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INTERNATIONAL TAX
CFC RULES

TAX ADMINISTRATION
TAXPAYER CONFIDENTIALITY

TRUSTS
WHEN ARE TRUSTS TREATED AS PROVISIONAL TAXPAYERS?

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DISSOLUTION OF PARTNERSHIP INTEREST

At common law, a partnership is not considered to be a legal entity or persona with legal personality separate from its partners. Rather, a partnership has been defined as a legal relationship between two or more persons who carry on a lawful business or undertaking, to which each contributes either money or labour, or anything of value with the object of making a profit, and of sharing that profit between them.

As such, all legal consequences flowing from a partnership accrue to the partners in their personal capacities. This is also the position under the Income Tax Act, 1962 (the Act). Therefore, any property of the partnership is co-owned by the partners in undivided shares. Each partner therefore has a proportionate interest in the partnership, and by acquiring an interest in the partnership, each partner acquires an undivided share in the assets of the partnership.

In SARS' Comprehensive Guide to Capital Gains Tax *(Guide)*, it is explained that as a result of the unique legal nature of partnerships, the taxation thereof can pose a number of practical difficulties. For example, the common-law principle is that when a new partner joins or a partner leaves, the existing partnership is dissolved, and a new partnership comes into existence. The *Guide* notes that if one was to strictly follow this principle, the effect would be to trigger a disposal of the entire interest of each partner each time a partner joins or leaves.

Practically, however, it is not intended that partners be regarded as disposing of their entire interests in the partnership assets every time a new partner is admitted or an existing partner leaves. Instead, each partner must be regarded as having a fractional interest in each of the partnership assets. To the extent that a partner's fractional interest in the partnership assets remains unchanged following the introduction of a new partner or the withdrawal of an existing partner, there will be no disposal. A disposal should occur only when a partner's fractional interest in an asset of the partnership is diminished.

What about the dissolution of a partnership? Does a disposal occur when the partnership is terminated and the partnership assets are distributed in accordance with the respective partner's interests in the partnership? This was the question that was determined in binding private ruling (BPR) 391, specifically in relation to an *en commandite* partnership.

EN COMMANDITE PARTNERSHIPS

Similar to a general partnership, a partnership *en commandite* is carried on in the name of one or more partners. However, in an *en commandite* partnership one or more of the partners' names remain undisclosed, ie, the limited partner(s). A limited partner will generally contribute a fixed sum to the partnership which will entitle it to receive a certain share of the profits, if any. However, unlike a general partnership, in the event that the partnership realises a loss, a limited partner will only be liable to the extent of its capital contribution to the partnership.

FACTS OF BPR 391

The applicant in BPR 391 was a resident private company and the limited partner in the partnership. The general partner (GP) was also a resident private company.

In terms of the ruling, the purpose of the partnership was to acquire and hold shares (Investco shares) in the share capital of Investco (a resident private company). The applicant and the GP held 27,01% of the issued ordinary share capital of Investco via the partnership as capital assets.

Each partner's interest in the partnership was as follows:

The GP held a 15% interest in the partnership, ie, a 15% undivided share in the Investco shares.
The applicant held an 85% interest in the partnership, ie, an 85% undivided share in the Investco shares.

The partnership agreement provided that all amounts received by the partnership from time to time, net of expenses and provisions for anticipated expenses, should be apportioned among the partners in terms of the above ratio.

In terms of the ruling application to SARS, the applicant intended to dissolve the partnership so that each partner could obtain a direct investment in Investco rather than holding its investment through the partnership.

It was noted that there would not be any change to each partner's bundle of rights in the Investco shares pre- and post-dissolution of the partnership. Subsequent to the dissolution of the partnership and the division of the Investco shares between the partners, the applicant would hold 22,96% of the Investco shares directly and the GP would hold 4,05% of the Investco shares directly.

TAX CONSIDERATIONS

Paragraph 1 of the Eighth Schedule to the Act defines a "disposal" as an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is, in terms of the Act, treated as the disposal of an asset. Paragraph 11 of the Eighth Schedule states that a "disposal" includes anything which results in the creation, variation, transfer or extinction of an asset, including instances where a disposal occurs.

One of the instances listed in paragraph 11 is the decrease in value of a person's interest in a company, trust or partnership as a result of a "value shifting arrangement". A "value shifting arrangement" is defined in paragraph 1 of the Eighth Schedule, in relation to a partnership, as –

- an arrangement;
- by which a person retains an interest in a partnership;
- but following a change in the rights or entitlements of the interests in that partnership, the market value of that interest decreases; and
- there is an increase in the direct or indirect interest held by a connected person in relation to the person; or
- a connected person acquires a direct or indirect interest.

The *Guide* provides an example of the tax consequences that would ensue where a partnership dissolves. The example notes that:

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

As noted above, the applicant submitted that post dissolution there would not be any change to each partner's bundle of rights in the Investco shares. Therefore, no disposal should be triggered upon the termination of the partnership.

SARS' DECISION

SARS' ruling, which corresponds with the above principle, noted that:

- The dissolution of the partnership pursuant to the termination of the partnership agreement, which will result in the applicant taking ownership of 85% of the Investco shares, will not be treated as a "disposal" as defined in Paragraph 1 of the Eighth Schedule.
- The proposed dissolution of the partnership will not constitute a "value shifting arrangement", as defined in Paragraph 1 of the Eighth Schedule – ie, the market value of the interest of each partner would not decrease but would remain unchanged.

Although the Eighth Schedule does not expressly deal with this question, SARS' decision is consistent with what is noted in the *Guide* in relation to the dissolution of partnerships.

The *Guide* provides a secondary example that illustrates when a disposal can be said to occur. It states that:

"The position would be different if the partnership assets comprised 50 shares in Company X and 50 shares in Company Y and partner A took over the 50 shares in Company X and partner B took over the 50 shares in Company Y. In that event partner A has disposed of 25 shares in Company Y to partner B in return for 25 shares in Company X. Likewise, partner B has disposed of 25 shares in Company X in return for 25 shares in Company Y."

From the above example, it is clear that the specific facts of a matter must be analysed to determine whether there is a variation of interests to determine whether a disposal has occurred. SARS' ruling may have been different if the facts were similar to the above example in the *Guide*. It is, therefore, always advisable to seek the advice of a tax practitioner or, like the applicant in BRP 391, obtain a ruling from SARS confirming the CGT consequences.

Puleng Mothabeng

Cliffe Dekker Hofmeyr

Acts and Bills:

- Income Tax Act 58 of 1962: Eighth Schedule: Paragraph 1 (definitions of "disposal" & "value shifting arrangement").

Other documents

- SARS' *Comprehensive Guide to Capital Gains Tax*;
- Binding Private Ruling 391 ("Tax consequences of the termination of an *en commandite* partnership").

Tags: *en commandite* partnership; general partnership; limited partner; value shifting arrangement.

ABUSE OF SINGLE DISCRETIONARY ALLOWANCES

Each South African resident natural person is afforded an annual single discretionary allowance of R1 million (SDA) by the South African Reserve Bank (SARB) under section B.4(A) of the Currency and Exchanges Manual for Authorised Dealers (the AD Manual).

The AD Manual contains the exceptions and permissions that are contemplated in the Exchange Control Regulations, 1961 (the Regulations). The SDA can be used for any legal purpose abroad, including when travelling overseas, for making offshore investments, and for generally remitting funds offshore as may be necessary and as is permitted.

However, section B.4(A)(xii) of the AD Manual expressly prohibits the SDA from being used to circumvent the Regulations where these Regulations would otherwise prevent a transfer of funds out of South Africa. This was the central issue in *Singh v South African Reserve Bank,* [2023] *(Singh)*, handed down by the North Gauteng High Court on 20 February 2023. Here the High Court affirmed that where a person's SDA is concerned, sharing isn't caring.

THE LAW

Regulation 3(1) of the Regulations prohibits any person from transferring funds out of South Africa without the approval of the SARB, unless that transfer is exempt from this prohibition by the SARB. Section B.4(A) of the AD Manual is one of these exemptions. Although there are also other provisions in the Regulations that place a limitation on the transfer of funds offshore, most notably Regulation 10(1)(c), which contains the general prohibition on the export of capital unless permitted by the SARB (including in the manner provided for in the AD Manual), the judgment in *Singh* only makes brief reference to Regulation 10(1)(c) and deals in greater detail with Regulation 3(1).

Section B.4(A) provides for the annual SDA granted to each South African resident natural person. This exemption recognises the need for a way to move relatively small amounts of money out of the country for travel or investment purposes without submitting an application to a bank authorised to approve exchange control applications by the SARB (authorised dealer), or the SARB itself.

