TAX UPDATE

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1. INTRODUCTION

The purpose of this update is to summarise developments that occurred during the third quarter of 2017, specifically in relation to Income Tax and VAT. Johan Kotze, a Tax Executive at Shepstone & Wylie Attorneys, has compiled this summary.

The aim of this summary is for clients, colleagues and friends alike to be exposed to the latest developments and to consider areas that may be applicable to their circumstances. The reader is invited to contact Johan Kotze to discuss their specific concerns and, for that matter, any other tax concerns.

The 2017 Draft Taxation Laws Amendment Bill and the 2017 Draft Tax Administration Laws Amendment Bill dominate this update, and rightly so. Each of you are encouraged to take a look at the draft amendments.

Interpretation notes, rulings and guides are all important aspects of the developments that took place, as they give taxpayers an insight into SARS' application of specific provisions. It is however important to note that these publications are not law, but may bind SARS. Taxpayers should nonetheless consider these publications carefully to determine whether, and how, they are actually applicable to their own circumstances.

Enjoy reading on!

2. MEDIA RELEASES

2.1. Publication of the 2017 Draft Taxation Laws Amendment Bill and the 2017 Draft Tax Administration Laws Amendment Bill for public comment

National Treasury and the South African Revenue Service (SARS) publish for public comment the:

- 2017 Draft Taxation Laws Amendment Bill (TLAB) and
- 2017 Draft Tax Administration Laws Amendment Bill (TALAB).

Together with the 2017 Draft Rates and Monetary Amounts and Amendment of Revenues Laws Bill (Rates Bill) published on 22 February 2017, these three draft Bills give effect to the tax proposals announced on Budget Day (22 February 2017), as published in the Budget Review. The two draft Bills released include most of the more complex and administrative tax proposals but exclude the proposals dealt with in the 2017 Draft Rates Bill, such as changes to the personal income tax brackets and rates and excise duties, and the introduction of the Health Promotion Levy (the proposed sugary beverage tax).

The main tax proposals contained in the 2017 Draft TLAB are:

- A levy on bargaining councils to address non-compliance
- A higher fringe benefit exemption for bursaries to learners with disabilities
- Removing the foreign employment income tax exemption in respect of South African residents
- Addressing the circumvention of anti-avoidance rules dealing with share buy backs, dividend stripping and contributed tax capital
- Strengthening anti-avoidance rules relating to mining environmental rehabilitation funds
- Extending the application of controlled foreign company rules to interposed foreign trusts and foreign foundations

- Changes in the tax treatment of banks due to IFRS9
- Tax amendments due to the SAM framework for long term insurers

The main tax administration proposals contained in the 2017 Draft TALAB relate to:

- Assisting micro businesses transitioning into the small business corporation system
- Employees' tax and reimbursement of travel expenses
- Application of the cap on deductible retirement fund contributions
- Taxation of interest payable in respect of normal tax by SARS
- Phased implementation of Tax Administration Act, 2011, interest rules by tax type

Due to constitutional requirements related to the definition of a money Bill, the draft tax amendments are split into two separate Bills, namely, a money Bill as required in terms of section 77 of the Constitution, dealing with national taxes, levies, duties and surcharges (the 2017 Draft Rates Bill and 2017 Draft TLAB), and an ordinary Bill as required in terms of section 75 of the Constitution, dealing with tax administration issues (the 2017 Draft TALAB).

3. DRAFT TAXATION LAWS AMENDMENT BILL

3.1. Interaction between the 'in duplum' rule and the statutory tax legislation

The following section is hereby inserted in the Income Tax Act after section 7C:

Section 7D – Calculation of amount of interest at official rate of interest

Where it must be determined what amount would have been incurred as interest in respect of any loan, debt, advance or amount of credit provided to a person or an amount owed by a person had that interest been incurred at the official rate of interest, that amount must be determined without regard to any rule of the common law or provision of any act in terms of which—

(a) the amount of any interest, fee or similar finance charge that accrues or is incurred in respect of a debt may not in aggregate exceed the amount of that debt; or

(b) no interest may accrue or be incurred in respect of a debt once the amount that has accrued or been incurred as interest is equal to the amount of that debt.'.

EXPLANATORY MEMORANDUM

INTERACTION BETWEEN THE *'IN DUPLUM'* RULE AND THE STATUTORY TAX LEGISLATION

[Applicable provision: section 7D of the Act]

BACKGROUND

A. Common law 'in duplum' rule in South Africa

The *'in duplum'* rule originated from the South African common law and has been applied through South African case law for over 100 years. The main aim of the *'in duplum'* rule is to protect borrowers from exploitation by lenders that allow and, in some cases, cause interest to accumulate unabated leading borrowers into further indebtedness. In terms of the common law *'in duplum'* rule, interest charged on a debt stops to run (i.e. accrue) where the total amount of the unpaid interest equals the unpaid principal debt.

B. Statutory 'in duplum' rule in South Africa

A statutory *'in duplum'* rule was later introduced into South African law in the National Credit Act No. 34 of 2005 ('NCA') which came into effect on 1 June 2007. The statutory *'in duplum'* rule goes even further in its application as it provides for a limit on a number of costs, in addition to unpaid interest, which added together may not be more that the unpaid principal debt. These costs include initiation fees, services fees, credit insurance, default

administration fees and collection costs.

The statutory '*in duplum'* rule is different from the common law *'in duplum'* rule in that the statutory '*in duplum'* rule applies to both unpaid interest and other finance related costs, whereas the common law '*in duplum'* rule only applies to unpaid interest. As a result, the statutory *'in duplum'* rule is regarded as being more onerous on credit providers and providing more protection for borrowers than the common law *'in duplum'* rule because the limit will be reached sooner given that other finance related costs that must be taken into account in respect of the statutory *'in duplum'* rule. Furthermore, the statutory *'in duplum'* rule overrides the common law *'in duplum'* rule in instances where a debt is regarded as a credit agreement governed by the NCA. However, in instances where a debt is not regarded as a credit agreement governed by the NCA, then the common law *'in duplum'* rule applies.

REASONS FOR CHANGE

Taxpayers sometimes enter into loan arrangements with parties, where the lender that is advancing that loan to the borrower (who is in some manner related party to the lender) will advance the loan at a zero or low interest rate in order for the loan arrangement to be favourable to the related party by saving on interest costs. The use of these zero or low interest loans creates a loss to the fiscus as it often leads to for example:

a. less PAYE collection where an employer grants a zero or low interest loan to an employee.

b. avoidance of donations tax where a person transfers assets to a trust in exchange for a zero or low interest loan.

c. possible avoidance of dividends tax where a company grants a shareholder a zero or low interest loan.

In order to counter the tax benefit as a result of the use of zero or low interest loans, the Act contains various anti-avoidance rules that deal with the taxation of a difference between the amount of interest actually incurred and the amount of

interest that would have been incurred at the official rate. These anti-avoidance provisions include the following:

i. Section 7C of the Act which applies in respect of zero or low interest loan advanced to a trust by a connected person of that trust. The official rate of interest is used under this provision to quantify a donation that arises from advancing a zero or low interest loan to a trust.

ii. Section 64E(4) of the Act where the official rate of interest is used to quantify a deemed dividend in respect of a zero or low interest loan made by a company to a shareholder by virtue of a share.

iii. Seventh Schedule where the official rate of interest is used under this provision for fringe benefit determination in respect of a zero or low interest loan between an employer and employee.

It has come to Government's attention that some taxpayers are relying on the *'in duplum'* rules to circumvent the above-mentioned anti-avoidance rules. Taxpayers rely on the '*in duplum'* rules to distort the quantification of the tax benefit derived from a zero or low interest loan between connected parties, on the difference between the amount of interest actually incurred and the amount of interest that would have been incurred at the official rate. These taxpayers claim that if a zero or low interest loan is advanced and the unpaid interest on that loan (and other costs, in the case of the statutory *'in duplum'* rule) reaches the amount of the unpaid principal debt, the *'in duplum' rules* apply to stop the interest (and other costs, in the case of the statutory *'in duplum'* rule) from running. Consequently, if the *'in duplum'* rules apply, then the application of the current anti-avoidance rules on the tax benefit on zero or low interest loans must also not be applied.

PROPOSAL

The above-mentioned anti-avoidance rules that deal with the tax consequences of zero or low interest loans in employer-employee relationships; shareholder-company relationships and natural connected person-trust relationships were introduced for purposes of determining the tax benefit derived from a zero or low interest loan between connected parties, on the difference between the amount of interest actually incurred and the amount of interest that would have been incurred

at the official rate. They are meant to override all instances where interest is either not levied or levied at a rate below the market value, irrespective of whether the *'in duplum'* rule applies or not. It is proposed that clarification be made in the Act so that anti-avoidance rules dealing with zero or low interest loans should apply in spite of the application of either the statutory *'in duplum'* rule or the common law *'in duplum'* rule.

EFFECTIVE DATE

The proposed amendment will come into effect on 1 January 2018 and applies in respect of interest incurred or deemed to have been incurred on or after that date.

3.2. Addressing abuse of contributed tax capital provisions

The following section is hereby inserted in the Income Tax Act after section 8FA:

Section 8G – Determination of contributed tax capital in respect of shares issued to a group company.

(1) For the purposes of this section—

'group of companies' means two or more companies in which one company (hereinafter referred to as the 'controlling group company') directly or indirectly holds shares or voting rights in at least one other company (hereinafter referred to as the 'controlled group company'), to the extent that—

(a) at least 50% of the equity shares or voting rights in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and

(b) the controlling group company directly holds at least 50% of the equity shares or voting rights in at least one controlled group company.

(2) Where a company issues shares to any company (hereinafter referred to as the 'subscribing company') that forms, after that transaction, part of the same group of companies as that company, the amount of the contributed tax capital in relation to those shares must, to the extent that the consideration for those shares—

(a) consists of; or

(b) is used, directly or indirectly to acquire,

any shares in another company that forms part of the same group of companies as those companies, be equal to so much of the total contributed tax capital attributable to shares of that class in that other company so acquired, determined in terms of subsection (3), as bears the same ratio that the number of shares so acquired bears to the total number of shares of that class.

(3) The contributed tax capital in relation to the shares in that other company must be—

(a) determined in terms of paragraph *(b)* of the definition of 'contributed tax capital' in section 1; and

(b) calculated as at the date from which that other company formed part of the same group of companies irrespective of whether that subscribing company formed part of that group on that date.

EXPLANATORY MEMORANDUM

ADDRESSING ABUSE OF CONTRIBUTED TAX CAPITAL PROVISIONS

[Applicable provision: section 1 of the Act - 'contributed tax capital' definition and the insertion of the new section 8G of the Act]

BACKGROUND

The concept of contributed tax capital (CTC) was introduced in the Act in 2011. CTC is a notional tax amount derived from contributions made to a company by holders of a class of shares as consideration for the issue of that class of shares by that company. It is reduced by any capital amount that is subsequently transferred back by the company to one or more shareholders of that class of shares (commonly known as a capital distribution) utilising that notional tax amount so received.

A distribution to shareholders which leads to a reduction of CTC does not constitute a dividend and is specifically excluded from the definition of 'dividend' in section 1 of the Act and as a result not subject to dividends tax. That said, any transfer by a company to a shareholder, in cash or in kind, which does not constitute a return of CTC will be regarded as a dividend.

In order for a transfer from a company to a shareholder to constitute a reduction of CTC (and accordingly fall outside the dividend definition) the definition of CTC requires that the company directors (or other persons with comparable authority) determine that the transfer constitutes a transfer of CTC. This implies that a specific resolution must be taken in order for a company to return CTC to its shareholders. Without this specific company resolution, no reduction of CTC can occur and the amount transferred would constitute a dividend and be subject to dividends tax at a rate of 20%.

REASONS FOR CHANGE

Government has identified structures in terms of which South African subsidiary companies with foreign parent shareholders increase their CTC and thereby avoid payment of dividends tax through capital distributions to its foreign shareholders. These capital distributions are not subject to CGT in the hands of the foreign parent shareholder if the underlying investment is not in immovable property in South Africa and therefore not within the South African CGT net.

The example of structures that have been identified whereby the concept of CTC is exploited include, but not limited to the following where CTC is either:

a. artificially created as a means to avoid dividends tax by way of capital distribution within a group of companies; or

b. a transaction, in substance, a share sale, is structured to create new or additional CTC.

A. Group company structures

In this structure, CTC is artificially created by the interposition of additional South African subsidiary companies as a means to avoid dividends tax through a capital distribution to foreign parent shareholders within a group

of companies.

A South African subsidiary company issues shares to a foreign parent shareholding company that is part of the same group of companies as the South African subsidiary company. As consideration for the shares issued, the foreign parent company provides the South African subsidiary company with shares in another South African company that is also part of the same group of companies.

EXAMPLE:

Foreign parent company (F-Co) with a local subsidiary (Local S-Co) interposes a new intermediate holding company (H-Co) between itself and the Local S-Co on an asset-for-share basis between the F-Co and H-Co. To facilitate the transaction the H-Co is either a resident or becomes a resident after the asset-for-share transaction. H-Co issues shares to F-CO and receives as consideration all the shares held by F-Co in Local S-Co . CTC is created within H-Co equal to the market value of the shares in Local S-Co notwithstanding that Local S-Co is pregnant with reserves built up in South Africa over many years. Dividends then flow from Local S-Co to the H-Co on an exempt basis (resident to resident) and the H-Co in turn then effects a capital distribution through a reduction in the newly created CTC to the F-Co thus avoiding dividends tax.

The transaction merely reorganises ownership within the group of companies, with no or limited movement of any operational assets.

B. *Disguised sale of shares*

The second identified structure involves a disguised sale of share transaction where instead of a standard disposal of shares between interested parties (shareholder A and possible new shareholder B), the interested parties instead enter into a structured transaction involving both shareholders and the target operational company (Op-Co).

EXAMPLE:

Shareholder B subscribes for the same class of shares in Op-Co as

Shareholder A where after Op-Co then utilises the consideration received for the shares issued to shareholder B to do a share buy-back from shareholder A. By effecting the transaction as detailed above additional CTC is created in Op-Co which would not have been the case if shareholder A and B merely entered into sale transaction of the shares of Op-Co. To differentiate between those transaction with no economic real reason other than the creation of a tax benefit and legitimate transactions, the proposed anti-avoidance measure will have to be targeted.

PROPOSAL

It is proposed that legislation be amended to include:

A. Group company structures

An anti-avoidance measure that adjusts the value of the consideration received for the issue of the shares by H-Co, to the extent that either

a. that consideration consists of; or

b. that consideration is use to directly or indirectly acquire;

shares in another company that also forms part of the same group of companies as H-Co, to be equal to the value of the CTC in Local S-Co as at the date when Local S-Co formed part of the same group of companies irrespective of whether that subscribing company formed part of that group on that date.It is proposed that the consideration for the shares received by the issuer be deemed not to exceed the amount of the CTC available in the issuer for that same class of share immediately before the issue of the shares by the issuer.

EFFECTIVE DATE

The proposed amendments will be deemed to have come into effect on 19 July 2017 and applies in respect of any share issued on or after that date.

3.3. Removing the 12-month limitation on joining newly established pension or provident fund

Section 1 of the Income Tax Act is hereby amended by the deletion in subsection (1) in paragraph *(c)*(ii) of the proviso to the definition of 'pension fund' of item *(cc)* and by the deletion in subsection (1) in paragraph *(b)* of the proviso to the definition of 'provident fund' of subparagraph (iii).

EXPLANATORY MEMORANDUM

REMOVING THE 12-MONTH LIMITATION ON JOINING NEWLY ESTABLISHED PENSION OR PROVIDENT FUND.

[Applicable provisions: Proviso (b)(iii) of the definition for provident fund and proviso (c)(ii)(cc) of the definition of pension fund]

BACKGROUND

The Act makes provisions in proviso (c)(ii)(cc) of the definition of 'pension fund' and proviso (b)(iii) of the definition of 'provident fund' in section 1 of the Act that if an employer establishes a new pension or provident fund, employees have up to 12 months to make application to join that fund. An employee who fails to make application to join within the 12 month period is not permitted to join that fund.

REASONS FOR CHANGE

The current limit of 12-month period for joining a pension or provident fund is restrictive and creates policy anomalies. The consequence of the current limit of 12-month period may be that employees can opt to be outside of the retirement saving system even though they are currently employed.

PROPOSAL

In order to encourage employees to contribute towards their retirement and remove practical difficulties, it is proposed that the current limit of 12 month period be removed so that employees are allowed to join a new established pension or

provident fund at any time, subject to the rules of the fund.

EFFECTIVE DATE

The proposed amendment will come into effect on 1 March 2018 and applies in respect of years of assessment commencing on or after that date.

3.4. Refinement of measures to prevent tax avoidance through the use of trusts

Section 7C of the Income Tax Act is hereby amended—

(a) by the substitution for subsection (1) of the following subsections:

(1) This section applies in respect of any loan, advance or credit that—

(a) a natural person; or

(b) at the instance of that person, a company in relation to which that person is a connected person in terms of paragraph *(d)*(iv) of the definition of connected person,

directly or indirectly provides to—

(i) a trust in relation to which—

(aa) that person or company, or

(bb) any person that is a connected person in relation to the person or company referred to in item *(aa)*,

is a connected person; or

(ii) a company that is a connected person in relation to the trust referred to in subparagraph (i).';

(b) by the insertion after subsection (1) of the following subsection:

'(1A) If a natural person acquires a claim to an amount owing by a trust or a company in respect of a loan, advance or credit referred to in subsection (1), that person must for purposes of this section be treated as having provided a loan, advance or credit to that trust or company—

(a) on the date on which that person acquired that claim; or

(b) if that person was not a connected person on that date in relation to—

(i) that trust; or

(ii) the person who provided that loan, advance or credit to that trust or company,

on the date on which that person became a connected person in relation to that trust or person,

that is equal to the amount of the claim so acquired.';

(c) by the substitution in subsection (2) for the words following paragraph *(b)* of the following words:

'of any amount owing in respect of a loan, advance or credit referred to in subsection (1) or subsection (1A).';

(d) by the substitution for subsections (3) and (4) of the following subsections:

'(3) If a trust or company incurs—

(a) no interest in respect of a loan, advance or credit referred to in subsection (1) or subsection (1A); or

(b) interest at a rate lower than the official rate of interest as defined in paragraph 1 of the Seventh Schedule,

an amount equal to the difference between the amount incurred by that trust or company during a year of assessment as interest in respect of that loan, advance or credit and the amount that would have been incurred by that trust or company at the official rate of interest must, for purposes of Part V of Chapter II, be treated as a donation made to that trust by the person referred to in subsection (1)*(a)* or subsection (1A) on the last day of that year of assessment of that trust.

(4) If a loan, advance or credit was provided by a company to a trust or another company at the instance of more than one person that is a

connected person in relation to that company as referred to in paragraph *(b)* of subsection (1), each of those persons must be treated as having donated, to that trust, the part of that amount that bears to that amount the same ratio as the equity shares or voting rights in that company that were held by that person during that year of assessment bears to the equity shares or voting rights in that company held in aggregate by those persons during that year of assessment.';

(e) by the substitution in subsection (5) for the words preceding paragraph *(a)* of the following words:

'Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) if—';

and

(f) by the deletion in subsection (5) of the word 'or' at the end of paragraph *(f)*, the insertion of the word 'or' at the end of paragraph *(i)* and the addition after that paragraph of the following paragraph:

'*(h)* that trust was created solely for purposes of giving effect to an employee share incentive scheme in terms of which—

(i) that loan, advance or credit was provided—

(aa) by a company to that trust;

(bb) for purposes of funding the acquisition, by that trust, of shares in that company or in any other company forming part of the same group of companies as that company (hereinafter referred to as a 'scheme company');

(ii) equity instruments, as defined in section 8C, that relate to or derive their value from shares in a scheme company may be offered by that trust to a person solely by virtue of that person—

(aa) being in employment on a full-time basis with; or

(bb) holding the office of director of,

a scheme company; and

(iii) a person that is a connected person in terms of paragraph *(d)*(iv) of the definition of connected person in relation to any scheme company is not entitled to participate in that scheme.'.

Paragraphs *(a)*, *(b)*, *(c)*, *(d)* and *(e)* of subsection (1) are deemed to have come into operation on 19 July 2017 and apply in respect of any amount owed by a trust or a company in respect of a loan, advance or credit provided to that trust or that company before, on or after that date.

Paragraph *(f)* of subsection (1) is deemed to have come into operation on 1 March 2017 and applies in respect any amount owed by a trust in respect of a loan, advance or credit provided to that trust before, on or after that date.

EXPLANATORY MEMORANDUM

REFINEMENT OF MEASURES TO PREVENT TAX AVOIDANCE THROUGH THE USE OF TRUSTS

BACKGROUND

An anti-avoidance measure aimed at curbing the tax-free transfer of wealth to trusts through the use of low interest or interest-free loans, advances or credit was introduced in 2016. In these tax avoidance schemes, a taxpayer transfers assets to a trust and the purchase price that the trust owes in respect of the assets is outstanding as a loan, advance or credit in favour of that taxpayer on which no interest or very low interest is charged. Alternatively, a taxpayer can advance a low interest or interest-free loan, advance or credit to a trust in order for the trust to use the money to acquire assets.

The use of low interest or interest free loans in this manner means that donations

tax is avoided when the assets are transferred in exchange for a low interest or interest free loan, advance or credit because these transfers are treated as sale transactions and not donations. Furthermore, in some instances, the amount that is owed to the taxpayers (i.e. the loan claim) can remain outstanding and the trust may have no real intention to pay it off. Coupled with the above, in some instances taxpayers reduce or waive the loan which is supposed to be paid back to him or her. This way, the waived amounts will not form part of his estate for purposes of estate duty. However, the taxpayer can make his children and/or spouse beneficiaries of the trust.

In order to make these types of tax avoidance schemes less attractive to taxpayers, the anti-avoidance measure under section 7C came into effect on 1 March 2017 and applies to all new loans, advances or credit and loans, advances or credit that were already in existence on the date it came into effect. For purposes of the anti-avoidance measure in section 7C, an ongoing and annual donation is triggered whenever interest free loans, advances or credit or loans, advances or credit with low rates that are made to a trust by:

a. a natural person; or

b. a company that is a connected person in relation to a natural person that advanced the loan, advance or credit to the trust at the instance of that natural person.

There is, however, a limitation in that such a natural person or company that advances the loan, advance or credit should be a connected person in relation to the trust or must be a connected person to another person that is a connected person in relation to the trust.

This ongoing and annual donation is taxed in the hands of the natural person at a rate of 20%. This is the case even when the company advances the loan, advance or credit to the trust. In every year of assessment of the trust that the interest free or low interest loan remains outstanding, the amount of the deemed donation made by the natural person to the trust is determined as the difference between the interest charged on the loan, advance or credit and the interest that would have been payable by the trust had the interest been charged at the official rate of

interest (as defined in the Seventh Schedule to the Act).

REASONS FOR CHANGE

Since the introduction of the anti-avoidance measure, it has come to Government's attention that taxpayers have discovered ways to avoid the deemed annual donation triggered by the anti-avoidance measure.

A. Interest-free loans, advances or credit and low interest loans, advances or credit made to companies owned by trusts

In order to avoid the application of the anti-avoidance measure, taxpayers advance interest free or low interest loans to companies whose shares are held by trusts. By advancing the loan to the company rather than the trust, the anti-avoidance measure will not apply as it currently only applies to loans advanced to trusts. As such, the fiscus will forgo the ongoing and annual donations tax on the deemed donation. These companies benefit from this low or no interest funding and tax can only be collected at a much later stage when the company makes distributions to the trust.

