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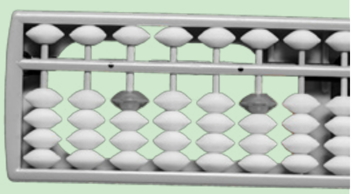

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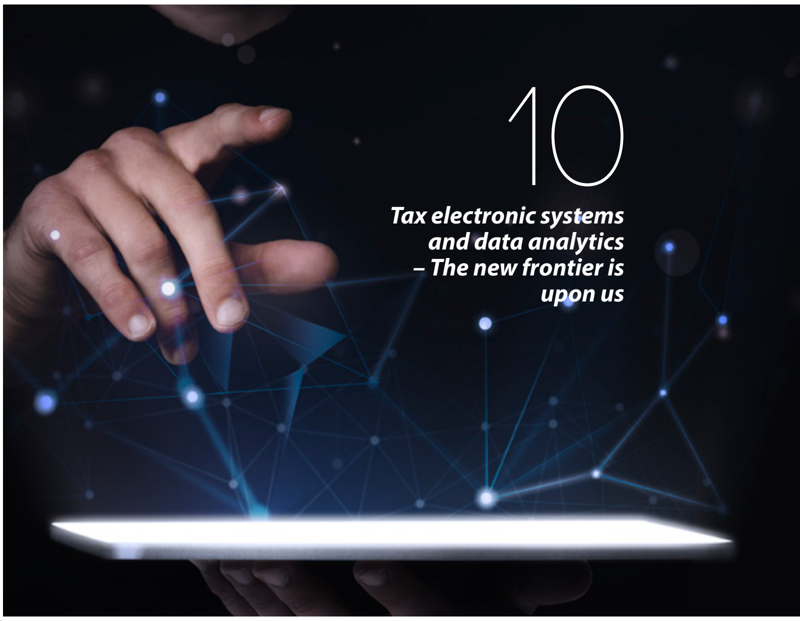

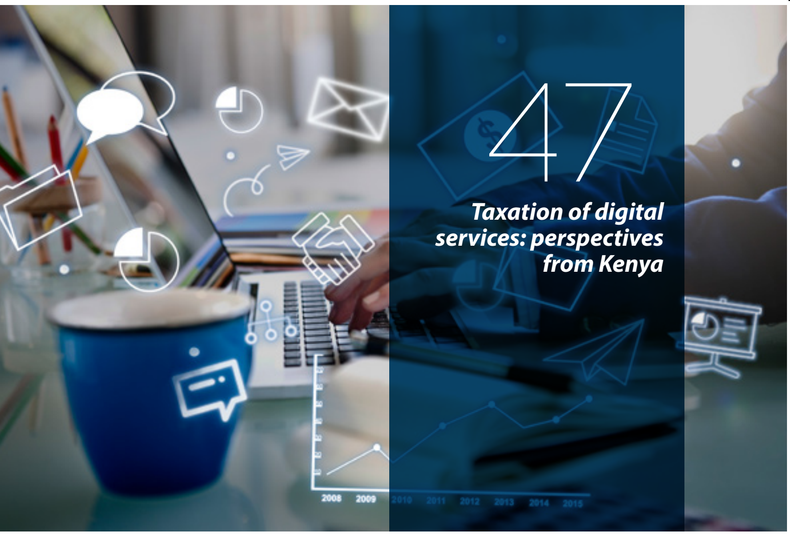

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SOUTH AFRICA'S GREYLISTING: LIMITED SHORT-TERM IMPACT MAKES IT MORE DANGEROUS

15 minutes CPD

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

The greylisting of South Africa by the Financial Action Task Force (FATF) was announced on 24 February of this year, two days after the 2023 Budget Speech.

Though expected and, according to government and financial practitioners, already 'priced-in', it nonetheless affirmed the continued deterioration in the country's standing as an emerging market. Countries get greylisted for a variety of reasons, of which none of these are good and they are provided with a set of requirements that they have to fulfil to be removed. Those who fail to comply either remain greylisted or they get blacklisted, with punitive consequences.

Mauritius, for all its reputation as a competitive, business-friendly jurisdiction, suffered greylisting in February 2020. It diligently complied with the FATF's requirements and, in a mere 20 months, returned to the company of the financially palatable. This diligence was noted by SA's government and by analysts as an example to follow.

But for Mauritius, greylisting was a profound shock. It reverberated through the entire, though admittedly small, country. It was a national headline that turned up the heat on the government and a financial sector critical to the island's economy. Citizens and businesses saw it as directly relevant to their livelihoods and as an inescapable indictment of their government. The pressure to be removed from greylisting was enormous.

SA's greylisting appears to be a very different affair Few citizens know about the FATF and the greylisting. A mere six months later, it barely features in the business media and is absent from the national conversation. The last government communication on the subject was on 17 May—an announcement by National Treasury of an allocation of R265 million to the Financial Intelligence Centre to ensure that the country meets the deadline of early 2025. It did not make conversation at the BRICS Summit despite talks of a future common currency, contrary to what many commentators had said would happen there. The International Monetary Fund (IMF), though, raised the issue in a 6 June press release on the state of the fiscus, pressing SA to return to compliance.

On the face of it, this oblivion is deeply concerning. It raises questions about the country's understanding of the significance of greylisting. As a result, it brings attention to its commitment to do what is required. On the face of it. Because, at the risk of stating the obvious, SA is not Mauritius. Two significant factors may explain the different reactions.

The first is that SA depends much less on external capital flows than Mauritius—a small, open economy with no natural resources. External direct and portfolio investments represented a massive 135 per cent of gross domestic product (GDP) on average between 2018 and 2022 (IMF). It represented a mere four per cent in the period. Mauritius depended on foreign debt capital equivalent to 100 per cent of GDP on average. SA's requirement was around 45 per cent. Mauritius's trade amounts to 120 per cent of GDP, while SA stands at around 60 per cent. It is thus not surprising to hear Minister Godongwana remarking to Parliament on 2 May: "*We have not seen any negative reaction by corresponding financial institutions to our institutions*", though acknowledging that "*we have to recognise the reasons we were greylisted do have major economic consequences*". Stated differently, the short-term impact of greylisting is a lesser concern than its long-term effects.

"Government failure is embedded in the fabric of society, thanks to an unfathomable deficit in skills, integrity and accountability"

The second is that SA has been mired in a long, worsening crisis that affects just about every aspect of life. Growth is near absent and negative when measured in GDP per capita. Private consumption is anaemic. Poverty is steadily rising, as is an already abysmal inequality. Unemployment is the world's worst. Crime and insecurity are at levels matching those of conflict-affected countries. Savings and productive investments are among the world's lowest. Productivity is falling. SA has seen its industrial sector savaged; manufacturing's share in GDP is now lower than the already low Sub-Saharan Africa average. Private sector debt is one of the world's highest. Business failures are at a record high and business creations are not keeping pace. Infrastructure failure is now endemic, forcing households and businesses to direct scarce resources towards essential services; they already pay a tax take that is among the world's highest.

Government failure is embedded in the fabric of society, thanks to an unfathomable deficit in skills, integrity and accountability. The Fragile State Index captures this national systemic decline in stark terms: from ranking in the 24th percentile in 2005, SA ranked in the 57th in 2022—a staggering 42 per cent rank loss similar to those of countries at war. EunomixGCR, my firm's geopolitical and country analysis and management programme, forecasts that SA will reach the 75th percentile in 2030, by which time it will be technically considered a failed state. My 2016 forecast for 2021 was 80 per cent accurate, if slightly optimistic . . . Mauritius, on the other hand, saw its ranking improve from the 18th to the 15th percentile between 2005 and 2022 and touched the 13th in 2020.

In such a context, greylisting is but one of the many emergencies that saddle SA. To the average South African and the average business, it means very little in absolute terms (the first factor above) and in relative ones (the second factor). This is why Minister Godongwana's warning about its longer-term economic consequences must imperatively be heeded and greylisting rapidly be resolved; its seeming lack of impact where so many crises take precedence dilutes its urgency, whereas it was *the* crisis in Mauritius.

TAX ELECTRONIC SYSTEMS AND DATA ANALYTICS — THE NEW FRONTIER IS UPON US

15 minutes CPD

KARL MULLER, Tax Director

The use of technology is certainly influencing all spheres of life and it is an essential tool in the financial world. Tax compliance has not been left unaffected; today, there are many tools and technologies available to assist in compliance. Key drivers of the increased tax management software are (i) the sheer volume of financial data generated by companies; (ii) the need to efficiently manage this data in the compliance process and (iii) increasing regulatory requirements.

It certainly appears that new technology is all the rage in the tax compliance sphere. In fact, according to an article in *Fortune Business Insights*, the global tax management software market size is currently valued at USD 14,4 billion and is projected to grow to USD 38,5 billion by 2030 (*Fortune Business Insights Market Report July 2023* Report ID: FBI102631).

The case for change

Does the proliferation of tax software mean that it is only a matter of time before it becomes imperative for companies to invest in technologies to simplify their compliance process, or can they continue to use only their existing accounting systems and tools such as Microsoft Excel?

For large companies and certainly for multinationals, the sheer volume of data and the risk of errors in compliance make it imperative to invest in technology to manage risk, simplify compliance and free resources to actively manage compliance. Whereas the solution may appear to be simple, it is not; it requires a very clear technology strategy to manage the various taxes across various regions.

Scope of technology

One of the biggest issues faced in this space is the lack of a single technology solution. Most solutions do not cover all regions or all taxes, meaning that multiple solutions will usually be required to increase the scope and, even then, there may be markets where no solution is available. Solutions focus on indirect and corporate income taxes. However, taxes such as customs and excise duties and withholding taxes are not as well represented in the technology space. In addition, new requirements for tax transparency such as Country by Country Reporting (CbCR) and the latest initiatives in respect of Pillar One and Pillar Two by the Organisation of Economic Co-Operation and Development (OECD) will require additional data to be available to comply. The increase in the requirement for transparency and enhanced compliance means that there is a constant need for additional technologies to cater for these new requirements.

Tax compliance and reporting also require additional non-financial information such as employee numbers, beneficial ownership, certain customer data and other information. Examples are disclosures required to be made by certain institutions directly to tax authorities of client information, which is used to check compliance. Special technology solutions are required for this.

"The increase in the requirement for transparency and enhanced compliance means that there is a constant need for additional technologies to cater for these new requirements"

Tax authorities and technology

Especially in the indirect tax space, more and more tax authorities are moving towards e-invoicing systems which require vendors to upload invoices directly into the portal. This enables the tax authorities to have greater insight into the actual output and input taxes to be disclosed in the VAT return. In many cases, the VAT liability is determined directly in the system.

One of the complications with these types of systems is that an interface with the existing accounting systems of the taxpayer is required. In many cases, not all data required for tax compliance is immediately available in the system and additional uploads are required for transactions such as imports and reverse VAT. Often, smaller enterprises are not required to be on electronic invoicing. This causes complications and while it would theoretically seem that an e-invoicing system is the solution, cross-border transactions remain an issue for compliance.

- The tax authorities in some countries require access to the financial systems of the taxpayer in the belief that this gives them full insight into the transactions of the taxpayer and, therefore, enables them to audit the tax liabilities of the taxpayer. One of the problems faced in this regard is that accounting systems are not set up in the same way, charts of accounts differ and data quality is also a factor. Only having access does not provide the solution, as it requires a full understanding of each taxpayer's reporting and accounting structure. These do not match across different enterprises, even enterprises in the same business area.