However, as stated previously, this exemption comes with the *caveat* in section B.4(A)(xii) that the discretionary allowance cannot be used to circumvent the Regulations. In essence, this means that the discretionary allowance must be used for the purpose intended (travel, foreign investments by individual natural persons, etc) and not as a means to sidestep South Africa's exchange control regime. In practice (although not mentioned in the judgment), each transaction involving the use of the SDA requires that the person using her SDA notifies the authorised dealer what it is being used for, which transaction is then reported to the SARB using the appropriate BOP code set out in the AD Manual.

Where the SARB suspects that a person has contravened the provisions of the Regulations (including the exceptions and permissions in the AD Manual), then Regulations 22A and 22C allow the SARB to issue a so-called "blocking order" which prevents that person from withdrawing funds from an impugned bank account. The court explained in *Singh* that Regulation 22A allows for the issue of a blocking order in respect of funds tainted by the contravention, while Regulation 22C applies to a blocking order in respect of funds which are as yet untainted.

BACKGROUND

In *Singh*, the applicant was an attorney and businessman. During 2019, the applicant transferred R80 million from his account at the Johannesburg branch of the State Bank of India to his Absa account. Half of this he then transferred out to various other bank accounts, while the balance remained in his Absa account.

Of the funds he had transferred out of his Absa account, the applicant remitted roughly R20 million out of South Africa via his Bidvest Bank account. Bidvest Bank prepared a report stating that several individuals were transferring money in amounts of R1 million into the applicant's Bank of Baroda account in the UK. It appeared that the applicant did this by transferring these funds to his Bank of Baroda account situated in the UK in R1 million tranches using other individuals' single discretionary allowances under section B.4(A) of the AD Manual.

On suspecting this abuse of section B.4(A), and thus the contravention of section B.4(A)(xii), Bidvest Bank reported this to the Financial Surveillance Department of the SARB. The Prudential Authority also reported the initial transfer into the applicant's Absa account to the SARB due to the source of funds not being verified. Following this, the SARB placed a blocking order on the applicant's Absa account holding the remaining R40 million. This was done in terms of Regulations 22A and 22C.

The applicant took exception to this and approached the High Court for this blocking order to be set aside. The applicant argued –

- firstly, that the alleged amount remitted was less than R40 million, and thus placing a blocking order on the full R40 million was not permitted by the Regulations;
- secondly, that he had not contravened the Regulations as the remittance of funds was done with the approval of Bidvest Bank, which is an authorised dealer; and
- thirdly, that the SARB had instituted the blocking order on the instruction of Bidvest Bank and the Prudential Authority.

DECISION

The High Court swiftly dispensed with the applicant's arguments. It found that Regulation 22C allows for untainted funds to also be the subject of a blocking order if it is suspected that the amounts involved in a person's contravention of the Regulations exceeds the amount of tainted funds. Therefore, the court decided that the SARB was permitted to issue a blocking order for the full R40 million in the applicant's Absa account.

Further, the court rejected the applicant's argument that the transfers using the SDAs of other individuals were permissible as Bidvest Bank, being an authorised dealer, approved them. This was because an authorised dealer cannot permit the remittance of funds in contravention of the Regulations (including the exceptions and permissions in the AD Manual). Regarding the applicant's third argument, the High Court found that the SARB had not relied on the investigations by Bidvest Bank or the Prudential Authority when deciding to issue the blocking order. Rather, the SARB had been prompted by these investigations to examine the flow of funds in and out of the applicant's various bank accounts, thus making its own decision as to the blocking order.

Therefore, the court found the applicant could not rely on Bidvest Bank's approval of the transfers, as this approval was obtained through the applicant's unlawful abuse of the SDA in contravention of Regulation 3(1).

COMMENT

At the end of the day, this decision is a reminder that if desiring to remit more than R1 million out of South Africa in a calendar year, a person should make use of lawful means of doing so. An individual can remit up to R10 million abroad annually using her foreign capital allowance (FCA), which is also provided for in the AD Manual. To do this, a person must first obtain a tax compliance status letter for approval of international transfers (TCS for AIT) from SARS, which letter states the amount a person seeks to transfer abroad and essentially that the person is tax compliant for purposes of the transfer. If the amount transferred is below the R10 million annual limit for the FCA, the individual's bank will likely authorise the transfer without any problems. However, if the amount exceeds the annual R10 million limit, prior SARB approval will also be required before the transfer can be authorised. While it is appreciated that the new TCS for AIT has made it more difficult to transfer funds abroad and that SARS has become stricter in considering TCS applications, one should make use of this process and to the extent necessary, seek professional advice.

South Africa's (relatively recent) greylisting by the FATF is well documented. While South Africa's exchange control rules, as contained in the Regulations, pre-date the advent of the FATF and its rules aimed at combatting money laundering and other financial crimes, the SARB has effectively used the Regulations to prevent the unlawful movement of funds into and out of South Africa. The judgment in *Singh* does not indicate why the applicant moved the funds abroad but it is understandable that transfers of this nature caught the attention of the SARB and specifically its Financial Surveillance Department and prompted the issuing of the blocking orders. While South Africa remains greylisted at this stage, it is comforting that the SARB is ensuring that laws aimed at preventing the unlawful transfer of funds abroad, such as the Regulations, are being enforced.

"In practice (although not mentioned in the judgment), each transaction involving the use of the SDA requires that the person using her SDA notifies the authorised dealer what it is being used for, which transaction is then reported to the SARB using the appropriate BOP code set out in the AD Manual."

Nicholas Carroll & Louis Botha

Cliffe Dekker Hofmeyr

Other documents

- Exchange Control Regulations, 1961: Regulations 3(1), 10(1)(c), 22A & 22C;
- Currency and Exchanges Manual for Authorised Dealers (AD Manual): Section B.4(A)(xii);
- Tax compliance status letter for approval of international transfers (TCS for AIT).

Cases

- *Singh v South African Reserve Bank* (2020/35964) [2023] ZAGPPHC 112 (20 February 2023).

Tags: single discretionary allowance; blocking order; tainted funds; tax compliance status (TCS) letter; approval of international transfers (AIT).

NEW SARB CIRCULARS FOR AUTHORISED DEALERS

On 23 May 2023, the Financial Surveillance Department of the South African Reserve Bank (FinSurv) issued four new circulars containing various amendments to the Currency and Exchanges Manual for Authorised Dealers (the AD Manual).

The AD Manual contains the permissions and exceptions contemplated in the Exchange Control Regulations, 1961. In this article, there is a brief discussion of the amendments proposed in each circular. In light of the recent challenges facing the South African economy and the rand, these changes are important and are briefly dealt with below.

EXCHANGE CONTROL CIRCULAR 3 OF 2023

Amendments in Circular 3 relate to private individuals ceasing to be tax residents, and require the completion of the tax compliance status (TCS) process by the individual or beneficiaries of the trust for transferring assets abroad from South African *inter vivos* trusts.

This circular proposes amendments to section B.2(J)(xii)(a) of the AD Manual, which deals with private individuals who cease to be residents for tax purposes, specifically individuals with blocked assets per a FinSurv directive given in terms of Exchange Control Regulation 4(2) pertaining to income and capital distributions abroad from South African *inter vivos* trusts. Whereas the section previously stated that such distributions may be transferred abroad, subject to the tax compliance status (TCS) process being completed by the trustees of the trust, the section now states that the transfer abroad is subject to the TCS process being completed by the private individual and/or beneficiaries of the trust.

EXCHANGE CONTROL CIRCULAR 4 OF 2023

Section B.2(C) of the AD Manual deals with the foreign direct investment dispensation available to South African resident companies. In this circular, FinSurv amends section B.2(C)(i)(b), which stated that foreign currency denominated facilities may be extended by authorised dealers to South African companies for the financing of approved foreign direct investments. The section has been amended to now also state that in instances where the South African parent company wishes to directly issue a foreign denominated guarantee to cover the borrowing facilities of its authorised foreign subsidiary abroad and not through an authorised dealer, FinSurv approval will be required.

EXCHANGE CONTROL CIRCULAR 5 OF 2023

In this circular the provisions of section I.3(B) in the AD Manual, dealing with borrowing abroad by residents, have been amended. Firstly, a new subsection has been added to section I.3(B)(iv)(a), which deals with the criteria that must be applied by authorised dealers when adjudicating applications for inward foreign loans and foreign trade finance facilities. Specifically, the new section I.3(B)(iv)(a)(hh) states that early repayments in respect of the inward foreign loan or foreign trade finance facilities may be effected offshore, provided that the relevant loans are fully drawn down and reported correctly on the Loan Reporting System, and that there are no anomalies on the Loan Reporting System. Simultaneously, section I.3(B)(v)(a)(ll) has been repealed – it stated that early capital redemptions may only take place where they have been approved by FinSurv.

