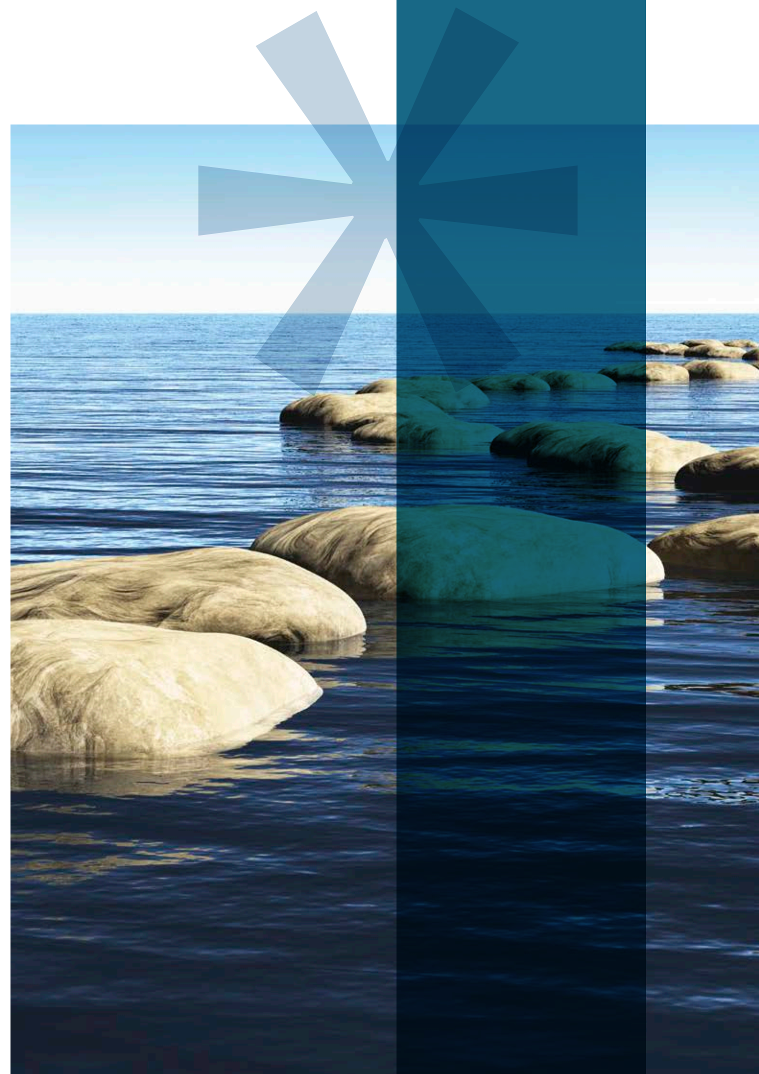

The Tax Faculty

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OCCUPATIONAL CERTIFICATE: TAX PROFESSIONAL

The skills gained in the qualification will provide successful learners with the advanced skill to practice as a tax consultant and advisor. Successful students will be eligible for membership of the South African Institute of Tax Professionals and the designation Tax Advisor (SA) and receive a professional occupational qualification that is registered on the National Qualification Framework (NQF 8).

COURSE DELIVERY

The certificate is delivered via The Tax Faculty's virtual campus and webinar platforms whilst the final exam is administered by SAIT.

The Tax Faculty recognises that learning is achieved through past experience and therefore the learning journey will begin with a diagnostic from which tailored learning journeys are implemented, giving you the best opportunity to gain your qualification without having to start from scratch.

COURSE OUTCOME

The occupational tasks of a Tax Professional includes the demonstration of the following competencies at an advanced level:

- Registering a taxpayer and finalising income tax, payroll tax and VAT returns;
- Reviewing or auditing tax balances;
- Mediating tax disputes;
- Writing tax opinions.

DURATION OF THE COURSE

18 months.

LANGUAGE

The teaching medium is English.

REGISTRATION

The course commences 4th July 2019
Registrations close 28th June 2019

REGISTRATION REQUIREMENTS

NQF 7 such as BCom in the fields of commerce, accountancy or law (or Equivalent).

3 years tax experience or signed learnership

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Monthly Instalment Option
Deposit: R3950
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WE DO E-LEARNING SO YOU CAN DO LIFE

BASIC CONSIDERATIONS AND RECENT AMENDMENTS

▶ **HANNEKE FARRAND,** hfarrand@ensafrica.com

As set out in the article, recent amendments to South African legislation have brought about significant changes to the tax regime for offshore trusts and their beneficiaries.

"An intricate range of tax provisions can apply to South African residents' relationships with offshore trusts."

A new world

The world of offshore trusts is now more dynamic than ever. The benefits of trusts as effective tools for the preservation of assets for future generations has been commonly known and accepted for decades. Globally, the trust environment is changing due to the introduction of the Common Reporting Standard and resulting Automatic Exchange of Information between various revenue authorities around the world. The original settlement and current beneficial ownership of trusts is now largely transparent.

In addition, some jurisdictions view offshore trusts as transparent vehicles with potentially significant tax implications for the funder and beneficiaries of these vehicles. This increased transparency has made beneficiaries more aware of their rights against trustees and their entitlement to information relating to the management and administration of the trusts.

An intricate range of tax provisions can apply to South African residents' relationships with offshore trusts. Foundations are also increasingly used which may have different tax consequences. The tax treatment of the funding of and distributions from offshore trusts has been the subject of debate for a number of years, culminating in the most recent amendments to the Income Tax Act which were approved by Parliament in 2018.

In essence, the Act provides for the taxation of income and capital gains distributed to South African resident beneficiaries. The funding of these vehicles can also trigger a donations tax liability and resulting attribution rules can apply to include income and capital gains in the hands of the donors. Where a person connected to the trust sells assets to the trust on loan account, interest is required to be charged.

The amendments brought about fairly fundamental changes relating to the payment of dividends and the use of the participation exemption in circumstances where trusts held shares in underlying companies.

Some highlights of the amendments relating to the participation exemption

Attribution rules

Donors may be taxed on income received by or accrued to the offshore discretionary trust if such income was received by or accrued to the offshore trust by way of donation, settlement or other disposition made by the resident, provided that such income would have been included in the offshore trust's income had the trust been a resident. Interest-free loans or low-interest loans granted to the offshore trust are also covered by these provisions.

Previously, this rule could have excluded dividends distributed to a non-resident trust by a foreign company. Such a foreign dividend would not have constituted income had the trust been a resident, by virtue of the participation exemption in section 10B(2)(a) of the Income Tax Act.

The participation exemption applies to foreign dividends received by or accrued to a person that holds at least 10% of the total equity shares and voting rights in the foreign company declaring the dividend. Such foreign dividends are exempt from tax.

The amendment to section 7(8) of the Act states that, when determining whether an amount constitutes income, the participation exemption must be disregarded in respect of a foreign dividend and amounts derived directly or indirectly from a foreign dividend that were received by or accrued to a non-resident such as an offshore trust where, among other requirements, more than 50% of the total participation or voting rights in the foreign company are held or exercisable by the offshore trust, and where the resident is a connected person, as defined, in relation to the trust.

South African resident donors are still able to benefit from the partial tax exemption that applies to all foreign dividends in terms of section 10B(3), in which case the dividends will be taxed at a maximum rate of 20%.

These rules will not apply to interest bearing loans. These require an arm's length rate of interest to be charged in terms of the transfer pricing provisions set out in section 31 or in terms of section 7C, which specifically regulates the charging of interest where assets are sold to a trust on loan account.

Capital distributions

Previously, a capital distribution to a South African resident beneficiary by an offshore trust arising from a prior year's foreign dividends derived from a foreign company would have been exempt from tax if the trust would have qualified for the participation exemption. Therefore, such a capital distribution would not have been taxable in South Africa in the hands of the beneficiary on the basis that no amount of income (as defined) would have arisen for the trust if it had been a resident.

Similar to the discussion above in respect of the attribution rules, the participation exemption must be disregarded under the same circumstances as discussed above, when determining the extent to which capital distributions will be taxed in the hands of the South African resident.

Capital distributions by an offshore trust which are derived from such foreign dividends would consequently be taxable in the hands of the South African resident beneficiary. However, South African residents would also still be able to benefit from the partial tax exemption applicable to foreign dividends.

Amendments to distributions of capital gains

Prior to the amendments below, paragraph 80(1) of the Eighth Schedule to the Act provided that if a trust vested an asset in a resident beneficiary, the beneficiary would be subject to capital gains tax in respect of the related capital gain determined by the trust in respect of the disposal of the asset. Paragraph 80(2) of the Eighth Schedule provides that if a trust disposes of an asset and vests the resultant capital gain in a resident beneficiary in the same tax year, the beneficiary would be subject to capital gains tax in respect of the capital gain.

Previously, these provisions appeared to not be applicable to offshore trusts. Subsequent to the legislative amendments, the resulting capital gain in respect of a disposal of an asset vested in a South African beneficiary of a trust is to be taken into account in determining the aggregate capital gain or loss of the resident beneficiary to whom the asset was disposed. This provision is now applicable to offshore trusts as well.

Remittance of offshore distributions to South Africa

South African exchange control residents may use their annual foreign investment allowances to fund offshore trusts. The South African Reserve Bank's Currency and Exchange Control Guidelines do not impose any restrictions on the remittance of distributions from offshore trusts to resident beneficiaries.

Reportable arrangements

Some arrangements in respect of offshore trusts may need to be reported to SARS, unless they are excluded in terms of the Tax Administration Act. Such reportable arrangements include contributions made by a resident to an offshore trust which exceed R10 million, and where such resident has or acquires a beneficial interest in the offshore trust. These arrangements must be reported to SARS within 45 business days.

TAX EMIGRATION'S IMPACT ON LOCAL & OFFSHORE TRUSTS

▸ HUGO VAN ZYL, wegkaner@iafrica.com

What happens to local and offshore trusts in the case of tax emigration? Our article examines this, with specific reference to anti-avoidance rules in the USA and UK.

The upcoming March 2020 change in tax law has forced many South African expatriates (Saffas) to re-look at their tax residency status in South Africa. 1 March 2020 (therefore the social media hashtags #Tax2020 and #TaxMigration) will see tax resident Saffas paying South African tax on their qualifying income exceeding the capped R1 million foreign income exemption. Qualifying income includes fringe benefits and incentive income from foreign employment income.

The tax exit charge in terms of section 9H of the Income Tax Act seems to be the only issue most tax emigrants consider. Once they decide to emigrate financially, they are asked about their local trust. Yet it is most important to discuss the pros and cons of retaining a local and offshore trust at the time of tax emigration.

The IRS in the USA, HMRC in the UK and the ATO in Australia have draconian anti-avoidance rules to address most of the tricks and tax planning South African expatriates came up with to escape the 36% capital gains tax on capital that vests in tax non-residents.

Tax residency, tax and financial emigration

Tax emigration (often a tax consequence in terms of a treaty) is usually much earlier than the financial or formal emigration (mostly a non-tax event that one can elect to do or not do). In terms of the Income Tax Act section 1 definition of a (tax) resident, the definition does not include " any person who is deemed to be exclusively a resident of another country for purposes of the application [tie-breaker test] of any agreement [DTA] entered into between the government of South Africa and that other country for the avoidance of double taxation."

Expats living in Dubai (United Arab Emirates) can normally tax emigrate once they have been in the UAE for more than six months. Expats living in the UK can be tax resident after 91 days, but backdated to the beginning of the UK's then tax year. South Africans with green cards and USA passports are USA tax residents and the IRS will tax their world-wide income despite the taxpayer not having been in the USA for a decade.

Treaties often deem younger clients (assume a couple being SA taxpayers) to be exclusively tax resident in the treaty country because they retain no permanent home in South Africa. Even should there be a farmhouse or holiday home, owned by a local trust, the centre of vital interest is most definitely the new home country of the clients. One or more of the young spouses, or their younger children, are often beneficiaries in terms of a trust created and funded by a previous generation, all of whom are tax resident in South Africa.

In planning financial emigration, one is quick to suggest that the trust is dissolved soonest, and the financial emigration delayed for at least three tax or calendar years. However, if the local trust is a true family trust the young family now living abroad are not the only trust beneficiaries. The beneficiaries residing in Australia or the UAE may face no estate duty but their siblings, nieces and nephews in South Africa remain and are exposed to estate duty. Grandparents often created the trust not for tax or estate duty reasons but to ensure that their self-created wealth would be used to educate their grandchildren. Dissolving the local or offshore trust is often a very emotional issue over which an emigrant couple has no control.

Tax issues to be considered

In South Africa, the local trust will be subject to both tax and exchange control (Excon) scrutiny, and we all know that vesting of capital gain and interest income may result in additional and higher tax rates. The vesting of rental income could see the tax emigrant filing a tax return as tax non-resident and paying tax based on source rules.

The increased CGT rate of 36% on gains vested from a South African trust to a tax non-resident is not the only issue the family needs to consider. SARS will not allow the conduit benefits in respect of capital gains to a non-resident and the family is quick to suggest the trustees then vest the gain in their grandparents or another family member. This will trigger the 18% CGT rate and then the stand-in tax resident beneficiary is asked to donate or advance the after-tax amount to the family living abroad. The relaxed Excon rules now allow for the South African family members to make use of their single discretionary allowance (SDA) and advance ZA Rand to the family abroad.

The question overlooked is how the foreign country will consider the incoming funds? We may be very clever in designing solutions not to pay South African donations tax but we then ignore the section 7(8) attribution of foreign income earned by the recipient because of the interest-free loan or donation made.

Anti-avoidance rules in the USA

In general, the reporting rules apply to a US person, that is a South African tax resident with a US passport or green card, who–

- Creates a foreign trust
- Transfers any money or property to a foreign trust
- Receives a distribution from a foreign trust
- Is treated as the US owner of a foreign trust

US tax consequences apply to both the US owners, the US tax registered beneficiaries of the foreign trust, and often to the foreign trust (being a South African trust) itself.