B. Transfer of loan claims to current or future beneficiaries of trusts

Under this avoidance scheme, taxpayers enter into an arrangement under which the loan claim of the natural person who made the loan, advance or credit to the trust (or the natural person at whose insistence a company made a loan to a trust) is transferred to another natural person. The natural person that the loan claim is transferred to is usually a current beneficiary of the trust or a future beneficiary of the trust to which the loan, advance or credit is made, such as a child or a spouse. By subsequently transferring the loan claim, taxpayers argue that this breaks the link between the natural person who advanced the loan and the loan. Because of this, the natural person to whom the loan claim is transferred does not account for the deemed ongoing and annual donation as that natural person did not advance the loan to the trust.

PROPOSAL

In order to curb the abovementioned avoidance, it is proposed that interest free or low interest loans, advances or credit that are made by a natural person or a company (at the instance of a natural person) to a company that is a connected person in relation to a trust should also fall under the anti-avoidance measure.

Furthermore, where a person that is a connected person in relation to a trust acquires a loan claim to an amount owing by that trust in respect of a loan, advance or credit that was originally advanced by a natural person or a company (at the instance of a natural person) to that trust, the person who acquires that claim will be deemed to have advanced the amount of that claim as a loan on the date that person acquired that claim.

EFFECTIVE DATE

The proposed amendment will come into effect on 19 July 2017 and applies in respect of any amount owed by a trust or company in respect of a loan, advance or credit provided to that trust before, on or after that date.

3.5. Excluding employee share scheme trusts from measures to prevent tax avoidance through the use of trust

EXPLANATORY MEMORANDUM

EXCLUDING EMPLOYEE SHARE SCHEME TRUSTS FROM MEASURES TO PREVENT TAX AVOIDANCE THROUGH THE USE OF TRUSTS

[Applicable provision: section 7C of the Act]

BACKGROUND

The anti-avoidance measure dealing with the tax treatment of interest-free or low interest loans, advances or credit was introduced in 2016. The anti-avoidance measure applies to loans, advances or credit made to a trust by either a natural

person or, at the natural person's instance, by a company in which that person together with connected persons in relation to that natural person hold an interest of at least 20%. In terms of the anti-avoidance measure, interest forgone in respect of interest-free or low interest loans, advances or credit made to trusts is treated as an ongoing and annual donation made by the natural person on the last day of the year of assessment of the trust.

The amount of the deemed donation made by the natural person to the trust is determined as the difference between the interest charged on the loan, advance or credit and the interest that would have been payable by the trust had the interest been charged at the official rate of interest (as defined in the Seventh Schedule to the Act). As a result of the anti-avoidance measure, donations tax is triggered and charged at a rate of 20% on that deemed donation.

REASONS FOR CHANGE

Trusts are used for various purposes other than to facilitate the transfer of wealth through the use of interest free or low interest loans, advances or credit. As a result, various uses of trusts and/or loans are specifically excluded from the application of the anti-avoidance measure. These include:

a. special trusts that are established solely for the benefit of persons with disabilities as referred to in paragraph (a) of the definition of 'special trust' in section 1 of the Act;

b. trusts that fall under public benefit organisations as contemplated in section 30 of the Act;

c. vesting trusts (where the vesting rights and contributions of the beneficiaries are clearly established);

d. loans that are advanced to a trust, to the extent that a loan used by the trust for funding the acquisition of the primary residence of the lender;

e. a loan that constitutes an affected transaction and is subject to the provisions of section 31 of the Act;

f. loans provided to the trust in terms of a sharia compliant financing arrangement; and

g. a loan that is subject to the anti-value stripping provisions of section 64E(4) of the Act.

In addition to the above, the anti-avoidance measure may have a negative impact on some employee shares schemes that often make use of trusts to hold shares in the employer company (or its associate) that will be allocated to qualifying employees. These types of trusts are established to facilitate incentive programmes for employees and cannot be treated in the same manner as trusts that are established to transfer wealth.

PROPOSAL

In order ensure that employee share schemes are not negatively affected, it is proposed that a specific exclusion for employee incentive schemes should be provided. However, certain requirements must be met for the exclusion to apply. These requirements are introduced in order to ensure that owners of businesses do not abuse the exclusion to transfer wealth to family members that are in the employ of the business.

In the first instance, it will be required that the trust should be a trust that is created solely for purposes of giving effect to an employee share incentive scheme in terms of which that loan, advance or credit was provided by a company to that trust for purposes of funding the acquisition, by that trust, of shares in that company or in any other company forming part of the same group of companies as that company. Secondly, shares (or other equity instruments that relate to or derive their value from shares in a company) may only be offered by that trust to someone by virtue of that person being in the full-time employment of a company or holding the office of director of a company. Lastly a person that is a connected person in terms of paragraph (d)(iv) of the definition of 'connected person' in relation to a company or any other company forming part of the same group of companies as that company (i.e. a person that holds at least a 20% interest either individually or collectively with connected persons) may not participate in that scheme.

EFFECTIVE DATE

The proposed amendment will be deemed to have come into effect on 1 March 2017 and applies in respect of any amount owed by a trust in respect of a loan,

advance or credit provided to that trust before, on or after that date.

3.6. Clarifying the rules relating to the taxation of employee share-based schemes

The following paragraph is inserted in the Eighth Schedule to the Income Tax Act, after paragraph 64D:

Paragraph 64E – Disposal by a trust in terms of a share incentive scheme

Where a capital gain is determined in respect of the disposal of an asset by a trust and a trust beneficiary has a vested right to an amount derived from that capital gain, that trust must disregard so much of that capital gain as is equal to that amount if that amount must in terms of section 8C be—

(a) included in the income of that trust beneficiary as an amount received or accrued in respect of a restricted equity instrument; or

(b) taken into account in determining the gain or loss in the hands of that trust beneficiary in respect of the vesting of a restricted equity instrument.'.

This paragraph deemed to have come into operation on 1 March 2017 and applies in respect of amounts received or accrued on or after that date.

Paragraph 80 of the Eighth Schedule is hereby amended by the substitution for subparagraph (2) of the following subparagraph:

(2) Subject to paragraphs 64E, 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62 *(a)* to *(e)*) who is a resident has a vested **[interest]** right or acquires a vested **[interest]** right (including **[an interest caused]** a right created by the exercise of a discretion) **[in]** to an amount derived from that capital gain but not **[in]** to the asset, the disposal of which gave rise to the capital gain, **[the whole or the portion]** so much of the capital gain **[so vested]** as is equal to the amount to which that trust beneficiary is entitled in terms of that right—

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary **[in whom the gain vests]** <u>who is entitled to that amount</u>.

And by the deletion of subparagraph (2A).

EXPLANATORY MEMORANDUM

CLARIFYING THE RULES

[Applicable provisions: sections 8C and 8C(1A) of the Income Tax Act No. 58 of 1962 ('the Act'), new paragraph 64E, paragraph 80(2) and paragraph 80(2A) of the Eighth Schedule to the Act]

I. BACKGROUND

The Act contains anti-avoidance rules aimed at preventing employees from characterising an employment income amount that is fully taxable at 45% (for example salary or bonus) as capital gains or dividends, which are taxed at lower rates or even exempt dividends. Section 8C (which deals with the taxation of directors and employees for vesting equity instruments) makes provision for the taxpayer to include the gain generated from the equity instrument granted in terms of the employee share scheme, in the income for the year in which the equity instrument vests in that taxpayer.

In 2015, amendments were made to the Act to address the anomaly that the disposal of an equity instrument by the trust to the qualifying beneficiary constitutes a non-event for capital gains tax (CGT) purposes in terms of paragraph 11(2)(j) of the Eighth Schedule. Consequently, clarification was made in various provisions of the Act to defer the recognition of the capital gain in the employee share trust when it disposes of shares to an employee until the equity instrument is unrestricted and

vests for purposes of section 8C. In particular, a new paragraph 80(2A) was inserted in the Eighth Schedule to clarify that where the trust disposes of shares and the profits vests into the hands of qualifying employee beneficiaries, then the provisions of paragraph 80(2) will not apply if such amount is to be taken into account in the hands of those qualifying employee beneficiaries for the purposes of section 8C of the Act.

In turn, in 2016, changes were made to section 8C to introduce measures to deal with schemes where restricted shares allocated to employees are liquidated in return for an amount qualifying as a dividend rather than restricted shares with an embedded gain. As such, amounts received by or accrued to employees through liquidations of restricted equity instruments effected whilst a restriction is still in place will be regarded as remuneration and be subject to tax at the employees applicable marginal tax rate.

The 2016 changes also included changes in section 10(1)(k)(i) of the Act to exclude from dividend exemption certain dividends in respect of restricted equity instrument scheme.

REASONS FOR CHANGE

It has come to Government's attention that the 2016 changes relating to section 8C(1A) of the Act overlap with the 2015 amendments made to paragraph 80(2A) of the Eighth Schedule dealing with the tax treatment of capital gains arising from disposals by employee share trusts. Section 8C(1A) of the Act seeks to include in income of the employee amounts derived through liquidation of restricted equity instruments effected before the restrictions fall away. This implies that the capital gain received by employees who are holders of a restricted equity instrument will be taxed as income. On the other hand, paragraph 80(2A) of the Eighth Schedule seeks to prevent the so called 'conduit pipe principle' in respect of gains arising on the disposal of trust assets which are vested in beneficiaries of the trust. Paragraph 80(2A) of the Eighth Schedule seeks to clarify that where the trust disposes of shares and the profits vests into the hands of the qualifying employee beneficiary, then the capital gains arising from such disposal will be taxed in the hands of the trust and not in the hands of the employee beneficiary, if such gain is to be taxed

as income in the hands of the employee beneficiary in terms of section 8C of the Act.

The interaction between section 8C(1A) of the Act and paragraph 80(2A) of the Eighth Schedule could result in a capital gain arising from the disposal of shares by a trust being subject to CGT in the hands of the trust and capital gains arising from liquidation of a restricted share being subject to income tax in the hands of the employee. The application of the above-mentioned provisions may create double taxation as capital gains arising from the disposal of shares by a trust will be subject to CGT in the hands of the trust, even in cases where the capital gains arising from liquidation of restricted equity instruments have been taxed as income in the hands of the employee. As such, the interaction between section 8C(1A) of the Act and paragraph 80(2A) of the Eighth Schedule needs to be addressed.

PROPOSAL

In order to address the anomaly arising from the interaction between section 8C(1A) of the Act and paragraph 80(2A), it is proposed that amendments be made to the Act by inserting a new paragraph 64E into the Eighth Schedule (which deals with disposals by a trust in terms of a share incentive scheme), to clarify that amounts included in the employee's income in terms of section 8C of the Act will be disregarded by the share incentive scheme for CGT purposes. In addition, changes will be made to paragraph 80(2) of the Eighth Schedule to clarify that these provisions will be subject to paragraph 64E of the Act. In turn, it is proposed that paragraph 80(2A) of the Eighth Schedule be deleted.

EFFECTIVE DATE

The proposed amendments will be deemed to have come into effect on 1 March 2017 and apply in respect of any amount received or accrued on or after that date.

3.7. Third-party backed shares: Amendment of the provisions to cover certain qualifying purposes

Section 8EA of the Income Tax Act, is hereby amended by the substitution in

subsection (3)*(b)* for subparagraph (vii) of the following subparagraph:

(vii) any person that holds equity shares in an issuer contemplated in subparagraph (ii) if the enforcement right exercisable or enforcement obligation enforceable against that person is limited to any rights in and claims against that issuer that are held by that person.

EXPLANATORY MEMORANDUM

THIRD-PARTY BACKED SHARES: AMENDMENT OF THE PROVISIONS TO COVER CERTAIN QUALIFYING PURPOSES

[Applicable provision: section 8EA of the Act]

BACKGROUND

The Act contains third party backed share anti-avoidance provisions in section 8EA of the Act aimed at dealing with preference shares with dividend yields backed by third parties. The dividend yield of third-party backed shares is treated as ordinary revenue per section 8EA of the Act unless the funds derived from the issue of the third-party backed shares were used for a qualifying purpose. This rule equally applies to domestic and foreign dividends.

The anti-avoidance rules however do have exceptions to allow for specific third party guarantees/obligations if the application of funds derived from preference shares are used for qualifying purposes as defined in section 8EA of the Act.

REASONS FOR CHANGE

In 2014, amendments were effected to the Act to allow for the pledging of the equity shares and associated debt claims in the issuer of the preference shares by the holder(s) of shares in that issuer of the preference share. However, the 2014 changes do not cover situations where the funds were to refinance any debt or other preference shares that were used for a qualifying purpose or to finance any dividends payable on another preference share that was used for a qualifying purpose.

Although the 2014 changes tried to address some of the concerns, however, it has come to Government's attention that the 'qualifying purpose' exemption that the targeted result of the legislation has been found to be overly restrictive and as such several possible variations of asset-backed preference share transactions entered into through the ordinary course of business for qualifying purposes, other than a direct or indirect acquisition of equity shares in an operating company, has been unduly restricted.

PROPOSAL

In order to address concerns regarding the fact that the qualifying purpose test is too narrow, and may impede legitimate transactions, an amendment is proposed to the legislation by removing the requirement for exclusion in subsection (3)(b)(vii)(aa) that the issuer of equity shares must use the funds solely for the acquisition of equity shares in an operating company.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply in respect of any dividends or foreign dividends received or accrued during years of assessment commencing on or after that date.

3.8. Extending the application of controlled foreign company rules to foreign trusts and foundations

Section 9D of the Income Tax Act is hereby amended:

(a) by the substitution in subsection (1) for the definition of 'controlled foreign company' of the following definition:

'controlled foreign company' means—

(a) any foreign company where more than 50% of the total participation rights in that foreign company are directly or indirectly held, or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies:

Provided that—

(a) no regard must be had to any voting rights in any foreign company—

(i) which is a listed company; or

(ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(b) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50% of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(c) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50% of the participation rights or voting rights in a foreign company, if—

(i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five% of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph *(e)*(ii) of the definition of 'company' in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—

(aa) holds less than five% of the participation rights of that scheme or arrangement; and

(bb) may not exercise at least five% of the voting rights in that scheme or arrangement,

unless more than 50% of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other; and

(b)(i) any foreign company, where one or more persons that are residents hold an interest in a trust that is not a resident or in a foreign foundation and that trust or that foundation directly or indirectly holds more than 50% of the total participation rights in that foreign company or may directly or indirectly exercise more than 50% of the voting rights in that foreign company; or

(ii) any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident,

(b) by the addition in subsection (2) the proviso of the following further proviso:

Provided further that for purposes of applying this subsection the percentage of the participation rights of a resident in relation to a controlled foreign company is equal to the percentage of the financial results of that foreign company that are reflected in the consolidated financial statements, as contemplated in IFRS 10, for the year of assessment of the holding company, as defined in the Companies Act, that is a resident;'

The following section in hereby inserted in the Income Tax Act after section 25BB:

Section 25 BC – Distributions by non-resident trust or foreign foundation deemed to be income of resident

If—

(a) any person that is a resident, other than a person that is a company, is a beneficiary in relation to a trust that is not a resident or a foreign foundation; and

(b) that trust or foundation holds a participation right as defined in section 9D(1) in a foreign company and that company would have constituted a controlled foreign company as defined in that section had that trust or foundation been a resident,

any amount received by or accrued to or in favour of that person during any year of assessment from that trust or foundation by reason of that person being a

beneficiary of that trust or foundation must be included in the income of that person.

EXPLANATORY MEMORANDUM

EXTENDING THE APPLICATION OF CONTROLLED FOREIGN COMPANY RULES TO FOREIGN TRUSTS AND FOUNDATIONS

[Applicable provision: section 9D and insertion of the new section 25BC of the Act]

BACKGROUND

South African residents are subject to tax on a worldwide basis. In order to curb avoidance, the Act contains CFC rules generally aimed at preventing South African residents from shifting tainted forms of taxable income offshore by investing in CFCs. These rules make provision for the net income of a CFC to be attributed and included in the income of South African resident shareholders. A CFC is defined as a foreign company where more than 50% of the participation rights in that foreign company are directly or indirectly held or more than 50% of the voting rights are directly or indirectly exercised by one or more South African residents. An amount equal to the net tainted income of a CFC is attributed to and included in the taxable income of South African resident shareholders in proportion to that resident's participation right or voting rights in the CFC. A foreign company is defined as any company which is not a resident.

However, foreign entities such as foreign trusts and foreign foundations do not fall within the ambit of South African CFC rules. Foreign trusts are only taxed in South Africa if they are effectively managed in South Africa. However, vested beneficiaries who are tax resident in South Africa are subject to tax on foreign trust income as that income vests in the South African resident beneficiaries. On the other hand, foreign discretionary trust income is not taxed in the hands of the South African tax resident beneficiaries until vesting occurs.

Similarly, foreign partnerships do not fall within the scope of the South African CFC rules. However, the South African residents will still be taxed on their share of

foreign partnership income. In some countries, such as France, CFC rules apply to entities such as foreign trust and partnerships.

Before the introduction of worldwide system of taxation in 2001, South Africa had Controlled Foreign Entity (CFE) rules aimed at preventing avoidance of the provisions dealing with taxation of foreign source investment income derived from a foreign country by a South African resident, by establishing offshore companies or trusts. These CFE rules deemed the investment income to have been received by or accrued to the resident from a South African source, thereby bringing it within the South African tax net. The term CFE was defined as any entity (company or trust) in which one or more residents of South Africa, individually or jointly, and whether directly or indirectly, hold more than 5 per cent of the 'participation rights' or are entitled to exercise more than 50 per cent of the votes or control of a foreign entity and has its place of effective management outside South Africa. However, in the Revenue Laws Amendment Act 74 of 2002, changes were made in the Act to replace the term CFE with the term CFC. As a result, foreign trusts were excluded from application of the CFC rules.

REASONS FOR CHANGE

Government has, since 2008, been concerned that the current CFC rules do not capture foreign companies held by interposed trust or foundations. Various interventions were explored but never implemented.

In the 2015 *Budget Review* it was announced that consideration will be given to allow CFCs held by interposed trusts or foundations to be subject to tax in South Africa. Of particular concern is the use of foreign discretionary trust or foundations in order to escape the application of CFC rules even if the participation or voting control requirements are met. This is achieved through interposing a foreign trust or foundation, in particular a discretionary trust, between South African tax residents and a foreign company, despite the fact that the foreign trust and the foreign company are part of the same group and consolidated by the South African tax resident group for financial reporting purposes under the IFRS 10.

A. IFRS 10

According to Appendix A of IFRS 10, consolidated financial statements are

the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. IFRS 10 requires, the parent that controls one or more other entities, to present consolidated financial statements. It defines the principle of control, and establishes control as the basis for consolidation. Further, it requires a taxpayer to consolidate any entity if, for example, it has rights that give the power to direct the activities that significantly affect the subsidiary's returns.

B. Base Erosion and Profit Shifting Action 3 Recommendations

The G20/OECD base erosion and profit shifting (BEPS) Action 3, Designing Effective Controlled Foreign Companies Rules final report, recommends a broad definition of entities that fall within the scope of CFC rules if these entities earn income that raises BEPS concerns.

Action 3 final report, recommends amongst others that non-resident companies that are consolidated in the accounts of a resident company in terms of IFRS should be treated as CFC.

PROPOSAL

In view of the above, it is proposed that the following changes be made in the Act in order for the CFC rules to capture foreign companies that would have been held as CFCs, if no foreign trust or foreign foundation was interposed.

A. Section 9D imputation

It is proposed that:

a. CFC rules in section 9D of the Act be adjusted so that a foreign company held through a trust or foundation that is not resident in South Africa and whose financial statements form part of the consolidated financial statements, as defined in the IFRS 10, of a group of which the parent company is resident in South Africa, is deemed to be a CFC for the purposes of section 9D of the Act.

b. a new subparagraph (c) in the definition of participation rights in section 9D of the Act be inserted to clarify that the meaning of

participation rights in this regard will be a percentage of a proportion of profits of a foreign company that was included or reflected in the consolidated financial statement of any company that is a resident.

B. New section 25BC of the Act

It is proposed that:

a. new section 25BC of the Act be inserted so that any distributions made by a foreign trust or foreign foundation, that holds shares in a foreign company would have been regarded as a CFC if no foreign trust or foreign foundation was interposed, to South African tax resident beneficiaries be deemed to be income in the hands of the South African tax resident beneficiaries and subject to normal tax in South Africa, based on the applicable tax rates.

b. the provisions of the new section 25BC of the Act will only apply to any person, other than a company namely natural person, trust, estate of a deceased person and insolvent estate.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply in respect of amounts that are paid or payable on or after that date.

3.9. Refinements of rules prohibiting deduction of tainted intellectual property

Section 23I of the Income Tax Act is hereby amended by the addition after subsection (3) of the following subsection:

(4) Subsection (2) must not apply where the aggregate amount of taxes on income payable to all spheres of government of any country other than the Republic by a controlled foreign company contemplated in that subsection in respect of the foreign tax year of that controlled foreign company is at least 75% of the amount of normal tax that would have been payable in respect of any taxable income of the controlled foreign company had the controlled foreign company been

a resident for that foreign tax year.

EXPLANATORY MEMORANDUM

REFINEMENTS OF RULES PROHIBITING DEDUCTION OF TAINTED INTELLECTUAL PROPERTY

[Applicable provisions: sections 9D and 23I of the Act]

BACKGROUND

Prior to 2007, the development on intellectual property was fully deductible and the payment of royalties was also fully deductible for the payor, if the payor was a South African fully taxable entity. In 2007, the Government introduced a new section 23I of the Act, which became effective on 1 January 2009. Section 23I of the Act is an anti-avoidance section that applies to expenditure incurred for the right of use of or permission to use intellectual property and not to expenditure incurred to acquire intellectual property. Its purpose is to prevent erosion of the South African tax base resulting from assigning South African intellectual property from South Africa to foreign entities with a lower effective tax rate, followed by the licensing of that intellectual property back to fully taxable South African taxpayers.

Section 23I of the Act prohibits deductions of expenditure incurred for the use of or right of use of or permission to use tainted intellectual property or any expenses which are calculated directly or indirectly on the expenditure paid for the use or right to use of or permission to use any tainted intellectual property to the extent that the expenditure is not income in the hands of the other party or proportional amount of the net income of a controlled foreign company (CFC) that is imputed to the South African resident.

However, a partial deduction is provided for in the event where a withholding tax on royalties is applicable. For example, if a withholding tax on royalties at the rate of 10% in terms of the agreement for the avoidance of double taxation applies, one third of the expenditure will be allowed to be deducted. If a withholding tax at the rate of 15% on royalties applies, a deduction of one half of the expenditure is

allowed. However, where an agreement for the avoidance of double taxation reduces the withholding tax rate on royalties to a rate that is below 10%, the expenditure incurred will be denied.

REASONS FOR CHANGE

At issue is the definition of 'tainted intellectual property'. Intellectual property is regarded as a tainted intellectual property if, *inter alia*, it was discovered, devised, developed, created or produced by the end user or by a taxable person that is a connected person to the end user. Of concern is the potential wide interpretation of the word 'developed' in the definition of 'tainted intellectual property' which if interpreted widely may be applied to modifications or improvements to existing intellectual property that was not originally developed, devised or created by the end user or a taxable person who is a connected person in relation to the end-user.