EXCHANGE CONTROL CIRCULAR 6 OF 2023

This circular contains the most substantial amendment to the AD Manual. It replaces the current section B.17 of the AD Manual, dealing with foreign currency holdings and other foreign assets of South African individuals. This section was amended in 2022 with the release of various circulars at the time of the 2022 Budget, but it has now been replaced in its entirety. In substance, the new section B.17 is quite similar to the previous version, but some of the interesting differences are:

- Section B.17(F), which deals with the disposal of legal foreign assets held by private individuals, has been retained; however, it now also states that where the authorised foreign asset is sold to a private individual with recourse to South Africa, the transfers in payment of the assets must be dealt with in terms of the R10 million and R1 million allowances.
- The same subsection also states that any sale of the authorised foreign assets to private individuals where payment will take place locally in rands resulting in no cross-border flow of funds other than change of ownership, must be referred to FinSurv and will also be subject to local tax disclosure as well as compliance by the relevant parties.
- Although lending of foreign assets has been provided for since the February 2022 amendments to section B.17, section B.17(H) now deals separately with the lending of legal foreign assets held by private individuals. One of the important changes in this regard, is that the new subsection states that where the authorised foreign assets are lent to other residents for use abroad, such transactions must take place without any recourse to South Africa, and if there is recourse to South Africa, for example, local repayment in rands, FinSurv approval is required.
- Section B.17(H) now also states that where the authorised foreign assets are lent to other residents for use locally, section I.3(B) of the AD Manual must be adhered to.

"Specifically, the new section I.3(B)(iv)(a)(hh) states that early repayments in respect of the inward foreign loan or foreign trade finance facilities may be effected offshore, provided that the relevant loans are fully drawn down and reported correctly on the Loan Reporting System, and that there are no anomalies on the Loan Reporting System."

Louis Botha

Cliffe Dekker Hofmeyr

Other documents

- Currency and Exchanges Manual for Authorised Dealers (AD Manual):
  - Section B.2(C)(i)(b), B.2(J)(xii)(a), B.17(F) & B.17(H));
  - Section I.3(B) (I.3(B)(iv)(a)(hh) & (v)(a)(ll));
- Exchange Control Regulations, 1961: Regulation 4(2);
- Exchange Control Circulars 3, 4, 5 & 6 of 2023.

Tags: tax residents; tax compliance status (TCS); foreign denominated guarantee; authorised foreign subsidiary.

COMPOUND INTEREST

Nobody enjoys paying tax, but since it is a legal obligation, one may as well make the most of it by legitimately saving where one can. This is because tax savings — even if fractional — compounded over prolonged periods of time, can contribute significantly to any person's financial position.

It was Albert Einstein who described compounding interest as the "eighth wonder of the world" saying, "he who understands it, earns it; he who doesn't, pays for it." This concept is not only limited to "interest" as we know it, but applies equally to anything that often or continuously adds to our wealth, such as reinvested dividends, reduced fees, and reduced taxes.

Compounding growth continues to fascinate, and its effects are best illustrated with a basic example. Ignoring inflation, if one invests R3,000 per month over a 40-year period at an annual rate of return of 5%, one's future gross value of the investment will be R4.5 million – compared to the total sum invested of only R1.44 million. By increasing the annual rate of return by a mere 2.5 percentage points to 7.5%, the end result would double to R9 million.

Once one understands this "Eighth Wonder", one can also appreciate that "tax delayed" equates to "tax saved". A list of the "Seven Tax Wonders" is presented below: it is a list of often either unknown or overlooked ways that, if applied correctly, could add those crucial percentage points needed to unlock the strength of the "Eighth Wonder".

WONDER 1: RETIREMENT FUND CONTRIBUTIONS

Often overlooked or regarded as a less exciting form of investment, pre-tax money can contribute significantly to the compounded growth of retirement savings.

Simply put, if one pays tax at the top marginal tax bracket of 45%, one pays R55 for every R100 investment. Retirement fund contributions qualifying for tax deduction means SARS is contributing to one's savings now.

While one will face tax consequences when drawing from these retirement funds in future, the Eighth Wonder would have already done its work by then. Added to this, one will likely pay tax at a much lower rate then, especially if one plans one's tax affairs carefully on an ongoing basis.

WONDER 2: TAX-FREE SAVINGS ACCOUNTS

Our tax legislation limits the contribution a person can make into their tax-deductible annual retirement fund. So one must consider where one invests one's after-tax money.

Natural persons can make annual investments up to R36,000 into tax-free savings accounts, with a lifetime limit of R500,000. If a person is able to reach this lifetime limit at a relatively early age and leave it untouched, it could easily grow to a couple of million rand by retirement age. This can then supplement one's retirement funding needs, tax free, while also aiding in reducing the marginal tax rate applied to other taxable retirement income.

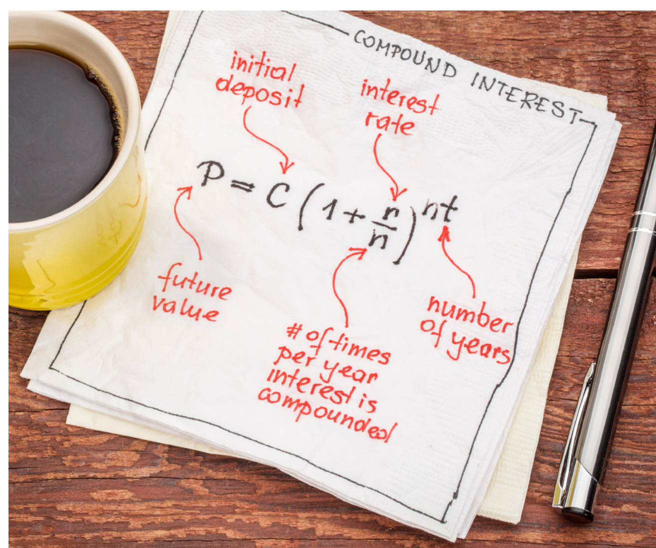
WONDER 3: INVESTING IN VEHICLES EXEMPT FROM CAPITAL GAINS TAX (CGT)

Qualifying collective investment schemes (CISs) and real estate investment trusts (REITs) enjoy exemption from CGT on the disposal of qualifying underlying assets.

Instead of investing in something directly, doing so via CISs and REITs means that the investor will not suffer CGT consequences every time the CIS or REIT sells an underlying asset. The CIS and REIT are accordingly able to reinvest pre-tax money following asset disposals.

The investor will be liable for CGT when disposing of the CIS or REIT investment, but by then, the Eighth Wonder should have already enhanced the value of the investment.

Depending on the nature and size of the asset, directly held investments can potentially be swapped by individuals, companies, and trusts for shares in CISs or REITs applying tax rollover relief.



WONDER 4: INVESTING IN LONG-TERM INSURANCE PRODUCTS

Not to be confused with life insurance, investments made in the form of a "policy" (as defined through a licensed life insurance company) hold potential tax benefits for an individual.

While an individual policyholder enjoys exemption from CGT on the disposal of such qualifying investment policy, the life insurance company itself is liable for tax on its underlying investments. The difference, however, is that the life insurance company is taxed at flat income tax and CGT rates of 30% and 12%, respectively. This compares favourably to the maximum tax rates applicable to individuals of 45% for income tax and 18% for CGT.

Investments in such qualifying policies make sense for individuals who find themselves on the wrong end of 30% on the tax rate table.

WONDER 5: DIRECT INVESTMENT IN FOREIGN ASSETS

A natural person – or trust not carrying on a trade – who acquired and disposed of an asset in a foreign currency, is not liable for CGT on the part of a resultant capital gain due to the devaluation of the rand over the holding period.

Thankfully, many locally available assets serve as effective rand hedges, but investors do not enjoy the same CGT treatment. Capital gains realised on the disposal of assets acquired and sold in rands generally attract CGT in full, despite the fact that a substantial portion may stem from a depreciating rand.

So, if one is considering investing in a foreign company listed on the JSE, there is a CGT benefit in rather acquiring the shares in that company on a foreign exchange.

Furthermore, individuals paying tax at a marginal rate below 45% may also end up paying tax on foreign dividends below the local dividends tax rate of 20%. This would, however, depend on the foreign country's dividends tax level.

WONDER 6: PROPERTY INVESTMENT ALLOWANCES

Our tax legislation contains various tax allowances available for property used for specific purposes, or situated in designated areas, but the perception is that they are only reserved for companies with significant property investments.

In fact, a person owning five or more new and unused residential units situated in South Africa and used solely for the purpose of a trade qualifies for an annual 5% allowance on the cost of such units.

While not everyone can afford an investment of five new residential properties, five individual investors could instead collaborate to house five qualifying properties in a single company which then qualifies for the allowance.

Investors also tend to overlook the fact that properties used in a trade, especially smaller rental trades, often contain many separately identifiable unaffixed assets. Such assets could qualify for tax allowances in their own right. Allowances on assets of such a nature are generally permitted over relatively short periods of time.