"Keeping the trust wealth a secret will most certainly come to bite the funder, the grantor or the settlor as well as the innocent cash-needy beneficiary spreading his or her wings."

- SA trust vesting or distributions by an SA trust (often classified by the IRS as foreign grantor or non-grantor trust) to an IRS taxpayer or resident beneficiary are deemed by the IRS to be gifts from the grantor (assuming he is alive). The IRS registered SA trust beneficiary is obliged to file Form 3520, reporting receipt of any distributions from a South African or any non-USA (foreign) trust irrespective of the value.

South African trustees then decide to vest the gain in the name of the funder (as he could anyway face section 7 attribution rules) and he or she then donates or gifts the gain to a US beneficiary, as SARS seems to exclude foreign trust vested assets that are on-donated as donations tax exempt. As mentioned, a US tax resident beneficiary (albeit living in SA) must then file said IRS Form 3520, yet now only when the aggregate value of all such gifts exceeded $100 000 during the year. The South African section 7(8) anti-avoidance should also not be overlooked.

The said $100 000 annual thresholds are reduced to only $16 076 for gifts that came from non-US companies or partnerships owned by the non-USA trust or the settlor.

Anti-avoidance in the UK

In the UK, as of April 2018, where a non-resident beneficiary (the SA funder and the grantor in the US example) receives a vested benefit from either an offshore or South African trust, one has to be extremely careful. If the South African resident trust beneficiary (UK tax non-resident) donates the benefit so received to a UK tax resident, the UK tax resident will be taxed as if the vesting was directly from the trust to the UK resident. The anti-avoidance rule looks back at vesting or distributions made in the last three years.

UK tax resident beneficiaries of non-resident trusts (read South African trusts) will now be charged capital gains tax in the UK, on South African situs gains realised by the South African trust. The UK attempts to tax the SA immigrants where the so-called settlor charge does not apply to the SA trust gains. This settlor charge (something like the USA grantor rules and section 7 attribution rules in South African) will not apply where–

- The settlor is dead; or
- The settlor was either non-domiciled or not resident in the UK, e.g., the SA resident grandparents funding the trust; or
- The trust is not 'settlor-interested', for example, the trust was set up for persons other than the settlor and his spouse, children or grandchildren, which is often done in South Africa to address local estate duty issues.

Where the SA trustees make capital payments exceeding the trust's past capital gains (distribution of cash or trust corpus which may be tax exempt in SA), these 'unmatched payments' are carried forward and matched with trust gains made in future years. The UK resident may then be taxed in the UK, not in the year the cash is paid but only once the gain is indeed realised.

For UK purposes a capital payment is any payment that is not taxed as income tax in the name of the UK beneficiary and will include:

- The transfer of an asset (cash or otherwise);
- The conferring of any benefit (e.g., low-interest loans, the rent-free occupation of trust property);
- Occasions when a beneficiary becomes absolutely entitled to trust assets.

The informed reader will be quick to point out that most offshore trusts should no longer own the UK enveloped homes. Yet many families cannot afford to move the UK home out of the company below the non-UK trust and now find different ways to transfer cash to the UK. Using debit loans from the SA trust (allowing the expat to avail of his R10m foreign capital allowance) is another popular mechanism used. Recently we have seen offshore trusts holding UK residential properties that fund the expat to buy a UK apartment. Once again, the HMRC is one ahead of us.

In the case of a low-interest loan from a South African or offshore trust to the UK resident, the value of the benefit is calculated using the notional interest rules. Interest is computed using the HMRC official rate. There is no reason to be concerned about ITA section 7C, as it only speaks to credit loans from tax residents. Now the UK also taxes debit loans from a trust, as we in SA would tax an employee on low or interest-free loans.

Is it time to review advances to children in the UK or rather suffer the new ATED charges in the UK on residential property held by entities registered outside the UK?

Be careful, as the rent-free occupation of trust property will see the UK tax resident being taxed on the value of the 'arms-length' rent that would be charged to a third-party tenant.

How to transfer wealth from SA or foreign trusts to expats

Waiting until the expat needs the funds is no longer the time to consider the future of the SA and offshore trust. The writer suggests that clients obtain international tax and estate planning advice the day their child mentions a gap year in a foreign country.

Even better, is it not time to call the diasporic SA family to a combined estate planning meeting? Keeping the trust wealth a secret will most certainly come to bite the funder, the grantor or the settlor (using the international terms) as well as the innocent cash-needy beneficiary spreading his or her wings.

Perhaps dissolving the trust or turning the discretionary trust into a bewind or vested trust is not such a bad idea? Before you jump ahead, call on your friendly STEP and SAIT registered adviser and tax practitioner.

CHANGES TO THE DIVIDEND PARTICIPATION EXEMPTION

▸ **IRMA LATEGAN,** irma.lategan@maitlandgroup.com

Our article examines the dividend participation exemption as it stands now, in light of recent legislative changes, and the effect on distributions by foreign trusts.

This article looks at the tax liability of South African beneficiaries of foreign trusts who receive a distribution from the foreign trust if the distribution is funded from foreign dividends received by the foreign trust. It also looks at the effect of the recent changes to the Income Tax Act. It is assumed that the settlor-charging provisions do not apply.

Section 10B(2) of the Income Tax Act exempts foreign dividends from tax if the shareholder holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend. This is commonly referred to as the "participation exemption".

The conduit principle is a common law principle, which has been codified in the Income Tax Act. It causes a trust, whether local or foreign, to operate as a conduit in relation to income distributed from the trust in the South African tax year in which it arises, that is current year income. Basically, the conduit principle implies that if a trust receives income and the income is vested in a beneficiary of the trust during the same year, the income will flow through the trust as if the trust did not exist. The income is received in its same form by the beneficiary, who would bear the tax liability. The participation exemption does not apply when dividends received by the foreign trust are distributed to beneficiaries in the same tax year, because the beneficiaries would not be the actual owners of the shares giving rise to the dividends. The application of the conduit principle would deem the dividend to be received by the beneficiaries but, as they are not the owners of the shares, the dividend exemption would not apply and they would be taxed at the maximum rate of 20% on foreign dividends.

However, the participation exemption does apply if prior year dividends received by a foreign trust are vested in a South African beneficiary. In other words, dividends would not be taxed in the hands of a beneficiary if the dividends were received by a foreign trust, which owns more than 10% of the total equity shares and voting rights in the foreign company declaring the dividend, and the dividends are then vested in a South African beneficiary in the following year.

The reason for the application of the exemption is found in the wording of section 25B(2A) of the Income Tax Act.

As the distribution would be out of income that arose in a previous year, section 25B(2A) requires one to look back at the previous tax year when the dividend (which would become capital in the following year) was received. One would then ascertain whether the foreign trust, if it had been resident in South Africa, would have been subject to tax on the dividend received by it. Only if the answer is yes, would the amount be taxable in the beneficiary's hands on distribution.

The trust would not be subject to tax on the dividend received if the trust owned more than

"The conduit principle implies that if a trust receives income and the income is vested in a beneficiary of the trust during the same year, the income will flow through the trust as if the trust did not exist."

10% of the company declaring the dividend. If the trust was a South African resident, the dividend would have constituted exempt income in the trust's hands, as it would have qualified for the participation exemption. Under the definition of "income" in section 1 of the Income Tax Act, "income" means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under the Income Tax Act. An amount that is exempt under section 10B(2) cannot fall within the "income" of the person concerned. It therefore follows that the amount received by a South African resident beneficiary in the year following receipt of the dividend by the foreign trust does not have to be included in their income under section 25B(2) of the Income Tax Act.

From 1 March 2019, section 25B(2A) was amended by specifically stating that the participation exemption may no longer be used where a foreign dividend is declared by a company to a foreign trust that holds more than 50% of the participating or voting rights in that foreign company.

The effect of this amendment can be illustrated by the following example:
Trust A is a foreign discretionary trust, of which the settlor is deceased, which holds 40% of the equity shares and voting rights in Company X, a foreign company.

Trust B is also a foreign discretionary trust, of which the settlor is deceased, which is unconnected to Trust A, and holds 60% of the equity shares and voting rights in Company X. Company X declares a dividend in November 2018.

Trust A and Trust B both vest the dividend in its South African beneficiaries in April 2019, i.e., during the following tax year (all trusts have a year-end in South Africa of 28 February).

Tax effect:

TRUST A	TRUST B
The South African beneficiaries receive the distribution tax free. Reason: the participation exemption applies (more than 10% is owned by Trust A). The new exclusion to the participation exemption does not apply as Trust A owns less than 50% of the shares in Company X.	The dividends will be taxed in the hands of the South African beneficiaries at a maximum rate of 20%. Reason: Trust B owns more than 50% of the shares in Company X and therefore the participation exemption does not apply.

The situation can be summarised as follows:

PERCENTAGE OF FOREIGN TRUST'S HOLDING IN FOREIGN COMPANY	TAX IN SOUTH AFRICAN BENEFICIARIES' HANDS UPON DISTRIBUTION OF DIVIDENDS IN FOLLOWING YEAR
Less than 10%	Dividends taxed at a maximum rate of 20%
Between 10 and 50%	Dividends received tax free
More than 50%	Dividends taxed at a maximum rate of 20%

FUNDING A FOREIGN TRUST

▶ **ELANA NEL,** elana.nel@stonehagefleming.com

Is it still a viable option to put money in a foreign trust? Our article reviews the impact of attribution rules, transfer pricing rules and deemed donations on these kinds of vehicles.

The South African tax implications of a foreign trust set up by a South African resident centre around how the trust is funded, which can either be through a donation or a loan. Specific circumstances may warrant funding a trust through a donation but this is usually not the best route as it triggers an immediate donations tax liability and the attribution rules apply.

For a loan, there are currently three tax concepts that need to be factored in:

- The attribution rules as set out in section 7 of the Income Tax Act and paragraph 72 of the Eighth Schedule to the Act
- The transfer pricing provisions as set out in section 31 of the Act
- Section 7C of the Act

Attribution rules

Attribution rules allow for income and capital gains to be attributed to a different person than the person (or trust) earning it – in certain circumstances. Section 7(8) and paragraph 72 deal specifically with the situation where income or capital gains accrue to a non-resident but should be attributed to a resident. This is where the income arises as a result of a donation, settlement or other disposition made by the resident to the non-resident.

Granting an interest free loan (or a loan at a below-market interest rate) to a trust is regarded as a continuing donation. As such, it could be considered a gratuitous disposition and section 7(8) and paragraph 72 would therefore apply.

Practically, the amount that is attributed to the resident in terms of section 7(8) and paragraph 72 is currently limited to the amount of interest that would have been charged should the non-resident have borrowed the money at a market related rate: the calculated interest amount. Furthermore, section 7(8) and paragraph 72 will only apply where an amount has actually been received by or has accrued to the non-resident. Where the income earned is less than the calculated interest amount the difference will carry forward to future years for possible attribution.

Example

Assume a South African tax resident makes an interest free loan of R10 million to a foreign trust and that a market related interest rate is 8% p.a.

YEAR	MARKET RELATED INTEREST THAT WOULD HAVE BEEN CHARGED	CUMULATIVE AMOUNT THAT MAY STILL BE ATTRIBUTED	ACTUAL INCOME ARISING IN FOREIGN TRUST AS A RESULT OF LOAN	ACTUAL CAPITAL GAIN ARISING IN TRUST AS A RESULT OF LOAN	AMOUNT ATTRIBUTED TO RESIDENT TO BE TAXED IN SA	UNUSED ATTRIBUTION AMOUNT FOR THE YEAR
1	R 800 000	R 800 000	R 900 000	R 0	R 800 000	R 0
2	R 800 000	R 800 000	R 0	R 0	R 0	R 800 000
3	R 800 000	R 1 600 000	R 0	R 2 000 000	R 1 600 000	R 0

Transfer pricing

The transfer pricing provisions apply where:

- Any affected transaction (as defined) is entered into
- Any term or condition of that transaction is different from an arm's length term or condition
- It will result in a tax benefit being derived by any person who is a party to the transaction

Where section 31 applies, the taxable income of the person deriving the tax benefit must be calculated as if that transaction had been entered into on an arm's length basis.

A loan granted from a resident to a foreign trust on an interest free or low interest basis will qualify as an affected transaction. There are currently differing opinions on whether the mere fact of not charging interest on a loan to an offshore trust results in a tax benefit.

Where the attribution provisions apply it can also be argued that there is no benefit, provided income and capital gains equal to the calculated interest are attributed.

Where section 31 applies, the taxable income of the South African tax resident must be calculated as if a market related interest rate was charged: the primary adjustment. Furthermore, where there is a difference between the amount included in the taxable income and the actual interest charged, the difference must (in the case of the lender being an individual) be deemed to be a donation made by the resident to the foreign trust. This donation is subject to donations tax: a secondary adjustment. This is separate to a section 7C donation and is levied in terms of section 31.

Section 7C

Section 7C deals with low or no interest loans to trusts and underlying companies. The effect of the provision is that the interest foregone will be regarded as a donation made by the lender to the trust and be subject to donations tax at 20%. The interest foregone is calculated as the difference between interest calculated at the 'official rate of interest' as defined (repo rate plus 1% or foreign currency equivalent of SA repo rate plus 1%) and the actual interest rate charged.

The provisions apply to both domestic and foreign trusts. There is, however, a specific exemption where the loan constitutes an affected transaction as defined in section 31(1), which is subject to the provisions of that section.

Interplay between sections 7(8), 31 and 7C

The interplay between the transfer pricing provisions, the attribution rules and section 7C is playing an increasingly important role in deciding if a trust is a suitable planning vehicle.