> *"The continued evolution of tax does mean that technology will also have to evolve to cater for this change"*

How should large taxpayers approach the use of technology?

Unfortunately, there is not a one-size-fits-all approach and each taxpayer needs to establish their own strategy and process to adapt the usage of technology. One critical area is to have a very clear technology strategy. This requires a clear plan of what is required and when which system will be implemented.

One approach is to tackle data quality first and to attempt to use tax determination software in order to minimise errors in tax codes and transaction posting. Whereas this appears simple, it is extremely difficult to eliminate all data errors and get 100% accuracy in tax determination. If it is understood that this is not the panacea, it is still an approach that has merit. This, then, would set the basis for selecting software that can assist in generating indirect and direct tax compliance. The technologies and providers of the most appropriate software for the different taxes should then be identified and selections made.

Another approach is to focus on analytical technology to identify errors and then take corrective action so that the data used for compliance is corrected in sufficient time to ensure full compliance. Part of this would then be to act based on findings in order to address the input of data to eliminate errors. In many cases, technologies have this data analytical capability built in, which enables corrections to be made prior to submission.
An alternative approach would be to focus on compliance reporting and dashboards to first identify where there are issues in compliance such as late returns, incorrect returns, resubmissions and tacking of tax audits. This provides senior management with a clear view of problem areas to be addressed and then to decide on appropriate actions such as data analytics and appropriate technology solutions.

All these approaches are subject to due consideration being taken of the effect on current technology in use for financial reporting and tax compliance by the taxpayer.

The business case for change

Many corporations always expect some form of payback for their investment; this is often a huge stumbling block for corporations, as the main benefit of investing in technology to assist in compliance is the reduction of risk and just getting it right. There are no benefits such as reduced tax. Therefore, the general approach to a return on investment is not possible.

Whereas one could try and quantify what the risk reduction is, this is extremely subjective and the real focus should be on speedy, high quality and efficient tax compliance. This reduces the reactive approach to dealing with issues after the fact and allows tax professionals in the organisation to proactively engage in business activities and improve compliance processes. In addition, they can use analytical tools and Artificial Intelligence to highlight areas needing attention or interventions. In this way, tax professionals can add value to the business by being a valued business partner.

Conclusion

Technology will certainly change the way in which compliance is done. Technology will streamline compliance and should improve transparency. Yet, it is still not the perfect solution that taxpayers, tax authorities and civil society expect it to be. The continued evolution of tax does mean that technology will also have to evolve to cater for this change. Tax authorities and taxpayers alike will need to embrace technology but tax compliance is still a long way away from real-time compliance and assessment.

THE FUTURE OF SOUTH AFRICAN TRADE

30 minutes CPD

ARISTA NEL, Trade Analyst at XA Global Trade Advisors

South Africa's future in trade depends on how it positions itself as a trading partner. The government's policies such as the Master Plans, make it clear that South Africa wants to have the upper hand in trade.

For example, the *Retail Clothing, Textile, Footwear and Leather (R-CTFL) Master Plan* requires that apparel and clothing accessories made from fabrics imported must be destined for retailers that have made local procurement commitments in terms of the R-CTFL Master Plan. These retailers must have signed the Master Plan or do so in the future.

These requirements ensure that the imported fabrics are ultimately used to support and promote local retailers and manufacturers and bring the manufacturing from neighbouring countries into South Africa. This approach to trade can help protect South Africa's domestic industries and create jobs; however, it can also make South Africa a less attractive trading partner for other countries.

Trading this way has both advantages and disadvantages. On the one hand, it can help protect South Africa's domestic industries and create jobs by promoting localisation. On the other hand, it can make South Africa a less attractive trading partner for other countries.

Ultimately, the success of South Africa's trade policy will depend on how well it balances these two competing goals, however, the trade-off should not be at the cost of our relationship with neighbouring countries.

Factors that shape South Africa's trade

The future of trade for South Africa is uncertain but there are a number of factors that could shape it. These include the African Continental Free Trade Area (AfCFTA) and the African Growth and Opportunity Act, the ongoing war in Ukraine, the rise of protectionism, the digital economy and climate change.

The African Continental Free Trade Agreement

South Africa is a member of the African Continental Free Trade Agreement (AfCFTA), which aims to create a single market for goods and services, reduce tariffs and lay the foundation for a continental customs union. However, there are a number of challenges that South Africa needs to address in order to fully benefit from the AfCFTA. These include:

- Diversifying exports: Currently, South Africa's exports are heavily reliant on commodities such as minerals and metals. This makes the country vulnerable to fluctuations in commodity prices. South Africa needs to diversify its exports to include more manufactured goods and services.
- Improving infrastructure: Poor infrastructure is a major obstacle to trade in South Africa. The country's roads, railways and ports are congested and outdated. This makes it difficult and expensive to transport goods and services. South Africa needs to invest in its infrastructure to improve the efficiency of its trade.
- Reducing trade barriers: South Africa has a relatively high level of trade barriers, which make it more difficult and expensive for foreign companies to do business in the country. Trade barriers need to be reduced to make it easier for foreign companies to invest and trade in South Africa.
- Improving the business environment: South Africa's business environment is relatively difficult and bureaucratic. This makes it difficult for businesses to start and operate in the country. South Africa needs to improve its business environment to make it easier for businesses to operate in the country.

If South Africa can address these challenges, it will be well-positioned to benefit from the AfCFTA and become a major player in the African economy. Once the AfCFTA is in full operation, it will create significant opportunities for South African businesses to export their goods and services to other African countries.

African Growth and Opportunity Act

The African Growth and Opportunity Act (AGOA) is a trade agreement between the United States of America (USA) and 46 African countries that was signed into law in 2000. AGOA provides preferential trade access to the United States (US) market for goods from eligible African countries. The current iteration of AGOA expires on 31 December 2025 and it is not yet clear whether the US Congress will renew it.

"In addition, protectionist policies may also lead to retaliatory measures from other countries, further exacerbating the challenges faced by South African exporters in accessing global markets"

The relationship between South Africa and the USA has been tense for a while, due to a number of factors, including the USA opposition to apartheid and South Africa's decision to abstain from voting on a UN resolution condemning the Russian invasion of Ukraine. However, the USA is still South Africa's second largest trading partner, accounting for 8% of South Africa's exports.

Nevertheless, if AGOA is renewed, it is likely that the benefits will be expanded to include more African countries. However, it is also possible that South Africa could be suspended from AGOA if the US government believes that the country is not complying with the terms of the agreement.

South Africa needs to take steps to ensure that it remains eligible for AGOA benefits, which includes:

- Stabilizing the political situation: South Africa needs to take steps to address the political instability in the country. This could include implementing reforms to address the underlying causes of the instability such as poverty and inequality. It also includes taking a more neutral stance on the war in Ukraine.
- Improving the economy: South Africa needs to improve its economy so that it is more attractive to investors. This could include reducing corruption, improving infrastructure and creating a more business-friendly environment.
- Diversifying trade partners: South Africa needs to diversify its trade partners so that it is not too reliant on the US market. This could involve increasing trade with other African countries and other regions of the world.

- The future of AGOA is uncertain but it is important for South Africa to take steps to ensure that it remains eligible for the benefits of the agreement. By doing so, the country can boost its economy and create jobs.

Challenges and opportunities for South Africa in the global economy

The war in Ukraine has disrupted global trade and could have a negative impact on South Africa's economy, which it already has on the inflation rate and the price increases of commodities and petrol. However, the war could also create opportunities for South Africa to export goods and services to countries that are looking to reduce their dependence on Russia and Ukraine.

Nevertheless, the rise of protectionism is a trend towards putting restrictions on trade, which could make it more difficult for South Africa to export its goods and services. This could have a significant impact on the country's economy, as exports play a crucial role in driving growth and creating jobs. In addition, protectionist policies may also lead to retaliatory measures from other countries, further exacerbating the challenges faced by South African exporters in accessing global markets. Therefore, it is crucial for the government and relevant stakeholders to actively engage in negotiations and promote free trade agreements to mitigate the potential adverse effects of protectionism on South Africa's export sector.

The digital economy is growing rapidly and this could create new opportunities for South Africa to trade goods and services online. However, South Africa needs to invest in its digital infrastructure in order to take advantage of these opportunities. This includes improving internet connectivity, expanding broadband access and developing secure online payment systems. Additionally, investing in digital literacy programmes and providing training to individuals and businesses will ensure that they have the necessary skills to participate effectively in the digital economy. By making these investments, South Africa can position itself as a competitive player in the global digital marketplace and drive economic growth in the country.

Climate change is a major challenge that could have a significant impact on trade. For example, rising sea levels could disrupt shipping routes and make it more difficult to transport goods and services. Most countries are implementing certain measures to reduce carbon gas. These measures include the promotion of renewable energy sources such as wind and solar power and the adoption of stricter emissions standards for industries. Additionally, many countries are also investing in research and development to find more sustainable and environmentally friendly ways to produce and transport goods. By taking these actions, countries hope to mitigate the effects of climate change on trade and ensure a more sustainable future for global commerce. South Africa needs to take steps to mitigate the effects of climate change in order to protect its trade interests.

If South Africa can address the challenges it faces, it can position itself to benefit from the opportunities that the global economy has to offer. Ultimately, trade leads to increased productivity, higher living standards and job creation both within and across countries.

In conclusion, the future of South African trade is uncertain. However, there are a number of factors that could shape it, including the African Continental Free Trade Agreement (AfCFTA), the African Growth and Opportunity Act (AGOA), the ongoing war in Ukraine, the rise of protectionism, the digital economy, and climate change.

These factors will undoubtedly have a significant impact on South African trade, with potential opportunities and challenges. On the one hand, the African Continental Free Trade Agreement (AfCFTA) presents a promising opportunity for South Africa to expand its trade relationships within the continent. On the other hand, the ongoing war in Ukraine and the rise of protectionism globally may create trade disruptions and uncertainties.

Moreover, the digital economy will play a crucial role in shaping trade patterns, allowing for new avenues of growth and competition. Lastly, climate change will necessitate a shift towards sustainable and environmentally friendly trade practices, which may require significant adaptation and investment. Ultimately, South Africa's trade future will depend on how it navigates these complex and interconnected factors.

PILLAR II AND THE PENDING GLOBAL MINIMUM TAX — **WHAT DOES IT LOOK LIKE IN THE SOUTH AFRICAN CONTEXT?**

▶ **LUTANDO MVOVO,** Executive Head: Internation Tax at Vodacom

South Africa is one of the 137 members of the OECD/G20 Inclusive Framework (IF) that has agreed to adopt the OECD IF's two-pillar solution.

In Chapter 4 of the *2022 Budget Review published* on 23 February 2022, which deals with revenue trends and tax proposals, National Treasury indicated that South Africa would propose legislative amendments to implement the OECD IF's two-pillar solution once the framework has been finalised and translated into a local context. In the *2023 Budget Review* published on 24 February 2023, National Treasury stated that during the 2023 legislative cycle, the government would publish a draft position on the implementation of Pillar II for public comment and draft legislation will be prepared for inclusion in the 2024 Taxation Laws Amendment Bill.

Some countries, mainly developed countries and low tax jurisdictions, have already started the process of implementing Pillar II rules.

What is Pillar II and how does it is work?

