Issue 48 | 2022
JULY

Unstructured CPD 150mins

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

CRYPTO ASSETS
PROPOSED GOVERNMENT SAFEGUARDS

GENERAL
FURTHER INTEREST RATE INCREASES

TAX ADMINISTRATION
TAX ON ANNUITY INCOME

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Editorial panel:
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DIVIDENDS RECHARACTERISED AS INCOME

On 18 February 2022, the South African Revenue Service (SARS) issued a draft interpretation note ("Effect on the date of issue of a share arising from a change in the redemption features") dealing with the circumstances where dividends in respect of preference shares are recharacterised as income in terms of section 8E of the Income Tax Act, 1962. Section 8E is an anti-avoidance provision that targets shares that have substantial debt features. Should the section be applicable, the dividend is deemed to be an amount of income that is accrued by the holder of the preference shares (as defined in subsection (1)) and not exempt from income tax. The issuer of the preference shares can equally not deduct the amount concerned even though it is recharacterised as income in the hands of the holder of the preference shares.

One of the key features of section 8E is that a preference share will be deemed to be a hybrid equity instrument to the extent that the issuer of the preference share is obliged to redeem the preference share within three years from the date of issue.

"It is not that clear what the position would be where the issuer of the preference shares defaults and an early redemption date arises in circumstances where this early redemption date still falls outside the initial three-year period."

The date of issue (as defined in subsection (1)) of a share is not only confined to the actual date upon which the share is issued by the company, but it includes the date on which –

- the company that issued the share undertakes the obligation to redeem the share in whole or in part; or
- the holder of the share, at any time after the share has been issued, obtains the right to require that that share be redeemed in whole or in part, other than as a result of its acquisition by the holder thereof.

The effect of this definition is that a date of issue can also arise where, subsequently, there is an undertaking by the issuer of the preference share to redeem the preference share within a period of three years.

Apart from the fact that SARS has indicated that additions or changes to the redemption features of a share will not automatically result in it becoming a hybrid equity instrument, a general approach has also been taken that any redemption after the expiry of a period of three years from the original date of issue of a preference share will not result in the share becoming a hybrid equity instrument.

To the extent that the original redemption date of a preference share falls outside the three-year period, it is indicated in the draft interpretation note that no new date of issue will arise where the redemption date is extended. This is irrespective of the fact that the extended redemption date may fall within a three-year period after the date upon which it was decided to extend the original redemption date. The only instance where one would be dealing with a restricted equity instrument is if the original redemption date is amended to fall within the original three-year period from the date that the preference share was originally issued. It appears that one would also not deal with a recharacterisation where there is an extension of the original redemption date even before the original three-year period has expired.

The test seems to be that, to the extent that the preference shares are redeemed after expiry of a period of three years from their original date of issue, one would not be dealing with a hybrid equity instrument and the dividends would not be recharacterised.

"One of the key features of section 8E is that a preference share will be deemed to be a hybrid equity instrument to the extent that the issuer of the preference share is obliged to redeem the preference share within three years from the date of issue."

It is not that clear what the position would be where the issuer of the preference shares defaults and an early redemption date arises in circumstances where this early redemption date still falls outside the initial three-year period. For instance, the preference shares could have been issued for an original period of five years and the default arises in year four. In these circumstances it appears that there will still not be a new date of issue, given the fact that the preference shares have already been held for a period of three years.

SARS' views are welcomed as they bring clarity to a much-debated topic. One of the arguments was always that, to the extent that the redemption date is amended, it brings about a new date of issue given the fact that the original date of issue has changed. In other words, there is a new right that arises, given the fact that the new right relates to a different redemption date as opposed to the original stipulated redemption date. This argument was based on the fact that the date of issue refers to the undertaking of the issuer to redeem the preference share and any extension will result in a new undertaking on the part of the issuer to redeem the preference share.

Emil Brincker

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 8E (including definitions of "date of issue", "hybrid equity instrument" & "preference shares" in subsection (1)).

Other documents

- Draft interpretation note ("Effect on the date of issue of a share arising from a change in the redemption features"): Issued by SARS on 18 February 2022 in terms of section 8E of the Income Tax Act 58 of 1962.

Tags: preference shares; hybrid equity instrument; date of issue; redemption date.

PROPOSED GOVERNMENT SAFEGUARDS

Crypto assets have been gaining momentum in South Africa and the South African government has made it clear, in the 2022 Budget Speech, that it is taking these developments very seriously.

In the Budget Review 2022, the government laid its cards on the table by proposing that regulatory bodies need to be established to safeguard the crypto owner. Government has taken note of the interventions proposed by the Intergovernmental Fintech Working Group (IFWG) which stipulate the following (see Budget Review 2022: Annexure F, page 166):

- "Including crypto asset service providers as accountable institutions within the Financial Intelligence Centre Act (2001). This change would address concerns around money laundering and terror risk financing through crypto assets and align the act to the standards set by the FATF [Financial Action Task Force, a global money laundering and terrorist financing watchdog] for virtual assets and related service providers. The proposed amendments to the Act were published in June 2020 for public consultation and are expected to be finalised in 2022."

- "Protecting consumers by considering the declaration of crypto assets as a financial product under the Financial Advisory and Intermediary Services Act (2002). According to this declaration, any person providing advice or intermediary services related to crypto assets must be recognised as a financial services provider under the Act and must comply with the Act's requirements. This will include crypto asset exchanges and platforms, as well as advisors and brokers. This work is expected to be finalised during 2022."

- "Enhancing monitoring and reporting of crypto asset transactions to comply with the Exchange Control Regulations of 1961. The process to include crypto assets in the regulations is underway."

WHAT DO THESE INTERVENTIONS MEAN FOR SOUTH AFRICAN CRYPTO ASSET OWNERS?

The first and second interventions explain the need for a regulatory body to regulate crypto assets in South Africa. These interventions are aimed at companies and individuals who "trade" on the market with clients' crypto assets and then later disappear with the money. Companies and individuals will be required to register with the Financial Sector Conduct Authority (FSCA) and adhere to their requirements.

In intervention 3 it is stated that government wants to intensify its monitoring of crypto asset owners that use South African exchanges to send crypto assets to an international exchange like *Binance*, etc. This practice is currently used for two reasons –

(1) The South African exchanges do not offer all the crypto asset trading pairs that international exchanges like *Binance* offer.

(2) Crypto asset owners partake in arbitrage trading. Arbitrage trading is when traders buy crypto assets internationally, where they are normally cheaper, and then send them to their South African exchange, where they are sold in South Africa for a higher premium. South African prices are generally more expensive than international prices.

Crypto asset owners currently have a R1 million discretionary allowance per financial year which allows them to send money/ crypto assets overseas without needing approval from the South African Reserve Bank (the SARB). This ruling is aimed at individuals sending more than R1 million and not obtaining the necessary approval from the SARB.

WHY REGULATION IS NECESSARY

Crypto asset owners should see these proposed interventions as a proactive approach from government to protect both the consumer and the South African fiscus. South Africa has seen an increase in crypto asset theft and the need for regulation has been high on the radar of the government. This follows high-profile cases where company founders allegedly stole billions of rands in crypto assets from South African crypto owners.

PROTECTING CRYPTO ASSETS

With crypto assets being volatile and regulation not being formally imposed yet, it is important that the crypto asset owner is equipped with the correct information to protect their assets from theft.

According to Tax Consulting South Africa, crypto assets need to be treated with the same security measures as a personal bank account. Just as a bank account has a security PIN that needs to always be kept private, a crypto asset account has an encryption key, and most crypto asset platforms offer Application Programme Interface key (API key). These API keys should be kept private as well.

“Clients should avoid giving out their API keys and if they are going to give it to someone, then it should be set to ‘read-only.’ When you are generating your API key, you can filter the rights for that API key generated. It is very seldom that someone is going to ask for your API key and if they do, then the client needs to be very wary of it and never be afraid to question it,”.

"In the Budget Review 2022, the government laid its cards on the table by proposing that regulatory bodies need to be established to safeguard the crypto owner."

The crypto asset owner needs to remember that if it sounds too good to be true, then it usually is. Therefore, crypto asset owners should do their research on companies that want to manage their accounts, and make sure that the company is registered with the FSCA. Another red flag that crypto asset owners need to be wary of is when a company offers exponential growth and returns.

“If companies are offering you 5% growth per day, that’s a bad sign. Even if companies are offering 1% to 2% growth per day it should be heavily scrutinised, because such growth in cryptocurrency is difficult to achieve.”.

If you are unsure about how to proceed with your crypto assets, then it is in your best interest to consult specialist tax practitioners and tax attorneys who are experts in crypto assets, to obtain correct and expert advice on how to manage your crypto assets.

"The crypto asset owner needs to remember that if it sounds too good to be true, then it usually is."

Thomas Lobban & Ruan Stander

Tax Consulting SA

Acts and Bills

- Financial Intelligence Centre Act 38 of 2001;
- Financial Advisory and Intermediary Services Act 37 of 2002;
- Currency and Exchanges Act 9 of 1933.

Other documents

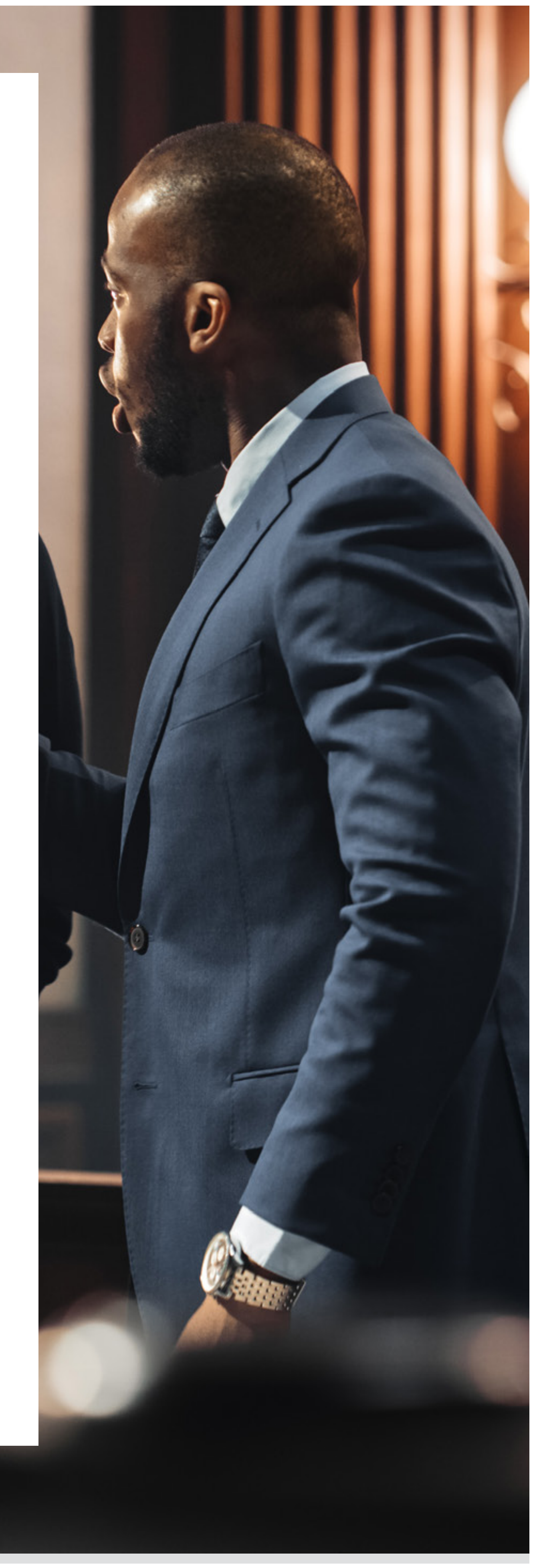
- Budget Review 2022: Annexure F, page 166;
- Exchange Control Regulations, 1961 (issued under the Currency and Exchanges Act 9 of 1933).