Where the interest rate applied to a loan to a foreign trust is less than the 'official rate of interest' and the attribution provisions are applied, it can be argued that there is no tax benefit as required for section 31 because SARS is still getting the tax amount due.

However, then section 7C will also apply, in addition to the attribution provisions. This is because the exemption from section 7C is not applicable where the transaction is not subject to the transfer pricing provisions. Effectively income tax (as if interest was charged) by virtue of the attribution provisions and donations tax by virtue of section 7C will be levied.

Even if there could be a timing difference in that there is limited income to attribute, there is likely to be a catch-up eventually. Please refer to the table above.

Alternatively, if the view is that section 31 applies, then similarly income tax (in the form of the primary adjustment) as well as donations tax (in the form of the secondary adjustment) are payable.

In circumstances where it has in the past been argued that no income is generated (i.e. due to the nature of the investments in the trust) that can be attributed to the lender, the transfer pricing provisions and, failing that, the provisions of section 7C will apply.

The way forward

In light of the above analysis, we recommend that loans from SA tax residents to foreign trusts be interest bearing at a market related rate. Charging interest will result in income tax only being due on the actual interest earned. It significantly simplifies record keeping, calculations and disclosures for South African tax purposes.

The minimum interest rate that should be charged is the official rate of interest. Interest should preferably be compounded monthly. If compounded annually, consider increasing the interest rate slightly. Where the interest is not paid out, future interest should be calculated on the loan value including unpaid interest.

While there may be circumstances where it can be argued (either by the lender or SARS) that the market related rate is different to the official rate of interest, section 7C does provide guidance that charging interest at the official rate of interest should be sufficient.

Charging an interest rate according to the above principles will ensure that section 7C does not apply. On the understanding that the rate of interest represents a market related interest rate, the attribution provisions and transfer pricing provisions will also not apply.

NO TAX HAVEN IS AN ISLAND

ANTHEA STEPHENS, anthea.stephens@maitlandgroup.com

How do new substance rules and policy efforts to combat tax fraud, evasion and avoidance impact compliance standards in jurisdictions formerly known as tax havens? Our article looks at recent developments.

"In order to avoid being placed on the blacklist in the future, all jurisdictions must comply with the EU fair taxation rules."

"No man is an island, entire of itself; every man is a piece of the continent, a part of the main." This expression is a quotation from English poet John Donne. The poet was not to know how true these words would ring as global governance and compliance standards continue to extend their reach and force even the most far-flung jurisdictions into the universal fold.

The European Union is working to improve tax good governance on a global level by encouraging positive change through cooperation. It is committed to encouraging transparency and levelling the tax playing fields across the world – an objective which it seeks to achieve through promoting a uniform approach to governance worldwide by creating a stronger deterrent for countries that do not abide by accepted standards.

Personal onus

Why should this be important to you? The reason is that global tax transparency has become an international buzzword and the onus is ultimately on you – not even your adviser – to make sure your tax and estate planning structures are compliant.

Lending action to words, in 2016, the Code of Conduct Group (COCG) appointed by the EU Council committed to the implementation of coordinated policy efforts in order to combat tax fraud, evasion and avoidance. The COCG was instructed to undertake a screening process based on the criteria agreed on by the member states in order to assess 'non-cooperation'. Jurisdictions were measured against the transparency of their tax regimes, their tax rates and whether their tax systems encourage multinationals to unfairly shift profits to low tax regimes, through creation of artificial tax structures, to avoid higher duties in other jurisdictions.

The COCG investigated the tax policies of over 90 jurisdictions, both within and outside the EU, each of which received a formal request to justify their frameworks for and effective applications of cooperative tax criteria. As a result of the responses received, on 5 December 2017 a blacklist of non-cooperative jurisdictions was published, as well as a further 'grey list' comprising jurisdictions that have committed to addressing the deficiencies in their tax systems by the end of 2018 (or 2019 for developing countries), which will be regularly monitored by the EU.

In order to avoid being placed on the blacklist in the future, all jurisdictions must comply with the EU fair taxation rules and must not offer preferential measures or arrangements that enable companies to shift profits to avoid levies. Although sanctions have yet to be designated for blacklisted countries, reputational damage and a higher level of scrutiny would be inevitable, and act as a suitable deterrent for those countries that wish to remain 'part of the main'.

A largely positive outcome

The listing process has therefore had a positive impact in that most jurisdictions have chosen to engage with the EU through a consultative dialogue, and the screening exercise has led many jurisdictions to make concrete, high level commitments to improve their standards. Consequently, during the period January 2018 to November 2018, a number of jurisdictions went from black to grey, and some have been removed altogether. The Crown Dependencies (Jersey, Guernsey and the Isle of Man) were found to be compliant with most principles of

good tax governance. However, one area that raised concern was the lack of a legal requirement of economic substance. They have made a commitment to address these concerns by the end of 2018 and have been working with the COCG to develop proposals to legislate the requirements for economic substance (substance rules). As they have been working closely together, their legislative provisions are expected to be the same, bearing in mind likely variations in procedural approach and implementation.

The key elements of the proposals include identifying entities that conduct 'relevant activities' and imposing substance requirements on those entities. 'Relevant activities' have been identified as banking, insurance, intellectual property, finance and leasing, fund management, headquarter type activities, shipping and holding company activities.

Resident companies undertaking such activities will be required to demonstrate that the company is 'directed and managed' in that jurisdiction and also that the core income generating activities are undertaken in that location.

The burning question is, what is intended by targeting holding companies as 'relevant activities'? What is the type or level of activity that renders a holding company relevant? Holding companies are commonly used to hold trust assets that comprise passive investments and imposing the substance requirements strictly in these types of entities would have far reaching and disproportionate consequences.

Companies that do not have control over other entities do not form part of this classification and therefore it is not intended to apply to asset or investment holding companies that typically hold an investment portfolio of minority stakes. Rather, in order for the substance rules to apply, a holding company must receive income from the activity of pure equity holding. For example, receipt of a dividend from an underlying entity in which it owns a 100% stake would qualify as income for these purposes, thus subjecting the holding company to the substance rules.

Caribbean response

It would, however, appear that the Cayman Islands' fund management and the BVI's holding company structures fall squarely within this ambit and there is therefore cause for concern that compliance with the substance rules might give rise to a mass-migration tidal wave, as entities unable to comply are forced to retreat from these islands. Both jurisdictions have committed to adopting legislation to implement the EU requirements in order to secure a place on the grey list. However, while one imagines that the legislation would be similar to that of the Crown Dependencies, we will not be able to assess the effect until it is released to the industry.

The BVI has accepted that it is likely to lose some business, but will most certainly be doing what it can to hold off a mass flight of business from the islands. Clearly, the BVI is not readily in a position to provide mind and management to all its companies, nor geographically well placed for directors to fly in for meetings, but many of its entities are passive investment holding entities that do not receive gross income from that activity.

It is encouraging that the substance rules are committed to a practical application, and their imposition is not intended to distort commercial reality. The intent is after all not to result in destruction of business, but rather to discourage secrecy that breeds in isolation and to provide further transparency through collaboration, as all jurisdictions move towards being 'part of the main'.

THE WIDENING BUDGET DEFICIT: THE NEED FOR A BIGGER ECONOMIC PIE

GREG SMITH, greg.smith@pwc.com

Budget 2019 was a difficult one. Our article unpacks some of the problems and looks at the options to make things better.

The 2019 Budget was tabled in Parliament on 20 February in one of the most difficult fiscal environments South Africa has ever faced.

Perhaps the most significant number in the Budget is the budget deficit. Currently estimated at 4.2 per cent of GDP for 2018/19, it is expected to grow to 4.7 per cent in 2019/20, and then to only fall slightly to 4.3 per cent and 4 per cent in 2020/21 and 2021/22 respectively. This is of significant concern, especially in light of the original 2018 Budget estimate of a deficit of 3.8 per cent for 2018/19.

This is not a rosy picture.

A reduction of the budget deficit is imperative, but how should this be achieved? Should the trend of significant tax increases over the past few years continue? Should government focus its efforts on reducing expenditure? Or should government proactively address the conditions that give rise to poor economic growth? Growing GDP would result in increased revenues, thereby increasing the size of the "economic pie" (and therefore the size of the slice of that pie that goes to the fiscus).

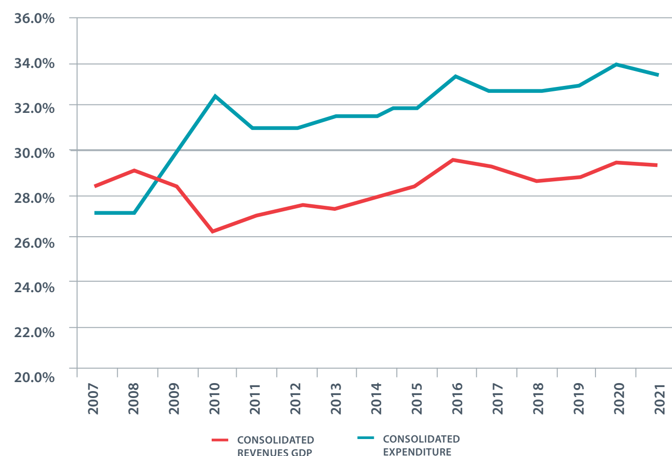
Tax Increases v Reductions in Expenditure

Since 2007/08, consolidated expenditure has ballooned from 27.2 to 32.9 per cent of GDP. This extraordinary growth has been funded partly by increases in taxes, which have had an adverse effect on growth, thereby further (indirectly) increasing the deficit.

As illustrated on the next page, expenditure growth has far outstripped tax revenue growth since 2008.

Clearly, expenditure as a proportion of GDP needs to fall substantially over the longer term if the deficit is to be brought under control. As discussed in more detail below, South Africa has run out of space for further tax increases.

Consolidated revenue and expenditure



Measures announced in the Budget to manage expenditure

State-owned entities

The challenges currently being presented by state-owned entities (SOEs), most notably Eskom, are having a profound effect on South Africa's public finances. Accordingly, the Budget announced certain measures regarding the turnaround and restructuring of Eskom, and gives a commitment that strict conditions, including cost containment measures, will be attached to fiscal support to Eskom. The same conditions will apply to fiscal support provided to other SOEs.

There was also a statement that financial support for SOEs beyond that provided for will be raised from the sale of non-core assets, and will be excluded from the expenditure ceiling.

Public sector wage bill

The Budget acknowledges that a key driver in the widening of the deficit is the public sector wage bill, which currently accounts for more than 35 per cent of consolidated public spending. This, together with increasing debt service costs, is crowding out other expenditure (e.g., on infrastructure and social spending).

Progress in moderating growth in the wage bill has, however, been made (despite above-inflation wage settlements). Recent data reflects a decline in employee numbers (owing to natural attrition) at a rate sufficient to absorb wage agreement pressures. The Budget announced a number of steps to manage growth in compensation and create a more sustainable wage bill through, for example, the scaling up of early retirement without penalties and changes to the performance bonus payment system. One reservation is that this process should include measures to ensure that encouraging early retirement of skilled and experienced people does not affect service delivery.

More needs to be done. The Budget is disappointingly silent on the President's 2018 announcement that a review of the configuration, number and size of national government departments would be undertaken to identify opportunities for savings in government expenditure. Hopefully, a concrete announcement in this regard will be made in the mini-budget in October.

Tax increases?

Since 2003/04, when gross consolidated tax revenues stood at 23.2 per cent of GDP, South Africa's level of taxation has grown steadily. For 2018/19, this figure is estimated to be 27.4 per cent, increasing further to 28 per cent in 2019/20 and 28.3 per cent in 2021/22.

Such increases in the tax burden are unsustainable in the long term, and are likely to crowd out space for further tax increases to fund initiatives such as the NHI and comprehensive social security reform.

Increases announced in this year's Budget

For 2019/20, tax increases amount to R15 billion. Significantly, R13.8 billion of that figure will be raised by providing negligible fiscal drag relief (i.e., relief for the effects of inflation) for personal income tax (PIT). Accordingly, no adjustments were made to the PIT brackets, nor to the medical tax credit. This might appear, to many, to be more palatable than rate increases. However, a failure to adjust for fiscal drag is no different to a rate increase (on the basis that all individuals will, effectively, be paying higher taxes on inflationary increases in their income).

Personal income tax

The Budget states that the 2019 tax proposals are "designed to minimise the negative impact on growth". However, PIT is, after corporate income tax (CIT), the most economically inefficient of all tax types, and the significant increase in PIT will increase pressure on already strained consumers, leading to a reduction in savings and consumption (and ultimately economic growth).

Acknowledging that government is under severe pressure to reduce the deficit, it is questioned whether the increase in PIT will have the desired effect of translating into additional revenues. In recent years, similar increases in PIT have actually resulted in lower than anticipated revenues. Indications are that these tax increases are having a pronounced negative effect on growth (and therefore tax revenues).

The impact of these increases on the behaviour of taxpayers should also not be ignored: high taxes incentivise taxpayers to avoid or evade taxes. SARS' tax statistics show that there has been a marked decrease in levels of compliance in recent years. This year's PIT increases can only worsen the situation, particularly in the context of weak economic growth and recent revelations of state capture and corruption on a grand scale.

In short, it can be argued that there is simply no room to increase PIT any further, and that this tax instrument has been completely exhausted as a revenue source. One simply needs to look at the numbers: the estimated tax to GDP ratio for PIT for 2018/19

"Should Government focus its efforts on reducing expenditure? Or should Government proactively address the conditions that give rise to poor economic growth?"

stalled at 9.8 per cent, despite significant tax increases in the 2018 Budget (which introduced tax increases in PIT of R7.5 billion). It is, however, now forecast that the shortfall in PIT collections for 2018/19 will amount to R8.4 billion. This does not bode well for the increases announced this year.

Corporate income tax
Perhaps in recognition of the fact that an increase in CIT would have a disastrous effect on already tepid economic growth, the CIT rate has been left unchanged.