Pillar II rules, commonly referred to as the OECD Global Anti-Base Erosion rules (GloBE rules), introduce a global minimum effective tax for Multinational Enterprises (MNEs). The GloBE rules are aimed at establishing a global floor on corporate tax competition and to stop the so-called 'race to the bottom' on corporate tax rates. These rules will apply to MNE Groups with global consolidated annual revenues of more than €750 million and ensure that they pay a minimum effective tax rate of at least 15 per cent on profits arising in each jurisdiction in which they operate. The threshold takes into account the consolidated financial statements of the MNE group. Therefore, not each subsidiary within the group has to meet the €750 million threshold.

In the event that the MNE Group's subsidiary in a particular country is subject to an effective tax rate below 15 per cent, the MNE Group will be required to top up for the difference. The Ultimate Parent Entity (UPE) of the MNE Group that falls within the scope of the GloBE rules is required to calculate top-up tax liability for each jurisdiction that has an effective tax rate which is below the minimum level of the taxation of 15 per cent. For example, if a subsidiary of ABC Group (UPE) in country M pays 3 per cent effective tax rate on the profits of €1 billion in country M (i.e. €30 million), the tax authority of the UPE jurisdiction can apply a top-up tax of an additional 12 per cent on those profits (i.e. €120 million). The determination of the GloBE income or loss is based on financial accounting, which is used to compute the effective tax rate for each jurisdiction and the top-up tax of each member of the MNE Group.

The GloBE rules will be implemented through three interrelated tax rules:

- An 'income inclusion rule' (IIR) allows the jurisdiction of the UPE to impose a top-up tax if foreign-earned MNE profits are taxed below 15 per cent minimum effective tax rate in any jurisdiction in which the MNE operates.
- An 'undertaxed payments rule' serves as a backstop to the IIR and denies MNE deductions or requires an equivalent adjustment to the extent that the low tax income of a constituent entity is not subject to tax under an IIR.
- A 'subject to tax rule' (STTR), a treaty-based rule that turns off treaty benefits on intragroup payments that are not subject to a minimum nominal rate of tax in the payee jurisdiction and allows source jurisdictions to impose limited source taxation on certain intragroup payments subject to below a minimum rate of 9 per cent.

The GloBE rules also provide for a Qualifying Domestic Minimum Top-Up Tax (QDMTT), which allows countries the first right to charge the top-up tax on low-taxed profits.

Will tax incentive survive post-implementation of GloBE rules?

It is a general global practice for countries that seek to attract foreign direct investment to introduce tax incentives, among other forms of incentives. However, Pillar II rules will have an impact on different tax incentives.

The GloBE rules do not explicitly prohibit countries from introducing or keeping the existing tax incentives. However, based on the manner in which these rules are intended to operate, tax incentives are more likely to trigger top-up tax under the GloBE rules, especially where they are treated as reductions in the GloBE effective tax rate calculation.

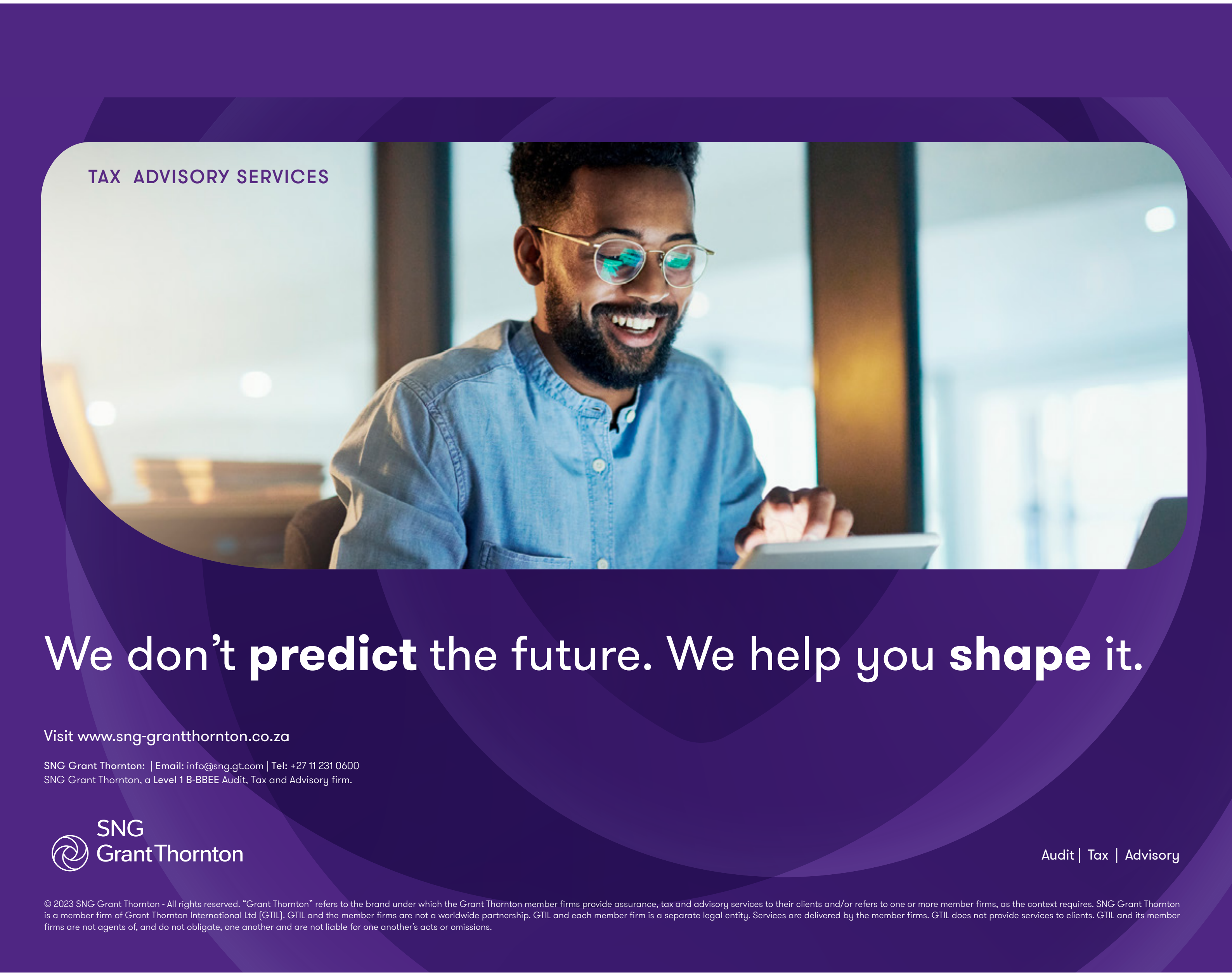
The GloBE rules will apply if the tax incentive reduces the effective tax below 15 per cent and to the extent that the accounting profit of the entity that benefits from the tax incentive is above the substance-based income inclusion. These will include tax incentives such as tax holidays, reduced rates or exemptions. However, not all tax incentives will be affected by the GloBE rules. For example, accelerated depreciation allowances will have a limited impact on the calculation of the effective tax rate as deferred tax adjustments are used in calculating covered taxes.

Tax incentives below 15 per cent effective tax rate will not provide any additional benefit for either the MNEs or the country providing such tax incentive. Instead, it is the country of the UPE that will benefit through top-up taxes. Therefore, tax incentives below 15 per cent effective tax rate applicable to businesses that meet the €750 million are unlikely to survive after the implementation of the GloBE rules.

> *"Countries that offer tax incentives such as reduced corporate tax rates, tax holidays, exemptions and deductions leading to an effective tax rate below 15 per cent will likely loose revenue to the countries of UPEs which, in most cases, are developed countries"*

The minimum tax conundrum: Does South Africa have a choice in implementing Pillar II?

While South Africa can be considered a high-tax jurisdiction, it has, like most developing countries, introduced tax incentives to attract foreign direct investment. These tax incentives include, *inter alia*, special economic zones (SEZs), Research and development (R&D), Urban Development zones, the Industrial Policy Project (IPP), tax incentives for capital expenditure incurred for mining activities and tax incentives for renewable energy. The existence of these tax incentives may bring the effective tax rates of some of the companies below the GloBE minimum level of 15 per cent.



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The impact of the tax incentives can be further explained using the following example: ABC Ltd group, a company tax resident in Country A has a foreign subsidiary, XYZ Ltd, tax resident in South Africa. ABC Ltd Group falls within the scope of the GloBE rules.Country A has adopted Pillar II rules and intends to implement the rules from June 2024. XYZ is located in a designated SEZ in South Africa and is therefore a qualifying company for SEZ purposes. As a result, it is subject to a 15 per cent corporate tax rate but its effective tax rate is 12 per cent. Since the effective tax rate of XYZ Ltd is below 15 per cent, Country A can apply the top-up tax of an additional 3 per cent on the profits of XYZ Ltd, resulting in South Africa losing tax revenue.

South Africa has a number of options to protect its revenue. One of these options is to evaluate the existing tax incentives to determine whether they are in line with GloBE rules. Any tax incentives that are likely to be impacted by the GloBE rules will need to be restructured. For example, such tax incentives could be limited to companies with annual revenues below €750 million and to wholly domestic companies.

South Africa may also opt to introduce a QDMTT but limit it to in-scope companies. For example, businesses with annual revenues below €750 million and wholly domestic companies could be excluded from the rules. This would ensure that South Africa collects its own top-up tax on profits of its taxpayers instead of the countries of the UPE. QDMTT is fully creditable against any liability under the GloBE rules and that would preserve South Africa's primary right of taxing its own income.

A number of countries, including countries that are members of the OECD IF have already proposed the introduction of domestic minimum taxes.

Concluding thoughts

The implementation of the GloBE rules will affect all countries whether they are members of the OECD IF or not. Countries that offer tax incentives such as reduced corporate tax rates, tax holidays, exemptions and deductions leading to an effective tax rate below 15 per cent will likely loose revenue to the countries of UPEs which, in most cases, are developed countries.

The nature of GloBE rules is that they follow a common approach. This means that countries, including OECD IF members like South Africa, are not obliged to implement them. While this may sound like a good option for countries, the option of doing nothing has a risk that South Africa may lose tax revenues to other countries that may top-up taxes. It is therefore important for South Africa to act swiftly to protect its tax base.

15 minutes CPD

HAS SARB GONE 'LOOP-THE-LOOP'?

▶ **ROBYN BERGER,** Tax Executive at Bowmans

Investment in South Africa remains plagued by exchange control laws, which results in costly and time-consuming processes for foreign investors.

A long-awaited change to the exchange control rules was enacted in 2021 with the relaxation of the so-called 'loop structure' rules. Many investors took advantage of this relaxation and restructured their existing South African assets so that they would be owned by approved foreign structures.

However, although no announcements have been made as yet, it would appear that the Financial Surveillance Department (FinSurv) of the South African Reserve Bank (SARB), intends back-tracking on this relaxation.

This article provides further information on this perplexing situation.

Exchange control law

The South African Reserve Bank (SARB) is responsible, on behalf of the Minister of Finance, for the day-to-day administration of exchange controls in South Africa. Exchange controls are regulated in terms of the Exchange Control Regulations of 1961, issued under section 9 of the Currency and Exchanges Act, 1933, read with the Currency and Exchanges Manual for Authorised Dealers (Exchange Control Manual). The primary purpose of these rules is to limit the extent to which South African residents and companies may transfer funds abroad.

While Finsurv attends to the day-to-day administration of exchange controls, policy is determined by the Minister of Finance. SARB acts as an adviser to the Minister of Finance and as an implementer of exchange control policy decisions. The rules are regularly updated through circulars published on the SARB website. The circulars are then incorporated into the Exchange Control Manual.