Tags: crypto asset transactions; crypto asset owner; Application Programme Interface key (API key).

SHARE INCENTIVE SCHEMES – BINDING CLASS RULING 78

On 15 October 2021, a landmark judgment was handed down by the Supreme Court of Appeal (SCA), ie, The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd (Spur Group)*, [2021].* [Editorial note: *See also* Tax Chronicles Monthly, *Issue 44 (Article 396), and Issue 47 (Article 438).] In the* Spur Group *case, the SCA held that a capital contribution made by an employer taxpayer to a trust established for purposes of an employee share incentive scheme was not deductible for income tax purposes.*

The judgment raised the question whether such capital contributions would henceforth always be considered non-deductible or rather whether it was a case of considering the merits and specific facts and circumstances of each case. Even though SARS class rulings are only binding on SARS for the persons specified in the ruling, many taxpayers would have been relieved when reading SARS Binding Class Ruling 78 issued on 24 January 2022 (BCR 78: "Employee share incentive scheme – shares in a foreign company") which, amongst others, determined the income tax consequences of an employee share incentive scheme. The SARS ruling, which is valid for a period of five years from 20 September 2021, is discussed in this article.



BACKGROUND FACTS

The applicants in BCR 78 (being resident companies forming part of the same group of companies) proposed implementing an employee share scheme. Importantly, the purpose of the employee share incentive scheme was to incentivise all the participating employees by affording them the opportunity to participate in the economic benefits and appreciation in value in the shares held by the share incentive trust that would be driven by their endeavours. Critically, this would be expected to be achieved by the participating employees being entitled to on-going dividends and indirectly the capital appreciation of the scheme shares by virtue of being entitled to so-called milestone distributions and leaver distributions as defined in the scheme rules and trust deed.

The proposed transaction steps of BCR 78 envisaged a typical share incentive scheme. In particular –

- The applicants (being the relevant employers of the group of companies in question) would make cash contributions to the co-applicant (being a share incentive trust).
- The co-applicant trust would use the proceeds of the contributions to acquire shares in the ultimate holding company of the group of companies in question (Holdco).
- The trustees of the co-applicant would allocate units in the co-applicant to the participating employees.
- A participating employee would be entitled to the following benefits in terms of the trust deed of the co-applicant:
    - proportionate share of 50% of any dividends received in respect of the scheme shares;
    - milestone distributions after an initial period of four years participation in the scheme and thereafter every five years of completed participation in the scheme; and
    - leaver distributions, being equivalent to milestone payments (and essentially determined on the same basis) payable to a participating employee that ceases employment with an applicant.
- The co-applicant would receive the gross foreign dividends that vest in the participating employees and would pass on the net amount (foreign dividend less the dividends withholding tax (DWT) at the applicable reduced rate) to the participating employees.
- The co-applicant would annually issue a certificate to participating employees certifying the amount of Holdco dividends derived by them and the amount of DWT accounted for by the trust on their behalf.

"BCR 78 thus reaffirms the principle that a contribution to a share incentive trust may well be deductible for income tax purposes depending on the specific facts and circumstances."

SARS RULING

SARS ruled, amongst others, as follows:

The contributions to be made by the applicants to the co-applicant (share incentive trust) would constitute expenditure deductible under section 11*(a)* read with section 23*(g)*, subject to the application of section 23H.

BCR 78 thus reaffirms the principle that a contribution to a share incentive trust may well be deductible for income tax purposes depending on the specific facts and circumstances. On the back of the SCA judgment in *Spur Group,* this is welcome clarification for taxpayers implementing share incentive schemes although taxpayers would be well advised to consider existing and future arrangements given the recent spotlight on such share incentive schemes. In particular, one should bear in mind that SARS rulings are not binding between SARS and all taxpayers and are based on *specific sets of facts.*

[Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply be relied on as they appear. Furthermore, a *binding class ruling* only applies to *SARS and the class referred to in the ruling* and is published for general information. It does not constitute a practice prevailing. A third party may not rely on a binding class ruling under any circumstances. In addition, published binding class rulings may not be cited in any dispute with SARS, other than a dispute involving the class identified therein.]

Jerome Brink

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 11*(a)*, 23*(g)* & 23H.

Other documents

- Binding Class Ruling 78 (issued on 24 January 2022).

Cases

- *The South African Revenue Service v Spur Group (Pty) Ltd* (Case no 320/20) [2021] ZASCA 145; [2021] JDR 2530 (SCA).

Tags: resident companies; share incentive scheme; dividends withholding tax (DWT).

THE AGED USUFRUCTUARY

Valuing a usufruct for estate duty purposes may incur a greater tax liability than disposing of it while the usufructuary is alive and paying donations tax, transfer duty and CGT.

When a usufruct ceases, it can have serious estate duty consequences for a deceased usufructuary. For this reason, amongst others, most planners nowadays shun the usufruct and use an *inter vivos* trust for estate planning. This article explores one of the options open to an aged usufructuary staring down the barrel of the estate duty gun.

At the heart of the problem is section 5(1)*(b)* of the Estate Duty Act, 1955. It states that a usufruct ceasing on a person's death should be valued by capitalising the right of enjoyment at 12% a year over the life of the person who becomes entitled to the right of enjoyment, or if the right is for a lesser period, over that lesser period. Under section 5(2), the Commissioner may approve a rate lower than 12% if satisfied that the property cannot reasonably be expected to produce a yield of 12%.

Typically, the bare dominium holder will be a family trust which, under section 5(3), is deemed to have a life expectancy of 50 years. The annual right of enjoyment of property with a market value of R100 at 12% is R12 (R100 × 12%). The value of a usufruct over 50 years is then determined by multiplying the annual right of enjoyment by the factor in Table B, which is 8.3045 = ZAR 99.65.

[*Author's note:* The life expectancy table (Table A) or the table for a fixed period (Table B) can be found in GNR 1942 in *GG* 2533 of 23 September 1977 or in the SARS *Comprehensive Guide to Capital Gains Tax* (Issue 9) in 8.35.7.]

The present value of R12 a year for 50 years can also be determined using Excel:

= PV(0.12,50,-12)

= ZAR 99.65

In effect, the inclusion for estate duty purposes is virtually equal to the full market value of the property. Under the First Schedule to the Estate Duty Act, estate duty is payable at the rate of 20% of the dutiable amount of the estate that does not exceed R30 million and 25% on any amount exceeding that figure (persons dying on or after 1 March 2018).

To avoid this outcome, the usufructuary could sell or donate the usufruct to the bare dominium holder during his or her lifetime. This option will have donations tax, capital gains tax and transfer duty (assuming a usufruct over immoveable property) implications, which would not have arisen on death. On death there would be no:

- donations tax, since the deceased has not disposed of property;
- transfer duty, since nothing is acquired by the bare dominium holder; nor
- capital gains tax, because the expiry of the usufruct would not give rise to any proceeds. [In this regard, see *Union Government v De Kock NO* [1918] AD 22 at 32.]

A comparison therefore needs to be made between the estate duty that would become payable and the aggregate of any donations tax, transfer duty and capital gains tax. If the aggregate of the three taxes is less than the estate duty, the usufructuary should consider disposing of the usufruct to the bare dominium holder, either for consideration or as a donation. Whether the usufruct should be sold or donated would depend on a number of factors such as the relative rates of donations tax and estate duty and the availability of the donations tax exemption when section 7C of the Income Tax Act, 1962 (the Act), applies to an interest-free loan.

DONATIONS TAX

Since a usufruct is a highly personal right, it may not be disposed of to anyone other than the bare dominium holder [see *Durban City Council v Woodhaven Ltd and others,* [1987], in this regard.]. The usufructuary could dispose of the usufruct to the bare dominium holder for consideration or as a donation. If sold for consideration on an interest-free or low-interest loan account, there could be continuing donations tax implications under section 7C in relation to the failure to charge interest at less than the official rate of interest as long as the loan remains outstanding. The balance of the loan still outstanding at the time of death would be included in the person's estate for estate duty purposes.

"A comparison therefore needs to be made between the estate duty that would become payable and the aggregate of any donations tax, transfer duty and capital gains tax."

Should the usufruct be donated, the donation could attract donations tax. In this regard, section 62(1)*(a)* of the Act provides that the donation must be valued by capitalising at 12% the annual right of enjoyment over the donor's life expectancy, or if held for a lesser period, over that period. Under section 62(2) the Commissioner may accept a lower yield, if satisfied that the property cannot reasonably be expected to produce a yield of 12% [also see *Commissioner for the South African Revenue Service v Klosser's Estate*, [2000]]. The life expectancy tables used for estate duty purposes are also used for donations tax purposes.

Thus, if the property had a market value of R100, the annual right of enjoyment at 12% would be equal to R12. If the usufructuary was aged 90 or above, his or her life expectancy would be 4.3 years with a present value factor of 3.21438. Thus, R12 × 3.21438 = R38.57. Or, using Excel: = PV(0.12,4.3,-12) = R38.57.

[Author's note: Ages above 90 are to be taken as 90. According to D Meyerowitz *Meyerowitz on Administration of Estates and their Taxation 2010* ed [online] Jutastat e-publications, it is stated that the footnote with this information was inadvertently omitted from the *Gazette.*]

This value is substantially lower than the value determined for estate duty purposes. In addition, the donor would be able to use the annual donations tax exemption of R100 000 provided in section 56(2)*(b)* of the Act.

The rate of donations tax is 20% on the cumulative value since 1 March 2018 of all taxable donations up to R30 million, and above that amount the rate is 25% (see section 64 of the Act).

TRANSFER DUTY

Assuming the usufructuary is not a VAT vendor, the bare dominium holder will be subject to transfer duty. Under section 2 of the Transfer Duty Act, 1949 (the TD Act), transfer duty is payable on the value of any property acquired by any person by way of a transaction or in any other manner, or on the amount by which the value of any property is enhanced by the renunciation, on or after the said date, of an interest in or restriction upon the use or disposal of that property.

So what must be determined is the value by which the bare dominium held by the bare dominium holder will be enhanced as a result of the acquisition of the usufruct. The enhancement relates to the estimated remaining period that the usufructuary would have enjoyed the usufruct, if he or she had not donated it to the bare dominium holder.

Transfer duty is based on the fair market value of the property. Under section 5(7) of the TD Act, the fair value must take into account the period for which the right is likely to be enjoyed. According to the SARS Transfer Duty Guide, the same tables used for estate duty purposes must be used for transfer duty purposes. The guide indicates that the rate of 12% will be used if the rental value is unknown. On a property valued at R100, the transfer duty will be based on R38.57 for a usufructuary aged 90 or older, assuming a yield of 12%.

Under section 2 of the TD Act, transfer duty is payable on a sliding scale, ranging between 0% on the first R1 million and 13% on property with a value exceeding R11 million.

WELCOMES NEW CORPORATE INCOME TAX DIRECTOR

VAT IT South Africa is pleased to announce the appointment of Nadia van Aswegen as the new Corporate Income Tax Director.

Nadia completed her SAICA articles with PwC and is a qualified Chartered Accountant (CA(SA)).

After completing her training contract, she joined PwC's Corporate International Tax department where she gained 9 years of valuable experience. Nadia managed integral projects and received various prestigious awards for serving clients and leading teams.

Throughout her career, Nadia gained valuable experience working with multi-national companies including JSE listed and mid-tier companies. She also obtained experience across a variety of industries including construction, healthcare, FMCG, and the entertainment and media industry. Her experience includes involvement in due diligence assignments, managing income tax compliance, income tax audits, the drafting of tax opinions, as well as voluntary disclosure applications and dispute resolution.