WONDER 7: HOUSING ONE'S BUSINESS IN A COMPANY

If one is running a business as an individual in one's own name, one may be paying more tax than necessary. The top marginal income tax rate for individuals is 45%, while the collective income tax and dividends tax rate for a company and its shareholders is 41.6%.

In the latter case, the dividends tax part could also be deferred as dividends do not need to be legislatively declared at any specific stage. Such a deferral will then add to the effect of the Eighth Wonder.

In many cases an individual is able to move their business into a company without triggering tax implications at that stage by correctly applying tax rollover relief measures contained in our tax legislation.

Applying these seven wonders will greatly improve the ability of the "Eight Wonder". But one must remember that any financial or investment decision requires a careful consideration of various factors, and tax is only one of them – so always seek out comprehensive investment advice before making an investment decision.

Louis van Manen

BDO

Tags: taxable retirement income; collective investment schemes (CISs); real estate investment trusts (REITs); property investment allowances.

CFC RULES

Tax can be confusing and scary, and when one's smart advisors throw in terms like "controlled foreign company," it is easy to feel overwhelmed. This article aims to demystify some of the aspects of this hugely complex area of tax.

Firstly, many developed countries have some sort of controlled foreign company (CFC) regime, essentially trying to extend their tax nexus to include overseas subsidiaries, especially if they pay low tax, or do not seem to do very much. So CFC rules are just a type of anti-avoidance provision to extend the tax nexus beyond the country's boundaries; they focus on *foreign* companies which are *controlled* by residents in that country, hence the name. South Africa's CFC rules are complex.

SO WHAT IS A CFC?

Imagine one has a South African (SA) company making widgets and paying a lot of tax, and one's rich uncle suggests setting up a subsidiary in a tax-friendly jurisdiction which buys the widgets at a low price (so low profits in South Africa) and onsells them at a high price, thus transferring some of one's SA profits offshore to reduce one's overall tax bill. The CFC rules (and *transfer pricing*) say that if SA residents (companies or individuals) majority own or control a company outside South Africa, then South Africa wants to have a good look at that pie and try to eat a piece.

The CFC rules are designed to prevent SA companies from shifting profits offshore, and where they are in point, the rules result in the income earned by those foreign subsidiaries being taxed in the hands of the SA parent.

HOW DO CFC RULES WORK?

South Africa's CFC rules operate like a giant net to capture the income of foreign subsidiaries owned or controlled by SA companies or persons. Here is how they work:

1. Ownership and control: The first thing is that SA residents need to have at least 50% of the ownership or control (and the net is very wide, based on participating interest) over the foreign subsidiary. This can be achieved through shareholding, voting rights, or other means of control. The SA residents do not even need to be connected, so this is a very broad test. If a CFC exists based on this, anyone who owns more than 10% of the foreign entity is required to disclose this to SARS annually and perform a CFC tax calculation to determine whether any SA tax is due.

2. Passive income threshold: South Africa's tax authorities are generally more interested in passive income generated by the foreign subsidiary, in particular interest, royalties, annuities, exchange gains, dividends and rental. If the foreign subsidiary's passive income exceeds a certain threshold, it can get caught in the CFC net.
3. Inclusion of income: Once the foreign investment is deemed a controlled foreign company, subject to certain exemptions, its passive income is added to the SA investor's taxable income (assuming its operational income is supported by sufficient business substance, to enjoy the foreign business establishment exemption). This means that the SA resident (individual or company) will be required to pay taxes on that portion of the income as is applicable to the shares held as if it was earned in South Africa.
4. Exemptions and calculations: Thankfully, there are exemptions, in particular the foreign business establishment exemption (and painful exclusions to the exemptions) as well as calculations to prevent double taxation and avoid excessive taxation. For example, a good catch-all exemption is that if the foreign subsidiary is subject to an adequate level of taxation in its home country (although this requires a detailed calculation), it is generally exempt from SA CFC tax.

It is also important to remember that having a CFC requires annual SA compliance (the dreaded IT10 form), even if an exemption applies so that no SA tax is payable, so it is important to be aware of one's CFCs and any filing and tax obligations that may arise.

This is a plain language summary of South Africa's CFC rules. These rules are simply designed (but not designed simply) to ensure that SA companies do not move profits to low-tax jurisdictions, and also to protect the country's tax base.

This is the broad picture, but the actual rules and calculations required are pretty complex; contact experts in the field if advice is needed.

Caoilfhionn van der Walt

Regan van Rooy

Other documents
- IT10 form.

Tags: controlled foreign company (CFC); shifting profits offshore; passive income.

MEASURING GOOD CAUSE

Adhering to court processes, no matter how trivial the compliance procedure may be, has always been paramount to one's expression of respect to the court and the overall facilitation of smooth litigious proceedings. But the waters often get murky when an overstep of court procedure on the one side is countered by an argument of lack of merit on the other side.

While both sides present equally topical issues to the court's table, the question thus becomes whether a party's misstep in court procedure trumps the merits in their case. This question was faced in the Tax Court (the Court) in the case of *Taxpayer N v the Commissioner for the South African Revenue Service,* [2023]. In this case, the Court was faced with ascertaining whether the delay by the South African Revenue Service (SARS) in its submission of a Rule 31 statement was of good cause such that a default judgment order may be granted against the appellant.

The appellant is a private company and had submitted its routine payroll taxes for each of the one-month periods from April 2019 until February 2021. In completing the returns and paying these taxes, the appellant claimed the employment tax incentive allowances for these periods in terms of the Employment Tax Incentive Act, 2013 (ETI allowances). SARS subsequently issued the appellant with revised assessments in which it disallowed the ETI allowances claimed by the appellant.

The appellant disputed the revised assessments and objected to same on 27 September 2021. Its objection was disallowed on 12 October 2021. The appellant then appealed against the disputed assessment on 12 November 2021. Both parties elected not to refer the dispute to alternative dispute resolution proceedings in terms of rule 10(2)(e) and rule 13(2) of the Rules promulgated under section 103 of the Tax Administration Act, 2011 (the TAA). Thus, the respondent's Rule 31 statement detailing the grounds on which it disputed the assessment and opposed the appeal was due within 45 days from 12 November 2021; this would be by 15 February 2022. Following the expiry of these 45 days, the appellant delivered a notice in terms of rule 56(1)(a) to SARS. This notice afforded SARS with an additional 15 days from the date of notice to remedy its failure to file its Rule 31 statement.

"With respect, while one appreciates some of the issues raised in the judgment, the court's interpretation of the 'good cause' criterion raises the risk of watering down the utility of the default judgment procedure."

When the respondent failed to remedy its default, the appellant proceeded to file a notice in terms of rule 56(1)(a), in terms of which it sought an order –

1. for its appeal against the assessments in respect of its payroll taxes to be upheld in terms of rule 56(2)(a); and
2. to direct SARS to issue reduced assessments in respect of each of the assessments.

At this point, 133 business days had lapsed after 15 February 2022, being the date on which SARS' Rule 31 statement was initially due. While SARS did seek condonation from the court for its late filing, the appellant countered this request on the basis that the respondent had failed to demonstrate good cause for this default to be condoned.

FINDINGS

This led the court down a rabbit hole of understanding just what it takes for good cause to be effectively established, and in this case, whether same was established well enough for the court to grant the appellant default judgment. In this deep dive, the court considered varying positions taken by other courts on similar issues. It began by first considering what rule 56(2) provides, which is that in the absence of good cause demonstrated by the defaulting party for the default in issue, an order may be made under section 129(2) of the TAA. With reference to case law, the TAA and the Rules, the court took into account the reasoning behind the delay, the prospects of success of SARS' case and the overriding interests of justice in determining good cause in this matter and came to the following conclusion.

The Court found that the explanation for the delay in the delivery of the Rule 31 statement was not sufficient. SARS' legal representative too conceded that there was no adequate explanation for the delay in the delivery of the Rule 31 statement. When considering the prospects of success, the respondent was of the opinion that the appellant did not qualify for the ETI allowance for various reasons. Further to this, SARS requested the appellant in terms of rule 7(2)(b)(iii) to furnish documents to further substantiate its claim to the ETI allowance. However, the appellant did not deliver the requested documents. If SARS' grounds for assessment and opposing the appellant's appeal were to be upheld, it would demonstrate that the appellant fraudulently claimed allowances in terms of the ETI Act.

With the above in mind, the overall consideration was whether it would be in the interest of justice to condone the default. Considering the reason behind the delay, SARS' prospects of success and the overarching interests of justice, the court was of the view that SARS demonstrated good cause as to why the default judgment should not be granted in favour of the appellant. However, adhering to court processes is just as important and the court still wanted to demonstrate this fact. As such, due to the delay in the delivery of the Rule 31 statement, the court ordered costs against SARS on an attorney client scale.