"Parties that have undertaken these restructures find themselves in a difficult position, as they cannot simply unwind these"

One of the most important regulations is regulation 10(1)(c), which acts as a catch-all provision to ensure that all cross-border transactions are treated under the exchange control regulations.

Regulation 10(1)(c) states that no person shall, except with permission granted by National Treasury and in accordance with any conditions as by National Treasury may impose, enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the country.

The term 'capital' is not well defined. Guidance has been provided by the courts, where it has been held that the word 'capital' must be expansively interpreted. However, the more recent case of *Oilwell (Pty) Ltd v Protec International Ltd and Others (2011 (4) SA 394 (SCA))* [2011] ZASCA 29; 295/10 (18 March 2011) rejected this approach; it held that Exchange Control Regulation 10(1)(c) does not apply to the assignment of a trademark to a non-resident.

Subsequent to the Oilwell judgement, the Exchange Control Regulations were amended to provide that the word 'capital' includes, without derogating from the generality of the term, any intellectual property right, whether registered or unregistered. To this day, the Exchange Control Regulations only clarify that the word 'capital' includes an intellectual property right. Practically, to prevent conflict with Finsurv, it is prudent to treat anything with money's value as capital.

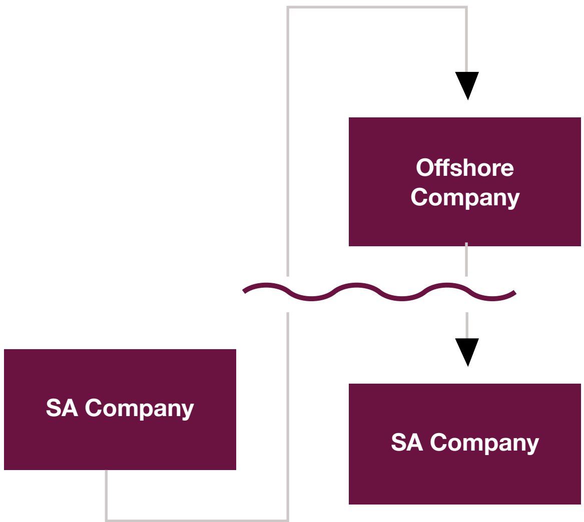
Specific rules apply to exchange control resident individuals and corporates wanting to externalise capital from South Africa. In the case of individuals, there are two primary avenues: they can use their annual discretionary ZAR 1 million allowance and, subject to a SARS tax clearance, they can use their annual ZAR 10 million foreign investment allowance.

Companies are subject to a comprehensive foreign direct investment regime which, depending on the level of investment required, may either be approved by their authorised dealer (being their local bank) or by Finsurv (investments in excess of ZAR 5 billion must be referred to Finsurv for approval).

Loop structures

A loop structure was considered to directly contravene the provisions of Regulation 10(1)(c). This is because a loop structure allowed South African resident individuals or companies to effectively externalise more capital than permitted under the legislated allowances.

- Currently, the *Exchange Control Manual* states that where a resident individual or corporate with authorised foreign assets invests in South Africa through an offshore structure, this constitutes a loop structure. A simplified loop structure can be diagrammatically illustrated as follows:



There are also other versions of loop structures that may arise. For example, certain foreign trusts that hold South African investments while having South African beneficiaries, may cause a loop. Parties are advised to check with their advisors whether their local or foreign structure constitutes a loop arrangement.

Until recently, loop structures were only permitted in limited circumstances; the general rule was that South African exchange control residents were permitted to enter loop arrangements provided that they did not, in aggregate, own more than 40% of the shares in the foreign company, regardless of the extent of ownership held by the foreign company in the South African assets.

In January 2021, Exchange Control Circular No. 1/2021, abolishing all restrictions on loop structures, was issued. The circular provides that individuals, companies and private equity funds may use authorised foreign assets to invest in South African assets through a loop structure, subject to some form of supervision from their authorised dealer and Finsurv. The investment must be reported to their authorised dealer as and when the transaction(s) is finalised and an annual progress report must be submitted to Finsurv via their authorised dealer.

Prior to this circular being published, changes were enacted to the tax legislation to give both Finsurv and SARS assurance that the relaxations would not lead to the implementation of ownership structures that would undermine the South African tax base.

Loop relaxation consequences

With the abolition of the 'loop' rule, many South Africans restructured ownership of their existing South African assets, whereby they sold these assets to approved foreign structures (usually held through foreign trusts).

To achieve these new ownership arrangements, the individuals typically incurred significant tax costs triggered by the sale of the existing South African assets to the approved foreign structures. Moreover, they may well have had to introduce a substantial amount of cash into South Africa, as the sale of South African assets on loan account is not permitted. The relevant parties then, in line with the prescribed rules, reported the transactions to Finsurv via their authorised dealers.

Finsurv responded to these submissions, stating that it does not approve such applications. Finsurv explained that the prohibition on loop structures had been removed to promote new investment into South Africa, not to allow parties to restructure their existing South African assets under approved foreign investments.

However, Exchange Control Circular No. 1/2021 does not limit the instances where a loop is permitted and neither do the changes effected to the Manual. Moreover, Finsurv has not repealed Exchange Control Circular No. 1/2021 or amended the Exchange Control Manual to better reflect its intention.

As the *Exchange Control Manual* currently reads, Finsurv approval is not required for such arrangements; rather, the parties entering these arrangements are only required to notify Finsurv and attend to the reporting requirements.

Finsurv has indicated that it is working on an updated circular, which will be issued to clarify its position. However, as things currently stand, it would seem that the rules outlined in Exchange Control Circular 1/2021 continue to apply. Despite this, parties complying with these rules are faced with the dilemma that Finsurv will state that it does not approve the transactions they have undertaken.

Conclusion

Nearly two years have passed since the circular was first issued and the uncertainty remains. Parties that have undertaken these restructures find themselves in a difficult position, as they cannot simply unwind these, given the tax costs that they have incurred to achieve them and the funds that they have introduced into South Africa. We can only hope that Finsurv will clarify its position soonest.

15 minutes CPD

A budget for a green future

▶ **DUANE NEWMAN,** Partner at EY

Ten or fifteen years ago, I would try to explain the concept of a carbon tax to colleagues, clients and the media; more often than not, I would be met with blank stares. How things have changed!

As more and more politicians and commentators have begun to understand the climate change crisis and the impact it is already having on all our lives, carbon taxes and the rest of the green agenda have now firmly moved to centre stage. Therefore, it is not a question of whether the February budget will contain environmental measures but rather the extent and the impact of the green measures that will feature. We already saw in the media coverage of the last budget that measures to boost solar energy were a major highlight.

In February 2023, Finance Minister Enoch Godongwana announced measures for household solar installations, with a rebate of 25% on the cost of the solar panels, to a maximum of R15 000. This measure, therefore, covers only a solar investment of up to R60 000, and there is no relief for purchases of inverters and batteries—which can be the biggest cost components in a domestic solar system. The measure is due to expire at the end of February 2024. I hope to see an announcement in the next budget that it will be rolled over and hopefully extended to cover all the components in a solar installation. It needs to reflect reality: you cannot use solar without inverters and batteries; the support should be comprehensive.

For corporates, the finance minister announced a 125% allowance for the cost of renewable energy assets purchased between 1 March 2023 and the end of February 2025. This two-year window is not long enough for projects that are currently in the planning phase. There can be long lead times and extensive planning horizons, affecting the time it can take to secure permission for new installations and the period to secure financing. Hopefully, the government will understand that larger projects cannot be rushed and the minister will extend the period that companies will be given to implement renewable energy projects.

It is becoming more and more important for export-oriented businesses to bring down their carbon footprint. The European Union's (EU's) Carbon Border Adjustment Mechanism (CBAM) will mean a new tax on imports into the block of carbon-intensive products, which might price some South African products out of the European market. Meanwhile, other territories and jurisdictions are looking to impose their own carbon border taxes. There is a transitional period for CBAM to 2025, with the financial impact from 2026. It is important that government supports businesses to remain export competitive so rebates and other incentives for greening production must be maintained and boosted in future budgets.

I referred earlier to the carbon tax. While the rates have been announced up to 2030, the big challenge businesses face concerns the allowances—the carrots in the carbon tax system. The national treasury has not yet published its discussion document on allowances from 2025 onward; this is eagerly awaited, as companies need to be clear about the extent and duration of the measures that will assist in alleviating their carbon tax burden. I am referring to the basic allowance, the trade exposure allowance, the performance benchmark, carbon offsets and the carbon budget allowance. We have been told that the phasing out of these allowances needs to be finalised before the end of Phase 1 of the carbon tax. Business needs long-term certainty on the effectiveness of carbon tax.

In theory, the basic allowance should be reduced, while allowances that need action from the company, such as carbon offset allowance, trade exposure and performance benchmarking need to be increased. Business needs to understand what needs to be done; planning for when those allowances are phased down is required, so the sooner we get clarity on the path forward, the better.

When it comes to the carbon offset allowance, the current market for carbon credits in South Africa is not large enough. There are very few buyers, apart from a few large companies with large carbon footprints such as Sasol, Eskom and Arcelor Mittal. We need to create a bigger market for carbon credits by increasing the value of the carbon offset allowance.

It is not clear whether we will have to wait until next year's budget for the long-awaited government announcement on the measures it will offer to encourage the transition to electric vehicles (EVs) and other greener engine technologies. Currently, duties on EVs are the same as those on internal combustion engine vehicles, and the government needs to seriously look at reducing duties on all battery vehicles to stimulate demand. The prices of EVs are too high for the South African market and at odds with global best practices. Internationally, duty rates have gone down and there has been price support at a consumer level. Clearly, South Africa is unlikely to be able to afford to give significant, generous fiscal support at the consumer level. However, a production incentive policy to support EV manufacturing needs to be finalised in order to provide high support for greener vehicles. The South African automotive industry is a major success story but it will not survive as its vital export markets phase out the internal combustion engine—unless there can be a swift transition to the production of EVs.

"It is important that government supports businesses to remain export competitive so rebates and other incentives for greening production must be maintained and boosted in future budgets"

- The scale of support needed for this local transition in production is daunting, and the national treasury can't afford to fund it all, given so many competing demands for its limited resources. Therefore, the South African government will also need to look for external support for this through the $8.5bn in climate transition funds for South Africa that were pledged at the COP 26 summit, as well as other finance packages. Hopefully, South Africa will secure further green grants and climate transition support at COP 28, which is due to be held from 30 November to 12 December 2023 in the United Arab Emirates.

One final matter I hope to see tackled in next year's budget speech is the Critical Infrastructure Programme (CIP), which is run by the Department of Trade, Industry and Competition. This is a cost-sharing grant for projects designed to improve critical infrastructure in South Africa. It was amended a few years ago to allow renewable energy projects to qualify. Unfortunately, with the energy crisis, it has been overwhelmed with applications and the government needs to think about recapitalising this programme.

In conclusion, there are several important environmental elements that will need to be addressed in next February's budget if South Africa is to continue to demonstrate its commitment to mitigating climate change.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15 minutes CPD

ADMINISTERING A TRUST:

MUCH MORE COMPLEX THAN BEFORE

THANDO LAMULA, Trust and Fiduciary Manager at Standard Bank

The Financial Action Task Force (FATF) is an intergovernmental organisation that aims to develop policies to combat money laundering. FATF also aims to make the flow of money through the financial systems more transparent in the hope of eradicating money-laundering and terrorism financing. Over a period, the FATF inspected South Africa's financial system and published its final report in October 2021.