While the purpose of the provisions of section 23I of the Act is to prevent the erosion of the South African tax base, it was never intended that section 23I of the Act would be overly restrictive in nature to the extent of discouraging South African companies from using South African resources where further minor ongoing maintenance of the existing intellectual property is necessary. As a result, where a South African company acquires an intellectual property rich foreign subsidiary which is licensed worldwide and utilises South African based expertise and infrastructure within the group to enhance the intellectual property which is also licensed for use in South Africa there is a risk that the group will be exposed to the application of section 23I of the Act.

PROPOSAL

In view of the above, it is proposed that the rules prohibiting the deduction of tainted intellectual property will not apply where net income of a CFC is deemed to be nil due to the application of the high-tax exemption.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply on amounts that are paid or payable during years of assessments commencing on or after that date.

3.10. Repeal of foreing employment income exemption

By the deletion of section 10(1)*(o)*(ii).

EXPLANATORY MEMORANDUM

REPEAL OF FOREIGN EMPLOYMENT INCOME EXEMPTION

[Applicable provision: section 10(1)(o)(ii) of the Act]

BACKGROUND

Domestic law

Prior to 2001, South Africa applied a source-based system of taxation. All income which was from a source in South Africa and certain types of income which were deemed to be from a source in South Africa were taxable in South Africa. This had the effect that income that was not from a South African source or not deemed to be from a South African source was not subject to tax in South Africa. As a result, section 10(1)(o) of the Act granted an income tax exemption only in respect of foreign employment income earned by officers and crew members employed on board any South African ship if those officers and crew members were outside South Africa for more than 183 days during the year of assessment.

However, from 1 March 2001 South Africa moved to a residence based system of taxation. This means that South African tax residents are subject to tax on their worldwide income.

That said, the scope of the section 10(1)(o) of the Act exemption was extended to include South African residents who are outside South Africa for the purposes of rendering services for, or on behalf of, their employer for a period which, in aggregate, exceeds 183 full calendar days during any period of 12 months commencing or ending during a year of assessment. Days spent outside South Africa when a person is not in employment do not qualify as days outside for the purposes of this exemption and would therefore, not be taken into consideration for the purposes of determining

the 183 day test. Further, the exemption only applies if, during the same period of 12 months, a person rendered services outside South Africa for a continuous period of at least 60 full days.

It is important to note that this exemption does not apply in respect of remuneration derived from services rendered outside South Africa for or on behalf of any employer in the national, provincial or local sphere of government or any public or municipal entity. Remuneration derived from holding of a public office to which that person was appointed or deemed to be appointed under an act of Parliament is also excluded from this exemption.

Tax treaties

South Africa has concluded more than 78 double taxation agreements (DTAs). The main purpose of a DTA is to eliminate double taxation of the same income, by allocating taxing rights between the source state and the residence state. The DTA article dealing with taxation of income from employment generally gives a source state a limited right to tax employment income received by individuals from the exercise of employment in the source state. On the other hand, the residence state has exclusive right to tax employment income received by the resident individual in respect of services rendered in a source state if the following conditions are all met:

a. the recipient of the income is not present in the source state for more than 183 days in twelve months;

b. the remuneration is paid by an employer or on behalf of an employer who is not resident in the source state; and

c. the remuneration is not borne by a permanent establishment of an employer in the source state.

If any of the above conditions is not met, the source state has a right to tax the income from employment exercised in the source state.

That said, the residence state is not precluded from taxing the same

employment income. However, if the residence state imposes tax in respect of the same income, that residence state is required to provide relief from double taxation by way of a foreign tax credit or exemption.

REASONS FOR CHANGE

When the section 10(1)(o)(ii) exemption was introduced in 2001, the main purpose of this exemption was to prevent double taxation of the same employment income between South Africa and the foreign host country. Also, during that time, South Africa had a more limited number of DTAs to assist with the prevention of double taxation. This exemption was never intended to create situations where employment income is neither taxed in South Africa nor in the foreign host country. As a result, the explanatory memorandum on the Revenue Laws Amendment Act, 2000, anticipated the possibility of the abuse of this exemption and stated the following:

> 'The effect of this relief measure will be monitored to determine whether certain categories of employees abuse it to earn foreign employment income without foreign taxation.'

It has come to Government's attention that the current exemption creates opportunities for double non-taxation in cases where the foreign host country does not impose income tax on the employment income or taxes on employment income are imposed at a significantly reduced rate.

In addition, this exemption creates unequal tax treatment between South African residents employed by a national, provincial or local sphere of government or any public or municipal entity and South African residents employed by the private sector. This is because the former employees do not qualify for the exemption in respect of foreign employment income, whereas employees in the private sector do qualify for the income tax exemption in respect of foreign employment income.

PROPOSAL

In view of the above, it is proposed that the current section 10(1)(o)(ii) exemption be repealed. As a result, all South African tax residents will be subject to tax on foreign employment income earned in respect of services rendered outside South

Africa with relief from foreign taxes paid on the income under section 6*quat* of the Act.

EFFECTIVE DATE

The proposed amendment will come into effect on 1 March 2019 and applies in respect of years of assessment commencing on or after that date.

3.11. Increase of thresholds for exemption of employer provided bursaries to learners with disabilities

By inserting section 10(1)(qA):

(qA) any bona fide scholarship or bursary granted to enable or assist any person who is a person with a disability as defined in section 6B(1) to study at a recognised educational or research institution: Provided that if any such scholarship or bursary has been so granted by an employer or an associated institution (as respectively defined in paragraph 1 of the Seventh Schedule) to an employee (as defined in the said paragraph) who is a person with a disability as defined in section 6B(1) or to any person with a disability as defined in section 6B(1) who is a member of the family of an employee (as defined in paragraph 1 of the Seventh Schedule) in respect of whom that employee is liable for family care and support, the exemption under this paragraph shall not apply—

(i) in the case of a scholarship or bursary granted to so enable or assist an employee, who is a person with a disability as defined in section 6B(1), unless that employee agrees to reimburse the employer for any scholarship or bursary granted to that employee if that employee fails to complete his or her studies for reasons other than death, ill-health or injury;

(ii) in the case of a scholarship or bursary granted to enable or assist a person with a disability as defined in section 6B(1) who is a member of the family of an employee, as defined in paragraph 1 of the

Fourth Schedule, in respect of whom that employee is liable for family care and support, to study—

(aa) if the remuneration proxy derived by the employee in relation to a year of assessment exceeded R600 000; and

(bb) to so much of any scholarship or bursary contemplated in this subparagraph as in the case of any such member of the family of that employee, during the year of assessment, exceeds—

(A) R30 000 in respect of—

(AA) grade R to grade twelve as contemplated in the definition of 'school' in section 1 of the South African Schools Act, 1996 (Act No. 84 of 1996); or

(BB) a qualification to which an NQF level from 1 up to and including 4 has been allocated in accordance with Chapter 2 of the National Qualifications Framework Act, 2008 (Act No. 67 of 2008); and

(B) R90 000 in respect of a qualification to which an NQF level from 5 up to and including 10 has been allocated in accordance with Chapter 2 of the National Qualifications Framework Act, 2008 (Act No. 67 of 2008);

EXPLANATORY MEMORANDUM

INCREASE OF THRESHOLDS FOR EXEMPTION OF EMPLOYER PROVIDED BURSARIES TO LEARNERS WITH DISABILITIES

BACKGROUND

Currently, the Act makes provision for tax exemption for all *bona fide* bursaries or scholarships granted by employers to employees or relatives of qualifying employees, subject to certain monetary limits and other requirements.

In 2016, changes were made to the Act to increase the monetary limits for employer provided bursaries to relatives of employees. If a bursary or scholarship is awarded to a relative of the employee, the exemption will apply only if the employee's remuneration does not exceed R400 000 during the year of assessment. In addition, the amount of the bursary or scholarship will be exempted up to a limit of R15 000 for studies from Grade R to 12 including qualifications in National Qualifications Framework (NQF) levels 1 to 4 and R40 000 for qualifications in NQF levels 5 to 10.

REASONS FOR CHANGE

In the 2017 *Budget Review*, a proposal was made to increase the threshold of the exemption for employer provided bursaries to relatives of employees. As a result, changes were made in the 2017 Rates and Monetary Amounts and Amendment of Revenue Laws Amendment Bill to increase the remuneration eligibility threshold for employees from R400 000 to R600 000 and the monetary limits for bursaries from R15 000 to R20 000 for education below NQF level 5 and from R40 000 to R60 000 for qualifications at NQF level 5 and above.

In addition, in order to cater for the limited resources in the majority of schools in South Africa for facilities required to properly accommodate learners with disabilities, Government proposed, in the 2017 *Budget Review,* a new exemption threshold for employer provided bursaries in respect of learners with disabilities. The costs encountered by educating students and learners with disabilities tend to exceed the costs faced by students and learners without disabilities. This may be due to a number of factors, such as:

a. specialised facilities and equipment;

b. specialised personnel;

c. specialised methods and modes of instruction; and

d. specialised transport.

PROPOSAL

In order to take into account the high costs of educating learners with disabilities, it is proposed that a new monetary limit be introduced as follows in cases where bursaries and scholarships are granted by employers to dependents with disabilities of qualifying employees:

i. The monetary limit in respect of exempt bursaries or scholarships for learners with disabilities be set at R30 000 per annum in the case of Grade R to 12 including qualifications in NQF levels 1 to 4; and

ii. The monetary limit in respect of exempt bursaries or scholarships for learners with disabilities be set at R90 000 per annum in the case of qualifications at NQF levels 5 to 10.

On the other hand, it is proposed that the monetary limit in respect of remuneration of qualifying employees with learners with disabilities should, as for those without learners with disabilities, be raised to R600 000 per annum.

In addition, it is proposed that the proposed relief for employer provided bursaries for the benefit of learners with disabilities be limited to employees and dependents of employees. Eligible dependents will be those who are under the family care and support of such employee as defined in paragraph (c) of the definition of 'dependent' in section 6B(1) of the Act. Also, the determination of disability status will refer to the determination of disability as defined in section 6B(1) of the Act.

Further, it is proposed that the expenses covered by the bursary or scholarship should include the elements that relate to educational services that are specific to learners and students with disabilities. These expenses are already described in the South African Revenue Service (SARS) document titled: 'LIST OF QUALIFYING PHYSICAL IMPAIRMENT OR DISABILITY EXPENDITURE' in the case where the cost is carried by the taxpayer.

EFFECTIVE DATE

The proposed amendment will come into effect on 1 March 2018 and applies in respect of years of assessment commencing on or after that date.

3.12. *Exclusion of impairment adjustments from the determination of taxable income*

Section 11 of the Income Tax Act is hereby amended:

(a) by the insertion after paragraph *(j)* of the following paragraph:

(*j*A) notwithstanding paragraph *(j)*, an allowance equal to 25% of the loss allowance relating to impairment, as contemplated in IFRS 9, if the person is a covered person as determined by applying the criteria in paragraphs *(c)*(i) to (iii) of the definition of covered person in section 24JB(1): Provided that the allowance must be increased to 85% of so much of that loss allowance relating to impairment as is equal to the amount that is in default, as determined by applying the criteria in paragraphs *(a)*(iii) to (vi) and *(b)* of the definition of 'default' as defined in Regulation 67 of the regulations issued in terms of section 90 of the Banks Act (contained in Government Notice No. R.1029 published in Government Gazette No. 35950 of 12 December 2012): Provided further that the allowance must be included in the income of that person in the following year of assessment;

EXPLANATORY MEMORANDUM

EXCLUSION OF IMPAIRMENT ADJUSTMENTS FROM THE DETERMINATION OF TAXABLE INCOME

[Applicable provision: insertion of new subsection (jA) of section 11 of the Act]

BACKGROUND

A. Summary of SARS Directive on impairment

On 17 February 2012, SARS issued a Directive for the tax treatment of doubtful debts by banks for application from the 2011 year of assessment. This SARS Directive only applies to banks and does not apply to other financial service providers. In summary, the Directive makes provision for the following allowance percentages to be granted in terms of section 11(j)

of the Act dealing with doubtful debts:

a. 25% of the incurred but not reported (IBNR) impairment provision for loans that cannot yet be identified to a specific loan;

b. 80% of portfolio specific impairment (PSI) provision for specific loans that are not yet in default; and

c. 100% of the specific impairment provision (SI) for loans that are individually identified as impaired and are close to in in default, provided a valid and accurate split can be distinguished from a PSI provision.

This Directive applies to banks as long as IAS 39 is applied by banks for accounting purposes.

B. Summary of IFRS 9 (new standard replacing IAS 39) on impairment

According to IFRS 9, it is stated that the impairment requirements relating to the accounting for an entity's expected credit losses on its financial assets and commitments to extend credit eliminate the threshold that was in IAS 39 for the recognition of credit losses. Under the impairment approach in IFRS 9 it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity should always account for expected credit losses, and changes in those expected credit losses. The amount of expected credit losses is updated at each reporting date to reflect changes in credit risk since initial recognition and, consequently, more timely information is provided about expected credit losses.

IFRS 9 has a 'three-stage' model for impairment provisioning based on changes in credit quality since initial recognition. These stages are as follows:

a. Stage 1: if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses

(IBNR).

b. Stage 2: recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition whether assessed on an individual or collective basis considering all reasonable and supportable information, including that which is forward-looking (PSI).

c. Stage 3: includes financial assets that have objective evidence of impairment at the reporting date (SI).

REASONS FOR CHANGE

The issue relates to the fact that the impairment requirements under IFRS 9 are determined on a significantly different basis from those under IAS 39. The key difference stems from the fact that the IAS 39 'incurred loss model' delays the recognition of credit losses until there is objective evidence of impairment. Furthermore, only past events and current conditions are considered when determining the amount of impairment (i.e. the effect of future credit loss events cannot be considered, even when they are expected). However, under the IFRS 9 'expected credit loss model', expected credit losses are recognised at each reporting period even if no actual loss events have taken place. In addition to past events and current conditions, reasonable and supportable forward-looking information that is available is considered in determining impairment. As a result of these differences, the adoption of the IFRS 9 accounting standard will result in significantly higher levels of impairments being recognised, particularly in stages 1 (IBNR) and 2 (PSI).

PROPOSAL

A. Affected parties

In view of the fact that banks that are registered in terms of the Banks Act No. 94 of 1990, are highly regulated by the South African Reserve Bank (SARB) and are subject to stringent capital requirements, it is proposed that the following tax treatment for doubtful debts be introduced for covered persons as defined in section 24JB of the Act.

B. Percentage allowed

Based on the above, it is proposed that the following allowance be allowed in determining the taxable income of a covered person as defined in section 24JB of the Act:

a. 25% of IBNR impairment provision;

b. 25% of PSI provision; and

c. 85% of SI provision that is equal to the amount that is in default as determined by applying the criteria in paragraphs (a)(iii) to (iv) and (b) of the definition of default as defined in Regulation 67 of SARB contained in Government Gazette No. 35950 of 12 December 2012.

In applying this 25% tax allowance, covered persons would apply the principles of IFRS 9 to arrive at the loss allowance as contemplated in IFRS 9 relating to impairment and the 25% will be allowed as a deduction under the proposed section 11(jA). The claimed in a year of assessment must be added back to income in the following year of assessment.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply in respect of years of assessment commencing on or after that date.

3.13. Deduction in respect of contributions to retirement funds

Section 11 of the Income Tax Act is hereby amended by the deletion of paragraph *(k)*.

The following section is hereby inserted in the Income Tax Act, 1962, after section 11E:

Section 11F – Deduction in respect of contributions to retirement funds

(1) For the purposes of determining the taxable income of a natural person in respect of any year of assessment there must be allowed as a deduction from the income of that person any amount contributed during a year of assessment to any pension fund, provident fund or retirement annuity fund in terms of the rules of that fund by a person that is a member of that fund.

(2) The total deduction allowed in terms of subsection (1) must not in a year of assessment exceed the lesser of—

(a) R350 000; or

(b) 27,5% of the higher of the person's—

(i) remuneration (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as defined in paragraph 1 of the Fourth Schedule; or

(ii) taxable income (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as determined before allowing any deduction under this section and section 18A.

(c) the taxable income of that person before—

(i) allowing any deduction under this section; and

(ii) the inclusion of any taxable capital gain.

(3) Any amount contributed to a pension fund, provident fund or retirement annuity fund in any previous year of assessment which has been disallowed solely by reason of the fact that the amount that was contributed exceeds the amount of the deduction allowable in respect of that year of assessment is deemed to be an amount contributed in the current year of assessment, except to the extent that the amount contributed has been—

(a) allowed as a deduction against income in any year of assessment;

(b) accounted for under paragraph 5(1)*(a)* or 6(1)*(b)*(i) of the Second Schedule; or

(c) exempted under section 10C.

(4) Any amount contributed by an employer of the person for the benefit of that person must be deemed—

(a) to be equal to the amount of the cash equivalent of the value of the taxable benefit contemplated in paragraph 2(l) of the Seventh Schedule determined in accordance with paragraph 12D of that Schedule; and

(b) to have been contributed by that person.

(5) For the purposes of this section—

(a) a partner in a partnership must be deemed to be an employee of the partnership; and

(b) a partnership must be deemed to be the employer of the partners in that partnership.

EXPLANATORY MEMORANDUM

DEDUCTION IN RESPECT OF CONTRIBUTIONS TO RETIREMENT FUNDS

[Applicable provision: deletion of section 11(k) and insertion of new section 11F of the Act]

BACKGROUND

The deduction for employee contributions to a pension fund were historically included in section 11(k), while deductions for contributions to a retirement annuity fund were included in section 11(n). As part of the wider retirement reform objectives, the tax deductibility of contributions to retirement funds was harmonised across all retirement funds through a replacement of section 11(k) from 1 March 2016, where the same deduction now applies to both employer and employee contributions to pension funds, provident funds and retirement annuity funds.

REASONS FOR CHANGE

The inclusion of the deduction in section 11(k) has created technical complications, since the opening proviso states that deductions under section 11 relate to taxable

income derived from the carrying on of a trade. However, not all allowable contributions to retirement funds relate only to income generated from the carrying on of a trade, which led to a specific exemption for retirement annuity funds under 11(n)(i)(ff) before 1 March 2016. The current location of the provision dealing with deductions for contributions to retirement funds under section 11(k) can also create anomalies, such as generating an assessed loss from contributions to retirement funds that are above the allowable limit when taxable capital gains are a part of the higher limit.

PROPOSAL

To remove the inconsistences and anomalies that arise from the current location of the provisions that allow for a limited deduction for retirement fund contributions under section 11(k), it is proposed that a new section 11F is inserted to effect this deduction. Additionally, a new limiting criteria for the allowable deduction is proposed to avoid circumstances that can create an assessed loss.

EFFECTIVE DATE

The proposed amendments will be deemed to have come into effect on 1 March 2016.

3.14. Industrial policy projects – window period extension

Section 12I of the Income Tax Act is hereby amended by the substitution in subsection (7) for paragraph *(d)* of the following paragraph:

(d) the application for approval of the project by the company is received by the Minister of Trade and Industry not later than **[31 December 2017]** 31 March 2020 , in such form and containing such information as the Minister of Trade and Industry may prescribe.'

(2) Subsection (1) is deemed to have come into operation on 31 March 2017.

EXPLANATORY MEMORANDUM

INDUSTRIAL POLICY PROJECTS – WINDOW PERIOD EXTENSION

[Applicable provision: Section 12I of the Act]

BACKGROUND

Section 12I of the Act allows taxpayers an additional investment and training allowance in respect of industrial policy projects if they meet certain criteria prescribed by way of regulation. The additional investment allowance ranges from 35% to 100% of the cost of any new and unused manufacturing assets used for the project – depending on whether the project has qualifying or preferred status, and whether it is located in an industrial development zone (or designated special economic zone).

The additional investment allowance has specific requirements that require the asset:

a. to be owned by the company claiming the additional allowance;

b. to be used for the furtherance of the industrial policy project carried on by that company;

c. to have been acquired and contracted for on or after the date of approval of the relevant project as an industrial policy project; and

d. was brought into use within four years from the date of approval of the relevant project as an industrial policy project.

REASONS FOR CHANGE

To assess the overall effectiveness of tax incentives such as 12I of the Act, Government will evaluate the relevant tax expenditure before it is considered for renewal at the end of its stipulated window period. According to subsection 12I(7)(d) of the Act, any application for approval of a project must be made before 31 December 2017.

In order to allow sufficient time for a review of the section 12I of the Act tax incentive to be completed, the window period will be extended from 31 December 2017 to 31 March 2020.

While the window period for the tax incentive will be extended, the current approval

threshold of R20 billion in potential investment and training allowances will not be increased at this stage. Tax revenues are under severe pressure in a fiscally constrained environment at present. As a result, no increase in the approval threshold for the 12I programme is currently being considered. The outcome of the proposed review will determine any further legislative amendments to section 12I of the Act.

PROPOSAL

It is proposed that the window period for applications for industrial policy projects in terms of section 12I of the Act be extended from 31 December 2017 to 31 March 2020.

EFFECTIVE DATE

The proposed amendment will be deemed to have come into effect on 31 March 2017.

3.15. Extending the scope of non-recoupment rule for venture capital companies

Section 12J of the Income Tax Act is hereby amended by substitution after subsection (9) of the following subsection:

(9) Notwithstanding section 8(4), no amount shall be recovered or recouped in respect of the disposal of a venture capital share or in respect of a return of capital if that share has been held by the taxpayer for a period longer than five years.

EXPLANATORY MEMORANDUM

EXTENDING THE SCOPE OF NON-RECOUPMENT RULE FOR VENTURE CAPITAL COMPANIES

[Applicable provision: section 12J of the Act]

BACKGROUND

In 2008, Government introduced the Venture Capital Companies (VCC) tax regime

as one of several measures to encourage the establishment and growth of Small, Medium and Micro-Enterprises (SMME) and as a tool to address job creation and inequality. Taxpayers investing in a VCC are allowed an upfront tax deduction for their investment in that VCC (whereas most equity investments are non-deductible) with a recoupment upon withdrawal if the investment is not held for a minimum period of five years.

REASONS FOR CHANGE

Similar to any other investment, investors investing in VCCs need to realise the value of their investments at some point. The investors subscribe for shares in a VCC and the VCC invests in qualifying companies and the investors have more than one option to realise the value of their VCC investment. Investors could realise the value of their investment by way of distributions from the VCC or by way of a disposal of their shares in the VCC. Distributions from the VCC could be in the form of dividends or returns of capital (reduction of CTC).

At issue is the distribution from the VCC in the form of returns of capital. It is argued that returns of capital may trigger a recoupment of the upfront income tax deductions allowed for the initial investment in the VCC, even if those returns of capital occurred after five years. This is not in line with the intention of the 2015 tax amendments that made provision for the tax deduction not to be recouped in respect of the disposal of a share in a VCC if that share has been held by that taxpayer for a period of at least five years.

As CTC refers to a notional amount for tax purposes derived from the value of contributions made to a company as consideration for the issue of a class of shares by that company, and capital gain refers to a profit from the disposal of shares, there is no policy rationale to allow for the disparity in the treatment of recoupment of tax deduction between the disposal of a VCC share and a return of capital in respect of a VCC share.