With respect, while one appreciates some of the issues raised in the judgment, the court's interpretation of the "good cause" criterion raises the risk of watering down the utility of the default judgment procedure. However, one must keep in mind that Tax Court judgments are not binding, and that the court's finding was likely influenced by the facts, potentially including facts not referred to in the judgment.

Ester Ooko & Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills
- Tax Administration Act 28 of 2011: Sections 103 & 129(2);
- Employment Tax Incentive Act 26 of 2013.

Other documents
- Rule 31 statement;
- Rules promulgated under section 103 of the Tax Administration Act, 2011: Rules 7(2)(b)(iii), 10(2)(e), 13(2), 31 & 56(1)(a) & (2)(a).

Cases
- *Taxpayer N v the Commissioner for the South African Revenue Service* [2023] (Case No 2022/37).

Tags: employment tax incentive allowances; default judgment; Rule 31 statement.

TAXPAYER CONFIDENTIALITY

While public interest litigation is a common occurrence in South Africa, it seldom involves the area of tax law. However, pursuant to the Constitutional Court's judgment in Arena Holdings (Pty) Ltd t/a Financial Mail and Others v South African Revenue Service and Others, *[2023], handed down on 30 May 2023, this might become a more regular occurrence and something the taxpayer and tax advisory community may see more of in future.*

The judgment considered the constitutionality of blanket confidentiality of taxpayer information. More specifically, whether sections 35 and 46 of the Promotion of Access to Information Act, 2000 (PAIA), and sections 67 and 69 of the Tax Administration Act, 2011 (the TAA), are unconstitutional to the extent that they preclude access to tax records by a person other than the taxpayer, even in circumstances where the requirements of section 46*(a)* and *(b)* of PAIA, the *"public interest override"*, are met.

The High Court had decided that these provisions were unconstitutional and the Constitutional Court (CC) was then required to decide whether to confirm the High Court's finding on the unconstitutionality, or not. At the same time, the South African Revenue Service (SARS) and some of the other respondents appealed against parts of the High Court's order. Ultimately, in a narrowly split decision, five judges confirmed the High Court's finding on unconstitutionality, with the remaining four judges deciding that the High Court's decision should not be confirmed.

In this article, the majority decision is discussed. Given the importance and potential implications of the judgment, the minority judgment will be considered in future.

BACKGROUND

The High Court application was brought pursuant to the third applicant, Warren Thompson, applying to SARS in 2019, in terms of PAIA, to gain access to former President Jacob Zuma's tax records, based on allegations made by Jacques Pauw in his book titled *The President's Keepers* and subsequently by several other people. It was alleged that there was "credible evidence" that former President Zuma was not tax compliant. SARS refused the PAIA application on the basis that former President Zuma was entitled to confidentiality under sections 34(1) and 35(1) of PAIA, as well as section 69(1) of the TAA. The third applicant launched an internal appeal against SARS' refusal, which was also dismissed by SARS on the same grounds, resulting in the applicants launching the constitutional challenge in the High Court.

THE MAJORITY'S ASSESSMENT OF THE MINORITY JUDGMENT

The majority judgment, written by Kollapen J, indicated that the minority judgment's finding that the impugned provisions of PAIA and the TAA pass the limitation test in section 36 of the Constitution of the Republic of South Africa, 1996 (the Constitution), was based on the following substantive conclusions:

- The prohibition on disclosure of tax records is not absolute and this matter is thus distinguishable from the CC judgments in *Johncom Media Investments Ltd v M and Others,* [2009], and *Mail and Guardian Media Ltd and Others v Chipu NO and Others,* [2013].
- Taxpayer compliance is dependent on the assurance of confidentiality of taxpayer information, which is what the impugned provisions seek to do.
- The disclosure of taxpayer information may breach the confidentiality required by South Africa's international obligations arising out of bilateral and multilateral taxation agreements currently in force.
- Extending the "public interest override" to taxpayer information would impact public figures and ordinary citizens alike and unduly impact the privacy interests of ordinary citizens who may warrant a higher level of privacy.
- There are less restrictive means to achieve the purpose, and these include the various exceptions in the TAA as well as the right of an interested person to report a substantial contravention of the law to the investigative or prosecutorial authorities.

THE BALANCING OF RIGHTS

The majority judgment explained that when interests of privacy and individual self-determination stand in conflict with the collective public interest and the values of openness and transparency, the conflict must be approached through the lens of the Bill of Rights by balancing those rights and interests, as contemplated by the limitation test in section 36 of the Constitution. In this particular instance, the balance was between the right to privacy in respect of taxpayer records against the communal interest and the claimed right to access those records when they provide evidence of serious criminality or a risk to public health or safety.

It was noted by the majority that Chapter 4 of Part 2 of PAIA contains extensive provisions that provide for the mandatory protection of at least 11 categories of information from public disclosure, including:

- private personal information about individuals;
- trade secrets of private parties;
- military and security information that could cause prejudice to the country's defence and security or would reveal information supplied in confidence by another state or international organisation; and
- information containing confidential information or trade secrets of the state, the disclosure of which might jeopardise the country's economic interests or put public bodies at a disadvantage in contractual or other negotiations, and so forth.

However, although PAIA provides for mandatory or discretionary protection of these categories of information, section 46 provides for what has been termed a mandatory "public interest override" that obliges the disclosure of information that would otherwise have been the subject of protection. Section 46 states, in a nutshell, that the disclosure of these categories of information must take place if –

- the disclosure of the information would reveal evidence of a substantial contravention of, or failure to comply with the law, or an imminent and serious public safety or environmental risk; and
- the public interest in the disclosure of the record clearly outweighs the harm contemplated in the provision in question.

The majority judgment notes that a PAIA requester who seeks to successfully invoke the benefit of section 46 has "formidable substantive and procedural hurdles to overcome". Before being obliged to release the record requested, the information officer must be satisfied that the public interest in disclosure clearly outweighs the harm that the provision in question contemplates.

The effect of the "public interest override" is to continue to maintain a high level of confidentiality while providing a carefully crafted, limited, restrained and relatively onerous basis for the lifting of confidentiality in the public interest. In addition to this, the third party in respect of whom the information relates, must be informed and given the opportunity to make representations before any decision is taken by the information officer.

THE SECTION 35(1) INSULATION AND THE QUESTION OF ABSOLUTENESS

In this respect, the majority agreed with the conclusion of the minority that taxpayer records generally contain personal information submitted to the tax authorities as part of compliance with the tax obligations imposed by law. However, the majority indicated that the key question is whether such information should enjoy unqualified and absolute protection from public disclosure. As it stands, section 35(1) of PAIA is so wide and limitless that it extends protection to all information in the tax records held by the state, irrespective of its nature and regardless of whether those records or parts thereof justify a claim to protection. This is in contrast to the other 11 categories of information referred to above and means that taxpayer information is also immunised from the section 46 override that applies to all these other categories of information.

By way of example, although not at issue in this case, section 35 also protects the income tax information of companies from disclosure, including public companies and listed companies, even though certain information of listed companies would ordinarily be in the public domain. Furthermore, section 35 applies to all tax statutes, including the Income Tax Act, 1962, the Value-Added Tax Act, 1991, and other tax statutes regarding the payment of mineral royalties, securities transfer tax, customs and excise, estate duty and transfer duty.

THE TAA AND ITS EXCEPTIONS

The prohibition on disclosure found in section 35(1) of PAIA is reinforced by sections 69(1), 67(3) and 67(4) of the TAA. However, the majority noted that the prohibitions contained in the TAA primarily relate to the administration of the tax system and the work of the organs of state and are not prohibitions on any general right of access to information.

Section 69(2) of the TAA states that a SARS official may disclose confidential information to a person other than another SARS official if it relates to disclosure to a court in respect of proceedings relating to the TAA or the South African Police Service and the National Director of Public Prosecutions for the purpose of proving a tax offence. The exception in section 70 of the TAA relates to the disclosure of information to organs of state for particular purposes, including the South African Reserve Bank, the Financial Sector Conduct Authority and the National Credit Regulator. The majority judgment indicated that whereas the minority found that these exceptions in the TAA mean that the prohibition is not absolute, it disagreed with this finding as it was tantamount to importing the TAA exceptions into PAIA to support the conclusion that the section 35(1) prohibition in PAIA is not absolute. According to the majority judgment, the exceptions in the TAA are not a partial allowance of the constitutional right that the public has of access to information held by the state and do not afford any public right of access to information. These exceptions would exist regardless of whether one has section 32 of the Constitution, containing the right of access to information, and PAIA. As these exceptions do not advance the rights of access to information and freedom of expression, they cannot be seen as exceptions to the prohibition on the right of access to information.