In its final report, the FATF indicated that South Africa (SA) has weak regulations to deal with anti-money laundering (AML). As a result, SA has been placed on the FATF's grey list until such time that the FATF recommendations have been met by SA. Among other low scores, the FATF has scored 11 areas of efficiency in implementing legislation in SA to be critically weak.

SA has since been on its toes; it has been tightening and strengthening its laws in order to adhere to the FATF recommendations. On the flipside, this intervention has caused a stir in most industries, including the trusts administration industry. This stir in the form of 'double' reporting to the Master of the High Court (Master) and the South African Revenue Service (SARS) has made the administration of trusts more complex and administrative-intensive than before. The complexities of reporting to both institutions are discussed below.

Master of the High Court—beneficial ownership reporting

Following the greylisting lashing from the FATF, there has been an abrupt change in the Trust Property Control Act (Act No. 57 of 1988) (TPCA). The TPCA amendment emanates from the General Laws (Anti Money-Laundering and Combating Terrorism Financing Amendment Act 22 of 2022). Section 11A of the TPCA requires trustees or trust administrators[1] to establish and keep an up-to-date record of information relating to beneficial owners of trusts. Trustees are thus required to make their reporting submissions to the Master. Section 11A of the TPCA further states that the Master must keep a register in the prescribed format containing the prescribed information on the beneficial owners of trusts. The prescribed form in which the Master must keep the records is in an electronic register. This particular register is in a format which is compatible with Google Forms to be uploaded to the Master's Portal. Currently, the Master is prototyping a new platform on the Integrated Case Management System (ICMS) Web Portal where the data can be uploaded. Therefore, Trustees are liable to submit the beneficial ownership information to enable the Master to generate the electronic register.

The information required about the beneficial owners, includes:
(a) full names;
(b) date of birth;
(c) nationality;
(d) an official identity document number or passport number, indicating the type of document and the country of issue;
(e) citizenship;
(f) residential address;
(g) if different from residential address, the beneficial owner's address for service of notices;
(h) other means of contact;

[1]For the purpose of this document, when making reference to both trustee and trust administrators the author made use of the word 'trustee' only.

(i) if the person is a registered taxpayer in SA, the person's tax number;
(j) the class or category of beneficial ownership under which the person falls;
(k) the date on which the person became a beneficial owner of the trust; and
(l) where applicable, the date on which the person ceased to be a beneficial owner of the trust.

"These new reporting requirements will place a high administrative and reporting burden on trustees"

According to section 1 of the TPCA, a 'beneficial owner' with regards to a trust instrument means a natural person who exercises effective control of the administration of the trust arrangements that are established pursuant to the trust instrument, the founder/s of the trust, each trustee of the trust and each *beneficiary referred to by name in the trust instrument*. Where the beneficial owner is a legal person, a person acting on behalf of a partnership or in pursuance of the provisions of a trust instrument, the natural person who directly or indirectly ultimately owns or exercises effective control of that legal person or partnership or the relevant trust property or trust arrangement pursuant to that trust instrument, should also be included.

Care must be given to the definition of a beneficial owner as this definition is far-reaching. In the case of a discretionary beneficiary, if that beneficiary has never received a distribution but the beneficiary is named as a beneficiary in the trust instrument, the new rules shall apply to them and they would need to be indicated on the beneficial owner register. However, if the beneficiary is not specifically named in the trust instrument and forms part of a class of beneficiaries, regardless whether they have received benefits or not, such beneficiary is not required to be included in the reporting.

SARS' new reporting requirements

In addition to the reporting requirements to the Master, SARS now also requires reporting of the beneficial owners of a trust, similar to the Master's requirements, in the trust's annual tax return. This seems to be a replication of information provided.

SARS also requires that all trustees must submit third-party returns for trusts by May 2024. A third-party return is a return where SARS mandates another person who employs, pays amounts to, receives amounts on behalf of or has control over assets of another person to submit a return on behalf of the other party.

Similar to financial institutions, when these perform third-party reporting and similar to medical aid institutions, when these are reporting medical tax information, the trust reporting requirement will follow the same reporting mechanism to SARS. All Trustees will act as third-party data providers to SARS via IT3 (t) reporting obligation.

This reporting requirement comes in the form of an IT3(t) form as prescribed in accordance with SARS' Business Requirement Specification—IT3 Data Submission.

The IT3(t) requires the following information to be submitted:

- Demographic information of the reporting Trust;
- Demographic information of Trust Persons or Beneficiaries;
- Taxable amounts distributed or vested in Persons or Beneficiaries;
- Details of non-taxable income distributed; and
- Trust financial flows.

The Government Gazette issued on 30 June 2023, stipulated information required as any amount vested in a beneficiary:

- Income (nett of Expenditure);
- Capital gains; and
- Capital amounts.

In this regard, all trusts are liable to report, excluding collective investment schemes and Employment Share Incentive Scheme Trusts. Similar reporting requirements will apply to Public Benefit Organisations from March 2024.

The Cost of non-compliance

A Trustee who fails to comply with the obligations outlined in the TPCA could, upon conviction, be liable for a fine not exceeding R10 million or imprisonment not exceeding five years, or both. SARS could also dish out administrative penalties.

Considerations from a practical point of view

These new reporting requirements will place a high administrative and reporting burden on trustees. For instance, reporting on class or unknown beneficiaries will not be possible. Decisions that may lead to vesting need to be recorded and provided annually—recordkeeping and retention might become a problem.

How will these changes affect the industry?

The trust administration industry is likely to see an increase in trust administration costs. These administration costs will most likely be based on a risk-based pricing approach. On the positive side, the sector is likely to be more formalised. It is important to stay close to the developments and to take the required actions with support from various advisory professionals.

CONTROLLED FOREIGN COMPANIES AND BUSINESS ESTABLISHMENT RELIEF

15 minutes CPD

NORMAN MEKGOE, Head of Tax at Andersen

Globalisation has led to the expansion of businesses beyond national borders, creating a need for tax laws that address the challenges of cross-border economic activities. In response to this, governments have introduced various measures to ensure a fair taxation system. One such measure is the controlled foreign company (CFC) rules. In South Africa, the CFC rules are contained in section 9D of the Income Tax Act (ITA).

The primary objective behind the introduction of CFC rules in South Africa in the early 2000s was to prevent the erosion of a country's tax base by South African-headquartered multinational companies shifting profits to foreign subsidiaries. These rules were designed to prevent companies from artificially shifting income from South Africa to subsidiaries in low-tax jurisdictions. This is achieved by attributing the income of a foreign subsidiary of a South African resident, that is, a CFC, back to the parent, thereby subjecting such income to South African income tax in the hands of the South African parent.

Foreign business establishment exemption

While the CFC rules are successful in curbing some forms of tax avoidance, they also pose challenges to legitimate business operations. To address this challenge, the South African CFC rules contain provisions, such as the foreign business establishment (FBE) exemption found in section 9D(9)(b) of the ITA, which aim to strike a balance between taxation and encouraging international business growth.

The FBE exemption aims to provide relief to companies engaged in genuine foreign business operations, exempting their foreign income from the ambit of the South African CFC rules. The rationale behind this exemption is to incentivise and support companies as they venture into foreign markets, thereby promoting economic growth and fostering international trade.

Currently, the FBE exemption exempts some of the income (mainly trading income) of a CFC from imputation if, as stated in the definition of a CFC in section 9D(1) of the ITA, the CFC has a fixed place of business located outside South Africa that is used for the continuation of that CFC's business for a period of not less than one year, where, among others, the following requirements are met:

- That fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct *the primary operations of that business*.
- That fixed place of business is suitably equipped for conducting *the primary operations of that business*.
- That fixed place of business has suitable facilities for conducting *the primary operations of that business*.

The Coronation case

The implementation of the FBE exemption has not been without its complexities and controversies. One notable case that sheds light on the intricacies of this exemption is the Coronation case. In this case, the South African Revenue Service (SARS) challenged the application of the FBE exemption by Coronation Fund Managers, a South African-based investment company.

In the Coronation case, the dispute revolved around whether the FBE exemption should apply to the income of Coronation's Irish CFC. SARS argued that the Coronation was not entitled to the FBE exemption on the basis that its Irish CFC was not suitably staffed, suitably equipped and did not have suitable facilities in Ireland to conduct its primary operations of investment management. Instead, the investment management functions were outsourced to other Coronation group companies in the United Kingdom and South Africa. Coronation, on the other hand, argued that investment management was not its primary operation as contemplated in the FBE exemption.

> *"The exemption acknowledges the importance of encouraging international trade and economic growth while also accounting for the intricacies of genuine business operations"*

To arrive at its decision, the courts analysed factors such as the level of substance in the foreign subsidiaries' operations, their business purposes and the extent of control exercised by the parent company. Ultimately, the courts ruled in favour of SARS, highlighting the importance of legitimate business activities and the need to consider the broader economic context. This ruling set a precedent for future interpretations of the FBE exemption, emphasizing the need to focus on the economic reality of the situation.

Proposed amendments

Following the judgement in the Coronation case, it is proposed in the 2023 Draft Taxation Laws Amendment Bill that the FBE exemption be amended to include a requirement that, for a CFC to qualify for CFC exemption, all important functions for which such a CFC is *compensated* should be performed either by the CFC itself or by another CFC in the same group of companies that is located and subject to tax in the same country as the CFC's fixed place of business.

To effect the proposed amendment, it is proposed that the words "*conduct/conducting the primary operations of that business*" in the definition of a CFC be replaced by the words "*perform/performing all the important functions of that business for which the controlled foreign company is compensated*".

Although the proposed amendments will provide some clarity on determining what constitutes a legitimate FBE, there are still a number of questions that are left unanswered. For example, to qualify for the FBE exemption under the new definition, the FBE would presumably need to be suitably staffed, equipped and have sufficient facilities to perform all the activities of significance to that business and for which that business is given something, i.e. being compensated. A number of tax commentators have raised some concerns with the proposed amendments.

One potential challenge with the definition (or an advantage from a taxpayer perspective) is whether the definition, in referring to compensation, means direct or indirect compensation. If the definition only refers to direct compensation, then this will mean that non-remunerated important functions (such as marketing, risk management, compliance, governance, accounting/financial reporting etc.) could potentially be outsourced offshore.

It remains to be seen whether the final amendments, which are due to be released later this year, will provide additional clarity on the application of the FBE exemption.

Conclusion

The FBE exemption is a pivotal provision that aims to strike a balance between promoting legitimate foreign business activities and preventing tax avoidance. Its introduction was spurred by the need to counter strategies by multinational companies to minimise tax liabilities through foreign subsidiaries. The exemption acknowledges the importance of encouraging international trade and economic growth while also accounting for the intricacies of genuine business operations. The Coronation case underscores the challenges in interpreting and applying this exemption, leading to discussions about potential amendments to ensure its effectiveness and fairness in the ever-evolving landscape of international taxation. As governments and businesses continue to navigate the complexities of cross-border operations, the FBE exemption remains a crucial consideration in shaping tax policies and strategies.

WITHDRAWAL OF PRACTICE NOTE 31:

PROPOSED AMENDMENTS

15 minutes CPD

PROF DAVID WARNEKE, Head of Income Tax Technical at BDO South Africa

The much-awaited proposed amendments in response to the submissions received by National Treasury on the withdrawal of SARS Practice Note 31 have been released for public comment. They are contained in the Draft Taxation Laws Amendment Bill of 2023 and unfortunately, reveal a lack of appreciation for the importance of this Practice Note in achieving equity in the taxation of ordinary transactions involving borrowed funds.