PROPOSAL

In order to address the possible inconsistent treatment of recoupments of tax deductions between the disposal of a VCC share and a return of capital by way of a reduction of CTC on a VCC share it is proposed that amendments be made to

the legislation to make provision for the tax deduction not to be recouped in respect of return of capital on a VCC share if that share has been held by the taxpayer for a period of at least five years. The holding period condition of five years will be the same as the holding period in respect of the disposal of a VCC share.

EFFECTIVE DATE

This proposed amendment will come into effect on 1 January 2018 and applies in respect of years of assessment commencing on or after that date.

3.16. Clarifying the scope of tax deductible donation status for international donor funding organisations

Section 18A of the Income Tax Act is hereby amended by the substitution in subsection (1) for paragraphs *(a)*, *(b)*, *(b*A*)* and *(c)* of the following paragraphs respectively:

(a) any—

(i) public benefit organisation contemplated in paragraph *(a)*(i) of the definition of 'public benefit organisation' in section 30(1) approved by SARS under section 30; or

(ii) institution, board or body contemplated in section 10(1)*(c*A*)*(i),

which—

(aa) carries on in the Republic any public benefit activity contemplated in Part II of the Ninth Schedule, or any other activity determined from time to time by the Minister by notice in the *Gazette* for the purposes of this section; **[and]**

(bb) complies with the requirements contemplated in subsection (1C), if applicable, and any additional requirements prescribed by the Minister in terms of subsection (1A); <u>and</u>

<u>*(cc)* has been approved by the Commissioner for the purposes of this section;</u>

(b) any public benefit organisation contemplated in paragraph *(a)*(i) of the definition of 'public benefit organisation' in section 30(1) approved by the Commissioner under section 30, which provides funds or assets to any public benefit organisation, institution, board or body contemplated in paragraph *(a)* <u>and which has been approved by the Commissioner for the purposes of this section; or</u>

*(b*A*)* (i) any agency contemplated in the definition of 'specialized agencies' in section 1 of the Convention on the Privileges and Immunities of the Specialized Agencies, 1947, set out in Schedule 4 to the Diplomatic Immunities and Privileges Act, 2001 (Act No. 37 of 2001);

(ii) the United Nations Development Programme (UNDP);

(iii) the United Nations Children's Emergency Fund (UNICEF);

(iv) the United Nations High Commissioner for Refugees (UNHCR);

(v) the United Nations Population Fund (UNFPA);

(vi) the United Nations Office on Drugs and Crime (UNDC);

(vii) the United Nations Environmental Programme (UNEP);

(viii) the United Nations Entity for Gender, Equality and the Empowerment of Women (UN Women);

(ix) the International Organisation for Migration (IOM);

(x) the Joint United Nations Programme on HIV/AIDS (UNAIDS);

(xi) the Office of the High Commissioner for Human Rights (OHCHR); and

(xii) the United Nations Office for the Coordination of Humanitarian Affairs (OCHA)

if that agency, programme, fund , High Commissioner , office , entity or organization:

(aa) carries on in the Republic any public benefit activity contemplated in

Part II of the Ninth Schedule, or any other activity determined from time to time by the Minister by notice in the Gazette for the purposes of this section;

(bb) furnishes the Commissioner with a written undertaking that such agency will comply with the provisions of this section; and

(cc) waives diplomatic immunity for the purposes of subsection (5)*(i)*; or

(c) any department of government of the Republic in the national, provincial or local sphere as contemplated in section 10(1)*(a)*, which has been approved by the Commissioner for the purposes of this section, to be used for purpose of any activity contemplated in Part II of the Ninth Schedule,'.

EXPLANATORY MEMORANDUM

CLARIFYING THE SCOPE OF TAX DEDUCTIBLE DONATION STATUS FOR INTERNATIONAL DONOR FUNDING ORGANISATIONS

[Applicable provision: section 18A(bA) of the Act]

BACKGROUND

The Act contains provisions in section 30 of the Act and the Ninth Schedule to the Act ('Ninth Schedule') which caters for exemption of public benefit organisations if they meet certain requirements as set out in the Act. In particular, section 30(1)(a) of the Act makes provision for exemption of activities listed in Part 1 of the Ninth Schedule. In turn, Part 2 of the Ninth Schedule makes provision for public benefit activities qualifying for tax deductible donations in terms of section 18A of the Act.

In 2008, changes were made in the Act to make provision for 'specialised agencies' as defined in section 1 of the Diplomatic Immunities and Privileges Act No. 37 of 2001 (DIPA) to qualify for tax deductible donations in terms of section 18A of the Act.

The section 18A tax deductible donation status is not automatic for these specialised agencies operating in South Africa. Their eligibility for tax deductible

donations is subject to meeting certain conditions as stipulated in sections 18A and 30 the Act.

REASONS FOR CHANGE

As previously stated, the Section 18A tax deductible donation status only apply to the specialised agencies as defined in section 1 of the DIPA. It has come to Government's attention that specialised agencies referred to in section 1 of the DIPA do not include all the agencies of the United Nations (UN), which form part of the South Africa - United Nations Strategic Cooperation Framework 2013-2017 (UNSCF).

The UNSCF gives a platform for UN agencies mentioned in the framework to operate in South Africa and offer development assistance.

PROPOSAL

In order to encourage support of the UN agencies operating in South Africa, it is proposed that changes be made in section 18A(bA) of the Act to include the following UN agencies operating in South Africa in terms of the UNSCF, which are not included in the definition of 'specialised agencies' in section 1 of the DIPA:

a. United Nations Development Programme (UNDP);

b. United Nations Children's Emergency Fund (UNICEF);

c. United Nations High Commissioner for Refugees (UNHCR);

d. United Nations Population Fund (UNFPA);

e. United Nations Office on Drugs and Crime (UNDC);

f. United Nations Environmental Programme (UNEP);

g. United Nations Entity for Gender, Equality and the Empowerment of Women (UN Women);

h. International Organisation for Migration (IOM);

i. Joint United Nations Programme on HIV/AIDS (UNAIDS);

j. Office of the High Commissioner for Human Rights (OHCHR); and

k. The United Nations Office for the Coordination of Humanitarian Affairs (OCHA).

EFFECTIVE DATE

The proposed amendment will come into effect on the date of promulgation of the Taxation Laws Amendment Act, 2017.

3.17. Addressing the tax treatment of debt forgone for dorman group companies

Section 19 of the Income Tax Act, 1962, is hereby amended—

(a) by the deletion in subsection (1) of the definition of 'reduction amount'; and

(b) by the addition in subsection (8) after paragraph *(c)* of the following paragraphs:

(d) to another person where the person that owes that debt is a company if —

(i) that company has not carried on any trade;

(ii) no amounts have been received by or accrued to that company;

(iii) no assets have been transferred to or from that company;

(iv) no liability has been incurred or assumed by that company; and

(v) that company owes that debt to a company that forms part of the same group of companies, as defined in section 41, as that company,

during the year of assessment in which a reduction amount in respect of that debt arises as well as during the immediately preceding three years of assessment:

Provided that this paragraph must not apply in respect of any debt—

(aa) incurred, directly or indirectly, by that company in respect of any asset that was disposed of by that company by way of an asset-for-

share, intra-group or amalgamation transaction or a liquidation distribution in respect of which the provisions of sections 42, 44, 45 or 47 applied; or

(bb) incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by—

(A) any other company that forms part of the group of companies referred to in subparagraph (v); or

(B) any company that is a controlled foreign company in relation to any company that forms part of the group of companies referred to in subparagraph (v); or';

(e) to another person where the person that owes that debt is a company that—

(i) owes that debt to a company that forms part of the same group of companies as that company; and

(ii) reduces or settles that debt, directly or indirectly, by means of shares issued by that company:

Provided that this paragraph must not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another person that—

(aa) did not form part of that same group of companies at the time that that other person incurred that debt; or

(bb) does not form part of that same group of companies at the time that that company reduces or settles that debt by means of shares issued by that company.

Paragraph 12A of the Eighth Schedule to the Income Tax Act is hereby amended—

(a) by the deletion in subparagraph (1) of the definition of 'reduction amount';

(b) by the substitution in subparagraph (6) for item *(d)* of the following item:

(d) to another person where the person that owes that debt is a company if —

(i) that company has not carried on any trade;

(ii) no amounts have been received by or accrued to that company;

(iii) no assets have been transferred to or from that company;

(iv) no liability has been incurred or assumed by that company; and

(v) that company owes that debt to a company that forms part of the same group of companies, as defined in section 41, as that company,

during the year of assessment in which a reduction amount in respect of that debt arises as well as during the immediately preceding three years of assessment:

Provided that this item must not apply in respect of any debt—

(aa) incurred, directly or indirectly, by that company in respect of any asset that was disposed of by that company by way of an asset-for-share, intra-group or amalgamation transaction or a liquidation distribution in respect of which the provisions of sections 42, 44, 45 or 47 applied; or

(bb) Incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by—

(A) any other company that forms part of the group of companies referred to in subparagraph (v); or

(B) any company that is a controlled foreign company in relation to any company that forms part of the group of companies referred to in subparagraph (v);

(c) by the addition in subparagraph (6) after item *(e)* of the following item:

(f) to another person where the person that owes that debt is a company that—

(i) owes that debt to a company that forms part of the same group of companies as that company; and

(ii) reduces or settles that debt, directly or indirectly, by means of shares issued by that company:

Provided that this item must not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another person that—

(aa) did not form part of that same group of companies at the time that that other person incurred that debt; or

(bb) does not form part of that same group of companies at the time that that company reduces or settles that debt by means of shares issued by that company.'

EXPLANATORY MEMORANDUM

ADDRESSING THE TAX TREATMENT OF DEBT FORGONE FOR DORMANT GROUP COMPANIES

[Applicable provisions: section 19 and paragraph 12A of the Eighth Schedule]

BACKGROUND

The Act makes provision for the tax implications in respect of a debt that is reduced, cancelled, waived, forgiven or discharged depending on whether the debt originally funded tax deductible expenditure or capital expenditure that is not tax deductible. Section 19 of the Act deals with tax implications in respect of a debt that is reduced, cancelled, waived, forgiven or discharged and applies to a debt that was used to fund tax deductible expenditure such as operating expenses. The Act makes provision for a recoupment i.e. reversal of income tax deduction previously granted in respect of an operating expense, which is then included in the income of the debtor and subject to normal tax. On the other hand, paragraph 12A of the Eighth Schedule deals with tax implications in respect of a debt that is

reduced, cancelled, waived, forgiven or discharged and applies to a debt that was used to fund a capital or an allowance asset. Paragraph 12A of the Eighth Schedule makes provision for the amount of debt that is now reduced, cancelled, waived, forgiven or discharged to first reduce the base cost of the capital or allowance assets so held by the debtor.

In turn, paragraph 12A(6)(d) of the Eighth Schedule makes provision for a group exemption in respect of debt that is reduced, cancelled, waived, forgiven or discharged between South African group companies. In particular, this subparagraph provides that the provisions of paragraph 12A do not apply to any debt owed by a person to another person where that person and that other person are companies that form part of the same group of companies as defined in section 41.

This means that where a debt between South African group companies is reduced, cancelled, waived, forgiven or discharged and that debt was used to fund capital assets, the amount of debt that is reduced, cancelled, waived, forgiven or discharged does not result in a reduction of base cost of the capital or allowance assets held by the debtor or reduction of the capital losses of the debtor.

REASONS FOR CHANGE

At issue is the fact that paragraph 12A(6)(d) of the Eighth Schedule, which makes provision for group exemption in respect of debt that is reduced, cancelled, waived, forgiven or discharged between South African groups companies is limited to apply in instances where a debt was used to fund capital or allowance asset as envisaged paragraph 12A of the Eighth Schedule and is not extended to apply to instances where a debt was used to fund operating expenditure as envisaged in section 19 of the Act. The absence of paragraph 12A(6)(d) group exemption in section 19 of the Act results is a technical impediment for groups of companies that wish to wind up the dormant companies within the same group of South African companies.

This is because when attempting to wind up a dormant company within the same group of South African companies that has an old irrecoverable debt owing to one of the group companies, any reduction, waiver, cancellation or discharge of the

debt potentially results in a recoupment for the dormant company in terms of section 19 of the Act as section 19 of the Act does not contain a similar paragraph 12A(6)(d) group exemption. This creates a scenario where a dormant company within the same group of South African companies as its creditor can have recoupment as a result of a debt that is cancelled, waived, forgiven or discharged which will result in a tax liability for that dormant company that it cannot pay. As a result, it will be difficult for the dormant company to be would up if it has a tax debt. Furthermore, it will also be difficult for SARS to collect this tax as the dormant company may no longer have assets (technically insolvent).

PROPOSAL

In order to bring clarity to the purpose of paragraph 12A(6)(d) group exemption and uniformity to the rules under paragraph 12A of the Eighth Schedule and section 19 of the Act in respect debt that is cancelled, waived, forgiven or discharged for dormant companies within the same group of South African companies, it is proposed that the current paragraph 12A(6)(d) group exemption should be replaced with a more targeted exclusion. In order to achieve this, it is proposed that:

a. Paragraph 12A(6)(d) group exemption will be extended to apply to section 19; and

b. Paragraph 12A(6)(d) of the Eighth Schedule, which makes provision for group exemption in respect of debt that is reduced, cancelled, waived, forgiven or discharged between South African groups companies will be limited to apply only to instances where the debtor is a dormant group company. Debt from non-resident group companies will, however, not be covered.

For purposes of this exclusion, a company will be regarded as being dormant if the company meets the following requirements during the year of assessment that the debt is reduced, cancelled, waived, forgiven or discharged and the preceding three years of assessment:

a. the company has not traded;

b. no amounts have been received or accrued to the company;

c. no assets have been transferred to or from the company; and

d. no liability must have been incurred or assumed by the company.

Lastly, this exclusion will not apply in respect of debt that arose in respect of assets that were subsequently disposed of under the re-organisation rules.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018.

3.18. Tax treatment of conversion of debt into equity and artificial repayment of debt

The following sections are hereby inserted in the Income Tax Act after section 19:

Section 19A – Recoupment of deductions in respect of interest incurred on intra-group debt exchanged for or converted to shares

(1) For the purposes of this section—

'converted debt' means any debt owed by a company that is settled, directly or indirectly, by—

(a) conversion to or being exchanged for shares in that company; or

(b) applying the proceeds from shares issued by that company; and

'debt' means any amount owed by a company to another company that forms part of the same group of companies as that company;

'interest incurred in respect of converted debt' means—

(a) the total amount of interest incurred in respect of that debt, in the year of assessment during which the debt was converted and in the preceding five years of assessment, by the company that converted that debt; or

(b) if that company incurred, assumed or novated that debt within the period

referred to in paragraph *(a)* in order to settle, take over, refinance or renew any other debt or debts that arose within that group of companies, the total amount of interest incurred, during that period, by that company and by any other company or companies forming part of the same group of companies in respect of—

(i) that debt; and

(ii) any other debt or debts that were so substituted, assumed, refinanced or renewed, whether directly or indirectly.

'recoupable interest' means the amount of interest incurred in respect of converted debt to the extent to which that amount—

(a) is or was allowable as a deduction in determining the taxable income of any company or companies within the same group of companies; and

(b) was not subject to normal tax in the hands of the company or companies that received that interest or to which that interest accrued;

(2) A company must in respect of any converted debt recover or recoup, subject to subsection (3), the amount of any recoupable interest by treating, for purposes of section 8(4)*(a)*—

(a) so much of that amount as does not exceed the amount of any assessed loss or balance of assessed loss of that company in respect of the year of assessment in which that debt was converted, as determined before applying this paragraph, as an amount recovered or recouped during that year; and

(b) a third of the amount that is not recovered or recouped in terms of paragraph *(a)* as an amount recovered or recouped in each of the three years of assessment immediately succeeding the year in which the debt was settled.

(3) If the company and the other company referred to in subsection (1) cease to form part of the same group of companies during any year of assessment, any amount of recoupable interest that has not been recovered or recouped must, for purposes of section 8(4)*(a)*, be treated as an amount recovered or recouped during

that year.

Section 19B –Recoupment in respect of intra-group debt exchanged for or converted to shares

(1) This section applies in respect of a company—

(a) that owes an amount to another company that forms part of the same group of companies as that company;

(b) that settles that debt, directly or indirectly, by converting it to or exchanging it for shares in that company or by applying the proceeds from shares issued by that company to any company that forms part of the same group of companies as that company; and

(c) that ceases, at any time during the period ending on the last day of the fifth year of assessment after the year of assessment during which that debt was settled, to form part of the same group of companies as the other company to which that debt was owed.

(2) If the face value of the debt owed by a company that was exchanged for or converted to shares in that company exceeds the market value of those shares as at the date on which that company ceases to form part of the same group of companies as the other company, that company must—

(a) reduce the amount of that excess by the amount, if any, of any interest incurred in respect of the converted debt that must be recovered or recouped in terms of section 19A; and

(b) treat the remaining amount of the excess as an amount recovered or recouped, for purposes of section 8(4)*(a)*, during the year of assessment in which that company ceased to form part of the same group of companies as the other company.

EXPLANATORY MEMORANDUM

TAX TREATMENT OF CONVERSION OF DEBT INTO EQUITY AND ARTIFICIAL REPAYMENT OF DEBT

[Applicable provisions: section 19, new sections 19A and B and paragraph 12A of the Eighth Schedule]

BACKGROUND

The Act contains rules dealing with the manner in which a taxpayer must account for the benefit derived from the waiver, cancellation, reduction or discharge of a debt owed by that taxpayer. Section 19 of the Act deals with tax implications in respect of a debt that was previously used to fund tax deductible expenditure such as operating expenses. It provides, firstly, for a reduction of the cost price of trading stock still held by a person if the debt was originally used to fund the acquisition of that trading stock. Secondly, provision is made for a recoupment that is subject to normal tax if the debt was originally used to fund deductible expenditure.

Paragraph 12A of the Eighth Schedule deals with tax implications in respect of a debt that was used to fund capital or allowance assets. Provision is made, for the reduction of the base cost of the capital or allowance assets still on hand with any remaining balance then being used to reduce any assessed capital losses of the person.

The provisions above apply only to the extent to which the waiver, cancellation, reduction or discharge of a debt gives rise to a 'reduction amount', i.e. the amount, by which the debt decreases exceeds the consideration received by the creditor in return.

REASONS FOR CHANGE

A. Conversion of debt into equity

In the current economic climate, there are various mechanisms by which a debtor may settle a debt with a creditor or a creditor may relinquish a claim

to have the debt repaid. One of the mechanisms is the conversion of debt owed by a company into equity in that company. This is achieved when a debt that is owed by that company to a creditor is settled by that company by using the proceeds derived from shares issued by that company to that creditor.

These types of debt conversion schemes are usually entered into in respect of loans advanced to a company by the controlling shareholder of that company. The shareholder and the company involved agree, in essence, that shares will be issued by the company to the shareholder for an aggregate amount that matches the face value of a debt owed by that company to that shareholder and that the proceeds will then be used to settle that debt. The shareholder in effect converts a debt claim against the company to equity financing. This arrangement is aimed at improving the company's balance sheet and retaining its financial sustainability.

SARS has issued a number of binding private rulings providing relief in respect of the application of the current tax rules where a debt owed by a company to its controlling shareholder is reduced or discharged in terms of an arrangement that in effect converts that debt into equity. The conversion of debt into equity is aimed at restoring or maintaining the solvency of companies under financial distress without triggering the debt reduction rules. The shareholder/creditor desires, in effect, the outcome that would have been achieved had that shareholder originally funded the company by means of an equity contribution rather than the debt so converted.

The dispensation governing such arrangements should therefore be aimed at achieving, in broad terms, the outcome that would have been achieved had the creditor funded the company by means an equity contribution rather than by a loan. Deductions claimed by the debtor company in respect of interest incurred on debt prior to its conversion into equity should therefore at the very least be recouped to the extent to which that interest was not subject to normal tax in the hands of the creditor/shareholder.

B. Abuse of artificial repayment of debt

Since the introduction of tax rules dealing with situations where a creditor waives, cancels, reduces or discharges a debt from 1 January 2013, it has come to government's attention that creditors and debtors are entering into short-term shareholding structures that seek to circumvent tax implications triggered by the application of these rules.

These structured arrangements involve a creditor that is an unrelated creditor subscribing for shares in the debtor company. The subscription price would be equal to the total amount of the borrower's indebtedness to the creditor in spite of the market value of the shares in the borrower. This subscription price gets paid to the debtor in cash and the debtor then uses the cash to settle the capital of and the interest on the loan or debt. Soon after the payment is effected, the original shareholder of the debtor will buy the shares that the creditor. The creditor will (if at all) only be subject to CGT on a very small gain in respect of the shares in the debtor sold to the shareholder.

PROPOSAL

In order to assist companies in financial distress, it is proposed that definitive rules dealing with the tax treatment of conversions of debt into equity be introduced.

In addition, in order to address the abuse of artificial repayment of debt, it is proposed that the rules assisting companies in financial distress should be limited to those involving group companies.

Based on the above, the following is proposed:

A. Exclusion of debt to equity conversions from the application of debt forgiveness rules

It is proposed that the rules dealing with debt that is cancelled, waived, forgiven or discharged should not apply to a debt that is owed by a debtor to a creditor that forms part of the same group of companies (as defined in section 1 in order to include multinational groups of companies).

In order to counter abuse of the above-mentioned relief by taxpayers who simply wish to cancel, waive, forgive or discharge a debt without any tax

consequences and do so with no real interest in the financial recovery of the indebted company, it is proposed that the creditor and the debtor be required to continue to form part of that same group of companies for at least five years from the date of the conversion. This relief will apply in respect of debt governed by both section 19 of the Act and paragraph 12A of the Eighth Schedule.

However, as an added deterrent on the possible abuse of this exclusion, it is further proposed that a deemed reduction amount should be triggered for the debtor if the debtor and the creditor cease to form part of the same group of companies during the prescribed five year period.

In this regard, an amount equal to the difference between the market value of the shares previously issued by the debtor to the creditor as consideration for the reduction or settlement of the debt (determined at the time the debtor and the creditor de-group before the end of the prescribed five year period) and the amount by which the debt was reduced, will be deemed to be a reduction amount of the debtor. This deemed reduction amount must be accounted for in terms of the normal rules by the debtor as a reduction amount that arises on the date that the debtor and the creditor cease to form part of the same group of companies. The amount that will be treated as a reduction amount will, however, be reduced by any amount of interest previously incurred and deducted by the debtor and that is reflected in the amount of the debt that is reduced or settled if the creditor did not pay normal tax on its accrual of that interest. This is because this amount will be subject to a claw-back provision.

B. *Claw-back of interest previously incurred and deducted*

Where the conversion of debt into equity does not trigger the application of the rules dealing with the tax treatment of debt that is waived, cancelled, reduced or discharged, it is further proposed that the tax consequences should be similar to those that would have applied had the creditor/shareholder funded the company by means of an equity contribution rather than the provision of a loan, i.e. as if the loan had always

been an equity investment.

As a result, any interest that was previously deducted by the borrower in respect of a debt that is subsequently converted into equity should be treated as a recoupment in the hands of the borrower to the extent to which that interest was not subject to normal tax in the hands of the company which received it or to which it accrued.

In addition, it is proposed that the amount that must be recouped must firstly be used to reduce any assessed loss of that debtor company in the year of assessment that the debt to equity conversion takes place. A third of any balance exceeding that assessed loss must be treated as a recoupment in each of the three immediately succeeding years of assessment.