South Africa's CIT rate is relatively high by global standards, and the CIT burden is amongst the highest globally, where the trend in CIT rates is downwards. According to the OECD and based on 2016 data, South Africa places one of the highest tax burdens on companies at 4.6 per cent of GDP. This is higher than all of South Africa's main trading partners.

Aside from the distortionary effect of CIT on consumption and savings (and therefore investment), a significant problem with a high CIT burden is that tax revenues are highly exposed to volatile corporate profits (as was abundantly illustrated in the wake of the 2008 global financial crisis, when the economic slowdown had a disproportionate effect on revenue collections).

Any increase in the CIT rate would arguably also increase the country's susceptibility to base erosion and profit shifting.

VAT (and other taxes)
Given the political fallout following the increase in the VAT rate last year, it is not at all surprising that the VAT rate was maintained at 15 per cent. A prevailing view is that VAT is regressive, and that VAT increases should, in view of our vast disparities in income and in wealth, be avoided at all costs. But should a further increase in VAT be avoided at the cost of economic growth?

Research conducted by the OECD and other bodies suggests that growth-friendly tax reform would shift the tax burden from taxes on income (CIT in particular) to consumption taxes, such as VAT and recurring property taxes.

South Africa's tax mix is currently (and despite the 2018 VAT rate increase) highly skewed towards a greater reliance on direct taxes and a lower reliance on indirect taxes. While this results in the tax system being relatively more progressive, it comes at the expense of a tax system that could be more growth-friendly. In this regard, an accepted principle internationally is that taxes should be raised as efficiently as possible, and that progressivity should be addressed through expenditure rather than through the tax system Progressivity should be measured having regard to fiscal policy as a whole (and not only having regard to the tax system).

Where to from here?

Government clearly has its work cut out for it. Since the Budget, it seems that Eskom's woes have worsened. This raises the ugly spectre of even weaker economic growth than forecast at the time of the Budget, resulting in lower revenue collections, and, ultimately, an even wider budget deficit.

The extent to which the budget deficit will widen and how such a wider deficit will be addressed will only become clearer in the fullness of time. Given that there is little scope for further tax increases, it is hoped that government will, in order to reduce the budget deficit, not only manage its spending appropriately but (more importantly) focus its efforts on measures that will enhance economic growth.

For Government, a smaller piece of a bigger economic pie should be preferred to a bigger piece of a smaller economic pie. The former is sustainable, the latter is not. And bigger pies feed more people.

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THE LATEST AMENDMENTS: FOREIGN COMPANIES HELD BY FOREIGN TRUSTS

PROFESSOR PHILLIP HAUPT, philliphaupt@gmail.com

Legislation that came into effect recently brought changes to the regime for foreign companies held by foreign trusts with South African beneficiaries. Our article examines the current position.

The problem

National Treasury and SARS have been trying for some years to deal with what they see as the problem of foreign companies held by foreign trusts with South African beneficiaries.

The foreign trust acts as a "CFC blocker". In other words, if a South African resident holds all the shares in a foreign company, it would be a "controlled foreign company", which means that its net income would be attributed to the South African resident shareholder each year for South African income tax purposes (in terms of section 9D of the South African Income Tax Act). Section 9D applies to foreign companies in which South African residents hold more than 50% of the participation rights (usually more than 50% of the shares). If, however, the shares are held by a foreign trust, section 9D cannot apply.

The solution?

National Treasury has now dealt with the problem, with effect from 1 March 2019, by amending the following provisions:

- Section 7(8) of the Income Tax Act with regard to the attribution of dividends accruing to a foreign trust from a foreign company in which that trust holds more than 50% of the total participation rights (whether alone or jointly with a connected person or persons in relation to the trust).
- Section 25B of the Income Tax Act with regard to the distribution of accumulated foreign dividends of a foreign trust where the dividends arise from a company in which that trust holds more than 50% of the total participation rights (whether alone or jointly with a connected person or persons in relation to the trust).
- Paragraph 72 of the Eighth Schedule to the Income Tax Act with regard to capital gains arising in a foreign trust from the disposal of shares in a foreign company in which that trust holds more than 50% of the total participation rights (whether alone or jointly with a connected person or persons in relation to the trust).
- Paragraph 80(4) of the Eighth Schedule to the Income Tax Act with regard to capital gains distributed by a foreign trust to a South African resident if the gains arose out of the disposal of shares in a foreign company in which that trust held more than 50% of the total participation rights (whether alone or jointly with a connected person or persons in relation to the trust).

The important aspects of these amendments are most easily explained by looking at a few examples.

Example 1

Mr X became ordinarily resident in South Africa for the first time on 1 March 2015. At that time he owned all the shares in a furniture manufacturing company in Europe, called X Ltd. These shares were worth €10 million on 1 March 2015. After becoming resident he was advised to dispose of his shares to a foreign trust.

Before

Had he kept the shares in his own name he would not have been taxed on the underlying profits of the company in terms of the "foreign business establishment" exclusion in section 9D(9) of the Income Tax Act. Also, any dividends received by him from the company would have been exempt from South African income tax in terms of the section 10B(2) "participation exemption".

Nevertheless, he decided to donate his shareholding in X Ltd to a foreign trust. There was no donations tax on the donation, because he held the shares before becoming ordinarily resident in South Africa for the first time (the section 56(1)(g)(i) exemption from donations tax applied). He had to pay capital gains tax on any increase in value of the shares from the time that he became resident to the date of the donation.

From that time onward, any dividends paid by X Ltd to the foreign trust were not taxed in Mr X's hands, because the attribution rule in section 7(8) only applied to amounts that would have been income had the foreign trust been South African tax resident. The trust was entitled to the section 10B(2) participation exemption, because it held 100% of the equity shares in X Ltd, i.e. at least 10%. This meant that the dividends accruing to the foreign trust were not income (being exempt).

This position changed with effect from 1 March 2019, however.

> *"Section 7(8) requires that in determining whether a dividend is 'income', the participation exemption in section 10B(2) has to be ignored if the foreign trust owns more than 50% of the shares in the foreign company."*

After

From that time section 7(8) required that in determining whether a dividend is "income", the participation exemption in section 10B(2) has to be ignored if the foreign trust owns more than 50% of the shares in the foreign company.

In our example, any dividend received by the foreign trust from X Ltd, on or after 1 March 2019, will be taxed in Mr X's hands in terms of the provisions of section 7(8). Mr X will be entitled to the section 10B(3) exemption, which means that 25/45 of the dividend will be treated as exempt, with only 20/45 included in Mr X's income in terms of section 7(8). As the dividend is taxed in Mr X's hands when it arises on or after 1 March 2019, it cannot be taxed again when actually distributed by the foreign trust to a South African resident (Mr X).

Unfortunately for Mr X, he cannot undo the trust without capital gains tax arising when the foreign trust distributes X Ltd shares to him. The capital gain would be the excess of the market value of the shares at the time that they are distributed over the original value when they were donated to the foreign trust.

As far as the dividends accruing to the foreign trust from X Ltd prior to 1 March 2019 are concerned, if such dividends are distributed to a South African resident beneficiary on or after 1 March 2019, the South African resident beneficiary will be taxed on 20/45 of such a dividend. This is due to section 25B(2B), which came into operation on 1 March 2019, effective for tax years commencing on or after that date. (SARS treats all foreign trusts as having a tax year that ends on the last day of February.)

If the foreign trust held only 50% of the shares in X Ltd, with an unconnected person holding the other 50%, any 'pre-1 March 2019' dividends from X Ltd distributed by the foreign trust on or after 1 March 2019 would be tax-free in the hands of a South African beneficiary (in terms of section 25B(2A) read with section 10B(2)). Also, any post-1 March 2019 dividends would not be taxed in Mr X's hands under section 7(8).

Example 2

The X foreign trust and the Y foreign trust hold 51% and 38% respectively of the shares in Z Ltd, a foreign company. Mr Z, a South African resident, holds 11% of the shares in Z Ltd. Both the X foreign trust and the Y foreign trust have South African beneficiaries. All the shares have been held as capital assets for more than 18 months and the shares have grown substantially in value over the period of holding.

Z Ltd is not a controlled foreign company, because South African residents do not hold, directly or indirectly, more than 50% of the shares or participation rights in the company.

If Mr Z sells his shares in Z Ltd to an unconnected foreign resident, his capital gain would be free of South African tax in terms of paragraph 64B of the Eighth Schedule. This is the participation exemption for capital gains tax, i.e. where there is a holding of 10% or more in the foreign company.

If the Y foreign trust sells its shares in Z Ltd to an unconnected non-South African resident person, and then distributes the resultant gain

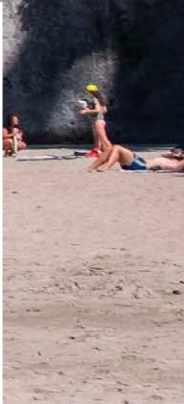
to a South African resident individual, either in the same year of assessment or a later year of assessment, such gain is not taxed as a capital gain in the hands of the South African beneficiary (see paragraph 80(2) of the Eighth Schedule).

After

If the X foreign trust sells its shares in Z Ltd on or after 1 March 2019 and then distributes the resultant profit to a South African resident beneficiary in the year it makes the gain, such beneficiary is taxed on the profit as a capital gain. This is due to the fact that the trust held more than 50% of the shares in Z Ltd prior to the sale. Had the sale and distribution taken place before 1 March 2019, the distribution would have been free of tax in the hands of the South African beneficiary. As a result of the introduction of paragraph 80(4) of the Eighth Schedule, a foreign trust holding more than 50% of the shares in a foreign company does not enjoy the participation exemption when it sells those shares.

If the X foreign trust sells its shares in Z Ltd on or after 1 March 2019 and does not distribute the gain to a South African resident beneficiary in the year of the sale, one will have to see whether the attribution rule in paragraph 72 of the Eighth Schedule applies, to attribute the gain to any donor or funder of the trust. This would not have been the case for sales prior to 1 March 2019.

Note: If a foreign trust holding either less than 10% or more than 50% of the shares in a foreign company made a capital gain before 1 March 2019 and then distributes this gain to a South African resident beneficiary on or after 1 March 2019, the South African resident beneficiary will be taxed on the gain if the gain has not previously been taxed in South Africa (paragraph 80(3) read with paragraph 80(4) of the Eighth Schedule).



Complications arising

These examples illustrate the complications brought about by the 1 March 2019 amendments aimed at dealing with foreign trusts that hold shares in foreign companies, where the holdings exceed 50% of the participation rights in the company.

Often the simplest is for South African residents to hold the shares in the foreign company directly. However, if Mr X in example 1 had kept the X Ltd shares in his own name, and then became non-resident at any time thereafter, he would be treated as having sold the shares in X Ltd the day before he became non-resident and would be liable for tax on any notional capital gain arising (section 9H(2)).

Proper tax planning is essential for foreign persons who decide to become tax resident in South Africa.

BAD AND DOUBTFUL DEBTS

▶ **JEROME BRINK,** jerome.brink@cdhlegal.com

Who decides when a debt has gone bad and what are the tax implications of a debt waiver for debtors and creditors? Our article looks at a complex minefield of changing rules.

It goes without saying that South Africa's economy has been under stress for more than a short while. Some of the factors which are often mentioned include structural inefficiencies, political uncertainty and corruption, energy issues, generally poor quality of education, emerging market sentiment and a complex and challenging regulatory environment. It follows that, given the general economic state of South Africa, many taxpayers, in the position of creditors or debtors, are faced with a challenging debt environment where creditors are forever struggling to obtain payment and debtors are constantly looking at ways and means to restructure their debt or, in a best case scenario, be fully released from their obligations.

"*The hardest thing in the world to understand is the income tax.*" – Albert Einstein. While many would be forgiven for discarding one of history's foremost geniuses' views on income tax to the proverbial scrap heap, tax practitioners the world over (and particularly in South Africa it may be emphasised), would willingly agree with Einstein's views that tax laws are often tricky to navigate. The South African tax rules regarding debt, whether it be bad, doubtful, written off, cancelled, waived, advanced, capitalised, interest-bearing, interest-free or converted into equity are constantly changing and many would proffer that such rules constitute a quintessential example of Einstein's views on the matter.

"Some of the more recent amendments were aimed at providing economic relief to debtors in an attempt to lessen the tax burden where debt is restructured, waived or partially written-down."

It is in this context that this article attempts to highlight and briefly discuss some of the key tax issues arising in respect of bad and doubtful debts in the hands of both the creditor and the debtor, as things currently stand. While there is a myriad of tax laws affecting debts and which could form the subject matter of an entire text book, this article attempts to highlight some of the more contentious issues facing taxpayers today.

Tax implications in the hands of creditors

The first prudent port of call when considering the tax implications of bad and doubtful debts in the hands of creditors is whether such debt is held on capital or revenue account. Generally, where the debt is in the form of a long-term loan it would be on capital account and one would have to consider the specific facts and circumstances of the case to ascertain whether the creditor would be entitled to a capital loss in the event that the debt is indeed considered as irrecoverable. One should, however, always consider the so-called "clogged loss" rules in paragraph 39, read with paragraph 56, of the Eighth Schedule to the Income Tax Act in respect of debts disposed of between "connected persons".

On the other hand, where the creditor holds the debt on revenue account (i.e., trade debt) one should consider whether the debtor is entitled to a bad debt deduction under section 11(i) of the Income Tax Act, or a doubtful debt allowance under section 11(j) of the Act. Section 11(i) of the Act in essence can only be claimed where four requirements are met, namely that there is an amount of a debt due to a taxpayer and that debt has during that year of assessment become bad. Furthermore such amount must be included in the taxpayer's income in the current year of assessment or must have been included in the previous years of assessment.