Nadia's achievements and career experience will undoubtedly prove valuable to VAT IT SA's new and existing clients. She has a passion for innovation and a talent for guiding clients through challenging tax legislation and finding tax-efficient solutions to meet their objectives. We firmly believe Nadia will enhance the support we provide to our clients and ultimately confirm VAT IT SA as one of the leading tax specialist firms in South Africa. **Read more** here.

You can contact Nadia for assistance with any Corporate Income Tax related matters

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CAPITAL GAINS TAX

The sale or donation of the remaining usufruct triggers a disposal under paragraph 11(1)*(a)* of the Eighth Schedule to the Act. Since the usufructuary and the bare dominium holder are likely to be connected persons, the proceeds will be equal to the market value of the remaining usufruct under paragraph 38. That market value is determined under paragraph 31(1)*(d)* by capitalising the right of enjoyment at 12% a year "over the expectation of life of the person to whom that interest was granted".

The wording of paragraph 31(1)*(d)* was probably designed with a full title holder in mind who grants a usufruct. To determine what the full title holder was disposing of, it would be necessary to look at the life expectancy of the usufructuary, because that is the value that the full title holder is disposing of. The wording also covers the situation in which the usufructuary disposes of the remaining right of enjoyment to the bare dominium holder, since the usufructuary is the person to whom the right of enjoyment was granted.

While the usufructuary is disposing of the remaining usufruct, this represents the relinquishment of the usufruct, not the granting of the usufruct to the bare dominium holder. It would not make sense to base the market value on the life expectancy of the bare dominium holder, since that does not represent the value of what the usufructuary owns at the time of disposal.

As is the case with donations tax, the Commissioner can approve a yield of less than 12% under paragraph 31(2).

If the usufruct was acquired before 1 October 2001 (valuation date), the valuation date value of the usufruct could potentially be determined using market value, time-apportionment or 20% of proceeds.

For a usufruct acquired on or after 1 October 2001, the base cost is likely to have been determined under paragraph 38, or if earlier, by using barter or exchange principles. [See *Comprehensive Guide to Capital Gains Tax* at 8.5A.]

A portion of the donations tax payable may qualify to be added to the base cost of the usufruct under paragraph 20(1)*(c)*(vii) of the Eighth Schedule to the Act, using the formula in paragraph 22. The qualifying portion of donations tax will increase the base cost of a pre-valuation date asset when the market value or 20% of proceeds method is used to determine the valuation date value. However, when the time-apportionment method is used, it will result in a lower base cost because the qualifying portion of donations tax comprises post-CGT expenditure which triggers the proceeds formula in paragraph 30(2). Thus, the higher the post-CGT expenditure, the greater the portion of the overall gain or loss that will comprise a capital gain or loss. It is unfortunate that the fiscus did not treat the donations tax as a selling expense under paragraph 30(5), which would have prevented this problem.

CONCLUSION

The dutiable value for estate duty purposes of a ceasing usufruct is based on the life expectancy of the person who takes over the right of enjoyment of the property, which can result in a large estate duty liability.

"The dutiable value for estate duty purposes of a ceasing usufruct is based on the life expectancy of the person who takes over the right of enjoyment of the property, which can result in a large estate duty liability."

By contrast, the method of valuing a usufruct for donations tax, transfer duty and capital gains tax purposes is based on the life expectancy of the usufructuary. It may be more tax efficient to pay donations tax, transfer duty and CGT during the usufructuary's lifetime than to pay estate duty on a ceasing usufruct on death.

[This article was first published in Accountancy SA (ASA) July 2021.]

Duncan McAllister

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 7C, 56(2)*(b)*, 62(1)*(a)* & (2), 64; Eighth Schedule: Paragraphs 11(1)*(a)*, 20(1)*(c)*(vii), 22, 30(2) & (5), 31(1)*(d)* & (2), 38;
- Estate Duty Act 45 of 1955: Sections 5(1)*(b)*, (2) & (3);
- Transfer Duty Act 40 of 1949: Sections 2 & 5(7).

Other documents

- SARS *Comprehensive Guide to Capital Gains Tax* (Issue 9) in 8.5A & 8.35.7;
- Meyerowitz D: *Meyerowitz on Administration of Estates and their Taxation* 2010 ed [online] Jutastat e-publications;
- SARS Transfer Duty Guide;
- The life expectancy table (Table A) or the table for a fixed period (Table B) (found in GNR 1942 in *GG* 2533 of 23 September 1977 or in the SARS *Comprehensive Guide to Capital Gains Tax* (Issue 9) in 8.35.7).

Cases

- *Union Government v De Kock NO* [1918] AD 22 [at 32];
- *Durban City Council v Woodhaven Ltd and Others* [1987] 2 All SA 315 (A); [1987] (3) SA 555 (A);
- *Commissioner for the South African Revenue Service v Klosser's Estate* [2000] (4) SA 993 (C); 63 SATC 93.

Tags: usufructuary; bare dominium holder; family trust; estate duty; official rate of interest; donations tax exemption; valuation date value.

INVESTMENT RULES

> "Following the devastating impact of the COVID-19 pandemic and concomitant lockdown these welcome changes will hopefully not only make investing into and out of South Africa more appealing, but also assist in South Africa's attempts to stimulate economic growth."

The exchange control changes announced in the 2022 Budget (the Budget) were far-reaching. Following the publication of the Budget, the Financial Surveillance Department of the South African Reserve Bank (FinSurv) released numerous circulars giving effect to these announcements. In terms of these circulars, certain sections of the Currency and Exchanges Manual for Authorised Dealers (the AD Manual) were amended.

A number of the changes announced relate to the making of investments into and out of South Africa. Some of the most important changes are discussed here in a bit more detail.

INSTITUTIONAL INVESTORS: INCREASE IN THE PRUDENTIAL LIMIT FOR OFFSHORE INVESTMENTS

In Exchange Control Circular 10/2022 numerous changes to section B.2(H) of the AD Manual, which deals with the exchange control rules pertaining to institutional investors, were announced. The most notable and important change relates to the amount of retail assets (assets from individuals, trusts, etc, received for investment purposes) that a South African institutional investor may invest offshore.

Prior to the publication of the circular, there was a prudential limit of 30% for offshore investments and an additional allowance of 10% for investments into Africa. This has now been replaced with a single limit of 45%, but with a requirement to report the number of African investments on a quarterly basis (as part of the general reporting requirement contained in the AD Manual) remaining. It is unclear why this requirement has remained, but it may be that FinSurv wants to monitor the impact of South Africa being part of the African Continental Free Trade Area and the effect on investments into Africa. The prudential limit applies to pension funds, linked and non-linked business life insurers, CIS managers and discretionary financial services providers registered as institutional investors with FinSurv.

In addition, it was announced that institutional investors may open foreign currency accounts locally, but that the amount of foreign currency held in these accounts will count towards the prudential limit. This is a relaxation from the previous rule where foreign currency could only be held locally where a foreign investment was sold and pending the reinvestment of those sale proceeds offshore.

For retail investors, including individuals, the announcement regarding the prudential limit ultimately means that they can potentially indirectly invest more of their assets offshore. Individuals can still invest offshore in their own names, using the single discretionary allowance and foreign capital allowance.

SOUTH AFRICAN RESIDENT COMPANIES: FOREIGN DIRECT INVESTMENT DISPENSATION

In terms of Exchange Control Circular 11/2022, section B.2(C) of the AD Manual, dealing with South African resident companies seeking to invest offshore, was amended. In terms of the amendment, a South African resident company can now invest up to R5 billion offshore annually, without prior FinSurv approval. In other words, such investments are subject only to authorised dealer approval. In addition, the requirement to repatriate sale proceeds from an investment approved under this dispensation was also removed, so that the sale proceeds may now be retained abroad. However, these sales would still have to be reported in the annual report submitted to FinSurv. The increased limits also apply to investments made under the foreign portfolio investment dispensation, which deals with investments where a South African resident company acquires less than 10% of the equity shares/voting rights in a foreign target.

DOMESTIC TREASURY MANAGEMENT COMPANIES

The limits currently applicable to domestic treasury management companies (DTMCs), which can hold funds in foreign currency for offshore investment purposes, have been increased pursuant to the following in Exchange Control Circular 12/2022:

- In relation to listed companies, the calendar year limit for offshore investment has been increased from R3 billion to R5 billion.
- In the case of unlisted companies, the calendar year limit has been increased from R2 billion to R3 billion.
- For financial services sector companies, such as banks and insurers, the DTMC may now invest up to R5 billion in a calendar year, which is up from the previous amount of R3 billion.

INWARD LISTINGS

Pursuant to the announcements in Exchange Control Circular 9/2022, section H of the AD Manual, dealing with the rules pertaining to inward listings, has been replaced with a brand new section.

Some of the most notable changes are:

- The uncertainty regarding the classification of inward listed instruments referencing foreign assets has been settled. Inward listed exchange traded funds and approved debt and derivative instruments referencing foreign assets remain classified as foreign assets. Banks and institutional investors need to keep this in mind as such investments would count towards their macro-prudential limit and prudential limit, respectively. However, investments into inward listed shares would not count towards these limits.
- Any instrument referencing foreign assets will now require prior FinSurv approval before listing, and these applications must include specific information referred to in section H.
- The classification of inward listed shares has been broadened to include shares on all South African exchanges and not only the JSE.
- The use of inward listed shares as acquisition currency is still permitted, but can still only be done with prior FinSurv approval. The criteria that will be considered, including the benefit to South Africa, are expressly stated.
- It is also noted that FinSurv can refer inward listing applications to National Treasury for its consideration.

COMMENT

Following the devastating impact of the COVID-19 pandemic and concomitant lockdown these welcome changes will hopefully not only make investing into and out of South Africa more appealing, but also assist in South Africa's attempts to stimulate economic growth.

"In addition, it was announced that institutional investors may open foreign currency accounts locally, but that the amount of foreign currency held in these accounts will count towards the prudential limit."

Louis Botha

Cliffe Dekker Hofmeyr

Other documents

- Currency and Exchanges Manual for Authorised Dealers (AD Manual): Sections B.2(C), B.2(H) & H;
- Exchange Control Circular 9/2022 (dealing with replacement of section H of the AD Manual);
- Exchange Control Circular 10/2022 (changes to section B.2(H) of the AD Manual);
- Exchange Control Circular 11/2022 (amendment of section B.2(C) of the AD Manual);
- Exchange Control Circular 12/2022 (increase in limits applicable to DTMCs).

Tags: domestic treasury management companies (DTMCs); inward listed shares.

FURTHER INTEREST RATE INCREASES

TAX AND VAT – INTEREST RATE INCREASES

SARS has again increased rates as detailed below.

It is important to remember that interest and penalties paid to SARS are not deductible expenses for income tax purposes. On the other hand, interest received from SARS is fully taxable (after deducting the current initial exemption of R23 800 per annum (R34 500 if you are 65 or older) for all local interest income earned by natural persons).

Income tax, provisional tax, dividends tax, etc

Payable to SARS on short payments of all such taxes (other than VAT): 7.75% per annum from 1 July 2022 (was 7.5% per annum with effect from 1 May 2022).

Payable by SARS on refunds of tax (where interest is applicable): 3.75% per annum from 1 July 2022 (was 3.5% per annum with effect from 1 May 2022).

If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 7.75% per annum from 1 July 2022 (was 7.5% per annum from 1 May 2022).

VAT

Payable to SARS on late payments: 7.75% per annum from 1 July 2022 (was 7.5% per annum from 1 May 2022).

Payable by SARS on VAT refunds after prescribed period: 7.75% per annum from 1 July 2022 (was 7.5% per annum from 1 May 2022).

Fringe benefits

Official interest rate for loans to employees below which a deemed fringe benefit arises: 5.75% per annum from 1 June 2022. See below for details of historical changes.

Dividends tax

Official interest rate for loans (designated in rands) to shareholders below which the interest on such loans can be deemed to be dividends on which dividends tax is payable: 5.75% per annum from 1 June 2022. See below for details of historical changes.