Assessing the judgments in *Chipu* and *Johncom*, the majority firstly noted that in *Johncom*, the CC found that the absolute prohibition on publication of any particulars of a divorce action or any information that came to light during such an action, was unconstitutional. This was based on the view in that case that, amongst other things, there were less restrictive means available to achieve the purpose of the limitation. The majority then considered the CC's judgment in *Chipu.* Here, it was held that the absolute prohibition applicable to the confidentiality of asylum applications and information contained therein, was also unconstitutional and that a less restrictive way of achieving the limitation could be achieved by giving the Refugee Appeal Board the discretion to allow the media to attend its proceedings and impose conditions on the reporting of those proceedings. Pursuant to this, the majority concluded that one must be careful not to elevate taxpayer confidentiality to some sacrosanct place where no exception to enable public access to it is possible, which in the majority's view is the effect of section 35 of PAIA, as a taxpayer is not at all subject to the "*public interest*" override. In addition, the majority disagreed with the minority's finding that this matter is distinguishable from *Johncom* and *Chipu.* It held that both cases dealt with vulnerable categories of people, that taxpayers cannot form a special category of persons that are entitled to an absolute level of protection from the disclosure of information that may reveal serious criminality and that both divorce proceedings and asylum proceedings were considered to be proceedings of a sensitive nature requiring privacy.

THE PURPOSE OF THE LIMITATION

The majority agreed with the minority that there is a need for an efficient tax administration system in a functioning democracy. Taxpayers who comply with their tax obligations are essential for a healthy fiscus and are entitled to a measure of confidentiality in the tax information they submit. However, the majority disagreed with the minority that this is a legitimate purpose for limiting the right of access to such information. Considering the exceptions in the TAA, the majority judgment expressed the view that the confidentiality provided for in the TAA is relative confidentiality, even without the section 46 override in PAIA, meaning that SARS' argument for absolute confidentiality to advance the purpose of taxpayer compliance loses traction. With reference to an expert report written by Prof Jennifer Roeleveld, the majority held that there was no evidence to support the conclusion that absolute confidentiality is a precondition for taxpayer compliance. It seems to agree with the report's description of the conceptual approach to the question of taxpayer confidentiality, that it is characterised by the underpinnings of transparency and confidentiality, and that there should be a legitimate balance.

The majority thus stated that the idea of absolute provisions, either in terms of openness or in terms of confidentiality, is not the uniform standard in terms of South Africa's jurisprudence or internationally. It notes that the applicants did not seek absolute transparency but merely that the public interest override also applies to taxpayer information, which in the court's view is consistent with the conceptual framework that Roeleveld used to preface her report. It thus concluded that there is no basis in principle or in terms of any evidence that absolute confidentiality is required to achieve taxpayer compliance and rejected the language used by SARS of a "compact" between SARS and taxpayers regarding confidentiality. Furthermore, the majority rejected SARS' reliance on a Kenyan tribunal's decision that protected taxpayer secrecy, as it was overturned by the Kenyan Court of Appeal, that held that disclosure of certain taxpayer information in certain contexts should be allowed, as the Kenyan Constitution attempts to "fashion an open and free country where governance is democratic and accountable to the *'wananchi',* the citizenry". It also held that comparing the South African dispensation to those of the UK and Canada, which have absolute prohibitions, and those of Sweden and Slovenia, which provide for disclosure, is not relevant. The question is whether section 35(1) of PAIA is consistent with South Africa's constitutional framework.

Regarding the risk of disclosure of personal taxpayer information, the majority held that considering the contents of the override provision in section 46 of PAIA, this would not be an issue. Furthermore, any risk of disclosure could also be effectively managed by the severability provisions in section 28 of PAIA, which provide for the severing or redacting of a record to overcome any risk posed by over-disclosure. Furthermore, the majority disagreed with the minority's finding that there would be a risk in high-profile public figures and ordinary citizens being equally exposed to the risk of the disclosure of personal information, as the override is not directed at a category of individuals but rather information that is in the public interest.

THE EFFECT OF APPLYING THE SECTION 46 OVERRIDE AND CONCLUSION

Viewed in its entirety, the majority held that the effect of applying the override would be:

- Confidentiality would continue to be the default position.
- The override would only apply in limited and closely defined circumstances, with a relatively high bar to lift confidentiality.
- Section 28 of PAIA could be invoked to deal with severability and ensure that the parameters of what is disclosed are properly managed.
- The third-party notice procedure would enable the taxpayer to make representations and be heard before a decision on disclosure is taken.
- An aggrieved party would have recourse to internal appeal mechanisms and the courts if necessary.

As such, the majority concluded that the limitation in section 35(1) of PAIA is unconstitutional and therefore, that section 46 of PAIA and sections 67(4) and 69(2) of the TAA are unconstitutional to the extent found by the High Court. The order of constitutional invalidity of the High Court was thus confirmed.

REMEDY

The majority decided that the finding of unconstitutionality should be suspended for 24 months, to allow Parliament to address the constitutional invalidity that was found to exist. Pending these measures, it read in certain words and provisions into section 46 of PAIA and sections 69(2) and 67(4) of the TAA, so that the public interest override applies to requests for taxpayer information.

In addition, the majority agreed with the submissions by the parties that the request under PAIA for former President Zuma's tax returns be referred back to SARS for consideration afresh in light of the CC's order.

COMMENT

The importance and significance of the judgment is apparent from the fact that on the same day the judgment was delivered, SARS issued a media statement stating, amongst other things, that it is considering the application of the judgment in full. Its media statement notes that the judgment does not set aside the tax confidentiality provisions in the TAA and sets a high threshold to meet when access is requested to a taxpayer's tax records.

Although the minority judgment and the other potential implications of the CC's judgment may well be discussed in future, it is important to appreciate that, despite the 5–4 split, the finding of the majority applies and that the landscape on taxpayer confidentiality has most certainly changed.

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962;
- Promotion of Access to Information Act 2 of 2000: Section 28; Chapter 4 of Part 2 (sections 33 to 46) (more specifically sections 34(1), 35(1) & 46*(a)* & *(b)*);
- Tax Administration Act 28 of 2011: Sections 67 (emphasis on subsections (3) & (4)), 69 (emphasis on subsections (1) & (2)) & 70;
- Value-Added Tax Act 89 of 1991;
- Constitution of the Republic of South Africa, 1996: Bill of Rights (emphasis on sections 32 & 36).

Other documents

- *The President's Keepers* (Jacques Pauw).

Cases

- *Arena Holdings (Pty) Ltd t/a Financial Mail and Others v South African Revenue Service and Others* [2023] ZACC 13, handed down on 30 May 2023;
- *Johncom Media Investments Ltd v M and Others* [2009] (4) SA 7 (CC);
- *Mail and Guardian Media Ltd and Others v Chipu NO and Others* [2013] (6) SA 367 (CC).

Tags: prohibition on disclosure of tax records; public interest override; administration of the tax system; disclosure of personal taxpayer information; tax confidentiality provisions.

BENEFICIAL OWNERSHIP REPORTING

Trustees are now faced with reporting obligations regarding the "beneficial ownership" of trusts to both the Master of the High Court's Office and to the South African Revenue Service (SARS). SARS has released additional requirements for reporting on the 2023 annual trust tax returns. These new requirements aim to enhance transparency and compliance within the trust sector. This article provides an overview of the additional information now required to complete the tax return and highlights important submission due dates.

ADDITIONAL INFORMATION REQUIRED FOR TRUST TAX RETURNS

Trustees are now required to provide the following information as part of the annual trust tax return:

- ***Beneficial ownership:*** Trustees must disclose the details of beneficial owners of the trust, providing greater transparency regarding the individuals who ultimately benefit from the trust's assets and income.
- ***Annual financial statements:*** Trustees must include the trust's annual financial statements as supporting documents, providing a comprehensive overview of the trust's financial position and activities during the tax year as well as the distributions made to beneficiaries of the trust.
- ***Trust deed:*** A copy of the trust deed, which outlines the legal framework and provisions governing the trust, must be submitted to SARS.
- ***Letters of authority:*** Trustees need to provide letters of authority that confirms their appointment as trustees and their authority to act on behalf of the trust.
- ***Minutes of meetings and resolutions:*** Trustees must include minutes of meetings and resolutions that document significant decisions and actions taken by the trustees on behalf of the trust.
- ***Details of the "main" trustee:*** Trustees are required to provide details of the "main" trustee who will act as the registered representative to SARS. This trustee will be responsible for communication and correspondence with SARS on behalf of the trust.
- ***Confirmation of banking details:*** Trustees need to confirm the trust's banking details, ensuring that accurate and up-to-date information is provided to SARS.

SUBMISSION DUE DATES

The submission due dates for trust tax returns are as follows:

Non-provisional taxpayer: Trusts that have no taxable income or engage in non-trade activities, or have distributed all income to beneficiaries, qualify as non-provisional taxpayers. The deadline for non-provisional taxpayer submissions is 23 October 2023.

Provisional taxpayer: Trusts subject to normal tax on their taxable income fall under the category of provisional taxpayers. Provisional taxpayer submissions must be made by 24 January 2024.