By way of background, Practice Note 31 was issued by the then Inland Revenue in 1994 and has remained the revenue collector's practice ever since. Although our income tax system has a separate 'trade' test in addition to an 'in the production of income' test that usually applies in determining whether expenditure is deductible for income tax purposes, the Note allows for an exception to the 'trade' test when determining the deductibility of expenditure that is incurred in the production of interest income. So, if a taxpayer who is not carrying on a trade lends money at interest and incurs non-capital expenditure that is in the production of the interest income, the Note allows the taxpayer to deduct the expenditure against the non-trade interest income, limited to the amount of the interest income.

The reason why the Note was originally issued and why the practice it sets out is still required is that, given the existence of our 'trade' test and in the absence of a profit-making motive on the part of the taxpayer lending the funds, a taxpayer in scenarios such as the one above would not be able to deduct the expenditure incurred, even if such expenditure was incurred for the purpose of earning the interest income.

The term 'trade' is given a wide definition in the Income Tax Act, which includes "*every profession, trade, business, employment, calling, occupation or venture*". In *Burgess v CIR* 55 SATC 185 which was decided in 1993, shortly before the Note was issued, it was held that the concept of 'trade' is extremely wide and that it embraces every profitable activity.

"Taxpayers are therefore cautioned to make contingency plans should the current narrow focus of the proposed exception to the 'trade' test survive into the Amendment Act"

However, despite its wide meaning, the term 'trade' does not necessarily embrace all activities that might produce income, most notably, passive income in the form of interest, dividends, annuities or pensions.

Although it is true that our income tax system has always had the 'trade' test in addition to the 'in the production of income' and non-capital tests in determining the general deductibility of expenditure, no comparative requirement to the trade test exists on the income side. An amount forms part of a taxpayer's 'gross income'—and is therefore potentially subject to taxation—if it is received by or accrues to the taxpayer during the year of assessment and it is not of a capital nature. There is no requirement that prior to inclusion in a taxpayer's gross income, an amount must be derived from a trade carried on by the taxpayer. Although it can be accepted that safeguards are required on the deductibility side to safeguard the fiscus, arguably the 'in the production of income' test serves that purpose and so one may validly question whether, in addition to the 'in the production of income' and non-capital tests, the taxpayer should be required to overcome the additional hurdle presented by a 'trade' test. In many circumstances it is unclear whether a trade is being carried on or not and therefore whether expenditure incurred is in fact at risk of disallowance by SARS. The Note goes a long way towards mitigating this risk. The requirement that deductions or set-offs have to be in respect of a trade results in a variety of inequitable situations, not only those addressed by the Note. For example, a non-trading holding company that holds a foreign-denominated debt may find itself in the position that if foreign exchange losses are realised in a year of assessment, it is prevented from carrying forward the losses to the following year for offset against foreign exchange gains realised in that year because it does not carry on a trade. It would then have to pay tax on the foreign exchange gains in that subsequent year without being able to offset the foreign exchange losses it incurred in the earlier year.

Be that as it may, since the Note was issued in 1994 it has assisted in achieving an equitable result in situations in which otherwise deductible expenditure is incurred by taxpayers in earning non-trade interest income. For example, say A and B are spouses, that B carries on a small business but that only A has the asset base acceptable to a South African bank for a working capital loan required by B's business. Therefore, the bank makes a loan to A who lends it at equivalent rate to B's business. In terms of the Note, A has an inclusion in gross income of the interest earned from B's business but is allowed to deduct the non-trade interest expenditure paid to the bank. If the Note is withdrawn, the result will be that A will be taxed on the interest income earned but will not be permitted to deduct the corresponding interest paid to the bank. This will result in both the bank and A being taxed on the same amount of interest income, with only one taxpayer obtaining a deduction—B's business, which is clearly inequitable.

It is difficult to fathom why SARS and National Treasury would wish to disallow the deduction by A of the interest expenditure incurred against interest income in the above scenario. An appeal to theoretical 'purity' of our income tax system—that for consistency the 'trade' test should apply in all circumstances—ignores the clear inequity that would be created by an application of the trade test to A in the above scenario. In any event, our income tax system is not otherwise 'pure' in that sense because there are instances of deductions which are expressly allowable in the absence of trade: contributions to retirement funds are allowed as deductions from an individual's taxable income, irrespective of whether the individual carries on a trade or not and the same is true for donations by taxpayers to approved public benefit organisations. When SARS first announced its intention to withdraw the Note in November 2022, it claimed that taxpayers were abusing it in structuring transactions in which deductions were claimed on the basis of the Note, while there was no corresponding inclusion in gross income for the recipient: where transactions are concluded with either exempt or non-resident taxpayers. No more specific information regarding the alleged 'abuse' of the Note was provided. If certain structures are considered to abuse the principle in the Note, the contents of the Note should be amended to address the concerns. To disallow the deduction of interest expenditure against interest income in the majority of situations addressed by the Note because certain taxpayers are entering into schemes that exploit the practice, is manifestly unfair.

Comments on the proposed withdrawal of the Note were invited, with a deadline of mid-December 2022. The February 2023 National Budget Review stated that after reviewing the public comments received on the withdrawal of the Note, Government would consider the impact of the proposed withdrawal and whether changes could be made in the tax legislation to accommodate legitimate transactions affected by such withdrawal. In the Draft Explanatory Memorandum to the Draft Taxation Laws Amendment Bill that was released for public comment on 31 July 2023, National Treasury stated that it is still Government's policy that the trade test should continue to apply to deductions and that "*clearly legislated tax policies are imperative in ensuring certainty for both taxpayers and SARS*". Thankfully, it did observe that it is not in the best interest of the fiscus that efficient access to funding for businesses should be hampered.

The Draft Bill proposes that the Note be withdrawn with effect for years of assessment commencing on or after 1 January 2024 and that a new provision, section 11G, with the same effective date will apply. This provision seeks to legislate the principle contained in the Note, but only in limited circumstances; it would only apply to interest income earned by a company that arises from a loan, advance or credit advanced by that company directly or indirectly to another company, where the creditor and debtor companies form part of the same group of companies. This proposal would therefore grant no relief to companies in other circumstances or to other types of taxpayer. It would also not assist taxpayer A in the small business loan scenario above.

Although there are various technical concerns with the provision, the main issue is the narrowness of its scope. The Draft Bill is open for public comment until 31 August 2023 and no doubt National Treasury will receive numerous submissions on the proposal. However, it seems likely that the Note will be withdrawn as originally proposed. Taxpayers are therefore cautioned to make contingency plans should the current narrow focus of the proposed exception to the 'trade' test survive into the Amendment Act.

TAX OPINIONS — WHAT ARE THEY WORTH?

30 minutes CPD

MARK BESTER, Solutions Principal at Bravura Solutions

Taxpayers have to contend with a minefield of complex tax legislation, specific anti-avoidance measures and if that is not enough then there are the general anti-avoidance regulations (GAAR) as well as the burden of onerous compliance and reporting obligations.

Given these complexities it stands to reason that taxpayers are unlikely to be able to navigate their way through all of this without the input of experts; should they choose to do so, then there are onerous consequences should they be found wanting by the revenue authority, namely the South African Revenue Service (SARS).

This article deals with the potential merits of engaging with an independent tax practitioner for the purposes of obtaining a tax opinion in support of the *tax position* taken with due consideration of the costs versus the benefits thereof.

A 'tax position' as defined in s221 of the Tax Administration Act 28 of 2011 (TAA) means an assumption underlying one or more aspects of a tax return including whether or not an amount is taxable or deductible or taxed at a lower rate or qualifies as a reduction of tax payable.

Under which circumstances would a taxpayer need a tax opinion?

1. **Tax legislation interpretation**—legislation is often interpreted literally or in terms of its perceived intended purpose (the purposive approach) and interpretation often depends on the circumstances relevant to a particular transaction; it is far from being black or white. Taxpayers who seek to avail themselves of the application of a certain section in the legislation, would require an opinion that either supports or refutes the application thereof. Where SARS takes an alternate view, this would normally lead to a dispute which gives rise to an understatement in the tax return and ultimately to the levying of an understatement penalty by SARS.
2. **Tax risk management**—if there is uncertainty about how legislation is applied, taxpayers often obtain a tax opinion that supports the view they have taken, that is, risk mitigation by obtaining a filing position for the tax position taken.

3. **Tax planning and structuring**—a taxpayer or the promoter of a tax planning or structuring initiative may seek a tax opinion (normally in terms of s223 of the TAA) dealing with the technical application of legislation as well as the applicability of the substance over form doctrine or the anti-avoidance provisions of a tax Act. The opinion would express a view as to whether the taxpayers position is likely to be upheld or not should the matter proceed to court.

The Tax Administration Act 28 of 2011

Section 221(1) provides that where there has been an *understatement*, the taxpayer *must* pay the understatement penalty determined unless the understatement results from a bona fide inadvertent error.

Once the requirements have been met, the penalty *must* be imposed. There is no definition of a *bona fide* (with good faith), inadvertent (unintended) error (the state of being wrong in conduct or judgement) but it is widely held to connotate an innocent misstatement by a taxpayer on their return, resulting in an understatement, while acting in good faith and without the intention to deceive (ITC No 1890 79 SATC 62).

An 'understatement' in terms of s221 means any prejudice to SARS in respect of a tax period as a result of a default in rendering a return, an omission from a return, an incorrect statement in a return or a failure to pay the correct amount of tax where no return is required.

'Substantial understatement' means a case where the prejudice to SARS or the fiscus exceeds the greater of five per cent of the amount of 'tax' properly chargeable or refundable under a tax Act for the relevant tax period or R1 000 000.

In terms of s223(3), SARS *must* remit a 'penalty' imposed for a 'substantial understatement' if SARS is satisfied that the taxpayer has made full disclosure to SARS of the arrangement, as defined in section 34, that gave rise to the prejudice to SARS or the *fiscus* by no later than the date that the relevant return was due and was in possession of an opinion by an *independent registered tax practitioner* that:

(i) was issued by no later than the date that the relevant return was due;

(ii) was based upon full disclosure of the specific facts and circumstances of the arrangement and, in the case of any opinion regarding the applicability of the substance over form doctrine or the anti-avoidance provisions of a tax Act, this requirement cannot be met unless the taxpayer is able to demonstrate that all of the steps in or parts of the arrangement were fully disclosed to the tax practitioner, whether or not the taxpayer was a direct party to the steps or parts in question; and

(iii) confirmed that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court.

What is evident from the penalty table below is that a taxpayer's perceived behaviour is a key driver for the penalty to be imposed. Any mitigating behaviour ought to result in a reduced understatement penalty. Under these circumstances, a tax opinion obtained from an independent registered tax practitioner will go a long way to influencing the penalty levied. Initially, SARS may not be swayed but as can be seen below the courts do take tax opinions into account when having to consider the appropriate understatement penalty to be levied.

S223. UNDERSTATEMENT PENALTY PERCENTAGE TABLE

1	2	3	4	5	6
Item	*Behaviour*	*Standard case*	*If obstructive, or if it is a 'repeat case'*	*Voluntary disclosure after notification of audit or criminal investigation*	*Voluntary disclosure before notification of audit or criminal investigation*
(i)	'Substantial understatement'	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	'Impermissible avoidance arrangement'	75%	100%	35%	0%
(v)	Gross negligence	100%	125%	50%	5%
(vi)	Intentional tax evasion	150%	200%	75%	10%

- The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each 'understatement'.