Donations tax

Loans to trusts by natural connected persons with interest charged at rates below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

Penalties

The amount of penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX – INTEREST RATES

- If inadequate interest is charged to an employee (including working directors) on loans (other than for the purpose of furthering their own studies) in excess of R3 000 from their employer (or associated institution), tax on the fringe benefit may be payable.

  Unless interest is charged at the "official" rate or greater, the employee is deemed to have received a taxable fringe benefit calculated as being the difference between the interest actually charged and interest calculated at the "official" rate.

"With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African 'repo rate' plus 1%."

  For employees' tax purposes, the tax deduction must be made whenever interest is payable; if not regularly, then on a monthly basis for monthly paid employees, weekly for weekly paid employees, etc.

- Subject to a number of exceptions, distributions of income and capital gains from a company / close corporation are normally subject to dividends tax at the flat rate of 20%. Loans or advances to or for the benefit of a shareholder / member will be deemed to be dividends but only to the extent that interest at less than the "official" rate (or market-related rate in the case of foreign currency loans) is payable on the loan, or fringe benefits tax is payable on an interest-free (or subsidised-interest) loan to an employee.

  It is not the amount of the loan but the interest reduction which is deemed to be a dividend. Low-interest loans are accordingly subject to dividends tax payable by the company and only in respect of the interest benefit.

- Loans to trusts by natural connected persons with interest charged below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

- With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African 'repo rate' plus 1%. For foreign-currency loans, the rate is the equivalent of the foreign "repao rate" plus 1%. The South African repo rate has been increased to 4.75% per annum (with effect from 1 June 2022).

THE "OFFICIAL" RATE OF INTEREST OVER THE PAST FIVE YEARS

With effect from		*Rate per annum*
1 August 2017	–	7.75%
1 April 2018	–	7.50%
1 December 2018	–	7.75%
1 August 2019	–	7.50%
1 February 2020	–	7.25%
1 April 2020	–	6.25%
1 May 2020	–	5.25%
1 June 2020	–	4.75%
1 August 2020	–	4.50%
1 December 2021	–	4.75%
1 February 2022	–	5.00%
1 April 2022	–	5.25%
1 June 2022	–	5.75%

Kent Karro

Tags: deductible expenses; natural connected persons; donations tax; taxable fringe benefit; low-interest loans; repo rate.

REMOTE WORKING

Given the ever-changing landscape of the past two years, the adage that nothing is certain except death and taxes is perhaps more apposite than ever. Whilst it may appear that a semblance of normality is returning, it is almost as certain as death and taxes that remote working will be a part of the next normal. South Africa's State of the Nation Address in February 2022 even made mention of a new remote working visa.

In light of this, companies with "work from home" policies should be especially mindful of potential tax exposures where "home" is in a foreign country. We deal with some of these potential exposures in more detail below.

CORPORATE INCOME TAX

The potential for a company to fall within a foreign country's corporate income tax net as a result of employees working from home in that foreign country is generally two-fold as –

- the company may be effectively managed from, and thus become tax resident in, that foreign country; or
- the company may form a taxable presence (permanent establishment) in that foreign country with the consequence that some or all of its profits may be subject to corporate income tax there.

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"Similarly, income earned by a non-South African tax resident employee working remotely in South Africa for a foreign employer will be subject to income tax in South Africa unless a DTA precludes South Africa from taxing such income."

In Issue 47 of Tax Chronicles Monthly (June 2022, Article 433) the guiding principles were set out that, according to the South African Revenue Service (SARS), should be applied when determining where a company is effectively managed. The guidance set out by SARS is largely consistent with the guidance set out by the Organisation for Economic Co-operation and Development (OECD) in its commentary on how this term should be interpreted in the context of double tax agreements (DTAs). However, it is noted that this commentary is based on a model DTA that is seldom followed to the letter when a DTA is formally concluded and brought into force by contracting states; there may also simply not be any DTA. Furthermore, the underlying domestic legislation must be considered along with the impact (if any) of the multilateral instrument (MLI) on existing DTAs.

For these reasons, it is recommended that companies that are possibly at risk of being effectively managed in a different country by virtue of employees working remotely there, should consider the need to obtain specialist tax advice. Regarding the second possible exposure outlined above, a company is generally at risk of having a permanent establishment in a foreign country if it –

- derives income from a source within that foreign country;
- has a fixed place of business there;
- is engaged in the delivery of construction or consulting services for a certain period of time in that foreign country; **or**
- has a dependent agent operating there on its behalf.

A comprehensive analysis of the risks and ways in which a permanent establishment can arise under each of the categories outlined above, is beyond the scope of this article and a consideration of the domestic legislation and the impact (if any) of the MLI is again critical. There are also important carve-outs that may apply having regard to the nature and extent of the activities being conducted in the other country. However, allowing employees to work from home in a foreign country may, inadvertently, result in the company having a fixed place of business there.

PERSONAL INCOME TAX

Income earned by a South African tax resident employee working remotely in a foreign country for a South African employer might be subject to personal income tax in that country. Where there is a DTA in place between South Africa and the foreign country, the foreign country's right to tax that employee's income will likely be determined by that DTA. Whether the South African employer has a permanent establishment in that foreign country could also be a factor in determining this right to tax.

In the absence of a DTA, the income may be taxable in both the foreign country and South Africa, though the employee may qualify for a rebate in terms of section 6*quat* of the Income Tax Act, 1962 (the Act). It should also be considered whether and to what extent the income qualifies for exemption in South Africa. For example, the income may qualify for the partial exemption outlined in section 10(1)*(o)*(ii) of the Act.

Similarly, income earned by a non-South African tax resident employee working remotely in South Africa for a foreign employer will be subject to income tax in South Africa unless a DTA precludes South Africa from taxing such income.

PAYROLL TAX AND SOCIAL SECURITY CONTRIBUTIONS

The obligation for an employer to register and account for payroll tax and social security contributions in a foreign country should also be considered where it has employees working from home in that foreign country. Whether or not this is indeed the case, can differ vastly from one country to another, though it will generally be dependent on whether –

- the income earned by the employee is subject to tax in the foreign country;
- the employer has business premises or an office available to it in the foreign country (here again it should be noted that if employees are expected to work from home in that foreign country then this may in and of itself result in the employer having business premises or an office available to it in the country); or
- the employer has a permanent establishment in the foreign country.

It is evident from the above that having employees work remotely in a foreign country could lead to various tax exposures and related obligations for the employer in that foreign country. It also remains to be seen how lenient or stringent revenue authorities across the globe will be, particularly in those instances where the employer is entirely unaware of the fact that its employees are working remotely in a foreign country. Only time will tell.

"For these reasons, it is recommended that companies that are possibly at risk of being effectively managed in a different country by virtue of employees working remotely there should consider the need to obtain specialist tax advice."

Lance Collop & Nicholas Carroll

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 6*quat* & 10(1)*(o)*(ii).

Tags: tax resident; model DTA; permanent establishment.

REPORTABLE ARRANGEMENTS

We are all familiar with GAAR to some extent but there is another wheel to the anti-avoidance wagon – reportable arrangements.

The South African Revenue Service (SARS) introduced the South African reportable arrangement provisions to the South African tax legislation in 2005 (section 76A of the Income Tax Act, 1962 (the Act)). This and its successor in the 2011 Tax Administration Act (the TAA) essentially require information on certain types of arrangements to be disclosed to SARS.

But what actually is a reportable arrangement, and when, to whom, and why should they be reported?

WHAT IS A REPORTABLE ARRANGEMENT?

Before we put the proverbial wagon before the horse, we first need to cover some important definitions in section 34 of the TAA to understand what a reportable arrangement is. The first definition is a "participant". A participant in relation to an arrangement is –

- a "promoter", who is responsible for organising, designing, selling, financing, or managing the reportable arrangement (arrangement being any transaction, operation, scheme, or understanding); or
- a company or trust which directly derives or assumes that it will derive a tax benefit by virtue of the arrangement.

An "arrangement" will be classified as a reportable arrangement in two instances:

- The arrangement is listed as a reportable arrangement by SARS in the Public Notice in terms of section 35(2) of the TAA (refer to Government Notice 140, published on 3 February 2016, *GG* 39650) provided that the arrangement leads to a tax benefit (ie, an avoidance, postponement, or reduction of liability of tax); or
- A "tax benefit" is, will be or is assumed to be derived by a participant by virtue of the arrangement and the arrangement entered into either (the below is not a complete list) –
    - contains provisions in terms of which the calculation of interest or finance charges are wholly or partly dependent on assumptions relating to the tax treatment of that arrangement;
    - contains characteristics of or similar to those of section 80C of the Act (ie, it includes round trip financing, an accommodating or tax-indifferent party or offsetting elements of commercial substance);
    - gives rise to an amount that will be an SA tax deduction but not an expense for financial reporting purposes or an income for financial reporting purposes but not gross income for SA tax purposes (unless a tax benefit is not the main or one of the main benefits, per the Public Notice);
    - does not result in a reasonable pre-tax profit for any participant, or if the present value of the pre-tax profit is less than the present value of the tax benefit.

WHAT HAPPENS IF MY PLANS COMPRISE A REPORTABLE ARRANGEMENT?

Once an arrangement is classified as a reportable arrangement the participant must, in terms of section 38 of the TAA, disclose the following information in relation to the reportable arrangement in the prescribed manner to SARS within 45 business days after the arrangement has qualified as a reportable arrangement:

"The reportable arrangement system is an important mechanism in playing detective and identifying impermissible tax avoidance transactions (in collecting the valuable information)."

- A detailed description of all of the arrangement's steps and features;
- A detailed description of the assumed tax benefits for all participants, including, but not limited to, tax deductions and deferred income;
- The names, registration numbers, and registered addresses of all participants to the arrangement;
- A list of all its agreements; and
- Any financial model that embodies its projected tax treatment.

That is a lot of information to be given to SARS on a platter.

Anything else?

As with almost every SA tax concept, there are exclusions (and sometimes exclusions to those exclusions) to reportable arrangement rules, referred to as excluded arrangements.

Some of these are listed below and will only be considered to be excluded arrangements to the extent that the arrangement is undertaken on a standalone basis and is not directly or indirectly linked to any other arrangement, and it was not entered into in order to obtain or enhance a tax benefit.

- A loan where a borrower receives or will receive an amount of cash or a fungible asset and agrees to repay at least the same amount received or return an asset of the same kind of quality and quantity to the lender at a determinable future date (section 36(1)*(a)* of the TAA);
- A lease agreement (section 36(1)*(b)*).

So the biggest question remains: what is the reasoning behind reportable arrangements and why are they required?

The simple answer to that is the SA anti-avoidance rules, GAAR! The reportable arrangement system is an important mechanism in playing detective and identifying impermissible tax avoidance transactions (in collecting the valuable information).