Should the debtor and the creditor cease to form part of the same group of companies within the prescribed three year period, any remaining balance of the interest previously deducted by the debtor, will have to be included in the taxable income of the debtor in full in the year of assessment in which they cease to form part of the same group of companies.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018.

3.19. General accepted accounting practice replaced by IFRS

Section 22 of the Income Tax Act, 1962, is hereby amended by the substitution in subsection (3A) for the words preceding paragraph *(a)* of the following words:

For the purposes of this section the cost price of trading stock referred to in subsection (2A) shall be the sum of the cost to the taxpayer of material used by **[him]** the taxpayer in effecting the relevant improvements, and such further costs incurred by **[him]** the taxpayer as in accordance with **[generally accepted accounting practice]** IFRS are to be regarded as having been incurred directly in

connection with the relevant contract, and such portion of any other costs incurred by **[him]** the taxpayer in connection with the relevant contract and other contracts as in accordance with **[generally accepted accounting practice]** IFRS are to be regarded as having been incurred in connection with the relevant contract, less a deduction of so much of—

EXPLANATORY MEMORANDUM

The proposed amendment to subsection (3A) for the words preceding paragraph (a) align the reference to the person liable for tax with the rest of the Income Tax Act by using the word 'taxpayer'. In addition, as the generally accepted accounting practice or GAAP is no longer relevant for financial reporting, the following amendment is proposed that will require all taxpayers to apply the IFRS methodology set out in IAS 11 regarding construction contracts.

3.20. Correcting the inconsistent tax treatment between cash grants and in-kind grants of trading stock

By the substitution for subsection (4) of the following subsection:

(4) If any trading stock has been acquired by any person for no consideration or for a consideration which is not measurable in terms of money, other than a government grant in kind, such person shall for the purposes of subsection (3), unless subsection (3) *(a)*(iA) applies, be deemed to have acquired such trading stock at a cost equal to the current market price of such trading stock on the date on which it was acquired by such person.

EXPLANATORY MEMORANDUM

CORRECTING THE INCONSISTENT TAX TREATMENT BETWEEN CASH

GRANTS AND IN-KIND GRANTS OF TRADING STOCK

[Applicable provision: section 22 of the Act]

BACKGROUND

In 2012, a unified system for the tax treatment of government grants was introduced. Under the unified system, government grants that are awarded to taxpayers are tax exempt in the hands of taxpayers that received them. A comprehensive list of government grants was also introduced in the Eleventh Schedule to the Act. This list is updated annually with any new government grants that are introduced so that taxpayers can have certainty when determining whether a government grant is tax exempt.

The Act allows taxpayers to make certain deductions against their income. Typically, taxpayers can deduct their operating expenses and, in some instances, taxpayers can also claim allowances on the costs incurred by taxpayers for the creation or acquisition of business assets. However, with regards to government grants, taxpayers are not allowed to deduct operating expenses and allowances on assets if the operating expenses and the cost price of the assets are funded by government grants that are exempt. Taxpayers are denied these deductions and allowances because if they were allowed to claim them, they would be getting a double benefit (i.e. an exemption on the government grant as well as a deduction of expenses and costs that the government grant was used on).

In this regard, the following rules were introduced:

a. If an exempt government grant is used to fund the acquisition, creation or improvement of trading stock, the cost price of the trading stock must be reduced by the amount of the exempt government grant.

b. If an exempt government grant is used to fund the acquisition, creation or improvement of any other asset other than trading stock, the base cost of the capital asset must be reduced by the amount of the exempt government grant.

c. If an exempt government grant is not used to fund the acquisition of an asset that is trading stock, an allowance asset or a capital asset, the

taxpayer must reduce section 11 deductions otherwise allowed by the amount of the exempt government grant.

d. In addition, if the grant exceeds the total amount of otherwise allowable deductions, the excess will be carried over into the next year.

This treatment is imposed in order to disallow any current or future deductions in respect of expenses and costs that are funded by exempt government grants. However, currently in-kind government grants (i.e. government grants in the form of goods or services as opposed to money that is then used to find the necessary expense or acquire an asset) are excluded from this treatment.

REASONS FOR CHANGE

When the unified system for the tax treatment of government grants was introduced, Government held the view that when a taxpayer receives an in-kind government grant, that taxpayer will have a zero base cost for the asset that is receives. This means that the taxpayer would have no tax costs to claim allowances on for expenditure on allowance assets, capital assets or for trading stock. This view was held because under such circumstances the taxpayer would not have been liable for the payment of the acquisition costs and hence would not have incurred these expenses.

This view remains true when dealing with the in-kind government grants of allowance assets and capital assets. However, in the case of the in-kind government grants of trading stock, a market value tax cost is provided for in the Act in the instance that a taxpayer acquires trading stock without having to pay for the trading stock. This deemed cost at market value has an anomalous result when applying the rules currently governing the tax treatment of government grants. This is because, when a taxpayer receives an in-kind government grant of trading stock, that taxpayer is given an unintended double benefit because the value of the trading stock received by the taxpayer will be exempt under the current rules while the provisions dealing with the valuation of trading stock also give the taxpayer a notional tax cost for the trading stock.

This notional tax value gives the taxpayer an added benefit because this market value will reduce the sale consideration that the taxpayer will get in the future when

selling the trading stock. This double benefit that a taxpayer can get when receiving an in-kind government grant goes is contrary to the tax treatment of all other government grants irrespective of the manner in which they are made available (i.e. whether in cash or in the form of an asset) and it should be aligned.

PROPOSAL

In order to align the resultant tax consequences of taxpayers receiving in-kind government grants of trading stock with those of all other government grants. To do this, it is proposed that the rule that provides for the market value cost price for trading stock should not apply to trading stock given to a taxpayer as a government grant. As a result of this proposal, trading stock that is given to a taxpayer in the form of a government grant will, similar to all other in-kind government grant, have a tax cost of zero.

EFFECTIVE DATE

These amendments come into effect on 1 January 2018 and apply in respect of years of assessment commencing on or after that date.

3.21. Extension of collateral and securities lending arrangement provisions

By the substitution in subsection (9)*(a)* for subparagraph (i) of the following subparagraph:

(i) the trading stock of any person during any year of assessment includes any—

(aa) security or any bond issued by the government of the Republic in the national or local sphere; or

(bb) bond issued by any sphere of government of any country other than the Republic,

if that bond is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule;

By the substitution in subsection (9)*(b)* for subparagraph (i) of the following subparagraph:

(i) the trading stock of any person during any year of assessment includes any—

(aa) security or any bond issued by the government of the Republic in the national or local sphere; or

(bb) bond issued by any sphere of government of any country other than the Republic,

if that bond is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule;

By the substitution in subsection (9)*(c)* for subparagraph (i) of the following subparagraph:

(i) the trading stock of any person during any year of assessment includes any—

(aa) security or any bond issued by the government of the Republic in the national or local sphere; or

(bb) bond issued by any sphere of government of any country other than the Republic,

if that bond is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule:

By the substitution in subsection (9)*(d)* for subparagraph (i) of the following subparagraph:

(i) the trading stock of any person during any year of assessment includes any—

(aa) security or any bond issued by the government of the Republic in the national or local sphere;

(bb) bond issued by any sphere of government of any country other than the Republic,

if that bond is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule;

EXPLANATORY MEMORANDUM

EXTENSION OF COLLATERAL AND SECURITIES LENDING ARRANGEMENT PROVISIONS

[Applicable provisions: section 22 of the Act and section 1 of the Securities Transfer Tax Act No. 25 of 2007 ('STT Act')]

BACKGROUND

The Act and the STT Act provide relief in respect of an outright transfer in beneficial ownership of specific financial instruments for both collateral arrangements and lending arrangements, hereafter collectively referred to as 'securities arrangements'. As a result, there are no income tax, CGT and STT implications (where applicable) if a listed share or government bond is transferred in a securities arrangement, provided that identical shares or bonds are returned to the borrower by the lender or to the lender by the borrower, as the case may be, within a specified limited period from the date on which the securities arrangement was entered into.

REASONS FOR CHANGE

In 2016, amendments were effected in the Act and the STT Act to include listed South African government bonds as allowable financial instruments for collateral and lending arrangements. As a result, listed South African government bonds that are transferred as collateral and under securities arrangements qualify for the above-mentioned relief (where applicable).

At issue is the fact that the above-mentioned 2016 amendments only focused on tax relief for collateral and lending arrangements of listed South African government bonds and do not apply to listed foreign government bonds. This limits the potential use of listed foreign government bonds, which can be utilised as a tool to mitigate risk and to diversify risk.

PROPOSAL

In order to address concerns regarding the scope of tax relief collateral and lending arrangements, it is proposed that tax relief be extended to include listed foreign government bonds. As a result, listed foreign government bonds that are transferred as part of collateral and lending arrangements will qualify for the above-mentioned special tax dispensation.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply in respect of collateral arrangements and lending arrangements entered into on or after that date.

3.22. Addressing circumvention of anti-avoidance rules dealing with share buy-backs and dividend stripping

The following section is hereby substituted for section 22B of the Income Tax Act:

Section 22B – Dividends treated as income on disposal of certain shares

(1) For the purposes of this section—

'exempt dividend' means any dividend or foreign dividend to the extent that the dividend or foreign dividend is—

(a) not subject to tax under Part VIII of Chapter II; and

(b) exempt from normal tax in terms of section 10(1)*(k)*(i) or section 10B(2)(a) or *(b)*; and

'qualifying interest' means a direct or indirect interest held by a company in another company, whether alone or together with any connected persons in relation to that company, that constitutes at least—

(a) 50% of the equity shares or voting rights in that other company; or

(b) 20% of the equity shares or voting rights in that other company if no other

person holds the majority of the equity shares or voting rights in that other company.

(2) Where a company disposes of shares in another company and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or that accrued to that company in respect of the shares disposed of must—

(a) to the extent that the exempt dividend is received by or accrues to that company—

(i) within a period of 18 months prior to; or

(ii) in respect, by reason of or in consequence of that disposal; and

(b) if that company immediately before that disposal held the shares disposed of as trading stock,

be included in the income of that company in the year of assessment in which those shares are disposed of or, where that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues.'

The following paragraph is hereby substituted for paragraph 43A in the Eighth Schedule of the Income Tax Act:

Par. 43A – Dividends treated as proceeds on disposal of certain shares.

(1) For the purposes of this paragraph—

'exempt dividend' means any dividend or foreign dividend to the extent that the dividend or foreign dividend is—

(a) not subject to tax under Part VIII of Chapter II; and

(b) exempt from normal tax in terms of section 10(1)*(k)*(i) or section 10B(2)*(a)* or *(b)*; and

'qualifying interest' means a direct or indirect interest held by a company in another company, whether alone or together with any connected persons in

relation to that company, that constitutes at least—

(a) 50% of the equity shares or voting rights in that other company; or

(b) 20% of the equity shares or voting rights in that other company if no other person holds the majority of the equity shares or voting rights in that other company.

(2) Where a company disposes of shares in another company and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or that accrued to that company in respect of the shares disposed of must—

(a) to the extent that the exempt dividend is received by or accrues to that company—

(i) within a period of 18 months prior to; or

(ii) in respect, by reason or in consequence of that disposal; and

(b) if that company immediately before that disposal held the shares disposed of as a capital asset (as defined in section 41),

be taken into account, in the year of assessment in which those shares are disposed of or, where that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues, as part of proceeds from the disposal of those shares.

EXPLANATORY MEMORANDUM

ADDRESSING CIRCUMVENTION OF ANTI-AVOIDANCE RULES DEALING WITH SHARE BUY-BACKS AND DIVIDEND STRIPPING

[Applicable provisions: section 22B and paragraph 43A of the Eighth Schedule]

BACKGROUND

A. Introduction of the concept of Share Buy-Backs

Prior to 1999, both the Companies Act No. 61 of 1973 ('the old Companies Act') and the Act did not cater for share buy-backs. The Companies Amendment Act No.37 of 1999 ('the 1999 Companies Amendment Act') made provision for a company to be able to buy back its own shares. The company acquiring its own shares could, however, not transfer such shares into its own name but the shares so acquired had to be cancelled as issued shares and restored to the status of authorised shares.

B. Share Buy-Backs and Secondary Tax on Companies (STC) Regime

Together with the introduction of the concept of share buy-backs by the 1999 Companies Amendment Act, amendments were made in the Act in 1999 to address the tax consequences resulting from the above. For example, the acquisition by a company of its own shares in terms of the amendments to the Companies Act in 1999 resulted in the cancellation of the shares and a reduction of the company's reserves (distributable or non-distributable). This, therefore, had an impact on the amount of reserves available for distribution by the company, i.e. dividends declared and consequently the STC to be collected in this regard.

As a result, proceeds of share buy-backs were included in the definition of dividend in section (1) of the Act to the extent that they are funded out of reserves that do not represent a return of capital. In turn, proceeds of share buy-backs that did not represent a return of capital were regarded as dividends and subject to STC. Furthermore, a shareholder company from which the shares are so acquired was entitled to an STC credit in respect of the portion of the selling price of the shares which constituted a dividend, provided that the dividend complied with other provisions relating to STC in the Act.

The interaction between share buy-backs and the STC regime entailed less risk to the fiscus due to the fact that: (i) STC was collected upfront at a company level and not at shareholder level; (ii) company to company dividends were not exempt from STC (other than dividends between a group of companies), but were subject to tax and qualified for STC credits if

the dividends complied with other provisions in the Act; (iii) tax planning using share buy backs was limited to group companies as a group company exemption applied in this regard and group companies were allowed to declare dividends free of STC.

C. *Share Buy-Backs and Dividends Tax Regime*

In 2012, South Africa moved from the STC regime to the dividends tax regime. The dividends Tax regime made provision for taxation of dividends at shareholder level and it replaced the STC regime that imposed a tax liability on the company declaring a dividend. The dividends tax regime aligned the South African basis of taxation of dividends with the international norm.

Currently, the dividends tax Regime makes provision for outright exemptions from dividends tax in respect of dividends paid to certain shareholders. Most notable is the dividends tax exemption in respect of all dividends paid by a resident company to another resident company. This exemption is based on the premise that the underlying profits of resident companies should only be taxed once at company level while the after tax profits in the form of dividends should only be taxed in the hands of shareholders when these after tax profits are distributed out of resident companies (for example when after tax profits are distributed to individuals, trusts and non-resident companies).

D. *Dividend Stripping Rules and Dividends Tax Regime*

With the introduction of the dividends tax regime, consequential amendments were made to the Act to introduce anti-avoidance measures aimed at stopping arbitrage opportunities that may arise as a result of the dividends tax exemption in respect of dividends paid by a resident company to another resident company. As a result, rules that target avoidance schemes known as dividend stripping were introduced in section 22B of the Act and paragraph 43A of the Eighth Schedule.

Dividend stripping occurs when a resident shareholder company that is a prospective seller of the shares in a target company avoids income tax

(including CGT) arising on the sale of shares in that target company by ensuring that the target company declares a dividend to that resident shareholder company prior to the sale of shares in that target company to a prospective purchaser. Such a pre-sale dividend to a resident shareholder company is exempt from dividends tax. This pre-sale dividend also decreases the value of the shares in the target company. As a result, the prospective seller extracts value from the company by effectively selling the shares through tax exempt dividends. As a consequence of this, the seller can sell the shares at a lower amount, thereby avoiding a much larger taxable capital gain.

Currently, section 22B of the Act and paragraph 43A of the Eighth Schedule attempt to discourage taxpayers from entering into these dividend stripping schemes. The anti-dividend stripping rules treat a pre-sale dividend as an amount of income or proceeds from the disposal of an asset of a shareholder company if those pre-sale dividends are indirectly funded by the prospective purchaser through a loan from or a loan guaranteed by the prospective purchaser or a connected person in relation to that prospective purchaser. This limitation that focuses on the manner in which the pre-sale dividend is funded was put in place because at the time, pre-sale dividends that were indirectly funded by the prospective purchaser were viewed as being abnormal and considered more suspicious that pre-sale dividends funded out of accumulated profits.

II. Reasons for change

A. Interaction of Share Buy-Backs and Dividends Tax Regime

As discussed above, when the STC regime was still in place, the interaction of share buy-backs and STC regime entailed less risk to the fiscus. However, with the introduction of dividends tax regime in 2012, Government has noticed that the interaction of share buy backs and dividends tax regime entailed more risk to the fiscus due to the following:

a. Unlike STC, dividends tax is collected at a later stage when dividends are paid to non-SA corporate shareholders;

b. Tax planning using share buy backs became prevalent due to the fact that company to company dividends are exempt from dividends tax; and

c. Share buy-backs are allowed in terms of the Companies Act and the sole or main purpose of doing share buy-back arrangement may not always involve tax planning but are based on commercial rationale, e.g. mergers and acquisitions.

Several schemes have been identified where taxpayers structure their transactions using share buy backs in order to avoid tax on taxable proceeds on the sale of shares. For example, if a company shareholder sells its shares to the acquirer, the sale proceeds would be ordinarily subject to CGT or normal tax on income. In order to avoid CGT or normal tax on income, the current shareholder's shares are acquired by the company as part of a share buy back in a share buy-back transaction. In view of the fact that directors of a company have discretion to determine whether a consideration for a share buy-back can be regarded as a dividend or proceeds on the sale of shares, an election is not made to reduce contributed tax capital and a dividend is paid. The tax advantage of payment of dividends instead of proceeds on the sale of shares is that company to company dividends are exempt from dividends tax, whereas proceeds on the sale of shares are subject to CGT or normal tax on income.

B. Interaction of Dividend Stripping Rules and Dividends Tax Regime

It has come to Government's attention that the current anti-avoidance measures on dividend stripping are being undermined due to the limited scope of its application. In the first instance, the current anti-avoidance rules apply where the prospective seller, immediately prior to the disposal of the shares in the target company holds more than 50% of the shares in in the target company. This threshold is too high and does not adequately encapsulate the scenarios under which these dividend stripping schemes are entered into. Focus should rather be placed on the ability of a company

shareholder that wishes to dispose of shares in another company to significantly influence the decision whether a dividend will be distributed in respect of those shares to achieve the desired reduction of the value of those shares. More specifically, the size of the direct or indirect interest held in that other company by that company shareholder and connected persons in relation to it that confers a significant influence to the company shareholder and this should be the focus.

Further, the focus of the current anti-dividend stripping rules on debt funding advanced/guaranteed by a prospective purchaser or a connected person in relation to a prospective purchaser is easily circumvented. This is because taxpayers have been opting to structure their sale of share transactions as share buy-backs and subscription arrangements with the pre-sale dividends either being funded by the accumulated profits of the target company or loan arrangements that are not caught under the current anti-dividend stripping rules. In particular, Government has identified schemes whereby taxpayers avoid the application of the anti-avoidance rules by raising loan funding to fund the pre-sale dividend from a third party (i.e. a person other than the prospective purchaser or a connected person in relation to the prospective purchaser), for example a loan from a bank.

PROPOSAL

In order to curb the use of share buy-back schemes as well as circumvention of dividend stripping rules, it is proposed that the current anti-dividend stripping rules should be broadened to take into account amongst other things the following:

a. variations in the share buy-back schemes that taxpayers are entering into to avoid normal tax on income or CGT on the outright sale of shares;

b. the limited scope of application of dividend stripping rules that focus only on debt funding advanced or guaranteed by a prospective purchaser or a connected person in relation to a prospective purchaser funding of the proceeds; and

c. the limited scope of application of dividend stripping rules, i.e. the fact that they apply only where the prospective seller, immediately prior to the

disposal of the shares in the target company holds more than 50% of the shares in in the target company.

A. *Dividend Stripping - Conversion Rules*

To achieve this, the current anti-dividend stripping rules covering trading stock as well as capital assets will be maintained. As with the current rules, the dividends in respect of shares that are disposed of will lose their exempt nature and will be treated as other consideration that is subject to tax depending on whether the shares were held on revenue or capital account. The anti-dividend stripping rules will also be amended to include timing rules to clarify when the tax consequences triggered by the provisions must be taken into account by the taxpayer that receives or accrues a tainted dividend.

a. Taxation of dividends in respect of shares held as trading stock

Section 22B of the Act will continue to apply when a person that is a company disposes of shares in a target company that are held as trading stock. Where section 22B of the Act applies, any tainted dividends received by or accrued to that person will not benefit from an exemption but will be included in the income of the person in the later of the year of assessment that the shares in the target company are disposed of or the year of assessment in which the that tainted dividend is received by or accrues to the person.

b. Taxation of dividends in respect of shares held as capital assets

Paragraph 43A of the Eighth Schedule will also continue to apply when a person disposes of shares in a target company that are held as capital assets. Where paragraph 43A of the Eighth Schedule applies, any tainted dividends received by or accrued to that person will also not benefit from the exemption but be treated as additional proceeds received by or accrued to the taxpayer in respect of the disposal by that person of the shares in the target company in the later of the year of assessment of that disposal or the year of assessment in which that tainted dividend is received by or accrues

to the person.

B. Application of the rules

The rules dealing with dividend stripping will apply in the following circumstances:

a. The person disposing of the shares in another company must be a resident company;

b. That person (together with connected persons in relation to that person) must hold at least 50% of the equity shares or voting rights in that other company or at least 20% of the equity shares or voting rights in that other company if no other person holds the majority of the equity shares or voting rights; and

c. an otherwise exempt dividend is—

i. received or accrues within eighteen months prior to the disposal of the target company shares; or

ii. received or accrues, regardless of the time of the receipt or accrual, by reason of or in consequence of the disposal of that other company's shares.

No regard will be had to how the tainted dividend is funded. This is because, taxpayers are funding the dividends in a number of ways and although the funding may in some instance be questionable, it is not the mischief that negatively affects the fiscus. The mischief is the conversion of taxable share sale consideration into exempt dividends.

EFFECTIVE DATE

The proposed amendments will be deemed to have come into effect on 19 July 2017 and apply in respect of any disposal on or after that date.

3.23. Refinements of the domestic treasury management company regime qualifying criteria

Section 1 of the Income Tax Act is hereby amended by the deletion in subsection (1) the definition of 'domestic treasury management company' of paragraph *(a)*;

'domestic treasury management company' means a company—

[**(*a*)** **incorporated or deemed to be incorporated by or under any law in force in the Republic;**]

(*b*) that has its place of effective management in the Republic; and

(*c*) that is not subject to exchange control restrictions by virtue of being registered with the financial surveillance department of the South African Reserve Bank;

Section 24I of the Income Tax Act is hereby amended by the substitution in subsection (1) for the definition of **'affected contract'** of the following definition:

'affected contract' means any foreign currency option contract or forward exchange contract to the extent that foreign currency option contract or forward exchange contract has been entered into by any person during any year of assessment to serve as a hedge in respect of a debt, where—

(a) that debt—

(i) is to be utilised by that person for the purposes of acquiring any asset or for financing any expenditure; or

(ii) will arise from the sale of any asset or supply of any services,

in terms of an agreement entered into by that person in the ordinary course of the person's trade prior to the end of the current year of assessment; and

(b) that debt has not yet been incurred by such person or the amount payable in respect of such debt has not yet accrued during that current year of assessment;

EXPLANATORY MEMORANDUM

REFINEMENTS OF THE DOMESTIC TREASURY MANAGEMENT COMPANY REGIME QUALIFYING CRITERIA

[Applicable provisions: definition of 'domestic treasury management company' in section 1, sections 24I and 25D of the Act]

BACKGROUND

In 2013, Government introduced a domestic treasury management company regime for exchange control and tax purposes. The regime was aimed at encouraging listed South African multinational companies to relocate their treasury operations to South Africa. Under this regime, listed South African multinational companies are allowed to establish one subsidiary to manage the group treasury functions without being subject to exchange control restrictions that apply to companies incorporated in South Africa.