ALIGNMENT WITH MASTER'S OFFICE REPORTING

SARS has indicated that it will reconcile the demographic information provided in trust tax returns with the information reported to the Master's Office. This alignment aims to identify any discrepancies and ensure consistency in reporting across institutions.

THIRD-PARTY RETURNS:

SARS has also introduced legislation requiring trustees to submit third-party returns. These IT3(t) certificates must contain demographic and financial information consistent with what is reported to the Master's Office and/or included in the annual financial statements. Trustees are required to submit these certificates by the end of May following the February tax year-end.

SIMPLIFYING REPORTING AND STATUTORY OBLIGATIONS:

Given the complex and evolving reporting and statutory obligations faced by trustees, it is important to seek professional assistance to ensure adherence to all regulatory requirements.

"Trustees must include the trust's annual financial statements as supporting documents, providing a comprehensive overview of the trust's financial position and activities during the tax year as well as the distributions made to beneficiaries of the trust."

Doné Howell

BDO

Tags: beneficial ownership; trust tax return; third-party returns.

WHEN ARE TRUSTS TREATED AS PROVISIONAL TAXPAYERS?

A NATURE OF THE PROBLEM

It is widely accepted that trusts must file annual income tax returns as registered taxpayers – but what about provisional tax returns? Many trustees believe that provisional tax returns are not required for trusts as long as all trust taxable amounts are attributed to parties outside the trust. Others believe that provisional trust tax returns are required in all circumstances (ie, even if all taxable amounts are attributed to trust funders and / or to trust beneficiaries).

As an initial matter, there are three potential sets of provisional taxpayers under the Fourth Schedule to the Income Tax Act, 1962 (the Act): (1) companies, (2) persons other than companies who derive specified types of income, and (3) persons that become provisional taxpayers by way of SARS notification. Under the strict terms of the "provisional taxpayer" definition in paragraph 1 of the Fourth Schedule, a trust potentially falls into the second category (ie, persons other than companies), but only if that trust is a person –

"A trust with any amount of income falling outside of both sections 25B and 7 should be viewed as deriving its own income, thereby requiring the submission of provisional tax returns."

who derives income by way of –

(i) any remuneration from an employer that is not registered in terms of paragraph 15; or
(ii) any amount which does not constitute remuneration or an allowance or advance contemplated in section 8(1).

Given that many trusts (especially family trusts) are almost entirely dedicated to investments, trusts seemingly fall within this category (because the amounts generated do not typically constitute remuneration, an allowance or an advance). The central questions are whether a trust can "derive" income and / or whether the circumstances exist for that income to be so derived.

Unlike a company, attribution of income arising in a trust is greatly dependent upon the stakeholders involved. Under section 25B of the Act, income received or accrued to a trust can be attributed to trust beneficiaries to the extent the income amount vests in a beneficiary by way of formal resolution via trust deed, will or other agreement (regardless of whether the amount simply vests while remaining in trust or actually distributed). Income received or accrued to a trust can also be attributed back to the funder under section 7 of the Act for tax purposes.

A trust with any amount of income falling outside of both sections 25B and 7 should be viewed as deriving its own income, thereby requiring the submission of provisional tax returns. However, what happens if trust amounts are fully vested in beneficiaries (and / or attributed back to the funder)? Are these income amounts attributed outside the trust still derived by the trust? This question is more than just a theoretical consideration. Most trustees (and / or their professional accountants acting on their behalf) vest all sums to beneficiaries to avoid any residual trust taxable income (thereby avoiding high marginal trust tax rates).

The core of the problem lies in the potential meaning and usage of the term "derive" as opposed to the terms "received or accrued". The Act is quite clear that trust amounts vested in beneficiaries under section 25B or attributed to funders under section 7 are deemed "received" or "accrued" outside the trust. The query is whether sections 25B or 7 result in derived amounts being similarly attributed outside of the trust?

Unlike the terms "received" or "accrued", the term "derive" is not used frequently or consistently within the Act. In terms of the provisional taxpayer definition under the Fourth Schedule, the term "derive" is used as an active verb in connection with a subjective noun. More specifically, under paragraph *(a)* of the definition, a provisional taxpayer is "any person (other than a company) who derives income . . . ." Under the exclusion of paragraph *(dd)*, a "natural person who does not derive any income from the carrying on of any business . . . ." is excluded from being a provisional taxpayer.

As will be discussed further below, the term "derive" is used differently elsewhere. In section 25B(1) and 25B(2), the term "derive" is used in tandem with "for the benefit of". In other parts of section 25B and section 7, the term "derived" is used more passively with "capital", "taxable income" or "income" that is "derived" from an amount without focusing on the party deriving that income. As a side matter, the term "derive" means either "to get something from something" or "to obtain a substance from something" according to the *Oxford English Dictionary.*

B TRUST ATTRIBUTION TO BENEFICIARIES

In terms of trust beneficiaries, the term "derived" is used under the trust rules of section 25B(1) in a precise manner that is distinct from a "receipt or accrual". In particular, the central portion of section 25B(1) states:

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

Hence, trust amounts are first "derived" in the hands of the beneficiary if "for the immediate or future benefit of any ascertained beneficiary who has a vested right". The residue is then derived for the benefit of the trust. Income so derived is "accrued" in the same manner. Looking at the mechanics of vesting, however, a timing problem could exist because the vesting of trust amounts to beneficiaries typically happens only at the end of the taxable year (ie, the end of February). This late vesting could mean that amounts are first derived for the trust until the year-end resolution. This latter outcome would indicate that trusts would be a provisional taxpayer even if all funds were ultimately vested in trust beneficiaries because the amount would initially be "derived" by the trust regardless.

Fortunately for taxpayers, section 25B(2) appears to come to the rescue. Section 25B(2) specifically deems vested beneficiary amounts as being "derived" by the trust regardless.

Fortunately for taxpayers, section 25B(2) appears to come to the rescue. Section 25B(2) specifically deems vested beneficiary amounts as being "derived for the benefit of that beneficiary". In particular:

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

Given this deeming override, trust amounts allocated to vested beneficiaries are deemed derived by the beneficiaries as opposed to the trust. The net effect would accordingly eliminate trusts as provisional taxpayers if all amounts are vested to beneficiaries before the tax year-end (assuming no section 7 attribution to one or more funders exists as discussed below).

A possible counterargument could be made based on the timing for mid-year provisional calculations. Under this approach, a taxpayer would be viewed as a provisional taxpayer until year-end when vesting will deem the amounts to be derived by beneficiaries. This mid-year outlook, however, makes little practical sense given that paragraph 19(1) of the Fourth Schedule requires a provisional estimate to be based on "the total taxable income which will be derived by the taxpayer in respect of the year of assessment".

C TRUST ALLOCATIONS TO FUNDERS

This non-provisional treatment does not seemingly apply as easily if trust income is attributed back to the funder under section 7. Section 7(5) and (6) are of greatest relevance in this regard. Section 7(5) attributes amounts back to the funder if a donation or discounted transfer (eg, a low-interest loan) is made to a discretionary trust. Section 7(6) attributes amounts back to the funder if a donation or discounted transfer is made to a revocable trust.

In both cases, the income of the trust "is deemed to be income" of the funder. Section 7 does not appear to attribute the location of amounts "derived". Like section 25B, the term "derived" is used distinctly from "income" received or accrued (see subsections (2A) and (2C) of section 7). While section 7 overrides section 25B (ie, section 25B is "subject to the provisions of section 7"), this override only directly addresses the attribution of income and is silent as to the location of amounts derived.

One could argue that section 7 attribution of income automatically includes a change in location for amounts "derived". Yet, given the lack of express language in this regard (like the precise language of section 25B(2)), such an argument would be hard-pressed linguistically.

D CONCLUSION

At the end of the day, determining whether a trust qualifies as a provisional taxpayer depends on whether and where the income is to be vested or attributed. If all trust amounts are fully vested in the hands of beneficiaries, provisional tax status is not of concern.

However, provisional tax status can be presumed if any income remains in the trust or is attributed back to the funder under section 7. This reservation for section 7 is of no small concern given the common application of section 7 when parties fund trusts with non-interest-bearing loans. Trustees in these circumstances should probably submit provisional tax returns as a matter of precaution.

In terms of general tax administration, forcing trusts to submit provisional tax returns with nil amounts makes no sense (ie, simply because section 7 literally attributes "income" as opposed to amounts "derived"). Nil provisional tax returns are of little or no value to the South African Revenue Service. The law under the Fourth Schedule should accordingly be changed to remove this anomaly. If concerns exist about section 7 reporting, third-party reporting such as an IT3(t), similar to that for beneficiaries, would seemingly be more appropriate.