Regan van Rooy

Acts and Bills

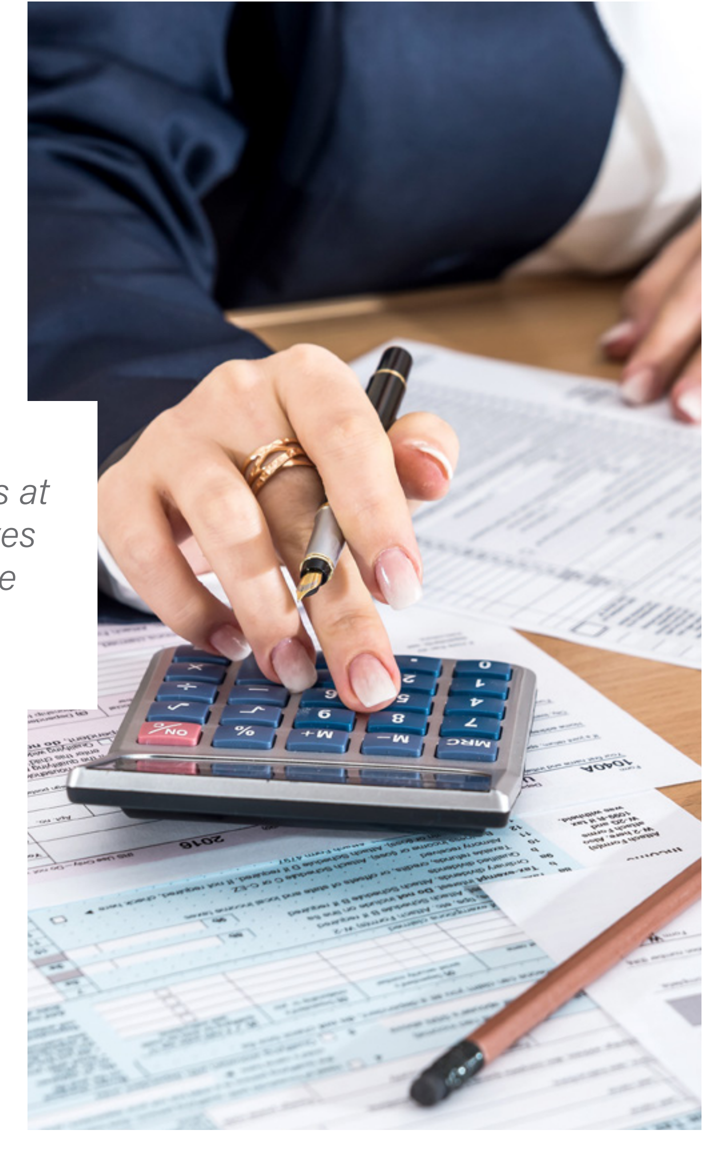
- Income Tax Act 58 of 1962: Sections 76A & 80C;
- Tax Administration Act 28 of 2011: Part B of Chapter 4 (sections 34 to 39); more specifically sections 34 (definitions of "arrangement", "participant", "promoter", "reportable arrangement" & "tax benefit"), 35(2), 36(1) *(a)* & *(b)* & 38.

Other documents

- Government Notice 140, published on 3 February 2016, in *GG* 39650.

Tags: reportable arrangements; tax benefit; tax-indifferent party.

TAX ON ANNUITY INCOME



The latest move by SARS to require the withholding of PAYE from annuity payments at an "effective tax rate" as required in directives issued to payers of annuities may help some annuitants to plan their finances, but may disadvantage others.

SARS issued IRP3e tax directives in terms of paragraph 2(2B) of the Fourth Schedule to the Income Tax Act, 1962, to all payers of annuities in early February 2022 (ie, to licensed insurers and retirement funds, collectively "administrators"). The directives required the administrators to withhold PAYE on the annuities paid at the "effective tax rate" or "fixed PAYE rate" prescribed by SARS on the annuitants.

Starting from 1 March or 1 April 2022, annuitants would have found that PAYE is withheld on the annuities they receive at the fixed PAYE rate – unless they opt out.

How SARS calculates the fixed PAYE rate

SARS has calculated the fixed PAYE rates as follows:

- **A** = Remuneration (as defined in the Fourth Schedule) from all sources as disclosed in EMP501 reconciliations submitted by employers / administrators
- **B** = Normal tax on A prior to rebates & tax credits
- **C** = Primary, secondary & tertiary rebates
- **D** = Medical tax credit (as per source code 4116)
- **E** = B-C-D
- **F** = Fixed PAYE rate = E/A*100

SARS will have also updated the fixed PAYE rates based on the new tax tables when they are circulated.

The fixed PAYE rate is applied to the gross value of the annuity paid. Where an individual receives more than one annuity from the same administrator under the same PAYE employer number, the fixed PAYE rate must be applied to each annuity. If the annuitant is entitled to a deduction or to an additional medical expense tax credit, the administrator, on request, can take both of these amounts into account in determining the lower PAYE rate to be withheld.

Taxpayers can also request that their administrators use the PAYE rates in terms of the normal PAYE deduction tables under the Fourth Schedule, or deduct PAYE at a higher rate. The risk of using the former (which is lower than the fixed PAYE rate) is that a taxpayer may have a significant income tax liability on assessment.

Importantly, a hardship directive for the annuitant to pay the income tax due only on assessment or a directive issued in terms of a double tax agreement would supersede the fixed PAYE rate.

"Starting from 1 March or 1 April 2022, annuitants would have found that PAYE is withheld on the annuities they receive at the fixed PAYE rate – unless they opt out."

CONSEQUENCES FOR ANNUITANTS

The directive to use the fixed PAYE rate will affect annuitants, particularly those who receive more than one stream of annuity from multiple administrators. PAYE on remuneration will now take into account all annuity streams and it is likely to push the annuitant into a higher marginal tax bracket. (It is also possible that SARS may take the tax rate in the latest assessment into account in determining the fixed PAYE rate. This rate would have taken other non-annuity sources of income into account such as interest, rental or capital gains.)

If there are taxpayers who have, through their own or their tax practitioners' calculations, ascertained that the fixed PAYE rate used against their annuity payments is too high and could result in a significant refund on assessment in addition to cashflow constraints, they should request their administrators to withhold PAYE at a more accurate rate. Any shortfall in PAYE withheld against the annuities can still be accounted for through the usual first, second and third provisional tax payments.

Joon Chong

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Fourth Schedule: Paragraphs 1 (definition of "remuneration") & 2(2B).

Other documents

- EMP501 reconciliations;
- Budget Review 2022/2023.

Tags: fixed PAYE rates; additional medical expense tax credit; marginal tax bracket.

ADJUSTMENTS

Finding transfer pricing a headache? TP adjustments are even worse...

Transfer pricing (TP) adjustments occur when a transaction between connected persons or associated enterprises has been found to be non-arm's length. An adjustment is made to the taxable income to either disallow a deduction or include a taxable amount, and therefore "correct" the taxable income. TP adjustments are complex and have other tax implications, not just in terms of the additional corporate tax due. A TP adjustment can also have withholding tax, customs and even VAT consequences. Moreover, TP adjustments comprise both a primary adjustment (ie, the "correction" to taxable income) as well as a secondary adjustment (ie, a further tax – dividends tax (paid by the company) or donations tax – that is payable as a direct consequence of the primary adjustment).

"A taxpayer is obliged to make a TP adjustment in its income tax return to reflect the arm's length fee that should have been earned for providing/receiving inter-company goods and services."

TIMING OF TP ADJUSTMENTS IS KEY

On 25 November 2020, in a South African tax court case, *CBA (Pty) Ltd v Commissioner for the South African Revenue Service* (Case No 24674), the verdict reaffirmed that tax is an annual event and therefore expenses and/or allowances must be claimed during the year in which they are actually incurred. This principle is also applicable to TP. Thus, a taxpayer engaging in cross-border intra-group transactions must do so at arm's length in respect of each year of assessment. If the arm's length test is not satisfied and there is a tax benefit for one of the parties to the transaction, then a TP adjustment may be necessary. To achieve an arm's length result, taxpayers often make use of retrospective TP adjustments. For example, if the taxpayer overpaid its foreign connected person supplier during the year and does not meet the arm's length operating margin set in terms of the TP policy, the supplier would need to issue a credit note to retrospectively adjust the operating margin to the arm's length level.

Applying the principle followed in the tax court case, it is doubtful that the SA Revenue Service (SARS) would agree with a taxpayer performing a retrospective adjustment in terms of a catch-up adjustment in a subsequent year and treating it as part of the calculation of the taxable income of the subsequent year. It is therefore critical for taxpayers to not only document their TP policy but also to ensure that TP adjustments are made throughout the year (as opposed to posting retrospective year-end adjustments to the accounting records).

TP ADJUSTMENTS AND DIVIDENDS TAX & PENALTIES

A taxpayer is obliged to make a TP adjustment in its income tax return to reflect the arm's length fee that should have been earned for providing/receiving inter-company goods and services. This will give rise to normal tax at the standard rate. In South Africa there is also a further consequence in the form of dividends tax at 20% on the TP adjustment (for individuals it is donations tax).

Should the taxpayer fail to make these adjustments in its tax return, there is a risk that SARS could make an adjustment for the income tax and dividends tax payable and seek to levy understatement penalties and interest.

Based on the views expressed in the judgment of *Volkswagen of South Africa (Pty) Ltd v Commissioner for the South African Revenue Service*, [2008], dividends tax payable by a company on a dividend *in specie* or a deemed dividend *in specie* falls outside the ambit of the dividends article of a tax treaty. The importance of this statement is that the rate of 20% on the deemed dividend cannot be reduced in terms of the dividend article of a treaty.

TP ADJUSTMENTS AND VAT

TP adjustments are usually done at year-end and may be either prospective or retrospective, and upward or downward depending on the circumstances. In relation to prospective adjustments, no action would be required from a VAT perspective since an increased transfer price for future supplies will be reflected on the relevant future invoices and VAT will be accounted for accordingly.

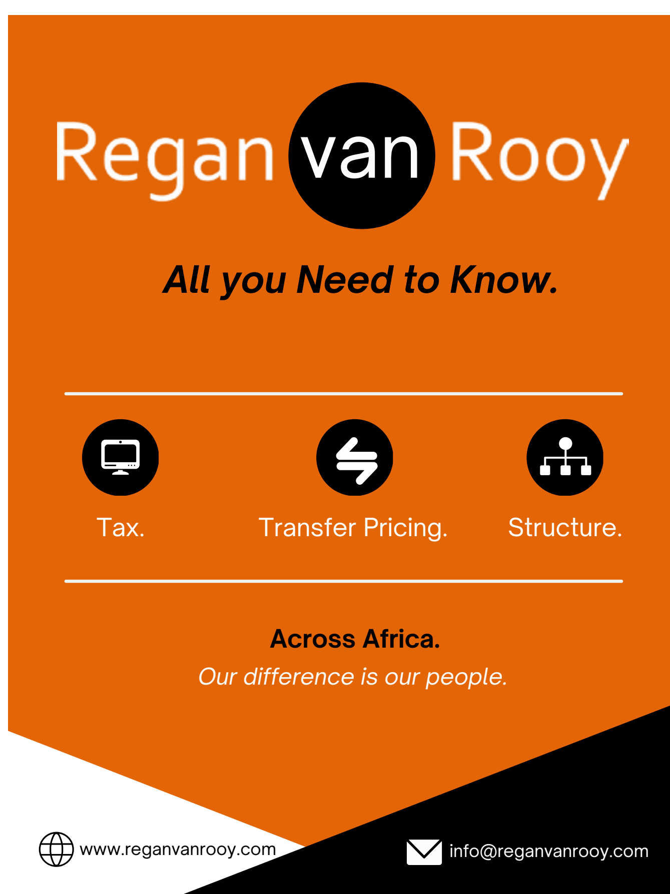
"In summary, a TP year-end adjustment will only have VAT consequences if there is a direct link between the TP adjustment and the consideration paid for the goods."

In relation to retrospective adjustments, if a foreign group company effects a year-end TP adjustment, a VAT liability (and customs duty) can arise if the price of goods imported is increased retrospectively. A VAT liability can also arise if the price for "imported services" is adjusted retrospectively. Exported goods and services will typically qualify for zero-rating, as long as the correct documentation is obtained.

In February 2022, the Italian tax authorities addressed the VAT treatment of TP year-end adjustments. In summary, a TP year-end adjustment will only have VAT consequences if there is a direct link between the TP adjustment and the consideration paid for the goods. It is not clear whether SARS will follow this approach.

NEXT STEPS

TP is never simple and adjustments add an extra layer of complexity. If you are scratching your head about TP adjustments, please reach out to experts in the field.



"In relation to retrospective adjustments, if a foreign group company effects a year-end TP adjustment, a VAT liability (and customs duty) can arise if the price of goods imported is increased retrospectively."