In the event that the debt does not constitute a trade debt, taxpayers often fall short at the last hurdle on the basis that the amount was not included in the taxpayer's income in a previous year of assessment. Under that scenario, a taxpayer may be able to claim a deduction under the general deduction formula contained in section 11(a) of the Act, read with section 23(g), although such a deduction is mostly limited to "money-lenders" given the long line of case law on the matter. This being an admittedly stringent hurdle to overcome.

Where the taxpayer cannot claim the debt as bad, one may be able to claim a doubtful debt allowance under section 11(j) of the Act. Section 11(j) of the Act historically provided for a discretion on the part of SARS to allow a deduction for doubtful debts where SARS considered that debt as doubtful. In practice, SARS allowed 25% of the face value of doubtful debts claimed. However, some taxpayers were able to obtain higher allowances where justification could be provided based on industry specifics and commercial realities.

SARS' wide discretion, however, made for uncertainty and section 11(j) was amended with effect from 1 January 2019. It now provides for specific requirements in respect of doubtful debt allowances, with reference to the treatment of such debts for International Financial Reporting Standards (IFRS) purposes. Where the taxpayer does not utilise IFRS in compiling their accounts, specific requirements are provided including, for instance, the amount of time that the debt has been outstanding. Banks have their own provision in section 11(jA) of the Act, given the specific nuances in that industry.

In addition to the income tax consequences affecting creditors in respect of bad and doubtful debts, VAT vendors should also carefully consider the VAT consequences

pursuant to irrecoverable debts governed in, amongst others, section 22 of the Value-Added Tax Act.

What is a bad debt?

While the certainty in relation to doubtful debts is welcomed as taxpayers can more objectively predict their doubtful debt provisions, a key issue has nevertheless always been what in fact constitutes a "bad debt" for tax purposes. Unfortunately the Act does not specifically define a "bad debt" and one must therefore consider the approach of fiscal interpretation of the issue. In considering the issue, one is directed to dictionary definitions with reference to the purpose and context of the provision within the Act. Generally, as enunciated in South African case law, a business-like, practical and sensible approach is preferred (see *Natal Joint Municipal Pension Fund v Endumeni Municipality 2012* [2] All SA 262 [SCA]).

One should also have regard to South African case law on the matter. For example, in *CIR v Delfos 6 SATC 92*, the Appellate Division (as it was then known) made reference to the fact that the Commissioner allowed a debt as bad on the basis that it was not likely to be recovered.

In addition to South African case law, one could utilise case law and guidance from international jurisdictions. In accordance with the aforementioned guidance, taxpayers have generally taken the view that a debt has gone bad where a reasonable prudent business person has concluded that such debt is not likely recoverable.

That said, there is some dispute as to when exactly a debt can be considered bad and SARS does not always accept taxpayers' submissions in this regard. For example, SARS has contended that a debt is not necessarily bad where a taxpayer hands the debt over to external debt collectors for further collection on the basis that the taxpayer has not given up all hope for collection. While the handing over of the debt to external agents is purely based on commercial realities and business decisions and not whether the debt is in fact unlikely to be recovered, it remains to be seen whether authoritative clarity in this regard will be forthcoming.

Interestingly, from a capital gains tax perspective, SARS accepts that a debt will become irrecoverable when the taxpayer has exhausted all reasonable steps to recover it (see page 832 of Issue 7 of the *Comprehensive*

Guide to Capital Gains Tax). Notwithstanding this currently contentious aspect of tax law, taxpayers should exercise utmost care in considering whether debts have gone bad for purposes of claiming deductions under section 11(i) of the Income Tax Act or as a capital loss under the Eighth Schedule to the Act.

Tax implications in the hands of debtors

The tax implications arising in the hands of debtors in light of a debt that is waived, cancelled or written off has also undergone various amendments over the years. Some of the more recent amendments were aimed at providing some economic relief to debtors in an attempt to at least lessen the tax burden where debt is restructured, waived or partially written-down. The debt reduction rules contained in section 19 of the Income Tax Act, read with paragraph 12A of the Eighth Schedule to the Act, also initially focus on the utilisation of the funding provided by the creditor in ascertaining the tax implications in the hands of the debtors.

It should be appreciated that debt that is reduced in the context of a donation, a deceased estate, or in an employment context has its own specific rules and is not dealt with under section 19 or paragraph 12A. Where donations tax, estate duty or employees' tax is not relevant, one applies the so-called ordering rules. Depending on what the debt was utilised to fund in the hands of debtors, there may be a reduction of the cost price of trading stock or recoupments. Alternatively, in respect of debt used to fund capital assets, there may be a reduction in the base cost of the relevant assets and thereafter a reduction in any capital assessed loss.

A complex minefield

The claiming of income tax deductions and / or capital losses in respect of debt that is waived, cancelled or written off and the corresponding effect this has in the hands of debtors constitute a complex minefield. This is in addition to the effect section 24J of the Income Tax Act may have where the debt is interest-bearing. Taxpayers and tax practitioners alike would be well advised to carefully study and continuously monitor amendments to the relevant provisions before taking any commercial decisions which could have adverse tax consequences for both creditors and debtors. This area of tax law is constantly changing and taking your eye off ongoing developments for an instant could result in a not so "Einstein moment".

15 minutes CPD

THE TRUE COST OF A CARBON TAX

Our authors examine the cost to corporate South Africa of complying with the soon to be implemented carbon tax and ask whether the tax rate is sufficient to incentivise behavioural changes in a low-growth environment.

▶ **JENNA MASON,** Jenna.Mason@kpmg.co.za & **NICOLE DE JAGER,** Nicole.deJager@kpmg.co.za

The preamble to the Carbon Tax Bill states that:

> *Since the costs of remedying pollution, environmental degradation and consequent adverse health effects and of preventing, controlling or minimising further pollution, environmental damage or adverse health effects must be paid for by those responsible for harming the environment …*
> (Our emphasis)

This is the 'Polluter Pays' Principle: Those who pollute should bear the costs of managing and preventing further damage to human health and the environment. The carbon tax, which is due to be effective from 1 June 2019, is the embodiment of this principle. The tax, which is set out in the Carbon Tax Bill, has been structured in such a way that those taxpayers that emit carbon dioxide and its equivalents (CO_{2e}) will be liable for an additional tax.

The carbon tax addresses the measures that Government is taking to meet its nationally-determined contribution in terms of the 2015 Paris Agreement on Climate Change. In terms of this agreement, which comes into operation in 2020, greenhouse gas (GHG) emissions should peak in 2020 to 2025, plateau from 2026 to 2035, and decline from 2036 onwards.

But what is the true cost of the new carbon tax to corporate South Africa? Will the maximum tax rate of R48 per tonne of CO_{2e} (after allowances) be enough to incentivise real environmental change? And if not, in an economy with close to zero growth, crippled further by load-shedding, can we afford to tax corporate South Africa even more?

The environmental cost

Up to now, South Africans have only experienced the environmental and health costs of pollution. Climate change, air and water pollution are negatively impacting South Africa's resources on a daily basis yet the long term side effects - the "costs of pollution" - are not taken into consideration when determining the final price of products or services.

The primary goal of the introduction of the carbon tax is to determine a cost associated with the environmental and health damages of excessive GHG emissions and to ensure that businesses and households take this price into account in their production, consumption and investment decisions. It is also intended to drive a change in corporate behaviour to encourage a move to cleaner technologies.

A first step to South Africa's adaptation and mitigation responses to climate change was to set a price of GHG emissions. After eight years of extensive stakeholder consultation, National Treasury's GHG pricing took the form of a tax to incentivise emissions reductions, rather than the alternative approach of using an emission trading system which relies on the market to determine the appropriate carbon price. This decision was made on the basis that a fixed price would be easier and more practical to administer, as well as the existence of an oligopolistic market structure in the energy industry - which may result in volatile and unreliable carbon prices.

Any tax payable under the carbon tax regime, one may argue, pales in comparison to the environmental and health costs South Africans face if the current course of pollution-as-usual is followed. But what is the actual tax cost?

The tax cost

In terms of the Bill, the carbon tax imposes an initial levy of R120 per tonne of CO_{2e} emissions above set tax-free allowances (which could reduce the initial carbon tax rate to as low as R6 to R48 per tonne of CO_{2e}). The Bill sets out a wide variety of allowances to allow businesses time to transition, including a basic percentage-based threshold of 60%, below which tax is not payable. Other allowances detailed in the Bill include a trade exposure allowance (to elevate the burden for trade exposed entities) and a carbon offset allowance (to allow entities to counterbalance investments in specific offset projects against their emissions).

The Bill specifies that this rate must be increased by consumer price inflation (CPI) +2% per year until 31 December 2022, after which the rate of tax is increased only by CPI. The impact of the carbon tax will also be reviewed at least three years after implementation, taking into account the progress made in reducing GHG emissions – which may result in changes to the rates and tax-free thresholds being made.

Carbon tax will be calculated per the extensive listing of sectoral activities classified in the Bill, which covers energy related activities; industrial processing and product use; waste; and agriculture, forestry and other land use. Waste and agriculture, forestry and other land use activities are exempt from carbon tax during the initial implementation period.

Although the carbon tax is relatively simple in structure, its implementation is likely to be challenging as GHG emissions are not regularly or consistently measured by a large percentage of corporate South Africa.

An additional compliance cost, whether it be external or internal, is therefore a given.

The compliance cost

SARS and the Department of Environmental Affairs (DEA) will jointly administer the tax. The DEA will collect the emissions data which will form the carbon tax base and incorporate it into the South African National Atmospheric Emissions Inventory System (NAEIS). SARS will be responsible for tax collection and assessment and will be supported by the DEA to verify reported emissions. Alignment between the DEA and SARS systems has reportedly already commenced with the intention that taxpayers will be able to use their DEA

"Whilst the environmental need to reduce GHG emissions is clear, South Africa's lack of economic growth cannot be ignored."

details for the SARS carbon tax registrations. SARS' access to the DEA's emission databases will increase pressure on taxpayers to strictly comply with the applicable emission thresholds that, where exceeded, will result in tax being payable.

Affected taxpayers will be required, on an annual basis, to account for their emissions (by submitting environmental levy accounts) and determine the related carbon tax liability as prescribed in the Bill and in terms of Customs and Excise Act.

Taxpayers who do not currently measure their $C0_{2e}$ emissions (from fuel combustion, industrial processes and fugitive emissions), or who do not have their emission calculations independently verified, will need to introduce systems soon to comply with the 1 June 2019 implementation date. Taxpayers will thereafter need to determine whether their emissions fall below the prescribed thresholds. Taxpayers will, thus, need to consider (and budget for) the associated costs to comply with the carbon tax (e.g., registration costs, emissions reading costs and tax advisory assistance). Some of these costs will be incurred on an annual basis. There may be trading costs for taxpayers investing in carbon offset projects, which in itself may require investment costs and further registration and advisory costs.

As the various costs associated with compliance mount, the question begs: is the tax rate of R120 per tonne of $C0_{2e}$ (before allowances) enough to incentivise real environmental change?

Too low to make a difference?

The High Level Commission on Carbon Prices estimated that, in order to drive transformational change, carbon tax should amount to US$40-80 per $C0_{2e}$ tonne by 2020, and US$50-100 per $C0_{2e}$ tonne by 2030.

South Africa's carbon tax rate, as it stands, falls outrageously below these levels. In fact, the current rate of R120 per tonne of $C0_{2e}$ is only 20% of the lowest price suggested above for 2020 to produce a meaningful reduction in carbon emissions. Last year, OECD Secretary-General, Angel Gurría stated that:

> *"The gulf between today's carbon prices and the actual cost of emissions to our planet is unacceptable. Pricing carbon correctly is a concrete and cost-effective way to slow climate change. We are wasting an opportunity to steer our economics along a low-carbon growth path and losing precious time with every day that passes."*

Whilst the environmental need to reduce GHG emissions is clear, South Africa's lack of economic growth cannot be ignored. South Africa is also heavily reliant on coal for energy, relative to other countries. This means that a carbon tax will have a far greater detrimental impact on the economy in South Africa than in other countries, if not structured carefully to take this into account. Perhaps in this light, the low initial price is justified.

The true cost?

During the consultation process, National Treasury stated that several studies have been undertaken which have indicated that the carbon tax will make a significant contribution to the reduction of GHG emissions and that the economic impact of the carbon tax would depend on how the revenues raised will be used. Currently these are planned to be implemented for revenue recycling measures.

Time will tell whether the carbon tax will have a positive impact on our GHG emissions or negatively impact the struggling South African economy. The true cost of a carbon tax remains to be seen.

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SUGAR TAX

In this two-part article, we provide commentary on the sugar tax as a health promotion measure by BDO's Dr Ferdie Schneider and Chairperson of the SA Canegrowers Association Graeme Stainbank.

HEALTH LEVY OR SUGAR TAX: IS THE PAIN WORTH THE GAIN?

▶ **DR FERDIE SCHNEIDER,** fschneider@bdo.co.za

We look at the basis for the levy, and positive and negative impacts on industry and consumers.

A sugar tax is not unfamiliar to South Africa. It was previously imposed on sugar sweetened beverages but abolished in April 2002, after nine years. The abolition followed industry lobbying. Previously, sugar tax was imposed to generate revenue. Reasons advanced for its reintroduction include addressing health concerns related to excessive consumption of sugar sweetened beverages, and reduction in demand and consumption of sugar sweetened beverages through price elasticity.

The current sugar tax, known as the health promotion levy, came into effect on 1 April 2018. The health promotion levy is administered in terms of the Customs and Excise Act through the application of the duty-at-source principle. The Minister, in a further attempt to discourage the consumption of sugary drinks, introduced an inflationary increase (5.2%) to the health promotion levy, effective 1 April 2019. The health promotion levy will increase from 2.1 cents to 2.21 cents per gram of sugar per 100ml, with the first 4 grams of sugar still exempted from taxation.

Health promotion levy or sugary beverage tax?