In Juta's Income Tax (Dennis Davis et al. Vol 2 in the notes pertaining to s 89quat (3) it is said:
"The test as to whether the grounds are reasonable, is objective, in relation to actions of the taxpayer. A mere subjective belief by the taxpayer that a deduction should be allowed, without taking advice on the matter, is unlikely to be reasonable. On the other hand, the reliance by the taxpayer on expert advice, even if it is wrong, will in most cases constitute reasonable grounds for the action taken."

"A tax opinion from an independent tax practitioner may provide a taxpayer with certain advantages which are not afforded a taxpayer who does not obtain a tax opinion as is evidenced above"

One would expect that in order to avail oneself of the relief provided in terms of s223(3) that a taxpayer would be obliged to submit the s223 tax opinion to SARS upon request by SARS in order for them to consider the remission or reduction of any understatement penalty imposed. However in *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (07 February 2023) the taxpayer refused to provide the tax opinion (on the basis that it was not an opinion obtained in terms of s223) to SARS and yet the courts remitted all understatement penalties on the basis of the taxpayer having taken expert tax advice in the form of a tax opinion. In this instance the obtaining of a tax opinion was in support of the taxpayer's contention that the understatement arose as a result of a bona fide inadvertent error. Presumably the obtaining of a tax opinion was evidence in support of the taxpayer acting in good faith and without the intention to deceive but it remains to be seen if the inadvertent (unintended) criteria is ultimately met once the Constitutional Court has heard the matter?

The benefits of a tax opinion

1. Potential remittance or reduction of understatement penalties (*Income Tax Case No 1880 78 SATC 103 (2014); Income Tax Case NO 1898 79 SATC 266 (2016); Income Tax Case NO 1890 29 SATC 62 (2016)*)
2. Potential remittance of penalty Interest in terms of s 89quat (*Income Tax Case No 1880 78 SATC 103 (2014)*)
3. Potential mitigation for award of costs by the courts in the tax litigation process (*Income Tax Case NO 1898 79 SATC 266 (2016); Income Tax Case NO 1890 29 SATC 62 (2016)*)
4. Managing a taxpayer's tax risk (filing position for the tax position taken).

In conclusion

A tax opinion from an independent tax practitioner may provide a taxpayer with certain advantages which are not afforded a taxpayer who does not obtain a tax opinion as is evidenced above.

However, there is no such thing as a free lunch and tax opinions, as with everything else, come at a cost whether it be in monetary terms or in time invested in briefing the tax practitioner, as well as the time it takes to obtain the opinion which may delay the implementation of the transaction in question (from experience it is normally all of the above).

Taxpayers are advised to obtain tax opinions preferably in terms of s223 of the TAA but it is submitted that even if a tax opinion, which does not conform with the requirements of s223, is obtained, it is still better than having no tax opinion; it still ought to influence the assessment of a taxpayer's behaviour and ultimately the understatement penalty imposed.

While taxpayers are advised to seek professional advice in taking tax positions, the required disclosures thereof and in rendering tax returns, the fact that they have taken advice does not amount to a 'get out of jail card' and the taxpayer will still be held responsible for the submissions made on their behalf (*Income Tax Case No 1948 84 SATC 110*).

As in any scenario, the costs versus the benefits of obtaining a tax opinion need to be weighed up by the taxpayer. Tax is complex and taxpayers are advised to take tax advice in the form of tax opinions on the tax positions taken lest they be marked by SARS and are found wanting!

POST-PANDEMIC PRIVATE WEALTH MIGRATION AND MOBILITY TRENDS

AMANDA SMIT, Managing Partner at Henley & Partners, South Africa

15 minutes CPD

Global private wealth migration trends have largely reverted to pre-pandemic patterns this year. Australia reclaims the top spot for the highest net inflows of millionaires, a position it held for five years prior to the COVID-19 outbreak.

China sees the biggest net outflows as it has done each year for the past decade. According to the latest Henley Private Wealth Migration Report, besides Australia, the highest proportion of wealthy families relocating this year are opting, for the UAE, Singapore, the USA, and Switzerland.

High-net-worth investors, regardless of their nationalities or where they live, are predictably looking to unlock access to countries that offer a better quality of life, top-tier healthcare and world-class academic institutions for their families. Above all, they want the option of being able to live in or relocate to safe, politically stable jurisdictions that protect and preserve their wealth. Countries that can offer this environment are likely to continue to outperform the rest, especially when it comes to attracting talented and affluent global citizens.

Building a legacy that lasts

Singapore, Switzerland, and the UAE have all built their reputations on the premise of being safe havens in which not only to live but also to preserve wealth. In addition, they have established themselves as highly attractive business hubs where companies can thrive in fiscally advantageous jurisdictions with favourable corporate tax rates, as well as zero wealth and inheritance taxes.

Security is also a key factor, particularly in uncertain times, which is why so much private wealth is flowing into countries that offer a robust regulatory environment where the rule of law is respected and economic freedoms are guaranteed. After enduring financial volatility in global markets, many investors have sought the security of brick-and-mortar assets. Through real estate-linked investment migration solutions, investors stand to gain not only a new property but also enhanced optionality, more security and greater peace of mind for their families.

They diversify their portfolios in multiple ways—in addition to the inherent diversity in real estate investments. Investment migration, which is a new asset class in and of itself, also offers geographical diversification to minimise risk and maximise opportunity.

Mitigating risk through domicile diversification

Historically, the driving motivation for investor migrants was to obtain an alternative residence or citizenship and to ensure that they had a Plan B in place. Only a handful would use these emigration assets to relocate to new countries with their families. Today, high-net-worth individuals want to build a portfolio of domiciles to safeguard their interests as they focus on gaining the widest optionality of living, working and investing in jurisdictions of their choice.

Out of the Top 10 countries that are successfully attracting net inflows of high-net-worth individuals in 2023, nine offer investment migration programmes. These countries have actively employed residence-by-investment programmes, which are sometimes referred to as golden visa programmes, as a strategy to draw in much-needed foreign direct investment.

Accessing tax-friendly jurisdictions in Europe

As high-net-worth individuals face multiple risks to their capital and lifestyles, demand for alternative residence and citizenship programmes is mounting. These affluent individuals want to secure pathways to better options to gain assurance that, in the face of future disruptions, they would be able to protect their families and their business interests. One of the principal risks typically is higher taxes; when there are abrupt government changes, this risk grows both exponentially and imminently.

The looming threat of tax policy overhauls has made many wealthy investors explore alternative residence options in jurisdictions with favourable tax environments, which also have real estate investment options, such as Cyprus and Greece.

"These affluent individuals want to secure pathways to better options to gain assurance that, in the face of future disruptions, they would be able to protect their families and their business interests"

Cyprus has one of the widest networks of double tax treaties in Europe, a low corporate tax rate, almost no withholding taxes and several personal income tax incentive schemes designed to cater to wealthy individuals. Cyprus's residence by investment option requires a minimum investment of EUR 300,000 plus VAT into real estate; it is popular among investors from Asia to the Middle East.

One of the top alternative residence options in Europe, the Greece Golden Visa Program requires a minimum real estate investment of EUR 250,000 to be eligible for a renewable five-year residence permit. Affluent individuals and expats who choose to relocate to Greece under the program also benefit from numerous tax incentives. Golden Visa investors who opt to transfer their tax domiciles can pay a lump-sum tax of EUR 100,000 for 15 years, regardless of their foreign-sourced income, making Greece an attractive option. After seven years of lawful residence, subject to meeting the legal requirements, Greek Golden Visa holders can apply for citizenship.

Tax-efficient residence options closer to home

Beyond Europe, affluent individuals are showing great interest in the newly launched Namibia Residence by Investment offering. To apply, investors must acquire a luxury residential property at President's Links Estate, a residential and golf estate in Walvis Bay. The minimum investment is USD 300,000 for retirees or USD 365,000 for those under 60. Renowned for its natural beauty, Namibia is one of Africa's most politically stable countries; it holds great appeal among investors who have foreign income streams, as taxes are generally only applied on locally sourced income.

Global investors seeking tax-effective jurisdictions are also considering the UAE's Residence by Investment initiative, whereby they can obtain a 10-year renewable residence visa by purchasing a property worth a minimum of AED 2 million (approximately USD 550,000). Wealthy individuals are flocking to the metropolises of Dubai and Abu Dhabi, which offer dynamic business hubs, zero income tax, an expansive network of double-tax treaties and no wealth taxes.

Mauritius has been garnering interest from businesspeople from mainland Africa and beyond, predominantly due to its business-friendly regulatory frameworks, attractive tax incentives and openness to investment. Globally mobile investors who wish to secure their own piece of paradise can opt to invest a minimum of USD 375,000 in a property that qualifies under the Mauritius Residence by Investment Program. This will guarantee their access to this international financial hub; it also offers a lucrative source of passive rental income, as Mauritius has a very healthy property market both for short- and long-term leases.

21st-century international families

The 20th century saw a record surge in wealth due to globalisation and technological advances. Today, we are witnessing the transfer of this wealth to the next generation of millennials, Gen-Zers and even Generation Alphas, many of whom have never worked in the family business or lived in the birth country of their forerunners.

Panama, a global financial centre, is often earmarked as a viable real estate-linked golden visa solution for international families, as it offers the right to live in a tax-effective and cosmopolitan country. It is also in close proximity to both the North and South American markets, which could serve an entrepreneurial family's business interests perfectly.

Across the Pacific, the Thailand Elite Flexible One Program, with a minimum real estate investment of THB 10 million (approximately USD 320,000), grants residence status for five years in this bourgeoning economic centre, where a low cost of living and a high-quality life converge. There is also the option to upgrade to another programme within the first two years.

Unlocking access to the global economy

By designing and investing in a portfolio of additional passports and residence permits, tailored to their specific requirements, entrepreneurs can open the doors to more of the world's leading wealth hubs and unlock lucrative business opportunities in other jurisdictions. One of the inherent advantages is that this enables them to expand their global footprints by promoting their goods and services into new markets that potentially have a stronger consumer buying power than those they can reach with just their own passport in hand. In a similar vein, they are guaranteed easy access to jurisdictions where they can grow business and personal networks, connect with influential industry leaders, partner with more companies, dip into larger pools of talented experts and, as a result, enhance the viability of their own operations.

Compared to what can be gained through international trade alone, the options that arise by having unrestricted physical and personal access rights to multiple jurisdictions are far greater, as they include unique benefits that cannot quickly or easily be replicated elsewhere such as banking, access to state-of-the-art infrastructure, premium education and top-tier healthcare. Securing greater access to the world's main markets by investing in additional residences and citizenships significantly extends the range and choice of what is available to us and to our families.

TAXATION OF DIGITAL SERVICES: **PERSPECTIVES FROM KENYA**

▶ **ALLAN WANG'ANG'A,** LLM Candidate in Commercial Law at the University of Johannesburg

60 minutes CPD

Digital transformation has been a key component in the transformation and the upscaling of business operations and services in Kenya and worldwide.