[*Editorial comment*: So as to avoid any possibility of penalties, some are suggesting that all trusts earning income should file nil provisional tax returns despite that fact that all the income is awarded to beneficiaries or attributed back to the funder. Nevertheless, again to avoid the risk of penalties, should SARS dispute that the trust is a provisional taxpayer, the tax return should be submitted by the deadline as if the trust is not a provisional taxpayer and not left until the January deadline applicable to provisional taxpayers.]

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 7 (more specifically subsections (2A), (2B), (5) & (6)), 25B (with emphasis on subsections (1) & (2)); Schedule 4: Paragraphs 1 (definition of "provisional taxpayer" (more specifically paragraphs *(a)* and *(dd)*) & 19(1).

Other documents

- *Oxford English Dictionary* (definition of "derive");
- IT3(t) form.

Tags: provisional trust tax returns; trust funders; trust beneficiaries; marginal trust tax rates; third-party reporting.

SETTLEMENT AGREEMENTS

It is common for contracting parties to enter into a settlement agreement to settle a contractual dispute. This is often the preferred route where parties want to settle a dispute expeditiously and eschew the financial and time implications of taking a matter to court. Typically, a settlement agreement would involve one party (Party A) paying another party (Party B) in full and final settlement of the dispute. A feature of settlement agreements (to ensure that the dispute is "over"), includes a clause that states that Party B, in return for the payment made by Party A, would release Party A from any and all claims Party B has against Party A.

It follows that the enquiry to determine whether VAT must be levied on a settlement amount received, is whether or not the payment of that amount is made for a supply of goods or services.

Where both parties are VAT registered, the VAT consequences of the settlement agreement must be evaluated prior to the parties ratifying such agreement. This begs the question as to whether the payment made by Party A to Party B in order to settle the dispute, comprises "consideration" for a supply made by Party B. If the answer is in the affirmative, then VAT must be accounted for. However, in many cases, the parties fail to take into account the VAT consequences of the settlement amount paid. In other words, the settlement agreement is silent on the issue of VAT. Where the settlement agreement does not stipulate whether the settlement amount is inclusive or exclusive of VAT, the settlement amount is deemed to be inclusive of VAT at the standard rate of 15%, in terms of section 64(1) of the Value-Added Tax Act, 1991 (the VAT Act).

It follows that the enquiry to determine whether VAT must be levied on a settlement amount received, is whether or not the payment of that amount is made for a supply of goods or services. This involves an interpretative exercise based on the VAT legislation and the surrounding facts and circumstances (which is often encapsulated in the settlement agreement itself). As a general matter, amounts received as compensation for losses or damages suffered are not consideration for any services supplied – these payments fall outside the VAT net. This article does not focus on these types of payments made in terms of a settlement agreement.

IS THERE A SUPPLY?

In line with the charging section 7(1)*(a)* of the VAT Act, there needs to be a "supply" of something (ie, goods or services) in order for the said section to be triggered. Since the South African VAT legislation was modelled on the New Zealand Goods and Services Tax Act, 1985 (the GST Act), the principles laid down by the New Zealand courts have had persuasive value in South African courts. South Africa's Supreme Court of Appeal (SCA), in handing down VAT judgments, has also utilised some of the principles handed down by the New Zealand courts in this regard.

The New Zealand courts have recognised the following important principles:

- "....Although services are defined as meaning anything which is not goods, it is still necessary for there to have been a supply of something."
- "It is fundamental to the GST Act that the tax is levied on or in respect of supplies. It is not a tax on receipts or turnover; it is a tax on transactions ...."

The term "supply" is widely defined in section 1(1) of the VAT Act to include "...performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law,... and any derivative of 'supply' shall be construed accordingly". The term "supply" has been interpreted by the New Zealand High Court as meaning "to furnish with or provide".

Based on the foregoing and in consideration of a typical settlement agreement, in return for the payment of the settlement amount, Party B would surrender its right to pursue legal action against Party A. Could it be said that the surrender of a right to pursue legal action is the "supply" of services (assuming there is nothing corporeal or tangible that may connote a supply of goods)? Notwithstanding, the fact that the definition of "services" in section 1(1) of the VAT Act is of wide import and includes "...cession or surrender of any right..", as a starting point, there must be a supply.

Interestingly, the New Zealand Revenue Authority published its interpretation statement regarding the GST treatment of settlement agreements. Where a typical settlement agreement between A and B includes a clause to the effect that B would forebear to sue in the future, such a clause may suggest a supply from a GST perspective. However, for a supply to be taxable, it must first be made in the course or furtherance of a taxable activity. The interpretation interrogates whether there is a "supply" in the form of services from B to A in return for the payment from A as "consideration? In terms of the definition of "services" (ie,"... anything done or to be done including the granting, assignment or surrender of any right or the making available of any facility or benefit but excludes supply of goods or money"), an act of giving up a person's right including a promise not to pursue a legal claim against another person, ie, forbearance to sue, is "services".

"In *Commissioner of Inland Revenue v New Zealand Refining Co Ltd* [1997] NZTC 13,187 Court of Appeal CA 239/95, it was held that despite the wide definition of consideration, 'there was a practical necessity for a sufficient connection between the payment and the supply.'"

A forbearance to sue must furthermore be given in return for a consideration; in other words, there needs to be a nexus/ connection between the supply and consideration – this requirement has also been confirmed by the South African Revenue Service (SARS), who recognised that although the definition of "consideration" is very wide and includes any payment which is in respect of, in response to, or for the inducement of, the supply of any goods or services, there must be a sufficient nexus between the supply and the payment for the supply to constitute consideration.

In *Commissioner of Inland Revenue v New Zealand Refining Co Ltd* [1997] NZTC 13,187 Court of Appeal CA 239/95, it was held that despite the wide definition of consideration, "there was a practical necessity for a sufficient connection between the payment and the supply". That case concerned a series of payments made by the New Zealand Government to the New Zealand Refining Company, pursuant to an agreement to release the government from an earlier undertaking. The issue that arose was whether those payments were consideration for any supply made by the refinery company. In order to receive the payments, the refinery had to be operational on the date of payment, failing which the only recourse was to withhold payment.

The Court of Appeal noted there was an expectation among the parties that the refinery would continue to operate, but that there was no contractual obligation to that effect. The government's only recourse in the event that the refinery ceased to be operational was to stop making payments. Although the payments were intended as an inducement to keep the refinery open, they were not linked to any identifiable supply. It was held that there were no obligations between the parties as if the refining company failed to meet the conditions for payment, the only recourse to the Crown was to withhold payment. The lack of any element of reciprocity between New Zealand Refining and either the Crown or third parties meant that the payments were received in the course of New Zealand Refining's taxable activity but were not payments made in consideration for any supply by New Zealand Refining.

The New Zealand Revenue Authority is of the view that where the agreement not to sue is merely a mechanism in order for A to ensure finality in the dispute, and does not have a separately attributable sum ascribed to it, there is no supply for VAT purposes. If there is a separate and ascribable value attached to the forbearance to sue, GST would be chargeable.

SOUTH AFRICAN CONTEXT

Based on the *dictum* of the SCA, it is noted that the interpretation of statutory provisions (eg, the definition of "supply"; "services"; "consideration", etc) in New Zealand can be applied to the South African provisions, as these definitions are similar and have the same functional equivalent as the definitions in South African VAT legislation.

In summary, in order to determine the VAT implications of a payment made in terms of a settlement agreement, one has to unpack the following:

1. Is there a supply made by the payee (ie, supplier) to the payor (ie, recipient)?
2. Is the payment received in respect of, in response to, or for the inducement of that supply?
3. Is the supply made in the course or furtherance of the enterprise of the supplier?
4. What is being supplied?

It is manifest that the above analysis would depend on the nature of the settlement agreement and the applicable VAT provisions – the starting point, as enumerated, would be to enquire: is there an underlying supply that is linked to this payment? Failure to apply one's mind to the settlement agreement, may result in a loss being realised in the hands of the payee as the payor may request a tax invoice from the payee in order to claim an input tax deduction on the payment made. This is normally the stage when the parties scramble to determine the VAT implications of a settlement amount made; this often results in further costs being incurred and is counterintuitive as this also prolongs the settlement process. Another consideration is that the payee must properly analyse the VAT implications of a settlement agreement owing to the fact that it has to discharge its onus of proving that such amount is not subject to VAT (if that is indeed the case), when SARS enquires as to the VAT implications of the settlement payment received – failure to do so will, most likely, result in the imposition of penalties by SARS.

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ENS

Acts and Bills
- Value-Added Tax Act 89 of 1991: Sections 1(1) (definitions of "consideration", "services" & "supply"), 7(1)*(a)* & 64(1);
- New Zealand Goods and Services Tax Act of 1985 (No 141).

Cases
- *Commissioner of Inland Revenue v New Zealand Refining Co Ltd* [1997] NZTC 13,187 Court of Appeal CA 239/95.

Tags: settlement agreement; compensation for losses or damages; consideration.

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