Regan van Rooy

Cases

- *CBA (Pty) Ltd v Commissioner for the South African Revenue Service* (Case No 24674); [2020] ZATC 21 (25 November 2020);
- *Volkswagen of South Africa (Pty) Ltd v Commissioner for the South African Revenue Service* [2008] 70 SATC 195.

Tags: transfer pricing (TP) adjustments; cross-border intra-group transactions.

INTRA-GROUP FINANCIAL TRANSACTIONS

On 11 February 2022 SARS released a new draft interpretation note that will help to clarify issues around intra-group loans, but several key issues still need to be addressed.

Debt is an important source of financing for investment. However, intra-group financial assistance can create opportunities for base erosion and profit shifting. Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational enterprises to "shift" profits from a higher-tax to a lower-tax jurisdiction, which results in loss for the tax base of the higher-tax jurisdiction.

This can be achieved by, *inter alia* –

- multinationals placing higher levels of third-party debt in high tax jurisdictions;
- multinationals using related-party financing to fund the generation of tax-exempt interest income; and
- multinationals using related-party loans to generate interest deductions in excess of the multinational's third-party interest expense.

BEPS has been a key area of interest for National Treasury and SARS, more so in recent years due to South Africa's slow economic growth and poor tax revenue collections. Before 2012, it was addressed through the thin capitalisation rules in section 31(3) of the Income Tax Act, 1962 (the Act).

In terms of these rules, a South African resident company in receipt of debt financing from a connected person would not be thinly capitalised, provided the total amount of connected party interest-bearing debt per investor did not exceed three times the level of fixed capital pertaining to that investor. In addition, the interest rate applied would not contravene the transfer pricing rules if the effective rate (after eliminating any excess loan funding) did not exceed the rates provided in Practice Note 2.

From 1 April 2012, section 31 was overhauled, resulting in section 31(3) and Practice Note 2 (ie, the previous South African thin capitalisation provisions), being repealed. Under the new rules, any debt financing received by a South African resident taxpayer from a foreign connected party constitutes a transaction that is subject to the general transfer pricing rules.

This involves a two-step analysis of the funding transaction concerned: Firstly, that the quantum of the debt should adhere to the arm's length principle; and secondly, that the interest rate applied should also adhere to the arm's length principle.

In 2013, a draft interpretation note was released by SARS providing guidance on how it would expect a South African taxpayer to confirm the arm's length nature of an intra-group financial transaction. In testing the arm's length nature of the debt and the interest rate, the 2013 draft interpretation note advocated, but did not make peremptory, a Debt to EBITDA ratio of 3:1 and a risk harbour rate not exceeding JIBAR plus 2% for ZAR denominated debt or, for foreign debt, the weighted average of the base rate of the country of denomination plus 2%, respectively.

"BEPS has been a key area of interest for National Treasury and SARS, more so in recent years due to South Africa's slow economic growth and poor tax revenue collections."

SARS advised that its guidance on the application of the transfer pricing rules to inbound debt, both in terms of the quantum and the interest rate, would not be finalised until the Organisation for Economic Cooperation and Development (OECD)'s working group on the transfer pricing of financial transactions was released. The resulting uncertainty placed an undue compliance burden on taxpayers.

The OECD released its transfer pricing guidance on financial transactions in 2020 and incorporated them in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration in January 2022 (the OECD Guidelines).

In parallel with this process National Treasury released its discussion paper entitled "Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments" on 26 February 2020. In this paper, it recognised that South Africa has a high corporate income tax rate in comparison to the global average and that taxpayers may engage in schemes or arrangements that will minimise their tax liabilities by placing most of their debt funding in high-tax jurisdictions (such as South Africa) to get the interest deduction. Consequently, after receiving comments on National Treasury's paper, government proposed to expand the scope of the existing interest limitation legislative rules contained in section 23M to limit the net interest expense deductions to 30% of earnings in respect of intra-group debt. These rules became effective together with the reduced tax rate (for years of assessment ending on or after 31 March 2023).

Bearing this in mind, on 11 February 2022, SARS released for comment its new Draft Interpretation Note on the "Determination of the Taxable Income of Certain Person from International Transactions: Intra-Group Loans".

In terms of the new draft interpretation note, SARS has confirmed that the pricing of an intra-group loan will be considered arm's length if it adheres to the arm's length principle in the OECD Guidelines. The OECD Guidelines require a comparison of the conditions in a controlled transaction with the conditions that would have been laid down if the parties had been independent and had undertaken a comparable transaction under comparable circumstances from both a lender's and borrower's perspective. It also clarifies that the impact of the sections 23M and 23N of the Act limitations on the deductibility of interest may only be considered *after* the transfer pricing rules have been applied in testing the arm's length nature of the intra-group financial transaction.

The 2022 draft interpretation note covers the full range of considerations in that it –

- discusses the application of the transfer pricing rules to a broad range of both direct and indirect funding arrangements, including back-to-back financial arrangements with banks and other financial institutions and guarantees;
- gives some welcome context on how SARS will apply the "associated enterprise" definition in section 31(1) (scheduled to come into operation on 1 January 2023 and which will broaden the application of South Africa's transfer pricing rules beyond transactions that currently take place between entities which fall within the confines of the connected persons definition);
- confirms that, in assessing the terms of a lending arrangement to determine whether the quantum of a taxpayer's debt and the rate of interest are arm's length, SARS will also consider the duration of the debt arrangement;
- revisits the substantive nature of the arrangement and provides guidance on when a purported loan is regarded as a loan, as opposed to a contribution to equity capital;
- addresses key commercial and financial comparability factors, such as the funding strategy of the groups and factors affecting the performance of businesses in the relevant industry sectors and the financial resources that are realistically available to the parties;
- gives guidance on approaching the comparability analysis, including the use of credit ratings, and the use of publicly available information to determine credit ratings, factors impacting credit ratings such as incidental benefits of being part of a group, covenants and guarantees in existence;
- gives guidance on the issue of loan fees and charges;
- gives alternatives on how to apply the arm's length principle in the absence of comparable uncontrolled transactions;
- discusses the methodology for determining risk-free and risk-adjusted rates of return;
- summarises the tax consequences of the level and cost of an intra-group debt not being arm's length;
- reiterates the importance of retaining appropriate documents that support the taxpayer's view that the intra-group debt is arm's length;
- confirms that SARS will apply the arm's length principle to affected transactions involving permanent establishments as if they are separate enterprises;
- discusses the headquarter company exclusions and the limitation on interest deductions by a headquarter company on financial assistance granted to it by a non-resident;
- notes that SARS is considering the use of advance pricing agreements on intra-group cross-border debt; and
- confirms that the withholding tax on interest calculation will not be affected by any transfer pricing adjustments.

"In terms of the new draft interpretation note, SARS has confirmed that the pricing of an intra-group loan will be considered arm's length if it adheres to the arm's length principle in the OECD Guidelines."

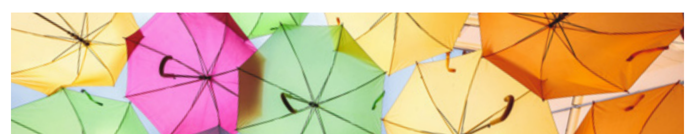
KEY POINTS IDENTIFIED:

- Most notable is that the 2022 draft interpretation note has removed all reference to risk identifiers and has instead reiterated the main burden on proving that the arrangement is at arm's length. The omission of these guidelines not only creates an undue compliance burden for taxpayers, but also a difficult administrative task for SARS' auditors.

- The 2022 draft interpretation note states that bank opinions or quotes do not form comparable support. The reasons presented are: (i) the approach represents a departure from an arm's length approach based on comparability because it is not based on comparison of actual transactions; and (ii) term sheets do not constitute formal loan offers. Although we understand SARS' concerns, we maintain there is merit in using such data as term sheets to attest to a third-party lender's willingness to provide a certain level of debt under the same terms and conditions as the funding arrangement concerned. It therefore serves as proof of what an independent party would be willing to accept and should accordingly be considered comparable to satisfy the arm's length principle.

- The 2022 draft interpretation note requires the transfer pricing analysis of the intra-group debt to be done at the time that the debt is given, which was expected; but then it also requires the appropriateness of the level and cost of the debt to be reassessed from "time to time". No standardised frequency of time is given for the reassessment. All that the draft states is that the frequency and timing will depend on the nature of the taxpayer's business and the amount of change and variability that it experiences. We agree that the ongoing assessment is in line with the principle of arm's length testing; however, the OECD advocates for a reassessment to be done every three years – would this be acceptable? For debt akin to an overdraft, the draft interpretation note suggests a reassessment several times a year – is this practical? For financial assistance that is available for draw-down over time, the draft interpretation note states that the amount actually drawn down and the amount which may still be drawn down are equally important – the question is whether SARS is suggesting an assessment at each draw down? – If so, this will create an insensible and unbusinesslike burden for taxpayers.

Thus, the 2022 draft interpretation note on intra-group financial transactions provides clearer guidance to South African taxpayers on how to determine and demonstrate the arm's length nature of inbound debt (which notably, effectively aligns with the OECD's global guidance and principles) and the deductibility of interest payments in respect thereof. However, several key issues need to be addressed before it is finalised.



Carryn Alexander

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 23M, 23N & 31(1) (definition of "associated enterprise" is to come into operation on 1 January 2023) & (3).

Other documents

- "Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments" (discussion paper released by National Treasury on 26 February 2020);

- Draft Interpretation Note on the Determination of the Taxable Income of Certain Person from International Transactions: Intra-Group Loans (released by SARS on 11 February 2022);

- Practice Note 2 (*"Income tax: Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic"* (14 May 1996) – repealed with effect from 1 April 2012).

Tags: base erosion and profit shifting (BEPS); South African resident taxpayer; corporate income tax rate; "associated enterprise" definition; advance pricing agreements.

UPDATED OECD GUIDELINES

On 20 January 2022 the Organisation for Economic Co-operation and Development (OECD) issued the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (the Guidelines). These guidelines are the latest instalment of the growing body of guidance issued under Action 13 of the OECD's Base Erosion and Profit Shifting (BEPS) project, which provide updated guidance on the application of the transactional split method approach that tax administrations should take for hard-to-value intangibles (HTVIs), and transfer pricing in financial transactions.

Today's globalised economy means that cross-border transactions are inevitable. Where the cross-border transactions are within a single group of companies, ordinary market forces are not necessarily decisive of the price charged between such related parties. This leaves scope for companies to use this flexibility in pricing to reduce the effective tax burden of the group. This is achieved through various methods, including structuring intragroup transactions so that the companies in comparatively high tax jurisdictions pay amounts to companies in jurisdictions with lower rates.

The flexibility in the prices set on intragroup transactions within multinational enterprises (MNEs) leads to a tension between states and their rights to tax gains from economic activity that is carried out within their jurisdictions.

States have resolved this tension through transfer pricing rules. These rules take various forms in different jurisdictions, but generally deem that the price of a given transaction will, for tax purposes, be determined on an arm's length basis.

Various methodologies can be applied in determining the arm's length price of a given transaction. The Guidelines extrapolate on the various methodologies for determining an arm's length price and the factual scenarios in which a particular method would be most appropriate.

The previous version of the Guidelines was published in 2017, and the current version consolidates the various guidance reports issued by the OECD on transfer pricing since the 2017 edition. The text of these reports had already authoritatively replaced the 2017 version at the time of publication. The three reports that comprise the basis for the updated Guidelines are the:

- Revised Guidance on the Application of the Transactional Profit Split Method – BEPS Action 10. Published on 21 June 2018 and incorporated into Chapter II, Part III, Section C and Annexes II and III to Chapter II of the Guidelines;
- Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles – BEPS Action 8. Published on 21 June 2018 and incorporated as Annex II to Chapter VI of the Guidelines; and
- Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10. Published on 11 February 2020 and incorporated into Chapter 1, Section D and Chapter X of the Guidelines.