Indeed, digital transformation spurs innovation, generates efficiencies and improves services while boosting more inclusive and sustainable growth, as well as enhancing well-being. [1]At the same time, the breadth and speed of the growth of digital services introduce challenges in many policy areas, including taxation.[2]

Action 1 of the *Base erosion and profit shifting (BEPS) Action Plan* highlighted tax challenges affecting the Digital Economy. Issues examined included: the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules; the attribution of value created from the generation of marketable location relevant data through the use of digital products and services; the characterisation of income derived from new business models; the application of related source rules; and ways to ensure the effective collection of value-added tax (VAT) /goods and services tax (GST) regarding the cross-border supply of digital goods and services.[3]

Indeed, it was noted that because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. It was also anticipated that various jurisdictions would enact unilateral tax legislations dealing with BEPS issues which affect the digital economy. Meanwhile, the BEPS Inclusive Framework member jurisdictions had been working towards member-based, long-term solutions that resulted in the *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*.[4]

While Kenya has not adopted the two-pillar solution, it has, over the years, developed a framework on the taxation of digital services. The subsequent sections comment on the prevailing regulatory framework on digital services tax in Kenya.

Taxation of digital services

Currently, digital services tax in Kenya is primarily applied to income tax and value-added tax. It was introduced through the Finance Act 2019 and enacted through the Finance Act 2020 with an effective date of 1 January 2021. It was introduced to the Income Tax Act of Kenya Cap 470 (the Income Tax Act) and the Value-Added Tax Act of Kenya 2013. The Income Tax (Digital Service Tax) Regulations 2020 and the (now) VAT (Electronic, Internet and Digital Marketplace Supply) Regulations 2023 regarding the application of income tax and value-added tax to digital services, were subsequently introduced.

The Income Tax Act

Under the Income Tax Act, digital services tax is payable by a non-resident whose income from the provision of services is derived from or accrues in Kenya through a business carried out over the internet or an electronic network, including through a digital marketplace. Non-residents with a permanent establishment in Kenya are specifically excluded from the ambit of the tax. Resident entities are also excluded, presumably because such entities already pay corporate income tax derived from services provided on digital platforms. This would therefore prevent the double taxation of income derived from these entities.

A digital marketplace is defined as an online or electronic platform which enables users to sell or provide services, goods or other property to other users. The Income Tax (Digital Services Tax) Regulations provide a list of applicable services, including: downloadable digital content providers including downloadable applications; over-the-top services magazines, television shows, films and podcasts; subscription-based media including news, magazines and journals; the provision of a digital marketplace; and the sale of, licensing of, or any other form of monetising data collected about Kenyan users which has been generated from the users' activities on a digital marketplace. The regulations exclude:

(a) online services which facilitate payments, lending or trading of financial instruments, commodities or foreign exchange carried out by financial institutions such as banks and insurance companies and financial service providers authorised or approved by the Central Bank of Kenya; and
(b) online services provided by Gover ment institutions.

Moreover, the tax would be applicable if the user is located in Kenya, meaning: (a) the user receives the digital service from a terminal located in Kenya; (b) the payment for the digital service is made using a debit or credit facility provided by a financial institution or company located in Kenya; (c) the digital service is acquired through an internet protocol address registered in Kenya or an international mobile phone country code assigned to Kenya; or (d) the user has a business, residential or billing address in Kenya.

Taxpayers would be required to pay tax at a rate of 1.5% on the gross transaction value. This could be payment received as consideration for services or, in the case of a digital marketplace provider, the fee paid for use of a digital marketplace.

> *"Under this framework, the recipient in a B2B transaction was required to account for the VAT on taxable supplies made on a digital marketplace and notify the supplier from the export country that the supplier is not required to account for the supply for the tax in Kenya"*

Through the Finance Act 2023, Kenya also introduced a digital asset tax. Effective 1 September 2023, the owner of a platform or the person who facilitates the exchange or transfer of a digital asset will be required to deduct digital asset tax at the rate of 3% of the gross fair market value consideration received or receivable at the point of exchange or transfer of a digital asset within five days after having made the deduction. The Finance Act 2023 provides a detailed definition of digital assets which includes anything of value that is not tangible such as cryptocurrencies, token codes and Non-Fungible Tokens (NFTs). This provision was apparently targeted at the rapid growth in the use of cryptocurrencies in Kenya and may prove onerous for an area that is argued to be relatively nascent in Kenya and with relatively thin margins.

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[1]OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[2]OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS.
[3]OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par 3.
[4]OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, par 357.

In addition, in an apparent move to capture digital content creators, the Finance Act 2023 has introduced a new category of income deriving from digital content monetisation. Income from these activities will be subject to tax through the withholding tax mechanism at the resident rate of 5% when paid to Kenyan tax resident persons and 20% when paid to non-residents. For residents, the withholding tax is an advance tax and it is offset against personal income tax calculated using graduated rates with the highest rate being 35% of monthly income. The Act defines digital content monetisation to mean offering for payment entertainment, social, literal, artistic, educational or any other material electronically through any medium or channel; it generally includes partnering with brands, sponsorships, affiliate marketing, subscription services for online content, earning commissions or fees from crowdfunding.

Non-resident digital service providers without a permanent establishment in Kenya may register under the simplified tax registration framework prescribed by the Commissioner-General of the Kenya Revenue Authority (KRA). The non-resident digital service providers that elect not to register through this framework will be required to appoint a tax representative. While the tax representative will perform tax obligations assigned to it under the Tax Procedures Act 2015 of Kenya, the Act does not relieve a taxpayer from performing any obligation imposed on the taxpayer under a tax law that the tax representative of the taxpayer has failed to perform. On the other hand, resident persons will be required to register under the simplified tax registration framework.

The person required to pay digital services tax will be required to submit a return in the prescribed form and remit the tax due by the twentieth day of the month following the end of the month when the digital service was offered. The Tax Procedures Act imposes penalties and interest for late payment of tax due and late filing of returns. An entity that liable for late payment of tax will pay a penalty of 5% of the tax due and interest of 1% per month on the amount unpaid. In addition, late filing of income tax company or partnership returns will attract a penalty of 5% of the tax due or Kenyan Shillings (KES) 20000, whichever is higher.

The Value-Added Tax Act

The Finance Act 2019 brought supplies undertaken through the digital marketplace within the ambit of VAT, introducing the VAT charge to the VAT Act 2013. The Cabinet Secretary of the National Treasury and Planning (the CS) was required to publish regulations providing a mechanism for the implementation of the new VAT charge. On 25 September 2020, the VAT (Digital Marketplace Supply) Regulations, 2020 (the 2020 Regulations) which sought to clarify how digital service tax would be applied were gazetted. These regulations were amended through the Value-Added Tax (Digital Marketplace Supply) (Amendment) Regulations 2022 (the 2022 Regulations) and repealed through the Value - Added Tax (Electronic, Internet and Digital Marketplace Supply) Regulations 2023 (the 2023 Regulations).

The VAT Act defines a digital marketplace as an online platform which enables users to sell goods or provide services to other users. Under the 2023 Regulations, digital service tax would apply to a taxable electronic, internet or digital marketplace supply made in Kenya. The 2020 Regulations excluded business to business transactions (B2B transactions) taking place on a digital marketplace from the ambit of the regulations. Instead, they would be taxable within the framework for the taxation of imported services to avoid potential double taxation of such services. Under this framework, the recipient in a B2B transaction was required to account for the VAT on taxable supplies made on a digital marketplace and notify the supplier from the export country that the supplier is not required to account for the tax in Kenya for the supply. On the other hand, when a supply was made by a non-resident in a business to consumer transaction (B2C transaction), the non-resident supplier was required to register for VAT in Kenya. The 2022 Regulations later amended these provisions so that all transactions, both B2B and B2C, would be subject to VAT under the digital marketplace regime. This meant that non-resident businesses making B2B and B2C digital supplies would be required to register and account for VAT in Kenya for supplies made to recipients in Kenya.

The 2023 Regulations provide an expanded list of digital or electronic supplies, among others: services that link the vendor to the recipient, including transport-hailing services or platforms; the sale of, licensing of, or any other form of monetizing data generated from the users' activities and the facilitation of online payments or exchange of digital assets excluding services exempt under the VAT Act.

As mentioned, the person making the supply is obliged to register for VAT if the supplies were made by a person from an export country to a recipient in Kenya. For sourcing purposes, the customer/recipient location may be determined by: (a) payment proxy, including credit card or debit card information and bank account information; (b) residence proxy, including the billing or home address or access proxy, including the internet address or SIM card information; and (c) access proxy, including the internet address or mobile country code of the subscriber identification module card of the recipient.

In addition, while the business entities may have a mandatory VAT registration threshold of KES 5 million in annual turnover, the Finance Act 2023 introduced an amendment requiring digital service providers to register for VAT whether they meet the turnover threshold of KES 5 million or not.

Upon registration, VAT is then charged at the standard rate of 16% of the taxable value of the supply and will be payable by the registered supplier or through its tax representative. Generally, all VAT registered taxpayers are required to accept only electronic tax invoices from registered taxpayers in compliance with the VAT (Electronic Tax Invoice) Regulations 2020 for purposes of claiming input tax and processing of refunds. However, non-resident suppliers of digital services are exempted from this provision. They are, however, required to register for VAT within 30 days of making a taxable supply and issue simple invoices or receipts showing the value of the supply and the tax charged.

Among other documents, the 2023 Regulations require that the national tax identification number issued to the applicant in the applicant's jurisdiction accompany the supplier's application for registration.

Registered taxpayers in Kenya may claim input tax charged in line with the VAT Act and the 2023 Regulations, provided that the non-resident supplier has issued an invoice or receipt showing the value and the tax charged in relation to the supply. Non-resident suppliers, however, are not allowed to claim input VAT for transactions relating to an electronic, internet or digital marketplace supply.

"The excise taxes may therefore be seen to increase the cost of finance for the majority of Kenyans"

Registered taxpayers will be required to submit a return in the prescribed form and remit the tax due in each tax period to the Commissioner on or before the twentieth day of the month following the end of the tax period. The Tax Procedures Act imposes a penalty of 5% of VAT tax due and an interest of 1% per month on the amount unpaid for late payment of tax. The Act also imposes a penalty of 5% of the VAT tax due or KES 10,000 whichever is higher for late filing of VAT returns.

Other taxes

The Excise Duty Act imposes 10% excise duty on imported mobile phones, excise tax of KES 50 per card on imported sim cards and 15% excise duty (previously 20%) on fees charged by digital lenders, which remains a contentious issue for digital lenders in Kenya. As of November 2021, the Digital Financial Services Association of Kenya reported that approximately 55.5% of Kenyan households depend on digital loans for business financing through its Credit Barometer report. The excise taxes may therefore be seen to increase the cost of finance for the majority of Kenyans.

Excise duty payable in respect of supplies of the above excisable services made by the supplier during a calendar month is payable on the twentieth of the succeeding month. Excise returns should also be filed by the twentieth day of the following month. Late payment of excise duty attracts 5% penalty of the tax due and an interest of 1% per month, while a late filing of excise returns attracts a 5% penalty of the tax due or KES. 10,000, whichever is higher.

Conclusion and comment

The framework on digital service tax in Kenya has had far-reaching implications by way of widening the tax base amid concerns that it may stifle a growing tech-based innovation ecosystem. In this regard, the KRA was reported to have collected KES 241 million in the financial year that ended in June 2022 (with 174 companies registered thereunder by the same date) and KES 174 million in digital service taxes in the six months to December 2022.[5]

While there may be an apparent policy intention to adopt the BEPS two-pillar solution, it remains to be seen whether Kenyans would see a phasing out of digital service tax which has resulted in significant tax revenue for government.

[5]See https://www.businessdailyafrica.com/bd/economy/kra-nets-sh174m-in-digital-service-taxes-in-six-months--4096648

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