Sugar tax is arguably (by some) akin to a sin tax as both aim to decrease consumption and increase revenue. In addition to raising revenue, sin taxes are often imposed to reduce negative externalities such as abuse. Although a sin tax decreases affordability, it often gives rise to smuggling, and illicit trading and production. A sugar tax, as in South Africa, can also be seen as a health promotion levy. The difference may seem academic but it speaks to the purpose of imposition. A sugar tax can have as it main objective to raise revenue for the fiscus, discourage unhealthy behaviour, or a combination.

SARS and the South African authorities argue that reduction in consumption of sugar sweetened beverages, resulting from higher prices, contributes directly to the health of lower socio-economic groups. This, in turn, relieves pressure on Government resources, such as public clinics. The revenue generated through the sugar tax can also fund health care and medication. By 31 December 2018, the sugar tax raised R2.3 billion even though most tax collections fell short of the estimates in Budget 2018. Budget 2018 estimated sugar tax revenue of R1.7 billion, whilst actual revenue was forecast at about R3.4 billion. Buoyancy in sugar tax revenue collections may arguably have caused its rate increase on 1 April 2019 (which did not apply to other taxes). This could indicate the view of the fiscus that the health promotion levy is a tax or revenue generator, and not a sin tax or behaviour-altering tax. Irrespective, the tax system may not be the ideal instrument to influence sugar intake.

Who pays the health promotion levy: industry or consumers?

Globally, sin taxes or health promotion taxes have been used for many years and are premised on the belief that price manipulation can alter behaviour. Factors that need to be taken into account are:

- The impact on the poor
- The regressivity of the tax
- The price elasticity of demand for sugar sweetened beverages, especially for lower income earners
- The substitution effect (where consumption is shifted to more unhealthy options and unhealthy sugar substitutes)
- The actual ratio of sugar intake through sugar sweetened beverages consumption to total sugar intake
- The impact on job losses
- The impact of other non-sugar sweetened beverages and unhealthy products on obesity

These are all factors that require further research before the Government makes a final decision on the tax. This debate is likely far from over.

Impact of a sugar tax

International evidence of the impact of similar taxes on sugar consumption suggests a variety of results. Many countries experienced a more–than-expected price increase, which may suggest that suppliers increased prices by more than the tax to increase profitability.

Other countries experienced an increase in calorie intake, increased administrative burden, reduced competitiveness, and less than expected revenue yield.

Some countries have experienced some degree of a substitution effect, job losses, a disproportionately higher impact on low-income earners, a lower than expected reduction in sugar intake, and a smaller than expected effect on obese individuals.

The media reported the South African Sugar Association's (SASA's) disappointment at the increase in the health promotion levy. SASA holds the view that the sugar tax caused serious damage to the sugar industry and significantly impacted the volumes of refined sugar sales locally. SASA estimates the impact on decline in local demand for sugar at approximately 200 000 tons per annum, or a reduction in industry revenue of about R1 billion per annum.

Sugar production contributes approximately R14 billion to South Africa's GDP and the industry directly employs 85 000 people and indirectly contributes to employment of 350 000 people through food processing and other sectors.

An unequal tax?

Although the health promotion levy may positively impact society, it could be discriminatory, especially against lower socio-economic groups. If the sugar tax is really impactful and reduces demand, it should increase unemployment in the sugar and sugar-products industries.

Opponents of the health promotion levy argue that it is regressive (heavier relative impact on the poor) and that negative health externalities are not caused by excessive sugar usage but factors such as malnutrition and unhealthy diets. Lower socio-economic groups may not be able to afford healthy food.

Perhaps one of the most important considerations for the imposition of a sugar tax is the effect on the poor. Though there have not been many scientific studies in this regard, it is most likely that a sugar tax will be regressive, in that it will tax the poor relatively higher than the rich.

National Treasury argues, however, that arguments about tax regressivity only focus on tax payments and do not consider the benefits to the poor, such as reduced consumption of unhealthy food or sugar sweetened beverages. This argument assumes a number of things, such as the price elasticity of consumption of sugar sweetened beverages, especially by the poor. Research shows that the poor consume as much as 300% more beverages and sugar sweetened beverages than the rich, further underlining the regressive impact of the imposition of a sugar tax.

Compliance costs to industry (and administration costs to SARS)

Recent reports by the South African Cane Growers' Association (SACGA) indicate that the health promotion levy has cost the sugar industry almost R1 billion since implementation. SACGA argues for abolition of the health promotion levy until a thorough assessment has been done on its economic and employment impact.

SACGA reported that the introduction of the health promotion levy resulted in soft-drink manufacturers reducing bottle sizes and product sugar content, which reduced sugar demand. Coca-Cola reportedly reduced beverage sugar content by 20% across all brands following the health promotion levy introduction. Sugar producers reported that decreased sales volumes and prices, and increased competition from low-price imports (mainly from Brazil) may cause collapse of the industry.

SACGA estimates that the health promotion levy has cost the industry R925 million in the 2018/19 year (1 April to 31 March). Losses of 64% (R592 million) were incurred by sugar-cane growers, which includes potential job losses of 6 500 in the cane-growing sector but excludes job losses in the sugar milling and beverage industries.

Taxpayer compliance and SARS administration costs are not yet accurately determined.

"A sugar tax can have as it main objective to raise revenue for the fiscus, discourage unhealthy behaviour, or a combination."

Measuring the long-term effect of the health promotion levy

Obesity is a global epidemic. By 2012, the percentage of the South African population considered obese was 10.6% of men and 39.2% of women. Many factors impact obesity, such as consumption preferences, portion sizes, education, and physical activity. The World Health Organisation (WHO) recommends sugar intake of less than 10% of total energy intake per day and it urges countries to use taxes and subsidies and other measures to change people's behaviour. The WHO specifically recommends measures designed to:

- Incentivise healthier behaviours
- Improve affordability of healthier food options
- Encourage consumption of healthier options
- Discourage consumption of less healthy options

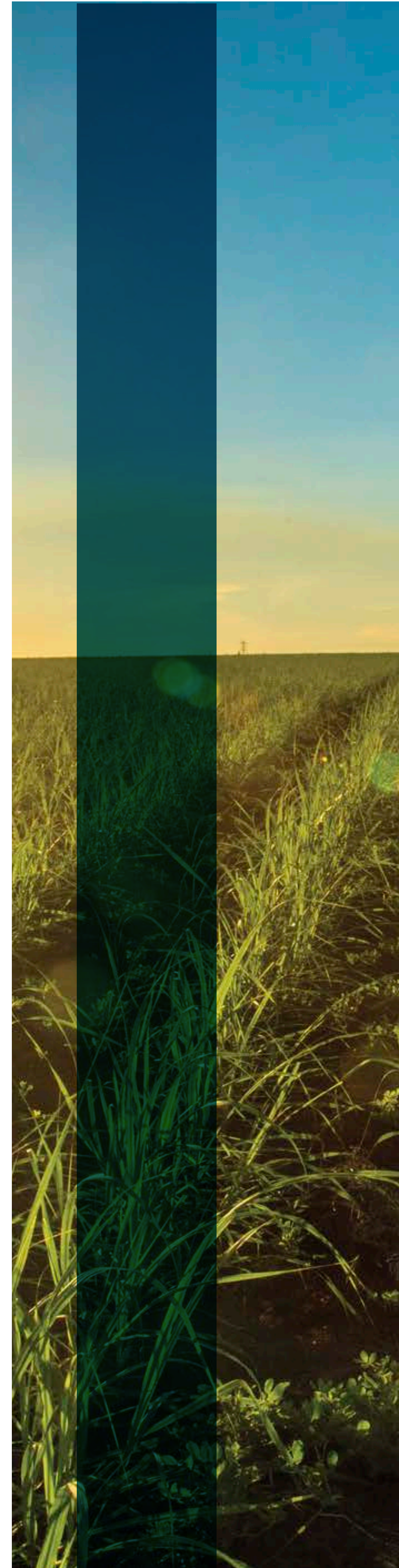
According to SACGA, little evidence exists that the health promotion levy had a discernible impact on public health. We believe that the impact of the sugar tax on the obesity epidemic has been minimal. This is because obesity is a multifaceted problem with many causes, including increasingly sedentary lifestyles and a growing reliance on cheap and highly calorific junk food. SACGA questions the health promotion levy's positive impact on obesity, but argues that its negative impact on the economy and jobs is certain.

Before introduction of the health promotion levy, a National Treasury media statement made reference to the Department of Health's Strategic Plan for the Prevention and Control of Non-Communicable Diseases 2013-2017 and to the National Strategy for the Prevention and Control of Obesity 2015-2020. These strategies aim to reduce obesity by 10% by 2020.

Treasury and academics are currently researching the impact of the sugar levy on industry and the consumption of sugary drinks, in order to project its reduction of obesity, and diseases of diabetes, strokes and heart attacks.

SUGAR TAX DEVASTATING TO AN INDUSTRY ALREADY ON ITS KNEES

▶ **GRAEME STAINBANK**, maxwilton@stainbankbros.co.za



We look at the effects of the tax on the people growing sugar and the sugar industry as a whole.

Picture this: Ulwazi Khumalo has been a sugarcane grower in Emthandeni, north of Durban, since 1997. Having farmed for more than 20 years, she is well acquainted with labouring long hours under the sun, failed crops and financial hardship that are the realities of being an agriculturalist.

Ulwazi is also a mother, a daughter and a granddaughter. Besides her six children, she supports her mother and her ailing grandfather. But the future of Ulwazi and her extended family is uncertain.

This year, she retrenched three of her trusted employees who have worked side-by-side with her for more than two decades. Ulwazi cannot afford their labour any longer, having produced sugarcane at a loss for more than three years.

Although her crops have recovered from the prolonged drought that hit KwaZulu-Natal, Ulwazi faces new trials that will not pass when the rains eventually come. Cane prices are at a record low, exacerbated by a substantial drop in the demand for sugar since the implementation of the sugar tax in April 2018.

Ulwazi's story is not a hypothesis. It's the true state of affairs for hundreds of small-scale growers and land reform sugarcane growers in KwaZulu-Natal. For them, farming has become a daily struggle for survival. Their enterprises and livelihoods are literally on the brink of collapse.

Enter the sugar tax

Before the implementation of the sugar tax in April 2018, the industry repeatedly cautioned National Treasury and the Department of Health – the two Government entities responsible for introducing the tax – about the dire consequences it will have on the economy and subsequently on jobs.

Warnings from the sugar industry about diminishing revenue and job losses have come to fruition. In just one season, which runs from 1 April to the end of March, the sugar industry has lost R1.3 billion in revenue and 10 000 jobs are at risk. These potential job losses are in the canegrowing sector alone and the figure does not include further job losses in the sugar milling and beverage industries.

"There is evidence that shows another unintended consequence of the tax – the influx of cheap sugar from neighbouring countries."

To add fuel to the fire, the sugar tax was increased with a further 5.3% in the 2019/20 budget, which will no doubt lead to more severe revenue losses, putting even more jobs on the line.

While the sugar tax may bring in revenue to the fiscus, this additional money comes at a huge cost to the industry and those employed by it.

The fact of the matter is there is currently no solid evidence that the tax on sugary beverages has had any tangible impact on obesity in South Africa. Obesity is a multi-faceted issue with many causes – inactive lifestyles, an increasing dependence on cheap junk food and genetics are some of the major factors that contribute to this epidemic.

To show that the sugar tax has a palpable impact on public health, an analysis of obesity before and after the implementation of the sugar tax needs to be done, controlling for other variables.

To our knowledge, no such study has been concluded. Our position remains that it was irresponsible to raise the sugar tax – which we know is costing thousands of jobs – when there is no evidence that the tax has made an impact on public health.

Devastating ripple effect

The sugar tax has from the outset dealt a momentous blow to the sugar industry that is reeling from the consequences of a devastating drought, plunging sugar prices and weak protection against cheap imports.

There is now also evidence that shows another unintended consequence of the tax – the influx of cheap sugar from neighbouring countries.

A number of stakeholders in the direct and industrial markets, including non-alcoholic beverage manufacturers, are relying on cheaper, imported sugar.

Sales to these markets have dropped significantly and the industry had no choice but to export more than 200 000 tons of sugar on to the world market in the past year. For every ton that is exported, or for a drop in the demand of South African-produced sugar, the industry loses approximately R5 000 in revenue.

There is a solution

We maintain that Government should, as an immediate solution, enact a moratorium on the sugar tax until a thorough and complete socio-economic impact assessment has been done. This will help secure the jobs of thousands of people, including the future and livelihood of small-scale growers and land reform farmers.

If Government agrees to do this until the true impact of the sugar tax on public health – but more importantly on the economy – is known, it will also help the industry to recover its losses. The livelihoods of all sugarcane farmers, including small-scale growers such as Ulwazi, depend on it.

DEBT BENEFIT AMENDMENTS REGARDING THE FUNDING OF ALLOWANCE ASSETS

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Do the recent changes to the debt benefit regime relating to allowance assets achieve the intended result? Or is there still a possibility for tax avoidance in this area? Our article looks at a few scenarios.

Background

Debt benefits arising from concession or compromise arrangements became a common phenomenon in South Africa. New regulations governing the tax treatment of debt benefits were introduced and became effective from 1 January 2019 for years of assessment commencing on or after this date. The purpose of the debt benefit regime, regulated by section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act, is to tax debt benefits arising when debt is waived, cancelled, extinguished or converted to equity, depending on the type of expenditure or asset funded by such debt.

Reasons for change

Amendments to the debt benefit provisions were made in an attempt to prevent possible tax abuse, whereby taxpayers tried to avoid the tax consequences of debt benefits by disposing of their assets before entering into arrangements that would trigger debt benefits. Where assets were already disposed of by the time a debt benefit in respect of such assets arose, taxpayers with no assessed capital loss could realise lower capital gains or higher capital losses and simultaneously avoid any additional tax consequences resulting from a debt benefit.