TRANSACTIONAL PROFIT SPLIT METHOD

The Transactional Profit Split (TPS) method entails identifying the profits which arise from a given transaction and then applying an economically appropriate split between the parties to approximate the division of profits that would have been accepted by parties dealing at arm's length.

The Guidelines contain further specifics on circumstances under which the TPS method is the most appropriate. They indicate the TPS method will generally be appropriate in the following scenarios:

- where the parties are making unique and valuable contributions under the intragroup transaction, as there will not likely be comparable transactions as the contributions are unique;
- where the business operations of the transacting parties are highly integrated, because in such instances the value created and to be apportioned is dependent on the existence of the integration; and
- where the parties share the economically significant risks in a transaction, such that each party can expect a share of profits, the risks may not be susceptible to reliable separation for each party – this will make the TPS method most appropriate.

The Guidelines now also clarify that the absence of comparable transactions does not necessarily mean that the TPS method is the most appropriate. Where comparable transactions are available the TPS is, however, unlikely to be the most appropriate.

It also provides further guidance on how to apply the TPS, by expanding on how to determine the level of profits available from a given transaction and the appropriate criteria for the allocation of profits between the parties given their contributions and risk assumed. The central tenet of these areas of guidance remains that the profit determination and split must be done based on reliable predictions of the economic outcome which could reasonably be anticipated by each party to the transaction given the levels of contribution and risk, and whether the contribution was made and risk undertaken at arm's length.

GUIDANCE FOR TAX ADMINISTRATIONS ON HARD-TO-VALUE INTANGIBLES

The updates here provide guidance for tax administrations to ensure that the HTVI methodology is applied consistently, and risk of economic double taxation is minimised. It also covers the interaction between HTVI and mutual agreement procedure under applicable tax treaties.

The HTVI principles in the Guidelines centre on the information asymmetry between tax administrations and parties to intragroup transactions and seek to rectify outcomes where this information asymmetry operated unreasonably in favour of the taxpayers.

The HTVI approach to transfer pricing entails that, where the actual profits and risks in a transaction turn out to be significantly lower or higher than anticipated by the transacting parties in their transfer pricing filings, tax administrations are entitled to use the disparity of the facts which have occurred and predictive assertions by the taxpayers as a basis to adjust the transfer pricing treatment of a past transaction. This is based on the fact that taxpayers have more information at their disposal to accurately predict the risk and returns from a given transaction, while tax administrations must rely on what is presented by taxpayers.

The Guidelines emphasise that the basis for HTVI adjustments must be balanced with taxpayers' need for certainty. Therefore, HTVI adjustments are to be made only on the basis of information or factors that reasonably could have been known by the parties to the transaction and therefore factored into the arm's length price declared.

The bulk of the update to the Guidelines regarding HTVI consists of examples of the application of HTVI adjustments and the factors to be considered by tax administrations.

TRANSFER PRICING IN FINANCIAL TRANSACTIONS

The newest aspects contained in the Guidelines are the portions on financial transactions. This guidance aims to equip stakeholders to appropriately assess the economic factors involved in intragroup financial transactions and how this translates into the application of the arm's length principle.

The guidance is divided into two major portions. First, the application of general transfer pricing principles contained in Chapter 1 of the Guidelines to financial transactions mentioned above, including how to conduct the accurate delineation analysis of the capital structure of MNE groups, and economically relevant characteristics that inform the analysis of the terms and conditions of financial transactions.

The second major portion of guidance is on specific issues to be considered in applying the arm's length principle to determine an appropriate price for financial transactions within MNE groups. The specific types of transactions covered include treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance.

CONCLUSION

Updated guidance on the application of transfer pricing methodologies is welcome for taxpayers, as it provides them with a greater understanding of the factors to be considered in compiling transfer pricing documentation which meets the requirements of tax administrations.

This results in greater certainty for taxpayers that form part of MNEs, regarding the appropriateness of their own tax treatment of their intragroup transactions and the anticipated position of the tax administrations involved.

"Various methodologies can be applied in determining the arm's length price of a given transaction. The Guidelines extrapolate on the various methodologies for determining an arm's length price and the factual scenarios in which a particular method would be most appropriate."

Tsanga Mukumba

Cliffe Dekker Hofmeyr

Other documents

- Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022: Chapter 1 (Section D); Chapter II: Part III (Section C) & Annexes II & III to Chapter II; Chapter VI: Annex II; Chapter X;
- Revised Guidance on the Application of the Transactional Profit Split Method – BEPS Action 10 (published on 21 June 2018);
- Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles – BEPS Action 8 (published on 21 June 2018);
- Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8–10 (published on 11 February 2020).

Tags: hard-to-value intangibles (HTVIs); cross-border transactions; intragroup transactions; transfer pricing rules; Transactional Profit Split (TPS) method.

OFFSHORE DISCRETIONARY TRUSTS AND REPORTABLE ARRANGEMENTS

The reportable arrangement provisions in Part B of Chapter 4 of the Tax Administration Act, 2011 (the TAA), contain mandatory disclosure rules that require taxpayers to report certain arrangements to the South African Revenue Service (SARS) on an upfront basis to enable it to investigate such arrangements for possible tax avoidance purposes.

Arrangements falling within the ambit of these provisions should be reported by the "participants" (defined in section 34 of the TAA) thereto within 45 business days of their entering into such arrangements. A "participant" includes the taxpayer, the person who is principally responsible for organising, designing, selling, financing or managing the arrangement (referred to as the "promoter" (defined in section 34)) and any other party to an arrangement that is listed in a public notice (Public Notice).

It follows that a single "reportable arrangement" (defined in section 34) can have multiple participants, with each having its own individual reporting obligation. It is a common practice for participants to nominate a single party to do the reporting as the non-reporting parties are exempted from having to do so if they obtain a written statement from the reporting party confirming that it reported the reportable arrangement to SARS.

Participants who fail to report their reportable arrangements to SARS within the 45 business days are subject to hefty penalties which recur on a monthly basis for each month that the failure continues, for up to 12 months. The penalty is R50 000 per month for the taxpayer and R100 000 per month for the promoter, and it is doubled if the anticipated "tax benefits" (defined in section 34) flowing from the arrangement exceed R5 million and tripled if they exceed R10 million. Any other person who is a party to the arrangement listed in the Public Notice is only subject to a one-off penalty of R50 000 in the event of such person's failure to report the arrangement within the 45 business days.

This article is concerned solely with paragraph 2.3 of the Public Notice, 2016, which lists the following as a reportable arrangement:

"Participants who fail to report their reportable arrangements to SARS within the 45 business days are subject to hefty penalties which recur on a monthly basis for each month that the failure continues, for up to 12 months."

"An arrangement in terms of which –

(a) a person that is a resident makes any contribution or payment on or after 16 March 2015 to a trust that is not a resident ***and has or acquires a beneficial interest in that trust;*** and

(b) the amount of ***all*** contributions or payments, whether made before or after 16 March 2015, or the value of ***that*** interest exceeds ***or*** is reasonably expected to exceed R10 million ..." (***Emphasis*** added.)

PARAGRAPH 2.3 OF THE PUBLIC NOTICE

Broken down into its individual components, paragraph 2.3 of the Public Notice has the following requirements, all of which should be satisfied for a reporting obligation to arise:

1. A resident must make a "contribution" or "payment" on or after 16 March 2015 to a non-resident trust (it is considered that these terms envisage a settlement or donation, and would not include a loan);

2. The resident must have or acquire a "beneficial interest" in the trust; and

3. Either the amount of all contributions or payments made by the resident to the trust or the value of the resident's beneficial interest in the trust exceeds or is reasonably expected to exceed R10 million.

A question that frequently arises is exactly when a resident acquires a "beneficial interest" in a fully discretionary and irrevocable trust? The answer to this question is important as it dictates when the contributions to such trust should be reported under the reportable arrangement provisions.

It is well-settled that the beneficiaries of a fully discretionary and irrevocable trust only have contingent rights to the trust assets. A contingent right is merely a *spes* – a hope that might never be realised. Such beneficiaries merely have a personal right against the trustees to administer the trust in accordance with the trust deed. This right should be distinguished from a real right which is a right that is enforceable against all persons and is the badge of ownership.

BENEFICIAL INTEREST

South African case law on the meaning of "beneficial interest" can be found mainly in the context of estate duty disputes. These cases equate a beneficial interest to a vested right in property and hold that it does not include a beneficiary's contingent right to receive benefits from a trust or estate. In this regard, the following was held by Schreiner JA in *Commissioner for Inland Revenue and Others v Sive's Estate,* [1955] (also see *Coronel v CIR* [1938]):

> ***"It is clear that what was held by A and ceases on his death must be a beneficial interest and not the merely legal or nominal interest held by a person occupying the position of an 'administrative peg'.*** The Legislature was taxing the passing of or the succession to beneficial interests in property, not changes consequent upon the death of a person holding property as a trustee or similar representative.
>
> ***It is, I think, also clear that what is deemed to be property passing on death, and what is the subject of a succession on death, does not include a chance or hope that the deceased might have had of receiving an interest in property in circumstances which, though they might have arisen, did not in fact arise. Such a chance or hope is not an 'interest held' by the deceased within the meaning of the provisions that I have quoted ...***
>
> In regard to the income, clause 45 has provisions of much the same shape as clause 44. The testator directs that the income shall belong to his children in equal shares and shall be paid over to them subject to certain provisions. ***Again the child gets no vested right to any of the income of the residue unless and until he or she reaches a certain age or unless and until the administrators exercise their discretion in his or her favour.*** Who will become entitled to the income is dependent upon the same kinds of uncertain events as those that govern the devolution of the capital. ***No one holds any beneficial interest in anything coming from the residue of the estate unless and until one or more of the uncertainties is resolved in his favour." (Emphasis*** added.)

The following remarks of Kubushi J in *M v M and Others,* [2015], are also instructive:

> "[57] During the duration of the trial, I took the liberty to request counsel to provide me with authorities explaining the term 'beneficial interest'. Both counsel furnished me with judgments wherein the concept of beneficial interest was discussed in relation to trusts. Counsel informed me that even after diligent search, they did not come across a judgment where the term 'beneficial interest' was especially defined.
>
> [58] I also could not find any judgment wherein the term 'beneficial interest' is defined. I looked up the term in the internet search engine in the Free Dictionary (Legal dictionary) by Farflex. The term is explained as: ***'the right to receive benefits on assets held by another party'; 'Beneficial interest in a trust is whereby one has vested interest in the trust assets';*** and 'A beneficiary of a trust has a beneficial interest in the trust property, the legal title of which is held by the trustee.' ..." ***(Emphasis*** added.)

Even if one is to accept that a beneficiary's contingent right to the assets of a fully discretionary trust constitutes a "beneficial interest", it will still be impossible to value such right for purposes of determining whether the R10 million reporting threshold is exceeded. In this regard, in distinguishing between vested and contingent rights, the following was held in *ITC 76* [1927] (at 70):

> "Vesting implied the transfer of dominium ... A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. ***A contingent interest was merely a spes – an expectation which might never be realised. From its very nature it could not have a definite present value.*** In the income tax sense, therefore, a vested right was an accrued right." ***(Emphasis*** added.)

This bolsters the interpretation that a beneficiary's contingent right to a trust's assets does not fall within the ambit of paragraph 2.3 of the Public Notice as the notice clearly requires the taxpayer to value his or her "beneficial interest" in the trust.

What is envisaged by the expression "beneficial interest" would, accordingly, seem to be a vested right to either the capital or the income of a trust, or both, for only in this situation is there anything that is capable of valuation.

"What is envisaged by the expression 'beneficial interest' would, accordingly, seem to be a vested right to either the capital or the income of a trust, or both, for only in this situation is there anything that is capable of valuation."