For tax purposes, the regime provides relief in respect of unrealised foreign currency gains and losses in that the domestic treasury management company is permitted to use its functional currency, other than the Rand, for currency translations.

In order to qualify as domestic treasury management company, a company must satisfy three criteria:

a. must be incorporated or deemed to be incorporated by or under any law in force in South Africa;

b. have its place of effective management in South Africa; and

c. must not be subject to exchange control restrictions by virtue of being registered with the Financial Surveillance department of the SARB.

All the above three mentioned requirements must be satisfied for a company to qualify as a domestic treasury management company.

REASONS FOR CHANGE

Experience with the domestic treasury management regime suggests that certain anomalous requirements need to be removed in order to make the domestic treasury management company regime more effective. Specifically, the requirement that a company must be incorporated in South Africa is cumbersome for companies that are incorporated offshore but wish to move their tax residency to South Africa.

A company that is incorporated offshore will still be tax resident in South Africa if it has a place of effective management in South Africa. Further, the process to move tax residency by changing the place of effective management is less cumbersome than changing the place of incorporation.

PROPOSAL

In view of the above, it is proposed that the requirement that a company must be incorporated or deemed to be incorporated by or under any law in force in South Africa be removed.

EFFECTIVE DATE

The proposed amendment will come into effect on 1 January 2018 and will apply in respect of any year of assessment commencing on or after that date.

3.24. Refinement to the taxation of financial assets and liabilities due to changes in accounting standard

Section 24JB of the Income Tax Act is hereby amended by the addition in subsection (1) in paragraph *(d)* of the definition of 'covered person' after subparagraph (iii) of the following subparagraph:

(iv) any subsidiary, as defined in section 1 of the Companies Act, of a company contemplated in subparagraph (i) or (ii);

Section 24JB of the Income Tax Act is hereby amended by the substitution in subsection (1) for the definition of 'derivative' of the following definition:

'derivative' means a derivative as defined in and within the scope of IFRS 9;

Section 24JB of the Income Tax Act is hereby amended by the substitution in subsection (2) for the words preceding paragraph *(a)* of the following words:

Subject to sections 8F, 8FA and subsection (4), there must be included in or deducted from the income, as the case may be, of any covered person for any year of assessment all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that are **[recognized]** measured at fair value in profit or loss in terms of **[International Accounting Standard 39 of]** IFRS 9 **[or any other standard that replaces that standard]** or, in the case of commodities, at fair value less cost to sell in profit or loss in terms of IFRS for that year of assessment, excluding any amount in respect of—

Section 24JB of the Income Tax Act is hereby amended by the substitution in subsection (2)*(a)* for the words following subparagraph (v) of the following words:

if that financial asset does not constitute trading stock.

Section 24JB of the Income Tax Act is hereby amended by the addition after subsection (2) of the following subsection:

(2A) A covered person must include in or deduct from income for a year of assessment a realised gain or realised loss that is recognised in a statement of other comprehensive income as contemplated in IFRS if that realised gain or realised loss is attributable to a change in the credit risk of the financial liability as contemplated in IFRS.

Section 24JB of the Income Tax Act is hereby amended by the addition after subsection (8) of the following subsection:

(9) Where a financial asset held by or financial liability owed by a covered person at the end of the year of assessment immediately preceding the year of assessment commencing on or after 1 January 2018 would have ceased to be subject to tax or would have become subject to tax in terms of subsection (2), had IFRS 9 applied on the last day of that immediately preceding year of assessment, that covered person is deemed to have–

(a) disposed of that financial asset or redeemed that financial liability; and

(b) immediately reacquired that financial asset or incurred that financial liability,

for an amount equal to the market value of that financial asset or financial liability on that day.

EXPLANATORY MEMORANDUM

REFINEMENT TO THE TAXATION OF FINANCIAL ASSETS AND LIABILITIES DUE TO CHANGES IN ACCOUNTING STANDARD

[Applicable provisions: section 24JB(1) and (2) of the Act]

BACKGROUND

The rules for the taxation of financial assets and financial liabilities were introduced to overcome the divergence that was occurring in the income tax and accounting treatment of certain financial assets and liabilities.

To simplify compliance, this regime requires covered persons (defined in section 24JB of the Act) for tax purposes to include in, or deduct from, their income all amounts in respect of financial assets and financial liabilities that are recognised at fair value at the end of the financial year in profit or loss in the statement of comprehensive income.

In order to determine this gain or loss by the covered person, that covered person should be utilising the accounting standard dealing with the financial assets and financial liabilities, that currently is International Accounting Standard (IAS) 39 (Financial Instruments: Recognition and Measurement).

Although there are different categories of financial assets and financial liabilities according to IAS 39, the general focus of section 24JB of the Act is on financial assets and financial liabilities that IAS 39 standard requires a covered person to either hold for trading purposes or upon initial recognition designate as at fair value through profit or loss.

With respect to designation of financial assets, a company may designate a financial asset at fair value through profit or loss on initial recognition if the following criteria amongst others are met:

a. the designation eliminates or significantly reduces a measurement recognition inconsistency sometimes referred to as an accounting mismatch.

b. a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.

Currently, section 24JB of the Act allows the exclusion of a financial asset that is a share, an endowment policy, an interest held in a portfolio of a collective investment scheme, an interest in a trust or an interest in a partnership on the premise that that financial asset is 'managed and its performance is evaluated on a fair value basis' as per IAS 39. In addition, these exclusions were allowed because the covered person holds these financial assets not for trading purposes but for a long period as investments on capital account.

REASONS FOR CHANGE

Given that as from 1 January 2018, banks must adopt the accounting standard called International Financial Reporting Standards (IFRS 9) which replaces IAS 39; amendments need to be made to section 24JB of the Act to ensure that it is in line with IFRS 9. In addition, although IFRS 9 in general retains the existing requirements (IAS 39 requirements) for classification and measurement of financial assets and liabilities there are certain exceptions with regards to the following:

a. IFRS 9 only allows designation when it eliminates, or significantly reduces, an accounting mismatch.

b. Under IFRS 9, the amount of the change in the fair value of a financial liability that is attributable to changes in the credit risk of that liability should

be disclosed in the 'other comprehensive income' statement.

c. On commencement of the application of IFRS 9 certain financial instruments will be reclassified and adjustments will be reflected in retained earnings and not through profit or loss.

PROPOSAL

A. References

It is proposed that all references to IAS 39 be changed to IFRS 9.

B. Changes in the designation of a financial asset

Given that in future IFRS 9 does not allow for a designation at fair value through profit or loss for a financial asset that is managed and its performance is evaluated on a fair value basis, it is proposed that the exclusions be afforded to the covered person if the relevant financial asset is not classified as trading stock, as defined in section 1 of the Act.

C. Treatment of financial liabilities under IFRS 9

It is proposed that the amount of changes in the fair value of a financial liability that is attributable to changes in the credit risk of that financial liability reflected in the statement of 'other comprehensive income' be subjected to section 24JB of the Act.

D. Transitional rule

It is proposed that if a financial asset held by or financial liability owed by a covered person at the end of the year of assessment immediately preceding the year of assessment commencing on or after 1 January 2018 would have ceased to be, or would have become subject to tax in terms of subsection (2), as the case may be, if IFRS 9 had applied on the last day of that immediately preceding year if assessment, that covered person is deemed for purposes of the Act to have–

a. disposed of that financial asset or redeemed that financial liability; and

b. immediately reacquired that financial asset or incurred that financial

liability,

for an amount equal to the market value of that financial asset or financial liability on that day.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply in respect of years of assessment commencing on or after that date.

3.25. Application of hybrid debt instruments rules in respect of covered person defined in section 24JB

EXPLANATORY MEMORANDUM

[Applicable provision: section 24JB(1) of the Act]

BACKGROUND

A. General application of hybrid debt rules

The Act contains anti-avoidance rules in sections 8F and 8FA of the Act aimed at curbing the use of equity instruments that are artificially disguised as debt instruments. In particular, section 8F focuses on the features of the instrument itself and section 8FA of the Act focuses on the nature of the yield of the instrument and they deal with the characterisation of any amount of interest incurred in respect of a debt instrument to be deemed as a dividend *in specie* declared and paid by the issuer if the debt instrument has specific equity-like or dividend like features. In view of the fact that these rules characterise interest as a dividend *in specie*, that interest does not qualify for a tax deduction.

B. Interaction of hybrid debt rules with taxation of financial assets & financial liabilities of a covered person

In certain instances, a covered person as defined in section 24JB of the Act

may from time to time issue structured products such as credit linked notes into the market that are dependent on the covered person's solvency.

In this instance, investors buy securities from the credit link note issuer that is a covered person, and in exchange they receive a fixed or floating coupon payment over the term of the security and at maturity.

C. IAS 39, IFRS 9 and 24JB of the Act interaction

In general accounting terms, hybrid debt instruments such as credit linked notes are regarded as credit derivatives. These hybrid debt instruments are in general accounted and treated as 'derivatives' and therefore the gains and losses are recognised at fair value through profit or loss (FVTPL) in line with IAS 39. Even under IFRS 9, the replacement accounting standard to IAS 39, these hybrid debt instruments would generally also be accounted for at FVTPL. Currently the Act makes provision for derivatives as defined in IAS 39 of a covered person to be subject to tax under section 24JB of the Act.

REASONS FOR CHANGE

If the credit linked notes issued by a covered person in terms of section 24JB of the Act are dependent on the bank's solvency, the anti-avoidance provisions of section 8F of the Act will apply to the credit linked note and will characterise any amount of interest incurred in respect of that credit linked note as a dividend *in specie*, and as a result, will not qualify for an interest deduction.

It has come to Government's attention that despite the application of the anti-avoidance provision in sections 8F and 8FA of the Act of denying a deduction of interest on the borrower's side, if the amount of interest is characterised as a dividend in *specie*, some covered persons referred to in section 24JB of the Act may still argue that they are entitled to claim a deduction of interest incurred due to the application of the provisions of section 24JB of the Act, while the counterparty is deemed to have received a dividend *in specie*.

PROPOSAL

In order to address the interaction between the anti-avoidance rules in sections 8F

and 8FA of the Act and the provisions relating to the taxation of covered persons in section 24JB of the Act, it is proposed that the Act be amended to clarify the policy intent that the anti-avoidance rules in sections 8F and 8FA of the Act override the provisions of section 24JB of the Act. As a result, it will be confirmed that a covered person in terms of section 24JB of the Act is not eligible for an interest deduction. The amount received by a counter party of a covered person in this instance is in terms of the application of the anti-avoidance rules in sections 8F and 8FA of the Act deemed to have received a dividend *in specie*.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 January 2018 and apply in respect of years of assessment commencing on or after that date.

3.26. Tax implications of the assumption of contingent liabilities under the corporate reorganization rules

Section 41 of the Income Tax Act is hereby amended by the insertion in subsection (1) after the definition of 'date of acquisition' of the following definition:

'debt' includes any contingent liability;

EXPLANATORY MEMORANDUM

TAX IMPLICATIONS OF THE ASSUMPTION OF CONTINGENT LIABILITIES UNDER THE CORPORATE REORGANISATION RULES

[Applicable provision: section 41 of the Act]

BACKGROUND

A. Asset sales and transfers for purposes of corporate restructures

Often in business, taxpayers sell or transfer their assets to other companies. They may choose to sell or transfer either an individual asset, a group of assets of a certain division or even an entire business as going

concern to other companies. These sales or transfers of assets are not always done because the assets are no longer needed by the seller or the shareholders of the seller. The taxpayers involved in these sales and transfers of assets may, in some instances, do so for purposes of re-arranging or restructuring their own operations or the operations of other companies with which they have a common shareholder (which would make them part of the same economic unit).

Restructuring the business operations of a company or companies belonging to the same economic unit can help struggling companies to improve their financial position or even help successful companies to expand more than if they continued operating under the same structure. Restructuring often requires that taxpayers should reallocate their existing assets, divisions or even their entire businesses between companies in the same economic unit. Such sales and transfers are disposals which trigger tax consequences for the seller.

B. Tax consequences of selling or transferring assets

Ordinarily, where an asset that is being sold is trading stock, the proceeds of that sale will result in income tax consequences arising (i.e. where the sale price (after reducing it by the cost of the trading stock) is taxed at marginal rates of taxation if the taxpayer is a natural person or the corporate rate of 28% if the taxpayer is a company). Where the asset that is being sold is a capital or allowance asset, CGT consequences will arise (i.e. the proceeds from the sale will be reduced by the base cost of the asset and a portion of any capital gain arising will be included in the taxable income the taxpayer and will as a result be subject to tax at the rates referred to above).

Restructuring transactions are not entered into by companies (and in particular the ultimate shareholders of the companies) to disinvest in their assets but are rather done to achieve operational efficiency and profitability. Growth in the profitability of companies would have a positive effect on the fiscus. As such, it is Government’s policy to encourage and simplify

corporate restructures. However, South Africa does not have a group taxation regime which would treat a group of wholly owned or majority-owned companies as a single entity for tax purposes. Under a group taxation regime, the transfer of assets within an economic unit would not trigger tax because the individual companies within the unit would be seen as one entity.

Instead of having a group taxation regime, the Act contains corporate reorganisation rules that postpone the tax consequences of taxpayers that sell or transfer their assets under specific circumstances. As a result, corporate restructures that comply with the corporate restructuring rules do not immediately trigger tax. The tax consequences are postponed until the assets are subsequently sold or transferred outside the economic unit to an unrelated third party.

REASONS FOR CHANGE

For purposes of ensuring that the corporate reorganisation rules are not abused by taxpayers to facilitate the sale or transfer assets outside of the economic units without triggering tax, there is a limitation on the types of consideration (i.e. the manner in which the sale price is settled) that a purchaser can use to pay for the assets. As a starting point, selling or transferring assets in exchange for cash is viewed as an indication that a taxpayer is no longer interested in the asset and wishes to permanently dispose of it.

As a result, the corporate restructuring rules allow a seller to sell or transfer assets in exchange for equity shares in the purchaser. In some instances, the legislation also allows a purchaser to assume (i.e. take over as the debtor) some or all the debts of the seller in exchange for the assets. These instances are:

a. where a person disposes of an asset to a company in exchange for the shares in that company in terms of section 42 of the Act;

b. where a company disposes of all its assets to another company for purposes of merging the two companies into one company in terms of section 44 of the Act; and

c. where a company disposes of all its assets to its shareholder(s) in anticipation of its liquidation, winding up or deregistration.

There are, however, requirements that must be met before a debt can be assumed for purposes of the corporate reorganisation rules. The debt of the seller must be older than 18 months before the sale or transfer of the assets. If the debt is not older 18 months, that debt can only be regarded as being permissible if it in the normal course of the seller's business (i.e. depending on the nature of the seller's business it would be expected that such debt would arise i.e. employee costs). The concept of debt in this regard requires that the seller must have an existing and real obligation to pay some other party and that other party must have a legal right to collect or receive the payment.

However, a seller and purchase may negotiate a selling price after considering and taking into account some of the contingent debts of the seller. Contingent debts differ from the debts that are currently allowed as permissible consideration under the corporate reorganisation rules. Unlike the debts currently catered for, contingent debts are anticipated obligations that will be confirmed only by the occurrence or non-occurrence of a future event. However, some contingent debts have a real economic impact on the sale transaction and it should be considered whether they should be provided for as acceptable consideration under the corporate reorganisation rules.

PROPOSAL

As indicated above, the concept of debt as it is currently contemplated under the corporate reorganisation rules and the Act as a whole refers to an existing and real obligation to pay some other party and that other party must also have a legal right to collect or receive the payment. In order to expand on this concept of debt for purposes of the corporate reorganisation rules, it is proposed that it should be clarified by way of a new definition in section 41 of the Act that the concept of debt for purposes of the corporate reorganisation rules will include contingent debt.

In addition, it should be noted that all the restrictions that are applicable to debt as it is current understood for purposes of the corporate reorganisation rules relating to the time that the debts arose (i.e. the 18-month rule discussed above), will also

apply to the contingent debt contemplated above.

EFFECTIVE DATE

The proposed amendment will come into effect on the date of promulgation of Taxation Laws Amendment Act, 2017.

3.27. Transferring retirement fund benefits after reaching normal retirement date

Par. (c)(i) of the definition of 'pension fund' is amended as follows:

(i) that the fund is a permanent fund *bona fide* established for the purpose of providing annuities for employees on retirement **[from employment]** date or for the dependants or nominees of deceased employees, or mainly for the said purpose and also for the purpose of providing benefits other than annuities for the persons aforesaid or for the purpose of providing any benefit contemplated in paragraph 2C of the Second Schedule or section 15A or 15E of the Pension Funds Act;

Par. (a) of the definition of 'provident fund' is amended as follows:

(a) that the fund is a permanent fund *bona fide* established solely for the purpose of providing benefits for employees on retirement **[from employment]** date or solely for the purpose of providing benefits for the dependants or nominees of deceased employees or deceased former employees or solely for a combination of such purposes or mainly for the said purpose and also for the purpose of providing any benefit contemplated in paragraph 2C of the Second Schedule or section 15A or 15E of the Pension Funds Act;

The definition of 'retirement fund lump sum benefit' is amended as follows:

retirement fund lump sum benefit' means an amount determined in terms of

paragraph 2(1)*(a)* <u>or *(c)*</u> of the Second Schedule;

Par. 2 of the Second Schedule is amended by adding the following:

(c) any amount transferred for the benefit of that person on or after normal retirement age, as defined in the rules of the fund, but before retirement date, less any deductions permitted under the provisions of paragraph 7.

Par. 7 is inserted in the Second Schedule :

RANSFER ON OR AFTER NORMAL RETIREMENT AGE BUT BEFORE RETIREMENT DATE: DEDUCTIONS

7. The deduction to be made from a lump sum benefit contemplated in paragraph 2(1)*(c)* is equal to so much of that lump sum benefit as is transferred for the benefit of a person from a—

(a) pension fund; or

(b) provident fund,

into any retirement annuity fund.

EXPLANATORY MEMORANDUM

TRANSFERRING RETIREMENT FUND BENEFITS AFTER REACHING NORMAL RETIREMENT DATE

[Applicable provisions: In section 1 of the Act, the definition of 'pension fund', 'provident fund', and 'retirement fund lump sum benefit' and, paragraph 2 and a new paragraph 7 of the Second Schedule]

BACKGROUND

In 2014, changes were made in the Act to allow individuals to elect to retire, and the date on which the lump sum benefit accrued to the individual depended on the date on which the individual elected to retire and not on the normal retirement age. As a result, members of retirement funds were allowed to postpone 'retirement' by keeping their benefits within their funds past the 'normal retirement age'. Retirees

may now 'elect to retire' at any age of their choice subject to the rules and regulations of each individual fund.

The above changes were initially considered because employees were failing to make a timeous election as to the proportion of their benefit they wished to take as a lump sum. This was making it difficult for employers to make appropriate arrangements and to withhold the correct amount of income tax for retirement purposes; therefore employers were falling foul of their withholding obligations.

Subsequently, it was also considered desirable from a policy point of view, that if a member is able to continue to work or support themselves alternatively, it is good that their benefits be preserved as long as possible.

REASONS FOR CHANGE

While members may retain benefits within respective funds, they may no longer make contributions to those funds. The members are thus effectively inactive.

In the case of employer funds, the employee may also have left the employ of the company and may wish to sever ties with the employer. The employer would also be left with the burden of having to keep in touch with an inactive member and deal with additional administration.

While employer funds can prohibit employees from retaining their benefits within the funds to avoid these issues, it would defeat the policy intent of the amendment since employees would simply withdraw their benefits.

PROPOSAL

In order to address these concerns, it is proposed that changes be made in the Act to allow employees to transfer their benefits into a retirement annuity for later consumption. Transfers to preservation funds are not currently included in the proposal as this would create a situation where members of pension funds can transfer their benefits into preservation funds and withdraw all the benefits in a lump sum withdrawal, thereby going against preservation.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 March 2018 and apply in

respect of years of assessment commencing on or after that date.

3.28. Postponement of annuitisation requirement for provident funds to 1 March 2019

BACKGROUND

In 2015, amendments were made to the Act regarding the tax treatment of provident funds in order to enhance preservation of retirement fund interests during retirement. As a result, provident funds will be treated like pension and retirement annuity funds and will be required to annuitise benefits. This implies that on retirement, members of the provident fund will be permitted to take up to a third of the retirement benefit as lump sum and annuitise at least two thirds. However, this will only be applicable for contributions made to a provident fund after the implementation date. All contributions made before the implementation date, and growth on those contributions, may still be taken as a lump sum on retirement.

The above-mentioned amendments were supposed to come into effect on 1 March 2016, however, in February 2016, Government postponed the annuitisation requirements for provident funds for two years until 1 March 2018. The postponement was done in order to provide sufficient time for the Minister of Finance to consult with interested parties, including National Economic Development and Labour Council (NEDLAC), regarding the annuitisation requirements for provident funds after the publication of the comprehensive policy document on social security, and to report back to Parliament on the outcome of those consultations no later than 31 August 2017.

REASONS FOR CHANGE

Several changes have taken place since the postponement of these amendments and the discussions on the comprehensive paper on social security are still underway in NEDLAC.

PROPOSAL

In view of the above, it is proposed that the provisions relating to the annuitisation

requirements for provident funds be postponed for 1 year from 1 March 2018 to 1 March 2019.

EFFECTIVE DATE

The proposed amendments will come into effect on 1 March 2019 and apply in respect of years of assessment commencing on or after that date.

3.29. Clarifying the VAT treatment of leasehold improvements

Section 8 of VAT Act is hereby amended by the addition of:

(29) Where leasehold improvements are effected by a vendor, being a lessee, to the fixed property of the lessor, the lessee shall be deemed to have made a taxable supply of goods in the course or furtherance of the lessee's enterprise to the extent that the leasehold improvements are made for no consideration. Provided that this subsection shall not apply where such leasehold improvements are wholly for consumption, use or supply in the course of making other than taxable supplies by the lessee.

Section 9 of the VAT Act is hereby amended by the addition of:

(12) Where any supply of goods is deemed to be made as contemplated in section 8 (29), that supply shall be deemed to take place at the time the leasehold improvements are completed.

Section 10 of the VAT Act is hereby amended by the addition of:

(28) Where a supply of goods is deemed to be made as contemplated in section 8 (29), the value of such supply shall be deemed to be nil.

The VAT Act is hereby amended by the addition of:

Section 18C – Adjustments for leasehold improvements

Where goods have been supplied to a vendor, being a lessor, as contemplated in section 8(29), the lessor shall be deemed to have made a taxable supply in the course or furtherance of the lessor's enterprise, and where a deduction of input tax would have been denied in terms of section 17(2), or to the extent that such goods

are not wholly for consumption, use or supply in the course of making taxable supplies by that lessor, those goods shall be deemed to be supplied by the lessor at the time the leasehold improvements are completed, in accordance with the formula:

A x B x C

in which formula—

'**A**' represents the tax fraction;

'**B**' represents the higher of—

(a) the open market value of the leasehold improvements; or

(b) the actual cost (including any tax) incurred by the lessee for effecting the leasehold improvements; or

(c) the total amount (including any tax) of leasehold improvements as agreed upon between the lessor and the lessee, and

'**C**' represents the percentage of the use or application of the goods for the purposes of making other than taxable supplies at the time the leasehold improvements are completed.