The debt benefit regime attempts to enhance tax symmetry by ensuring that debtors are taxed on the corresponding gains that creditors are allowed to claim as losses for normal tax purposes. The Taxation Laws Amendment Act 2018 introduced amendments, including section 19(6A) and paragraph 12A(4) of the Eighth Schedule, to the debt benefit regime.

This article highlights these amendments and illustrates their application by way of an example with specific focus on the new provisions regulating debt benefits in respect of allowance assets.

Debt benefits received during years of assessment commencing before 1 January 2019

Paragraph 12A(3) of the Eighth Schedule regulated debt benefits received on allowance assets still held by the taxpayer at the time debt benefits arose. These debt benefits had to be applied to reduce the base cost of such assets. Any excess remaining, after the base cost was reduced to nil, had to be recognised by the taxpayer as recoupments in terms of section 19(6), limited to the capital allowances previously claimed on such assets.

Taxpayers who therefore disposed of allowance assets before entering into debt benefit arrangements realised lower capital gains on such disposals (due to higher base costs as the base cost could not be reduced if the asset was no longer held). In addition, recoupments would be included in the taxpayer's income to the extent of capital allowances previously claimed. If all capital allowances were already recouped under section 8(4)(a) upon initial disposal, no additional recoupment had to be included in the taxpayer's income. Consequently, upon

"The debt benefit regime attempts to enhance tax symmetry by ensuring that debtors are taxed on the corresponding gains that creditors are allowed to claim as losses for normal tax purposes."

the receipt of debt benefits, the taxpayer could avoid all tax implications triggered under the debt benefit regime. In reaction to the latter, recent amendments were made to the regulation of debt benefits received on debt used to fund allowance assets. The new regime is discussed next.

Debt benefits received during years of assessment commencing on or after 1 January 2019

The amended regulation determines that for assets not disposed of in a year of assessment prior to that in which the debt benefit arises, such debt benefit should be applied to reduce the base cost of such assets. In respect of allowance assets, section 19(6) will deem the excess of the debt benefit remaining after the base cost has been reduced to nil to be a section 8(4)(a) recoupment, limited to the capital allowances previously granted.

For assets disposed of in a year of assessment prior to that in which the debt benefit arises, paragraph 12A(4) of the Eighth Schedule will apply. Paragraph 12A(4) has been amended to also cover allowance assets (and no longer only capital assets). In terms of paragraph 12A(4) the absolute difference between the actual capital gain or loss on disposal and the gain or loss that would have been determined if the debt benefit had been taken into account should be treated as a capital gain in the year of assessment in which the debt benefit arises. Furthermore, if the actual recoupment on disposal (without taking the debt benefit into account) is less than the recoupment that would have been determined had the debt benefit been taken into account, section 19(6A) deems the difference to be a section 8(4)(a) recoupment in the year of assessment in which the debt benefit arises.

It is evident that the Act provides clear guidance on the tax treatment of debt benefits arising on debt used to fund the acquisition of allowance assets:

- where the asset was not disposed of in a year of assessment prior to the year of assessment in which the debt benefit arises; and
- where the asset was disposed of in a year of assessment prior to that in which that debt benefit arises.

Therefore, where an asset is disposed of in the same year of assessment in which the benefit arises, a taxpayer will only be able to apply the provisions of paragraph 12A(3) and section 19(6) because the asset is then not disposed of in a year prior to that in which the debt benefit arises.

The following example illustrates a scenario where an allowance asset is disposed of and a debt benefit is obtained (in respect of debt used to fund the acquisition of such an asset) in the same year of assessment:

Example: Company A (with a 31 December year-end) incurs a debt of R2.5 million to fund the acquisition of a second-hand manufacturing machine on 1 January 2017. This machine constitutes an allowance asset qualifying for section 12C allowances at 20% per year over five years. Company A sells the machine to a non-connected company for R2.8 million on 31 January 2019. The creditor waives R800 000 of Company A's outstanding debt on 31 March 2019 due to its inability to pay.

Company A cannot apply paragraph 12A(4) or section 19(6A), as the disposal did not occur in a year of assessment "prior" to the year of assessment in which the debt benefit arises.

- *However, section 19(6) and paragraph 12A(3) of the Eighth Schedule could be applied (because the allowance asset was not disposed of in a year of assessment prior to that in which that debt benefit arises) as follows:*

  A section 8(4)(a) recoupment of R1.5 million [total capital allowances previously claimed where proceeds exceeds cost] and a capital gain upon disposal of R300 000 [proceeds (R1.3 million) less base cost (R1 million)] need to be recognised. Proceeds are determined as R2.8 million (selling price) less R1.5 million (recoupment); and base cost as R2.5 million (cost) less R1.5 million (allowances).

  Because the machine is already sold at the time the debt benefit arises, the debt benefit cannot be applied to reduce its base cost in terms of paragraph 12A(3). Due to a higher base cost, a capital gain of only R300 000 is realised. No section 19(6) recoupment is triggered, since all previous capital allowances claimed have already been recouped.

  Hence, the debt benefit of R800 000 will have no effect on Company A's normal tax liability, as the machine was sold in the same year of assessment in which the debt benefit arose.

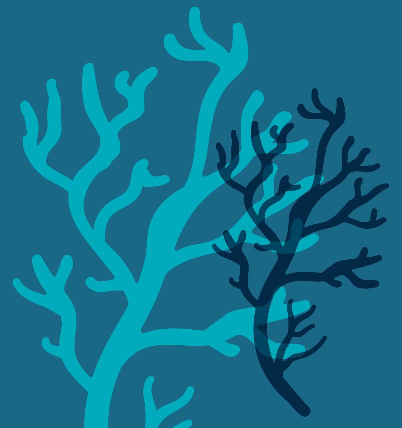
This scenario could be prevented if the wording of section 19(6A) and paragraph 12A(4) read "…disposed of and no longer held at the time the debt benefit arises". Then, a disposal and debt benefit that took place in the same year of assessment would also be covered by these provisions and would then have the following effect:

The capital gain and recoupment that would realise if the debt benefit is taken into account would first be determined. The base cost of the asset would then be reduced with the debt benefit of R800 000, resulting in a lower base cost of R200 000 (R1 000 000 less R800 000) and no recoupment under section 19(6). Upon disposal, the section 8(4)(a) recoupment will be the same, amounting to R1.5 million. Because of the reduced base cost, a capital gain of R1.1 million [proceeds (R1.3 million) less base cost (R200 000)] will be realised.

Paragraph 12A(4) would determine that the absolute difference between the actual capital gain (R300 000) and the capital gain that would have realised by taking the debt benefit into account (R1.1 million) needs to be recognised as a capital gain (R800 000). This will ensure that Company A is taxed on its debt benefit of R800 000 received. Section 19(6A) would not apply, because the recoupment of R1.5 million would not be less than the recoupment that would have been determined if the debt benefit were taken into account.

An end to tax avoidance?

Even after recent amendments, the debt benefit regime still allows room for possible tax avoidance. Based on the example provided in this article, uncertainty still seems to prevail in respect of the tax treatment of debt benefits received on debt used to fund the acquisition of allowance assets where the allowance asset is disposed of and the debt benefit is received in the same year of assessment.



The Tax Faculty

sait South African Institute of Tax Professionals

CONSIDERATIONS BEFORE SUBMISSION OF ITR14: LIMITING SARS DISPUTES BY GETTING IT RIGHT THE FIRST TIME

The primary responsibility of the tax practitioner with regard to the submission of the ITR14 is to ensure that complete and accurate information is submitted to SARS and that defendable positions are taken whenever Uncertain Tax Positions arise.

WORKSHOP

5.5 HOURS

The tax compliance function is not simply an administrative function; the tax practitioner must exercise "reasonable care" when preparing the ITR14. Failure to do so may lead to an understatement penalty of 25% in a standard case – even where the taxpayer is in an assessed loss position.

The course will be case study based and learning will occur on a practical and interactive basis.

PRESENTERS

Johan Heydenrych
Director: Tax Services KPMG Services (Pty) Ltd

Vian Strydom
Director: KPMG SA

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WE DO E-LEARNING SO YOU CAN DO LIFE

Q&A

The Tax Helpline service is available exclusively to SAIT members. Log your tax-related technical queries via www.thesait.org.za

We present some questions and answers on expense deductions for travel, interest-free loans to family members, key man insurance policies and tax on foreign income in the absence of a double taxation agreement.

Q I would like more info on the expense deduction of overseas travel by employees for work or personal reasons. Is the cost fully deductible as an expense and are there any qualifying criteria?

Expenditure is allowed to the extent that it was "laid out or expended for the purposes of trade", in accordance with section 23(g) and read with section 11 (incurred in carrying on a trade) and 11(a) (in the production of income and not capital). It follows that expenditure incurred overseas by an employee is deductible to the extent that the employee was engaged in the business of the taxpayer. So long as you can prove the business purpose of expenditure, it is deductible. And remember that SARS has published a table of subsistence allowance rates in foreign currencies, for use where the employee gets a subsistence allowance while abroad. In *Notes on SA Income Tax 2019* (Haupt) the list starts on page 1004.

Q My client is lending her daughter R1.9 million to pay off her house. The loan will be repaid interest free over 8 years. Can you please give me clarity on the tax implications?

We accept that, if there is a tax benefit, the parties would be able to rebut the presumption of purpose – see section 80G of the Income Tax Act.

SARS's view, following the Brummeria case, was that "the judgment may be applied in all cases in which benefits in a form other than money (such as the right to use an interest-free loan) are granted in exchange for goods supplied, services rendered or any other benefit given." But they confirm, in the practice generally prevailing, that the "Brummeria case is clearly not authority for the general conclusion that the value of the right to use an interest-free loan should in each and every case be included in the borrower's gross income". It requires the quid pro quo for it to turn into gross income.

Judge Froneman in CSARS v RM Woulidge said, "as long as the capital remains unpaid the failure to charge interest represents a continuing donation…" The court case dealt with section 7 of the Income Tax Act.

The parties, if they do not view this as a donation (not property or the waiver of a right), will have to prove that it was not a donation as defined in section 55(1) of the Act or, if it was, that section 56(2)(c) applies.

We accept that the daughter is not a minor. With regard to loans to children (not minors) it is generally accepted that the interest-free loan does not actually result in a donation for donations tax purposes. The question is whether the interest not charged constitutes a donation – the 'failure to' as the Judge said.

Whilst our courts have held that the non-charging of interest is a continuing donation,

SARS has only applied that in the context of section 7 and the attribution rules in the Eighth Schedule – essentially for normal income tax purposes.

Section 7C was specifically introduced to cater for the avoidance of estate duty and donations tax. It deems a donation to arise when an interest-free loan is made to a trust by a person connected to the trust (under certain circumstances). We make the comment about section 7C to illustrate that the Act had to be amended to treat the interest-free loan to a trust as a donation.

Q With regard to a qualifying key man insurance policy (deductible under section 11(w) of the Income Tax Act as it meets all the requirements), is input VAT claimable on the premiums of such a policy?

Section 16(3)(a)(i) of the VAT Act allows a vendor to make a deduction of input tax in respect of supplies of goods and services made to the vendor during a tax period. “Input tax” is defined in section 1(1) of the VAT Act as, amongst others, VAT paid on goods or services supplied to a vendor, to the extent that the vendor acquires the goods or services for the purpose of consumption, use or supply in the course of making taxable supplies.

A key man policy is a short-term insurance policy for VAT purposes. The insured and beneficiary of the policy is the person that takes out the policy. Any amount paid out in terms of the policy will accrue to the insured. If the insured is a VAT vendor, the proceeds on the policy will constitute consideration for a taxable service on which output tax must be accounted (section 8(8) of the VAT Act). The premiums paid in respect of the policy constitute normal business expenses to protect the business against disruptions in the case of the death or loss of a key member of the business. As such, the expense relates directly to the operation and continued operation of the business or VAT enterprise.

Any VAT paid on such policies would accordingly be linked directly to the operation of the VAT enterprise and would accordingly constitute recoverable input tax as envisaged in section 1(1) of the VAT Act, read with section 16(3) thereof. VAT incurred on key man policy premiums by a VAT vendor would generally qualify as recoverable input tax.

Q I have a client who is a South African resident. He worked in Panama and was abroad for 291 days of which one period was for 75 days. The client received a payslip in Panama and paid tax in Panama. When submitting his tax return I claimed the section 10(1)(o) deduction. SARS has now said that this deduction cannot be allowed as the client claimed the foreign tax credit. Why is this relevant and should I have taken another avenue?

Panama is not a country with which the RSA has an agreement for double tax avoidance. Relief for any double tax that then arises will be by way of a rebate for the foreign tax (under section 6quat) or by way of an exemption. Based on the information provided we accept that the individual met all the requirements of section 10(1)(o)(ii): more than 183 full days, more than 60 full days continued and in employment.

We accept that you declared the foreign sourced income (in Panama) as exempt income in the individual’s RSA return of income. It is not declared by way of a deduction as there is no South African IRP5 for this amount.

No double tax will then arise on assessment and the foreign tax cannot be deducted under section 6quat(1C). For the same reason, the taxpayer will also not be entitled to a foreign tax credit. The reason for both is that there is no amount in respect of the income from a source in Panama included in the individual’s taxable income in the RSA.

Case Law
Wrap-up

JOHNNIE KRUGER, DARREN BRITZ & KELSEY JAYES,
Tax Consulting South Africa

Our round-up of case law includes a pronouncement on understatement penalties, the denial of a condonation and postponement request by a taxpayer and whether a sum of money in respect of a lease premium constitutes revenue or capital.

PURLISH HOLDINGS (PTY) LIMITED v CSARS (76/18) [2019] ZASCA 04

Issue

At issue in the appeal against a decision of the Tax Court is SARS's entitlement to payment of understatement penalties by the appellant, in accordance with the provisions of section 222(1) of the Tax Administration Act for the years of assessment in question and, if so, the quantum thereof.