DEFINITION OF "BENEFICIARY" IN SECTION 1(1) OF THE INCOME TAX ACT

If the Commissioner had intended the position to be otherwise, he could have made such intention clear in the Public Notice by using appropriate language. For example, in terms of its definition in section 1(1) of the Income Tax Act, 1962 (the Act) a "beneficiary" in relation to a trust means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust.

This definition clearly includes both vested and contingent interests in a trust. If it was the intention that contributions and payments to discretionary trusts should be reported, the provision should have arguably required a reporting obligation where any resident "beneficiary", as defined, makes a contribution to a non-resident trust and the gross value of the trust's assets exceeds or is reasonably likely to exceed R10 million. This has not been done, and the language used suggests the opposite.

"South African case law on the meaning of 'beneficial interest' can be found mainly in the context of estate duty disputes."

It is understood that SARS equates the term "beneficial interest" with a "contingent right" and that, according to its interpretation, residents are required to report their contributions to fully discretionary and irrevocable non-resident trusts if the aggregate contributions and payments or value of the trust's assets exceeds or is reasonably likely to exceed the R10 million threshold.

The views expressed in this article do, however, point in the opposite direction and resident beneficiaries of fully discretionary and irrevocable non-resident trusts should take note of these views should they ever be challenged by SARS for not reporting their trust contributions under the paragraph 2.3 of the Public Notice.

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Acts and Bills

- Income Tax Act 58 of 1962: Section 1(1) (definition of "beneficiary");
- Tax Administration Act 28 of 2011: Chapter 4, Part B (sections 34–39) (specifically section 34 (definitions of "arrangement", "participant", "promoter", "reportable arrangement" & "tax benefit").

Other documents

- Public Notice (Government Notice 140 (published on 3 February 2016 in *GG* 39650)): Paragraph 2.3;
- Free Dictionary (Legal dictionary) by Farflex (https://legal-dictionary.thefreedictionary.com/).

Cases

- *CIR and Others v Sive's Estate* [1955] (1) SA 249 (A); 20 SATC 66 (at 86 & 88);
- *Coronel v CIR* [1938] TPD 530; 10 SATC 158;
- *M v M and Others* (559/2007) [2015] ZAGPPHC 66 (4 February 2015);
- *ITC 76* [1927]; 3 SATC 68 (U) (at 70).

Tags: reportable arrangement; beneficial interest; discretionary trusts.

TEMPORARY LETTING OF RESIDENTIAL PROPERTY BY DEVELOPERS

The Taxation Laws Amendment Act, 2021 inserted a new section 18D into the Value-Added Tax Act, 1991 (the VAT Act), with effect from 1 April 2022. Section 18D deals with the temporary letting of residential property by a property developer, more specifically with the change in use adjustment required to be made by a developer on letting of residential property, the VAT treatment of any subsequent sale of a residential property that has been temporarily let, and the deemed input tax deduction available to developers upon the sale of the property in question.

BACKGROUND

Where a property developer who is registered for VAT develops residential properties for sale, the developer is entitled to deduct the VAT incurred on the development costs as input tax and is obliged to levy VAT at the standard rate on the sale of each developed unit.

Notwithstanding a developer's intention to sell the developed property, it often happens that in adverse market conditions the developer is unable to find a buyer at the required selling price. The developer may then opt to let the property unit temporarily to generate some cash flow until such time as market conditions are more favourable and a suitable buyer can be found.

"Sections 18D, 9(13) and 10(29) have now been inserted into the VAT Act to clarify the VAT treatment of the temporary letting of residential property with effect from 1 April 2022."

The letting of residential property as a dwelling is exempt from VAT. Consequently, the moment the units are let, the developer is regarded as having made a change in use of the unit for VAT purposes from a taxable application to an exempt application. VAT then becomes due and payable by the developer in terms of section 18(1) on the open market value of the unit as at the date on which the property is let.

It was recognised in the 2010 Budget Review that the value of this adjustment is disproportionate to the exempt income received by the developers and that options should be investigated to determine a more reasonable dispensation in dealing with the temporary letting of residential properties developed for sale.

Section 18B of the VAT Act was then introduced with effect from 10 January 2012 and granted temporary relief to developers who were then allowed to temporarily let the residential units for a period of up to 36 months before a change in use adjustment was required. However, the temporary relief provided under section 18B ceased to apply on 1 January 2018.

Consequently, residential property developers who then, for the first time, let their properties from 1 January 2018, were once again required to perform the change in use adjustment in terms of section 18(1) on the open market value of the property when the unit was first let as a dwelling. However, the difficulties created by the section 18(1) adjustment which existed prior to the section 18B temporary relief measures remained and developers were once again faced with cash flow difficulties resulting from the disproportionate adjustment.

For a period, the South African Revenue Service (SARS) allowed developers who performed a section 18(1) adjustment and who then subsequently sold the fixed property to deduct the total amount of VAT previously paid under section 18(1), against the output tax payable on the sale price. This was in terms of its VAT News 14 (March 2000). However, when SARS issued Binding General Ruling 55 (BGR55) on 10 September 2020, it took a completely different view, and stated that the subsequent sale of a dwelling for which a developer performed a section 18(1) adjustment would not be subject to VAT, but that it would rather be subject to transfer duty. This was on the basis that the property no longer constitutes an enterprise asset of the developer. The developer was accordingly not entitled to claim any input tax deduction on the subsequent sale of the property.

This led to much confusion amongst property developers, specifically, regarding whether the change in use adjustment resulted in the subsequent supply of the residential fixed property being permanently removed from the VAT net. Some property developers considered that output tax was still payable when the unit was subsequently sold while others did not.

SECTION 18D

Sections 18D, 9(13) and 10(29) have now been inserted into the VAT Act to clarify the VAT treatment of the temporary letting of residential property with effect from 1 April 2022.

Section 18D(1) defines the term "developer" to mean a vendor who continuously or regularly constructs, extends or substantially improves fixed property or part of that fixed property consisting of any dwelling for the purpose of disposing of that fixed property after the construction, extension or improvement.

In the same subsection "temporarily applied" is defined to mean the application of fixed property or a portion of a fixed property in supplying accommodation in a dwelling under an agreement, or more than one agreement, for letting and hiring thereof, which agreement or agreements relate to a combined total period not exceeding 12 months. The proviso to the definition states that "temporarily applied" does not apply to rental agreements which provide for a fixed rental period exceeding 12 months, in which case section 18(1), and not section 18D, will apply.

Subsection (2) provides for the adjustment and stipulates that where a developer develops residential fixed property for purposes of sale, but temporarily lets such property as residential accommodation in a dwelling, the fixed property is deemed to be supplied by the vendor for a consideration in money equal to the adjusted cost to the vendor of the construction, extension or improvement of such fixed property or portion thereof. The term "adjusted cost" is defined in section 1(1) of the VAT Act and is essentially the VAT inclusive cost of the goods or services in respect of the development of the property. The developer will be required to make the output tax adjustment, being the tax fraction of the adjusted cost, in the tax period in which the lease agreement comes into effect.

Subsections (3) and (4) provide for the VAT treatment of the subsequent sale of the temporarily let property. They provide that where a developer subsequently sells the fixed property in question within the 12-month period that the property was let, the sale is deemed to be a taxable supply in the ordinary course of the vendor's enterprise and the vendor must levy and account for VAT on the consideration charged for the property at the earlier of the date of any payment of consideration or registration of the property in the Deeds Registry.

Finally, subsection (5) provides that the developer is entitled to claim a deemed input tax deduction equal to the adjusted cost for the construction, extension or improvement of such fixed property, where the property –

- is sold during the 12-month "temporarily applied" period as contemplated in subsection (3);
- is temporarily applied for the 12-month period, and then immediately after the 12-month period is no longer used to supply accommodation in a dwelling; or
- falls within the proviso to "temporarily applied", being property subject to a fixed-term lease greater than 12 months, and which was subject to a section 18(1) adjustment.

"The letting of residential property as a dwelling is exempt from VAT."

ANALYSIS

Although section 18D seems to address the difficulties previously experienced by developers, on a closer look, a few questions remain unanswered. Specifically, questions in respect of the deemed input tax deduction.

Firstly, if one considers the provisions as they currently read, specifically section 16(3)*(o)*, read with section 10(29), it appears that a developer will now be allowed a higher input tax deduction being equal to the actual adjusted cost of the property and not only of the tax fraction of such adjusted cost. This seems to be incorrect as the input tax deduction should be equal to the output tax previously accounted for, which is the tax fraction of the adjusted cost. This will hopefully be corrected or clarified in due course.

Secondly, the position is clear that where a developer has a lease for a fixed period exceeding 12 months, the developer is required to perform a change in use adjustment in terms of section 18(1) and will then be entitled to claim a deemed input tax deduction in terms of section 18D(5), read with section 16(3)*(o)*. However, it is not clear what the position is when the property developer already made an adjustment in terms of section 18D(2) based on the intention to let the property only for a period not exceeding 12 months, but where the lease period is extended beyond 12 months due to a change in circumstances.

In this instance, the developer will already have made a deemed supply in terms of section 18D(2) and cannot be required to make another adjustment in terms of section 18(1). However, the subsequent deemed input tax deduction will not be permitted in terms of section 16(3)*(o)* as the requirements of section 18D(5) will not have been met. It does not seem to be correct that in this instance the developer is not entitled to claim any input tax deduction upon the sale of the property. In these circumstances, it seems that the vendor should be permitted to claim an input tax deduction once the property is sold in terms of section 18(4), calculated on the lesser of the adjusted cost or the open market value of the property. This position would, however, need to be clarified by SARS.

Lastly, section 18D(5)*(a)* entitles the developer to claim a deemed input tax deduction where a property is sold within the 12-month temporarily applied period, at the time that such property is sold. However, the position regarding the deemed input tax deduction allowed in the remaining two circumstances is less clear. As it currently reads, paragraphs *(b)* and *(c)* of section 18D(5) state that the deduction is allowed upon the expiration of the 12-month temporarily applied period where the property is no longer let to supply residential accommodation, or where a section 18(1) adjustment was applied where the property was subject to a fixed-term lease exceeding 12 months. This seems to imply that the input tax deduction may be claimed either once the 12-month period expires and the developer no longer lets the property, or once the 18(1) adjustment is performed, as the case may be, and does not clearly specify that such deduction may only be claimed when the property is subsequently sold in these instances. Notwithstanding the omission to clarify the timing of the deemed input tax deduction, it appears that the intention is, in each of the circumstances provided for under section 18D(5), for the deemed input tax deduction only to be claimed upon the sale of the property by the developer. Section 18D, however, does not explicitly provide for this, and this will also need to be clarified.

CONCLUSION

While section 18D seems to have been developed with the correct objective in mind and does indeed provide some clarity on the VAT treatment of the temporary letting of residential property by developers and some cash flow relief, the provision is still in need of further "construction, extension or improvement" to provide further clarification. It is advisable that developers seek expert VAT advice to ensure compliance with the provisions of this section.

"While section 18D seems to have been developed with the correct objective in mind and does indeed provide some clarity on the VAT treatment of the temporary letting of residential property by developers and some cash flow relief, the provision is still in need of further 'construction, extension or improvement' to provide further clarification."

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Acts and Bills

- Value-Added Tax Act 89 of 1991: Sections 1(1) (definition of "adjusted cost"), 9(13), 10(29), 16(3)*(o)*, 18(1), 18B, 18D (more specifically subsections (1) (definitions of "developer" & "temporarily applied") & (5));
- Taxation Laws Amendment Act 20 of 2021.

Other documents

- 2010 Budget Review;
- Binding General Ruling 55 (issued by SARS on 10 September 2020);
- VAT News 14 (March 2000).

Tags: residential property developers; adjusted cost; deemed input tax deduction.

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