EXPLANATORY MEMORANDUM

CLARIFYING THE VALUE ADDED TAX TREATMENT OF LEASEHOLD IMPROVEMENTS

BACKGROUND

A lessee may, during the period of a lease agreement effect improvements on the leasehold property that belongs to the lessor. These improvements may either be obligatory or voluntary. These improvements would generally refer to improvements that become permanently attached to the leasehold property.

In terms of the common law, improvements that become permanently attached to the leasehold property become the property of the lessor.

REASONS FOR CHANGE

Currently, the VAT Act does not provide guidelines in respect of the VAT treatment of leasehold improvements effected by the lessee to the leasehold property during the period of a lease agreement. Concerns have been raised that lessee and lessor vendors are uncertain of how to treat these leasehold improvements for VAT purposes. The lack of clarity in the VAT Act has led to inconsistencies in the VAT treatment.

PROPOSAL

It is proposed that the following amendments be made in the VAT Act to clarify that:

A. Deemed Supply of goods by the Lessee

a. The lessee shall be deemed to have made a taxable supply of goods to the lessor to the extent that the leasehold improvements are made for no consideration. The value of this supply is deemed to be NIL in these circumstances. There is no deemed supply if the lessee, being a vendor, uses the leasehold improvements wholly for purposes of making exempt supplies.

B. Adjustments for the lessor

a. Where leasehold improvements are supplied to the lessor by the lessee, as contemplated in the new section 8(29), the lessor shall be deemed to have made a taxable supply of goods in the course or furtherance of its enterprise, to the extent that the lessor, at the time of completion of the leasehold improvements, uses the fixed property otherwise than for making taxable supplies.

b. This adjustment will ensure that the lessor is placed in the same position that it would have been in had the lessor effected the leasehold improvements itself and the use of the improvements were for the making of non-taxable supplies.

c. The value of supply of goods in respect of the adjustment will be the higher of the open market value of the improvements or the actual

cost to the lessee of effecting such improvements or the total amount as agreed upon between the lessor and the lessee. This value will be deemed to be inclusive of VAT. The lessor's output tax liability will be calculated by applying the tax fraction to the value of the supply and then further applying the percentage to which the lessor uses that property for purposes other than making taxable supplies.

d. The time of supply for the lessor to declare an output tax shall be at the time of completion of the leasehold improvements.

C. Connected persons

With respect to connected persons, the normal time and value of supply rules of the VAT Act will apply with regard to the value and time of supply for leasehold improvements.

EFFECTIVE DATE

The proposed amendments will come into effect from 1 April 2018.

3.30. Goods supplied in the course of manufacturing of goods temporarily imported

Section 11 of the VAT Act is hereby amended by the following changes to subsection (1)*(b)*:

(b) the goods have been supplied in the course of processing, repairing, cleaning, reconditioning or manufacture of **[repairing, renovating, modifying, or treating]** any goods to which subsection (2)(*g*) (ii) or (iv) refers and the goods supplied—

EXPLANATORY MEMORANDUM

GOODS SUPPLIED IN THE COURSE OF MANUFACTURING OF GOODS TEMPORARILY IMPORTED

BACKGROUND

In circumstances where goods are imported under Item 470 of paragraph 8 of Schedule 1 of the VAT Act (Schedule 1), any services supplied directly in relation to the processing, repair, cleaning, reconditioning or manufacture of those goods may be zero-rated in terms of section 11(2)(g)(ii) of the VAT Act, read together with Schedule 1. In addition, section 11(1)(b) of the VAT Act makes provision for any goods supplied in the course of conducting those repairs, cleaning, reconditioning or even modification, to be zero-rated where those goods have been wrought or affixed to or consumed in the course of conducting the repairs, modification, renovation or treating.

REASON FOR CHANGE

However, section 11(1)(b) of the VAT Act does not permit the zero-rating of goods that are supplied in the course of manufacturing goods entered under Item 470 (temporarily imported).There does not seem to be any policy rationale for this exclusion.

PROPOSAL

In order to address this anomaly, it is proposed that the VAT Act be amended to provide for the zero-rating of goods supplied in the course of manufacturing goods that were temporarily imported under Item 470 of paragraph 8 of Schedule 1 including aligning with the terminology of the said Schedule.

EFFECTIVE DATE

The proposed amendment will come into effect from 1 April 2018.

3.31. *Clarifying the zero-rating of international travel insurance*

Section 11 of the VAT Act by the substitution of subsection (2)(d) of the following :

(d) (i) the services comprise the—

(aa) insuring;

(bb) arranging of the insurance; or

(cc) arranging of the transport,

of passengers or goods to which any provisions of paragraph (a), (b) or (c) apply or

(ii) insuring or the arranging of the insurance of passengers on an international journey, where the insurance of those passengers is provided under a single inbound or outbound insurance policy in respect of which a single premium is levied: or

EXPLANATORY MEMORANDUM

CLARIFYING THE ZERO RATING OF INTERNATIONAL TRAVEL INSURANCE

BACKGROUND

It is common for people who travel out of the country to obtain travel insurance to cover medical risks as well as risks related to loss of luggage. In some instances, the international travel may have a domestic leg to it (such as a stop-over in another city in the Republic) before the international leg of the journey commences. In most cases, insurers charge a single premium that provides travel insurance for the entire journey and includes both the domestic portion and the international portion.

The VAT Act provides for insurance and the arranging of insurance related to international travel to be zero-rated. The provisions of section 11(2)(a) of the VAT Act in relation to passengers or goods, state that the zero-rated insurance is limited to the transport of passengers or goods:

a. From a place outside the Republic to another place outside the Republic; or

b. From a place in the Republic to a place in an export country; or

c. From a place in an export country to a place in the Republic.

In relation to the transport of passengers, in terms of section 11(2)(b) of the VAT Act, the zero-rating also applies where the services comprise the transport of passengers from a place in the Republic to another place in the Republic to the extent that the transport is by air and constitutes 'international travel'.

In relation to the transport of goods, the zero-rating also applies where the services comprise the transport of goods from a place in the Republic to another place in the Republic to the extent that those services are supplied by the same supplier as part of the supply of services to which the scenarios stated in section 11(2)(a) of the VAT Act apply (section 11(2)(c) of the VAT Act).

REASON FOR CHANGE

The zero-rating does not extend to insurance provided during the period that the insured is:

a. Transported to and from the insured’s original point of departure (e.g. while en-route to or from the airport); and

b. Not being physically transported while on the international journey (for example, while the insured stays in a hotel).

These insurance services would currently be subject to VAT at the standard rate. Since insurers regard the single premium as being in relation to a single supply of international travel insurance, this provision creates a difficulty in practice since the premium cannot be separated into the cover for the local portion, the international portion and the period during which the insured is not physically travelling. Hence the provisions of the VAT Act relating to the zero-rated portion and the standard-rated portion cannot be applied. To assist with this practical problem, SARS issued a Binding General Ruling (No. 37) to clarify the VAT treatment of international travel insurance.

PROPOSAL

In order to address the practical concerns, it is proposed that the zero rating provisions in the VAT Act pertaining to travel insurance cover provided as part of an international journey be clarified.

EFFECTIVE DATE

The proposed amendments will come into effect from 1 April 2018.

3.32. Services supplied in connection with certain movable property situated in an export country

Section 11 of the VAT Act is hereby amended by the following changes to subsection (1)*(b)*:

Section 11 of the VAT Act is hereby amended by the following changes to subsection (2)*(g)*:

(i) movable property (<u>excluding debt securities, equity securities or participatory securities</u>) situated in any export country at the time the services are rendered;

EXPLANATORY MEMORANDUM

SERVICES SUPPLIED IN CONNECTION WITH CERTAIN MOVABLE PROPERTY SITUATED IN AN EXPORT COUNTRY

BACKGROUND

The VAT Act makes provision for services supplied that are directly in connection with movable property that is situated outside the Republic at the time that the services are rendered to be zero-rated. The term 'movable property' is not defined in the VAT Act. In terms of the Companies Act, movable property is defined to include securities or shares. This implies that any services that are supplied to a resident of the Republic that are directly in connection with securities (debt

securities, equity securities and participatory securities) in a foreign incorporated company that is listed on the JSE but which fall under a main register that is held in a foreign country, could be interpreted to mean the supply of services in a movable property that is situated in an export country.

REASON FOR CHANGE

As previously stated, the VAT Act makes provision for the zero rating of services (fees charged) that are supplied directly in connection with movable property that is situated in an export country at the time the services are rendered. This implies that services supplied relating to securities or shares in a foreign incorporated company listed on the JSE but which fall under a main register that is held in a foreign country should be subject to zero-rating. This creates an anomaly in the application of the VAT provisions on these services.

PROPOSAL

In order to address this anomaly, it is proposed that clarification be made in the VAT Act to specifically exclude debt securities, equity securities or participatory securities from the zero-rating provisions of section 11(2)(g)(i) of the VAT Act. These services will now be subject to VAT at the standard rate.

EFFECTIVE DATE

The proposed amendment will come into effect from 1 April 2018.

3.33. Liability for tax and limitation of refunds in respect of National Housing Programmes

The VAT Act is hereby amended by the addition of:

Section 40C – Liability for tax and limitation of refunds in respect of National Housing Programmes

(1) This section applies in respect of the supply of services deemed to be made by the vendor in terms of section 8 (23) which services were supplied before

1 April 2017.

(2) Where the Commissioner issued any assessment relating to tax periods ending before 1 April 2017 for an amount of tax or additional tax in respect of any supply of services as contemplated in subsection (1) in respect of application of the provisions as contemplated in section 11 (2) *(s)* in respect of that supply, the Commissioner must, on written application by the vendor, amend that assessment to the extent that the amount of tax, additional tax, penalty or interest that arose as a result of that assessment has not yet been paid on that date:

Provided that the assessment will not result in a refund to the vendor.

(3) The Commissioner may not make any assessment for tax periods ending before 1 April 2017 in respect of the deemed supply of services contemplated in subsection (1).

(4) If the vendor has charged tax at the rate referred to in section 7 (1) instead of the rate of tax in terms of section 11 (2) *(s)* in respect of the supply contemplated in subsection (1), the Commissioner may not refund any such tax or any penalty or interest that arose as a result of the late payment of such tax, paid by the vendor to the Commissioner.

EXPLANATORY MEMORANDUM

The proposed insertion seeks to clarify a technical aspect. In 2015, amendments were made in the VAT Act to abolish the zero rating of the supply of goods and services for government's national housing programme with effect from 1 April 2017. However, both the National Treasury and municipalities are not yet ready to give effect to the VAT amendments. As a result, an announcement was made in the 2017 Budget to postpone the repeal of the zero rating provision by 2 years until 1 April 2019. As a result of this extension, the proposed insertion of new section 40D seeks to ensure that past assessments that have been finalised for the periods prior to 1 April 2017 are not re-opened either by SARS or the vendor. However, with regard to past assessments that have not been finalised,

applications may be made to SARS to consider reviewing the assessment. However, the review of such assessment may not result in a refund paid to the vendor. Further, no new assessment may be issued by SARS in this regard.

3.34. Bargaining Councils

PART II

BARGAINING COUNCIL TAX RELIEF

Section 95 – Definitions

For purposes of this Part, unless the context indicates otherwise, any meaning ascribed to a word or expression in the Income Tax Act, bears the meaning so ascribed, and—

'**bargaining council**' means a bargaining council that is established in term of section 27 of the Labour Relations Act;

'**bargaining council levy**' means the bargaining council levy imposed by section 97;

'**Income Tax Act**' means the Income Tax Act, 1962 (Act No. 58 of 1962);

'**investment income**' means—

(i) any income in the form of dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature;

(ii) any interest as contemplated in section 24J of the Income Tax Act (other than any interest received by or accrued to any co-operative bank as contemplated in paragraph (a)(ii)(ff)), any amount contemplated in section 24K of the Income Tax Act and any other income which, by the laws of the Republic administered by the Commissioner, is subject to the same treatment as income from money lent; and

(iii) any proceeds derived from investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or

immovable property;

'**Labour Relations Act**' means the Labour Relations Act, 1995 (Act No. 66 of 1995);

'**member**' means a member of a bargaining council; and

'**qualifying period**' means any year of assessment commencing on or after 1 March 2012 and ending on or before 28 February 2017.

Section 96 – Exemptions

There must be exempt from normal tax any amount received by or accrued to—

(a) any member during the qualifying period as sick pay or holiday pay from a scheme or fund as contemplated in section 28(1)(g) of the Labour Relations Act; and

(b) a bargaining council as investment income during the qualifying period.

Section 97 – Bargaining council levy

There must be levied, paid and collected for the benefit of the National Revenue Fund a levy, to be known as the bargaining council levy, in respect of any amount of income exempt in terms of section 96, calculated in terms of section 98.

Section 98 – Amount of bargaining council levy

The amount of the bargaining council levy must be calculated at a rate of 10% on the sum of—

(a) any amount that should have been be deducted or withheld by that bargaining council by way of employees' tax in respect of an amount contemplated in section 96(a) in respect of the liability for normal tax of that member as contemplated in paragraph 2 of the Fourth Schedule to the Income Tax Act.

(b) any amount contemplated in section 96(b).

Section 99 – Payment of bargaining council levy

A bargaining council must submit a return and pay the bargaining council levy to the Commissioner on or before 1 September 2018.

Section 100 – Circumstances in which bargaining council tax relief does not apply

(1) The exemption contemplated in section 96 and the bargaining council levy contemplated in section 97 do not apply in respect of any amount to the extent that tax in respect of that amount was—

(a) withheld from an amount received by accrued to a member;

(b) assessed by the Commissioner on or before 22 February 2017 ; or

(c) paid in respect of the qualifying period.

(2) The exemption contemplated in section 96 does not apply if the bargaining council levy is not paid on or before 1 September 2018.

EXPLANATORY MEMORANDUM

TAX RELIEF FOR BARGAINING COUNCILS REGARDING TAX NON-COMPLIANCE

Background

Some bargaining councils have not deducted Pay-As-You-Earn (PAYE) from a large number of members for holiday, sick leave and end of the year payments. The bargaining councils receive money as contributions for certain benefits from employers of their members (who have not deducted PAYE on those amounts) and at an appropriate time or upon occurrence of a certain event (depending on the rules of the bargaining council), the money is paid to the employees who are members of the bargaining council, without deducting PAYE.

Many bargaining councils have also not been paying income tax in respect of the growth/returns generated from the financial investments of the bargaining council.

Reasons for change

It has come to Government's attention that the bargaining council's non-compliance with the tax legislation potentially extends back a number of decades. Given that some of these bargaining councils would be at risk of closure or would suffer severe financial distress if high penalties and interest are imposed for non-compliance, and given the unique circumstances of this case, specific set of provisions is required to address the situation.

Proposal

It is proposed that a certain degree of relief be introduced in this regard. However, bargaining councils are expected to be fully tax compliant going forward and will not be afforded relief in future.

Based on the above, the following relief is proposed with regard to non-compliant bargaining councils:

a. non-compliant bargaining councils will be required to pay a bargaining council levy of 10% of the total employees' tax that should have been deducted from all payments made by the bargaining councils to their members between 1 March 2012 and 28 February 2017;

b. non-compliant bargaining councils will be required to pay a bargaining council levy of 10% of the income tax that should have been paid in respect of all undeclared income (growth/returns) received by them between 1 March 2012 and 28 February 2017;

c. the relief will apply in respect of the 5 year period, beginning on 1 March 2012 to 28 February 2017. The 5 year period is linked to the period for record keeping requirements in terms of section 29 of the Tax Administration Act;

d. bargaining councils must submit a return and pay the bargaining council levy to SARS on or before 1 September 2018; and

e. bargaining councils that were tax compliant will not be entitled to this relief and will not be entitled to tax refunds.

Effective date

The proposed amendments will come into effect on 1 March 2018.

4. DRAFT – TAXATION ADMINISTRATION LAWS AMENDMENT BILL, 2017

4.1. Timing of accrual of interest payable by SARS

The Income Tax Act is hereby amended by the insertion after section 7C of the following section:

Section 7D – Timing of accrual of interest payable by SARS

In determining the taxable income derived by any person during a year of assessment, any amount of interest to which a person becomes entitled that is payable by SARS in terms of a tax Act is deemed to accrue to that person on the date on which that amount is paid to that person.

Section 7D comes into operation on 1 January 2018 and applies to amounts of interest paid by SARS on or after that date.

EXPLANATORY MEMORANDUM

When interest is payable by SARS on amounts refundable the taxpayer is obliged to include the amount of interest in the taxpayer's gross income on the earlier of the year in which such interest accrues or is received. Where interest accrues over more than one year of assessment it gives rise to practical difficulties as technically assessments for previous years may have to be reopened to reflect the correct amount of interest that accrued to the taxpayer in respect of the relevant years of assessment. In order to create certainty and simplify the taxation of interest payable by SARS it is proposed that the Income Tax Act be amended to provide that interest payable by SARS only accrues on the date of actual payment.

4.2. *Transitional measures for micro business to migrate into the small business corporation tax regime*

Section 48C of the Income Tax Act, 1962, is hereby amended by the addition of the following subsection:

(4) Where in the course of a year of assessment a registered micro business is deregistered in terms of paragraph 10(2) of the Sixth Schedule and a person that qualifies as a small business corporation as defined in section 12E becomes liable for payment of tax in terms of section 5 in respect of the taxable income of that deregistered micro business, that person is exempt from any penalties for underpayment of tax for which that person, solely as a result of that person becoming so liable in respect of that taxable income, would otherwise become liable under the Fourth Schedule to this Act or Chapter 15 of the Tax Administration Act.

EXPLANATORY MEMORANDUM

Qualifying micro businesses (with turnover up to R1 million a year) and small business corporations (with turnover up to R20 million a year) are eligible for preferential corporate income tax rates. The former are taxed on turnover, while the latter are taxed on taxable income. Where a registered micro business exceeds the R1 million turnover threshold during a particular year of assessment, it is required to notify the Commissioner accordingly within 21 days from the date on which the qualifying turnover of the registered micro business so exceeded the threshold. The Commissioner is then obliged to deregister the micro business with effect from the beginning of the month following the month during which the threshold was so exceeded.

Currently, there are no transitional measures for micro businesses that have grown sufficiently during the course of a particular year of assessment to migrate into the small business corporation tax regime. This can result in unforeseen administrative penalties for a deregistered micro business. The proposed amendment enables the

deregistered micro business to transition smoothly by exempting the micro business from any penalties for underpayment of tax under the Fourth Schedule to the Income Tax Act or Chapter 15 of the Tax Administration Act, 2011, to which the micro business would otherwise have become liable solely as a result of being deregistered due to its qualifying turnover exceeding R1 million.

4.3. Exemption to file dividend tax return in the case of tax exempt savings vehicles

Section 64K of the Income Tax Act, 1962, is hereby amended by the substitution for subsection (1A) of the following subsection:

(1A) If, in terms of this Part a person has—

(a) paid a dividend; or

(b) received a dividend contemplated in paragraph *(a)* of the definition of 'dividend' in section 64D**[, other than a dividend derived from a tax free investment contemplated in section 12T,]** that is exempt or partially exempt from dividends tax in terms of section 64F or 64FA,

that person must submit a return in respect of that dividend to the Commissioner by the last day of the month following the month during which the dividend is paid or received, unless the dividend received—

(i) is derived from a tax free investment contemplated in section 12T; or

(ii) is received by a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, or a beneficiary fund defined in section 1 of the Pension Funds Act, of which the receipts and accruals are exempt from normal tax in terms of section 10(1)*(d)*(i).'

EXPLANATORY MEMORANDUM

The Tax Administration Laws Amendment Act, 2016, exempts persons who derive

a dividend from a tax free investment (section 12T of the Income Tax Act) from submitting a return in respect of that dividend. Retirement funds are tax exempt savings vehicles, as is the case with tax free investments, and the exemption from submitting returns is now also extended to these funds.

4.4. Pension, provident and retirement fund deductions spread

Paragraph 2 of the Fourth Schedule to the Income Tax Act is hereby amended by the addition to subparagraph (4) of the following proviso:

Provided that the amount of the contribution to be deducted in terms of paragraphs*(a)*, *(b)* and *(b*A*)* may not in any month exceed one-twelfth of the amount stipulated in paragraph(i)*(aa)* of the proviso to section 11*(k)*'

This amendment comes into operation on 1 March 2018 and applies in respect of years of assessment commencing on or after that date.

EXPLANATORY MEMORANDUM

For purposes of calculating income tax, employees are able to deduct contributions to pension, provident and retirement funds from their income in terms of section 11*(k)*. The deduction is limited to the lesser of R350 000 or 27,5 per cent of remuneration or taxable income. Contributions under these limits are deducted in full. Where the capped amount of R350 000 per year applies, the amendment proposes to spread the application of the cap for employees' tax purposes over 12 months.

4.5. Deemed employers in the case of certain dividends paid

The Fourth Schedule to the Income Tax Act is hereby amended by the substitution for paragraph 11A of the following paragraph:

11A. (1) Where by virtue of the provisions of paragraph *(b)*, *(d)* **[or]**, *(e)* or *(g)* of the

definition of 'remuneration' in paragraph 1, the remuneration of an employee includes—

(a) any gain made by the exercise, cession or release of any right to acquire any marketable security as contemplated in section 8A;

(b) any gain made from the disposal of any qualifying equity share as contemplated in section 8B; **[or]**

(c) any amount referred to in section 8C which is required to be included in the income of that employee;

(d) any amount received by or accrued to that person by way of a dividend contemplated in—

(i) paragraph *(dd)* of the proviso to section 10(1)*(k)*(i);

(ii) paragraph *(ii)* of the proviso to section 10(1)*(k)*(i); or

(iii) paragraph *(jj)* of the proviso to section 10(1)*(k)*(i),

the person by whom that right was granted **[or]**, from whom that equity instrument or qualifying equity share was acquired or by whom that dividend was distributed , as the case may be, is deemed to be a person who pays or is liable to pay to that employee the amount of the gain referred to in paragraph *(a)* or *(b)* or the amount referred to in paragraph *(c)* or *(d)*.

(2) Employees' tax in respect of the amount of remuneration contemplated in subparagraph (1) must, unless the Commissioner has granted authority to the contrary, be deducted or withheld by the person referred to in subparagraph (1) from—

(a) any consideration paid or payable by that person to that employee in respect of the cession, or release of that right or the disposal of that qualifying equity share, as the case may be; **[or]**

(b) any cash remuneration paid or payable by that person to that employee after that right has to the knowledge of that person been exercised, ceded or released or that equity instrument has to the knowledge of that person vested or that qualifying equity share has to the knowledge of that person

been disposed of; or

(c) any amount paid or payable by that person to that employee in respect of any dividend contemplated in paragraph *(dd)*, *(ii)*, or *(jj)* of the proviso to section 10(1)*(k)*(i):

Provided that where that person is an 'associated institution', as defined in paragraph 1 of the Seventh Schedule, in relation to any employer who pays or is liable to pay to that employee any amount by way of remuneration during the year of assessment during which the gain contemplated in subparagraph (1)*(a)* or *(b)* or the amount contemplated in subparagraph (1)*(c)* or *(d)* arises; and—

(i) is not resident nor has a representative employer; or

(ii) is unable to deduct or withhold the full amount of employees' tax during the year of assessment during which the gain or the amount arises, by reason of the fact that the amount to be deducted or withheld from that remuneration by way of employees' tax exceeds the amount from which the deduction or withholding can be made,

that person and that employer must deduct or withhold from the remuneration payable by them to that employee during that year of assessment an aggregate amount equal to the employees' tax payable in respect of that gain or that amount and shall be jointly and severally liable for that aggregate amount of employees' tax.