Facts

The appellant, having paid provisional income tax to SARS, applied for a refund of the amount paid on the basis that it had not yet commenced trading. The appellant was not registered as a vendor in terms of the VAT Act at that time and consequently did not submit VAT returns for the period in question. SARS imposed audits in respect of both corporate income tax and VAT. SARS proceeded to issue assessments in respect of corporate income tax and VAT and thereafter levied understatement penalties.

The appellant lodged an objection against the understatement penalties and SARS confirmed the imposition of understatement penalties but applied lower rates. Aggrieved by the outcome, the appellant approached the Tax Court. In addition to dismissing the appellant's appeal, the Tax Court increased the understatement penalties to 100% of both assessed corporate income tax and VAT.

Outcome

The Supreme Court of Appeal found that SARS had proven that there were understatements as contemplated by section 221 and that the understatements were not as a result of a *bona fide* inadvertent error by the appellant.

However, the court held that the Tax Court was incompetent to increase the reduced penalties and that the appeal against the decision of the Tax Court should partially succeed.

Core Reasoning

For an understatement penalty to arise any of the actions or omissions referred to in paragraph (a) to (e) of the definition of "understatement" in section 221 of the Tax Administration Act must result in some prejudice to SARS or the fiscus. In terms of section 102(2) of that Act, the burden of proof rests on SARS to prove the facts on which SARS based the imposition of an understatement penalty.

The Supreme Court of Appeal held that SARS must not only show that the taxpayer committed an act as listed in paragraphs (a) to (d) in terms of the definition of "understatement" in section 221, but also that such conduct caused SARS or the fiscus to suffer prejudice.

Furthermore, the court held that use of additional SARS resources for purposes of auditing constitutes prejudice to SARS and that prejudice is not only determinable in financial terms.

The court was satisfied that SARS had proven that there were understatements as contemplated by section 221 and that the understatements were not as a result of a bona fide inadvertent error by the appellant.

SARS had never raised the issue of the increase of the reduced penalties for adjudication before the Tax Court and only sought to justify the reduced penalties. Therefore, the court held that the Tax Court was incompetent to increase the reduced penalties and that the appeal against the decision of the Tax Court should partially succeed.

1. The appeal is upheld to the limited extent set out in paragraph 2 below.
2. Paragraphs 2, 3, 4 and 5 of the order of the Tax Court are set aside and paragraph 6 is renumbered to read 2.

The order of the Tax Court, referenced above, reads as follows:

1. "The taxpayer's appeal against the levying of understatement penalties in respect of income tax and VAT for the 2011-2014 years of assessment is dismissed.
2. The Commissioner's understatement penalty of 25 per cent in respect of income tax is set aside.
3. The understatement penalty of 100% is imposed in respect of income tax for the 2011-2014 years of assessment.
4. The Commissioner's understatement penalty of 50 per cent in respect of VAT is set aside.
5. The understatement penalty of 100 per cent is imposed in respect of the understatement of VAT payable in respect of 12/2010, 02/2011 and 12/2012.
6. Each party is to pay its own costs."

Take-away

The decision confirms that the Tax Court was incompetent to increase the understated penalties as SARS did not raise this issue before the Court.

Further, understatement penalties can only be imposed on a taxpayer in the instance where an audit reveals that the taxpayer indeed understated the amount of tax payable.

The fascinating part of this judgment is that the Supreme Court of Appeal found that the use of additional SARS resources to conduct an audit caused prejudice to SARS. On this basis, SARS was entitled to impose understatement penalties.

XYZ (Pty) Ltd v CSARS 13868

Issue

This matter considered whether a taxpayer (the appellant) was entitled to condonation for the late filing of its Rule 32 statement of grounds of appeal and a postponement of the court hearing to allow the appellant time to prepare the Rule 32 statement.

Facts

The Commissioner for the South African Revenue Service (the respondent) issued a revised assessment on 28 November 2013 on the basis that the appellant had understated its income. The appellant objected to the assessment on 13 June 2014 and which objection was subsequently disallowed by the respondent on 29 October 2014. Following this disallowance, the appellant filed its notice of appeal on 19 November 2014.

On 18 July 2017, the respondent filed its statement of grounds of assessment and opposing the appeal in terms of Rule 31(2). On 24 July 2017, the appellant requested an extension of time to file the Rule 32 statement, which was granted by the respondent until 15 December 2017. The appellant failed to deliver its Rule 32 statement timeously and failed to apply for a further extension.

On 16 February 2018, the respondent filed a notice in terms of Rule 56(1)(a) wherein it notified the appellant of its intention to apply for default judgment. On 24 July 2018, the respondent filed its application for default judgment in terms of Rule 56(1)(b), read with section 129(2) of the Tax Administration Act. The appellant failed to oppose the application or respond in any manner whatsoever.

On 3 September 2018, the respondent applied for a date for the hearing of the appeal and the matter was set down for hearing on 13 November 2018. On 7 November 2018, the appellant's legal representative made contact with the respondent, complaining that the appellant's documents were in possession of the Respondent. By agreement between the parties, the Tax Court postponed the matter on 13 November 2018 to 27 February 2019. The appellant was further ordered in terms of Rule 56(2)(b) to file its Rule 32 statement on or before 27 February 2019, failing which the respondent would be entitled to default judgment.

The appellant again failed to deliver its Rule 32 statement, despite having been ordered to do so by the Court. On the morning of the hearing, held on 27 February 2019, the appellant's legal representatives served and filed an application for condonation, postponement and other relief. The respondent opposed the application and argued the matter without having to file an affidavit.

Outcome

The appellant's application for condonation and postponement was dismissed with costs. An order was further granted in terms of section 129(2) of the Tax Administration Act, in terms of which the assessment was confirmed and the appellant's appeal dismissed with costs of suit.

Core Reasoning

In setting out the reasons for its decision, the court made reference to the appellant's conduct throughout the proceedings and which demonstrated, in the court's view, that the appellant had deliberately delayed the matter.

During the period between 18 July 2017 (when SARS delivered the Rule 31 statement) and 27 February 2019 (the day of the court hearing), the appellant failed to deliver its Rule 32 statement. This was effectively a 19-month delay without sufficient grounds to explain the appellant's persistent failure to deliver the Rule 32 statement.

The court further considered argument raised by the appellant, which was that certain documents had been seized by SARS and which were required by the appellant to prepare the Rule 32 statement. The court dismissed this ground on the basis the Rule 32 statement does not have to be accompanied by any documentation. It was also noted that the appellant had sufficient information to lodge an objection and pursue the appeal, thus it had not been demonstrated why the documents were needed for the Rule 32 statement.

To the extent that the appellant indeed required certain documents to prepare the Rule 32 statement, the court held that the appellant should have requested these documents under the Rule 36 discovery process.

Take-away

The decision is significant for two reasons. The decision confirms the tax court will not entertain condonation and/or postponement requests by taxpayers who intentionally delay proceedings. Taxpayers must have substantive grounds and properly motivate the application.

More importantly, SARS are not averse to filing an application against a dilatory taxpayer for default judgment under Rule 56. This means that a failure by the taxpayer to adhere to timeframes governing the appeal process will give SARS grounds to seek a dismissal of the taxpayer's appeal and confirmation of the assessment by the court. The taxpayer also faces an adverse cost order, which means paying SARS' counsel fees on the applicant's own appeal application. Taxpayers must ensure that a notice of appeal is not filed on a whim but carefully considered and, if filed, pursued until finality.

XYZ (Pty) Ltd v CSARS 14189

Issue

This matter addresses the question of whether the receipt by the appellant of a sum of money in respect of a lease premium constitutes revenue or capital.

Facts

The appellant is a 100% state-owned company. It is mandated to develop and operate 11 500 hectares of industrial land and its key role is developing and operating an industrial development zone (IDZ) as well as attracting investments.

In 2009, the appellant and DF (Pty) Ltd concluded a lease agreement in respect of a property in the IDZ for an initial lease period of 12 years, with two renewal periods. Under the DF lease agreement, the appellant was required by DF to build a facility on the property. However, during this process, DF had been unable to make payment and construction had ceased.

In 2010, the appellant concluded a separate lease agreement with MN Properties (Pty) Ltd in terms of which the property (which was leased to DF) would be leased to MN but subject to DF's tenancy. Accordingly, the appellant assigned the DF lease agreement to MN, which assignment was consented to by DF. The terms of the assignment were as follows:

- MN would pay the appellant an amount of R125 million in consideration for the assignment (the lease premium);
- The appellant would be substituted by MN as landlord in terms of the DF lease agreement; and
- DF would pay all amounts due in terms of the DF lease agreement to MN.

The appellant did not include the whole lease premium amount of R125 million in its gross income, alleging that the lease premium was a customer deposit. SARS raised an assessment on the lease premium and imposed a 10% understatement penalty thereon.

The appellant argued that the payment of the lease premium was of a capital nature in that it merely constituted proceeds in respect of the disposal of an asset, being the right, title and interest in the DF lease agreement. Alternative relief was sought by the appellant in the form of a deduction.

Outcome

The taxpayer's appeal was dismissed, thereby confirming the Commissioner's assessment and interest thereon at 10%, with no order as to costs.

Core Reasoning

In reaching its decision, the court stressed the importance of the intention of the appellant in determining whether a receipt is capital or revenue in nature but stated that evidence after the fact requires a high standard of scrutiny as it is prone to reconstruction.

In this regard, the court held that the burden of proof rested on the appellant to show that the assignment of the DF lease agreement relieved the appellant from the status and rights of landlord over DF. The court dismissed the oral evidence presented in favour of the appellant as such evidence was contradictory and unsubstantiated. The court further noted that the documentary evidence of the appellant, such as the annual financial statements thereof, did not support the intention that the rights, title and interests in the DF lease agreement be sold to MN and that the lease premium be proceeds in respect of that sale.

Accordingly, the court found that the intention of the appellant was always to enter into a rental agreement, fully knowing that the receipt flowing therefrom is revenue in nature. The cession of rights was held not to be a sale of assets but was intended for the appellant to earn a lease premium. The court accordingly held that the receipt of the lease premium by the appellant is of a revenue nature and therefore taxable in the hands of the appellant.

The alternative relief requested by the appellant was also denied as it is required by section 11(h) of the Income Tax Act that the lease premium must have been included in the gross income of the appellant before any deduction thereof could have been allowed. As this was not done, the appellant was not entitled to the deduction.

Take-away

This decision confirms the importance of the intention of taxpayers as a factor in determining whether a receipt is of a revenue or capital nature and the objective factors which support such intention. Where taxpayers are unable to prove their intention through oral and documentary evidence, such taxpayers will not be regarded as having discharged their onus of proof.

Thus, taxpayers must ensure that they maintain accurate records of all transactions and that they are able to provide evidence which supports their intention when alleging that a receipt is of a capital nature.

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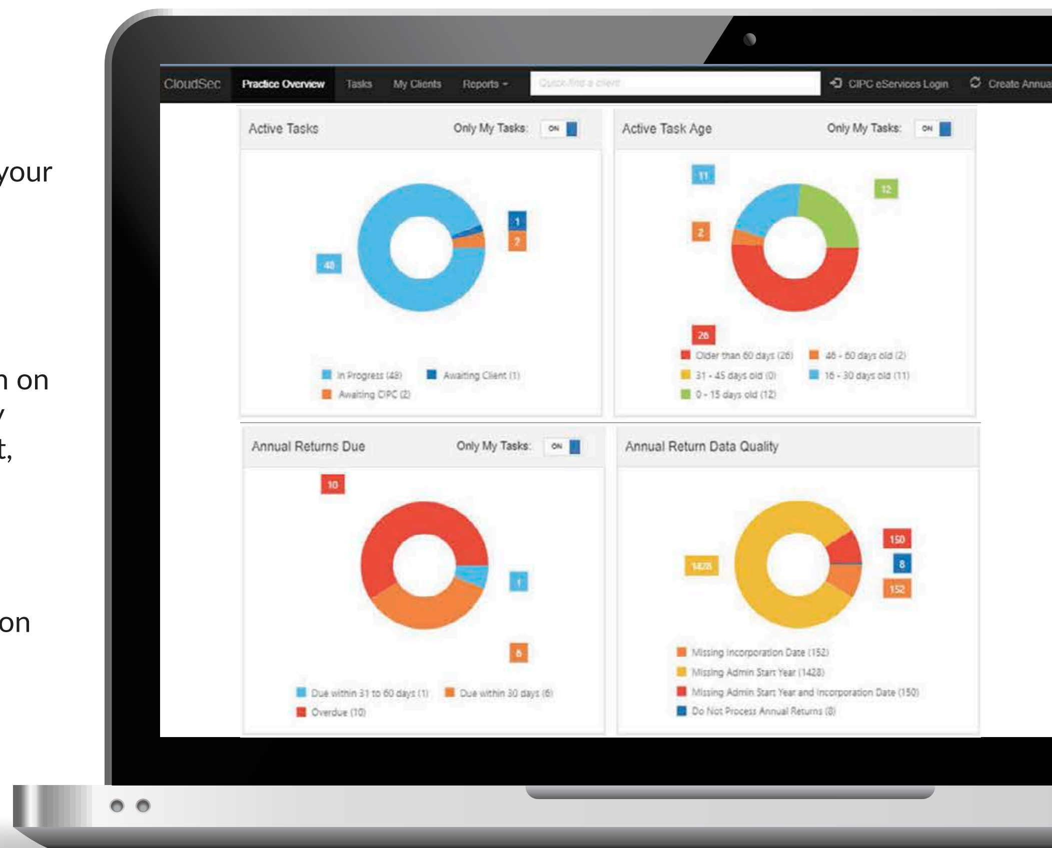

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