(3) The provisions of this Schedule apply in relation to the amount of employees' tax deducted or withheld under subparagraph (2) as though that amount had been deducted or withheld from the amount of the gain referred to in subparagraph (1)*(a)* or *(b)* or the amount referred to in subparagraph (1)*(c)* or *(d)*.

(4) Before deducting or withholding employees' tax under subparagraph (2) in respect of remuneration contemplated in subparagraph (1)*(a)* **[or]**, *(c)* or *(d)*, that person and that employer must ascertain from the Commissioner the amount to be so deducted or withheld.

(5) If that person and that employer are, by reason of the fact that the amount to be deducted or withheld by way of employees' tax exceeds the amount from

which the deduction or withholding is to be made, unable to deduct or withhold the full amount of employees' tax during the year of assessment during which the gain referred to in subparagraph (1)*(a)* or *(b)* or the amount referred to in subparagraph (1)*(c)* or *(d)* arises, they must immediately notify the Commissioner of the fact.

(6) Where an employee has—

(a) under any transaction to which neither that person nor that employer is a party made any gain; or

(b) disposed of any qualifying equity share as contemplated in subparagraph (1),

that employee must immediately inform that person and that employer of the transaction or the disposal and of the amount of that gain.

(7) Any employee who, without just cause shown by him or her, fails to comply with the provisions of subparagraph (6) shall be guilty of an offence and liable on conviction to a fine not exceeding R2 000.

This amendment comes into operation on 1 March 2018 and applies in respect of years of assessment commencing on or after that date.

EXPLANATORY MEMORANDUM

The proposed amendment adjusts the wording of paragraph 11A to provide for changes in employees' tax brought about by the expansion of the definition of 'remuneration' in 2016.

Paragraph 11A of the Fourth Schedule to the Income Tax Act deems certain persons to be persons that pay or are liable to pay amounts to employees by way of remuneration. This means that these persons fall into the definition of 'employer' for purposes of the Fourth Schedule. The Taxation Laws Amendment Act, 2016, expanded the definition of 'remuneration' in the Fourth Schedule to include any amount received by or accrued to a person by way of a dividend contemplated in paragraphs *(dd)*, *(ii)* and *(jj)* of the proviso to section 10(1)*(k)*(i) of the Income Tax

Act. The persons paying these dividends are therefore considered to be employers and must now deduct employee's tax in respect of the dividends paid or payable by that person to the employee.

4.6. Expanding internal remedy before review application to the High Court

Section 9 of the Tax Administration Act is hereby amended:

(a) by the substitution for subsection (1) of the following subsection:

(1) A decision made by a SARS official **[and]** or a notice to a specific person issued by SARS under a tax Act, excluding a decision given effect to in an assessment or a notice of assessment that is subject to objection and appeal,**[—**

(a) **is regarded as made by a SARS official, authorised to do so or duly issued by SARS, until proven to the contrary; and**

***(b)*]** may in the discretion of a SARS official described in **[subparagraphs (i) to (iii)]** paragraphs *(a)* to *(c)* or at the request of the relevant person, be withdrawn or amended by—

[(i)]*(a)* the SARS official;

[(ii)]*(b)* a SARS official to whom the SARS official reports; or

[(iii)]*(c)* a senior SARS official.'; and

(b) by the addition of the following subsection:

<u>(3) A decision made by a SARS official or a notice to a specific person issued by SARS under a tax Act is regarded as made by a SARS official authorised to do so or duly issued by SARS, until proven to the contrary.</u>

EXPLANATORY MEMORANDUM

It has been submitted that, with regard to decisions that are not subject to objection and appeal, a taxpayer can potentially be prejudiced by not having access to other effective internal remedies that may provide relief. The taxpayer's only other remedy would then be to take the matter up on review before the High Court in terms of the Promotion of Administrative Justice Act, 2000 (PAJA).

Decisions by SARS are generally subject to the internal remedy in section 9 of the Tax Administration Act, in terms of which specified SARS officials may reconsider the decisions. Decisions that are given effect to in an assessment or notice of assessment are however excluded, since assessments generally have the separate remedy of objection and appeal. As a result of the public comment process on the 2016 legislation, a situation has been identified where a decision given effect to in a notice of assessment is not subject to objection and appeal. It is therefore proposed that such a decision be subject to the remedy under section 9. This will afford the taxpayer an internal remedy before exercising the external remedy of a review application to the High Court under PAJA.

4.7. Banks' advice on suspected transactions

Section 190 of the Tax Administration Act, 2011, is hereby amended by the substitution for subsection (5A) of the following subsection:

(5A) If a person who carries on the 'business of a bank' as defined in the Banks Act, 1990 (Act No. 94 of 1990), holds an account on behalf of a client into which an amount referred to in subsection (5) is deposited, reasonably suspects that the payment of the amount is related to a tax offence, the person must immediately report the suspicion to SARS in the prescribed form and manner and**[, if so instructed by SARS,]** not proceed with the carrying out of any transaction in respect of the amount for a period not exceeding two business days unless—

(a) SARS or a High Court directs otherwise; or

(b) SARS issues a notice under section 179.

EXPLANATORY MEMORANDUM

Currently, section 190(5A) requires a bank, if it reasonably suspects that the payment of an amount is related to a tax offence, to immediately report the suspicion to SARS in the prescribed form and manner. Upon such notification SARS has the discretion to instruct the bank to hold the funds for two business days, pending an investigation by SARS into the matter. Following representations by members of the financial sector, it is proposed that a bank be enabled to place an automatic hold on the taxpayer's account where the bank reasonably suspects that the payment of any amount into the taxpayer's account is related to a tax offence and the matter is subsequently reported to SARS. This will ensure that the funds are secured as soon as the transaction is reported. The two (2) business days will commence when the hold is placed and the transaction is reported to SARS.

4.8. Clarification of interest on understatement penalties

Section 270 of the Tax Administration Act is hereby amended by the substitution for subsection (6E) of the following subsection:

(6E) Until the date on which the whole of Chapter 12 and of Schedule 1 to this Act come into operation <u>in respect of a tax type</u>—

(a) the accrual and payment of interest on an understatement penalty imposed under section 222 must be calculated in the manner that interest upon <u>an</u> additional tax <u>penalty imposed under a tax Act, prior to the repeal of the penalty by this Act,</u> **[is]** <u>was</u> calculated in terms of the interest provisions of the relevant tax Act; and

(b) the effective date referred to in section 187(3)*(f)* for tax understated before 1 October 2012 must be regarded as the commencement date of this Act.

EXPLANATORY MEMORANDUM

The proposed amendment clarifies that the manner in which interest was calculated in respect of an additional tax penalty under the provisions of the tax Act imposing the penalty, prior to the repeal of the penalty by the Tax Administration Act, will apply for purposes of the calculation of interest on understatement penalties until Chapter 12 of the Tax Administration Act has come into effect.

4.9. Different dates fo new interest regime

Section 272 of the Tax Administration Act, 2011, is hereby amended by the substitution for subsection (2) of the following subsection:

(2) The President may determine different dates for different provisions of this Act to come into operation <u>and for the purposes of Chapter 12 and the provisions relating to interest in Schedule 1, the Minister may determine by public notice the date on which they come into operation in respect of a tax type.</u>

EXPLANATORY MEMORANDUM

The full interest scheme of the Tax Administration Act as set out in Chapter 12 and the consequential amendments to the interest provisions of the tax Acts have not been promulgated with the rest of the Act with effect from 1 October 2012 in light of the system changes required to implement the new interest scheme. This was effected by section 272(2) of the Act that provided that the President may determine different dates for different provisions of this Act to come into operation. SARS now seeks to implement the new interest scheme in phases based on tax type. Accordingly, an amendment is proposed to allow the Minister, for purposes of Chapter 12 and the provisions relating to interest in Schedule 1 once promulgated, to determine by public notice the date on which they come into operation in respect of a tax type.

5. CASE LAW

5.1. C:SARS v Marula Platinum Mines Ltd

Marula Platinum Mines Ltd was a subsidiary of Impala Platinum Holdings Ltd, one of the world's primary producers of platinum group metals, i.e. platinum, palladium, gold rhodium, uridium and ruthenium ('pgm's'), as well as base metals such as nickel, copper and cobalt.

Marula, during the years of assessment, had been involved in mining in Limpopo and it did not own the land which it mined, but held mining rights in respect of the areas where it conducted its operations.

Marula's operations comprised two distinct phases. The first phase entailed extracting ore from underground rock and bringing it to the surface, such ore containing pgm's as well as base metals. The second phase involved crushing and milling of the mineral-bearing ore to expose the mineral elements and then subjecting it to a froth floatation process from which a mineral-bearing concentrate in powder form was derived.

Marula, from the inception of its operations, had planned to sell the pgm's and base metals in the form of a concentrate. At no stage did Marula sell or trade in the mineral-bearing ore that it had extracted during the first phase of its operations. It was simply too bulky and therefore Marula was unable to economically transport the ore by road or rail but the concentrate in powder form derived from the second phase of its operations could be economically transported and sold by Marula.

Marula sold the concentrate to its fellow subsidiary company, Impala Refinery Services (Pty) Ltd (IRS), in terms of a written contract concluded with IRS. The payment provisions of the contract were structured in such a way that the purchase price of the concentrate was dependent on the ruling market prices for the different pgm's, while payment by IRS in respect of the purchases of the concentrate, would only be made five months later.

Marula, in the result, had submitted returns for the years of assessment wherein it

deferred, in terms of section 24M of the Income Tax Act, the inclusion in its gross income of the selling price for the concentrate to IRS (in respect of the last four months of each year), to the following year of assessment. However, the expenditure incurred by Marula in respect of the sales of the concentrate, was claimed as a deduction under section 11(*a*) of the Act in the year that it was incurred, and not in the year of assessment that the selling prices of the concentrate were included in Marula's gross income.

The expenditure consisted of on-mine operation costs, concentration and smelting operation costs, overheads, royalty fees and drying charges. There was therefore a disjuncture in a tax year between expenditure and income.

SARS had taken the view that, in respect of each of the years of assessment, Marula had correctly excluded unquantified sales of concentrate to IRS from its gross income under section 24M of the Income Tax Act. However, SARS had invoked the provisions of section 23F(2) of the Act by disallowing a percentage of the section 11(*a*) deductions claimed by Marula in respect of each of the years of assessment. That disallowance of expenses incurred by Marula resulted in a substantial increase in its liability for the payment of income tax in the years of assessment, which had prompted an unsuccessful objection to the assessments and the eventual appeal to the Gauteng Tax Court (see *ITC 1875* 77 SATC 161).

Marula took the view that the expenditure incurred by it related to mining activities and not to the production, manufacturing, purchasing or acquisition of trading stock. The deductions claimed in respect thereof could therefore not be recouped under section 23F(2) of the Act.

Section 23F(2) provided that expenditure relating to the acquisition of 'trading stock' (which is generally deductible) is to be disregarded to the extent that any amounts relating to the disposal of that trading stock did not accrue during the same year of assessment in which the expenditure had been incurred.

The Tax Court held that the ore mined by Marula formed part of a mining process; that it was not economically viable to sell the ore in that form nor did Marula intend selling it in that state; and, therefore, the ore did not constitute trading stock.

The Tax Court further found that once the mineral ore had been concentrated into

'a higher value product' it qualified 'to be characterised as trading stock.' It therefore held that SARS was entitled, in terms of section 23F(2) of the Act to recoup the deduction of expenses only in respect of phase 2, and not phase 1 of Marula's operations.

The Tax Court referred the assessments back to SARS for reconsideration on the basis that section 23F(2) of the Act applied only to phase 2, being the 'concentrator phase.' It further held that the deductions for administration, audit and drying charges did not fall within the purview of section 23F(2) of the Act.

SARS appealed the judgment and orders made by the Tax Court, while Marula noted a cross-appeal against the Tax Court's order allowing SARS to recoup the deductions for the second phase in terms of section 23F(2) of the Act.

The adjudication of the appeal involved the application and interpretation of section 23F(2) of the Act, read with the definition of 'trading stock' in section 1 of the Act.

The central issue for determination was whether the operations of Marula whereby mineral-bearing ore was extracted from the land and subjected to processes resulting in a mineral-bearing concentrate, amounted to a manufacturing process, with the result that the ore and concentrate constituted 'trading stock' as contemplated in section 1 of the Act.

Judge Fourie held the following:

(i) That section 23F(2) is an anti-avoidance provision that caters for the situation where a taxpayer has disposed of trading stock in the ordinary course of its trade during a year of assessment for a consideration, the full amount of which will not accrue to the taxpayer during that year, but in respect of which expenses incurred on the acquisition of that trading stock, had, in that year or in any previous year of assessment been allowed as a deduction under section 11(*a*) of the Act. Any amount that would otherwise have been deductible under section 11(*a*) must, to the extent that it exceeds the amount received or accrued from the disposal of that trading stock, be disregarded during that year of assessment. Therefore, the purpose and function of section 23F(2) is to delay the section 11(*a*)

deduction of the cost of trading stock until the income from the disposal of that trading stock has been included in the taxpayer's gross income.

(ii) That in the present case the income derived by Marula from the sale of the concentrate (in respect of the last four months of each of the years of assessment) was excluded from Marula's gross income in terms of section 24M of the Act, to be included in the following years when it became quantifiable. Therefore, if Marula's activities constituted the disposal of 'trading stock' as defined in section 1 of the Act, section 23F(2) would find application and prevent the 'mismatch' of the deduction of the cost of the trading stock with the taxation of the income from the disposal of that trading stock, by delaying the section 11(*a*) deduction until the year of assessment in which the corresponding income is taxed.

(iii) That 'trading stock' is defined in the Act as including anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer, and anything the proceeds from the disposal of which forms or will form part of the taxpayer's gross income. For anything to qualify as 'trading stock' under the first part of the definition in section 1 of the Act, it can be acquired by the taxpayer for the purposes of manufacture, sale or exchange, or it can be manufactured by the taxpayer for the purposes of sale or exchange. It is not a prerequisite that to qualify for trading stock that what the taxpayer acquires is immediately saleable or realisable. It is sufficient if that which is acquired is intended to be used for the manufacture of something else.

(iv) That in the present matter it was common cause that the mineral-bearing ore was mined by Marula for the purpose of manufacture of the concentrate. Therefore, the fact that the ore was not intended to be disposed of in the state in which it was mined, is legally irrelevant in view of the purpose for which it was mined, i.e. to manufacture the concentrate. The finding of the Tax Court that the ore did not constitute trading stock as it had in itself no saleable or realisable value, cannot be sustained. As held in *Richards Bay Iron and Titanium (Pty) Ltd and Another* v *CIR* 58 SATC

55, it suffices that the ore was intended to be used for the purpose of manufacturing the concentrate and it accordingly constituted 'trading stock' as defined in section 1 of the Act.

(iv) That, as recorded earlier, the Tax Court had held that the concentrate qualified to be characterised as trading stock. This finding is no doubt correct, as the evidence shows that the concentrate was derived by a process of manufacturing, as envisaged in the definition of 'trading stock' in section 1 of the Act. This involved the conversion of the ore into mineral-bearing concentrate by crushing and milling it to expose the minerals and then subjecting it to a froth floatation process. This process was analogous to those employed in *Richards Bay*, *supra*, both of which were held to be processes of manufacture within the meaning of the definition of 'trading stock' in section 1 of the Act.

(v) That it had to be stressed that, before Marula extracted the concentrate, the ore was not saleable, but the end product ('the concentrate') was a valuable commodity available in a commercially acceptable and disposable form. As in the case of *Richards Bay* and *Foskor*, one cannot ignore the processes to which the mineral-bearing ore was subjected, with the result that an end product that was significantly different from the raw ore was derived. What the evidence showed was that the concentrate was not only significantly different from the raw ore, but upon completion constituted an essentially different entity in its own right.

(vi) That the process of manufacture followed in the instant matter could not be materially distinguished from those employed in *Richards Bay* and *Foskor*. *Richards Bay* could not be distinguished as it appeared from the *dictum* in that case at 328J, (58 SATC at 75) that the court, distinct from the concession that had been made independently, had held that the evidence established that the relevant stockpiles had been produced or manufactured within the meaning of the definition of 'trading stock.'

(vii) That, accordingly, not only was the mineral-bearing ore extracted by Marula for the purpose of manufacture of the concentrate, but the concentrate itself

was derived by a process of manufacturing, as envisaged in the first part of the definition of 'trading stock' in section 1 of the Income Tax Act and it should be added that the concentrate also qualified as trading stock in terms of the second part of the definition in section 1 of the Act, as the proceeds from its disposal formed part of Marula's gross income.

(ix) That it followed that Marula's activities constituted the disposal of trading stock, as a result of which SARS was entitled to invoke section 23F(2) of the Act, by delaying the deduction of section 11(*a*) expenses by Marula until the year of assessment in which the corresponding income was to be taxed.

(x) That the finding that the activities of Marula constituted manufacturing and not mining effectively puts paid to Marula's substantive grounds of opposition. That section 23F(2) referred to deductions claimed under section 11(*a*) and not to any other deductions, is also made clear by *Silke on South African Income Tax*, *supra*, Par. 14 and this appeal dealt solely with the deductions covered by section 23F(2), i.e. deductions under the provisions of section 11(*a*) and the present judgment was not concerned with any other deductions.

(xi) That SARS was entitled in terms of section 23F(2) of the Act to recoup the relevant portion of the deductions relating to phases 1 and 2, i.e. the on-mine operation costs and the concentrating and smelting operation costs and the court had already recorded Marula's concession that SARS was entitled to recoup the expenditure in respect of royalty fees, therefore the remaining issue was that of the drying charges and the court found that SARS was entitled in terms of section 23F(2) to recoup the relevant portion of these drying charges.

(xii) That in the result the appeal should succeed while the cross-appeal should be dismissed.

5.2. *ZRA v Packers International (Private) Ltd*

Appellant, being the Zimbabwe Revenue Authority ('ZRA'), was tasked with the obligation to collect taxes and other statutory dues and fees under various legislative instruments including the VAT Act.

Respondent ('Packers') was a private limited company duly registered as such under the laws of Zimbabwe and it operated fast food outlets and grocery shops throughout the country and was a registered operator in terms of the VAT Act.

The system of collection of VAT, as embodied in the VAT Act, involved the imposition of tax at each step along the chain of manufacture of goods or the provision of services subject to VAT. Consequently, every registered operator was required in terms of section 28 of the VAT Act to submit returns to the ZRA every month, calculate the VAT due on the return and make payment of such calculated VAT.

Due to the sheer volume and complexity of the VAT collection system, ZRA lacked the capacity and manpower to effectively monitor each and every transaction liable to VAT and, as a consequence, it was heavily reliant on the self-assessment process by registered operators and in order to ensure that operators complied with the requirements to render returns and collect VAT, ZRA conducted periodic investigations as well as audits.

Packers and ZRA have had a dispute on the manner in which the former had been performing its obligations to file returns and render VAT to ZRA under the VAT Act.

ZRA, as a consequence, had requested Packers to submit returns for the period extending 2009 to 2013 and on 12 March 2014 ZRA gave notice to the effect that failure by Packers to comply with its request by 17 March 2014 would result in assessments being estimated and issued.

ZRA, on 17 March 2014, advised that it was in the process of compiling the assessments in question and that in due course it would advise Packers of its obligations in relation to VAT, income tax and PAYE and ultimately the assessments were issued and sent to Packers.

Packers, on 2 May 2014, filed an objection to the assessments with ZRA who had

upheld one of the objections and had dismissed the rest.

Packers did not pay the assessed taxes resulting in ZRA placing a garnishee against a number of Packer's bank accounts held with FBC Bank for collection of an amount of USD19 696 645,44.

Packers, when it became aware of the garnishee, launched an urgent chamber application which was the subject of this appeal in which it had sought the setting aside of the garnishee order and an order stopping ZRA from interfering with its 'business operations'.

Packers, subsequent to the aforementioned, appealed to the Fiscal Appeals Court where it challenged the decision of ZRA in rejecting the objections.

On 25 June 2014 the High Court issued a final order in terms of which ZRA was ordered to uplift and suspend the garnishee order that had been placed on Packers' accounts with FBC Bank until the appeal that was pending before the Fiscal Appeals Court was finalised.

The High Court further ordered ZRA to allow a period of seven working days to elapse, after the upliftment and suspension of the original garnishee order, whereafter it was ordered to replace it with a fresh garnishee order for the sum of USD xxxxx which would remain in place until the appeal was finalised or payment was made in full, whichever came first.

The High Court also ordered ZRA not to unlawfully interfere with Packers' business operations and its day-to-day activities, including the placing of its officers at Packers' business premises.

The High Court found, in determining the urgent application, that the liability on the part of a registered operator under section 36 of the VAT Act (Payment of tax pending appeal) remained extant and was not extinguished by the noting of an appeal unless ZRA directed that the obligation fell away pending finalisation of the appeal.

The High Court further found that the appointment of FBC Bank as agent in terms of section 48 had been done lawfully and it therefore refused to accede to the request to revoke the appointment.

However, in an apparent *volte face*, the court *a quo* went on to consider the reasonableness of the exercise of discretion by ZRA as viewed against the provisions of the Constitution and the Administrative Justice Act [*Chapter 10:28*].

ZRA had been aggrieved by the High Court's order and then appealed to the present court, the Supreme Court of Zimbabwe, on a number of grounds.

The issues for determination in the appeal may be summarised as follows:

- Whether ZRA was entitled at law to issue garnishee orders and appoint agents for the payment of value-added tax;
- Was the court *a quo* entitled to *mero motu* pick a dispute on behalf of the parties and determine the matter on that basis;
- Was the court *a quo* at law empowered to remove the garnishee order and impose an interdict against ZRA.

ZRA contended that the court *a quo* had deviated from the cause of action as pleaded by Packers and gave relief framed on alleged unreasonableness on the part of ZRA which was raised by the court *mero motu*.

It was contended further that if the court *a quo* had confined itself to the lawfulness of the conduct of ZRA, it would have correctly found that the actions of the latter were lawful and consequently it would have declined the prayer to issue the interdict.

Judge Gowora held the following:

<u>As to whether ZRA legally entitled to issue garnishee orders</u>

(i) That the VAT Act provides a detailed mechanism for vendors to keep certain records and to periodically calculate, account for and pay value-added tax to ZRA. The Act as a whole and, in particular, its provisions relating to assessments and the payment, recovery and refund of tax provisions are indispensable tools for the prompt collection of tax due. From an economic point of view, the provisions of the VAT Act are meant to ensure a steady, accurate and predictable stream of revenue for the fiscus.

(ii) That these provisions are an embodiment of the principle 'Pay Now Argue

Later', suggesting that an appeal would not have the effect of suspending payment. The principle is aimed at discouraging frivolous or spurious objections and ensures that the whole system of tax collection in the country maintains its efficacy. This serves the fundamental public purpose of ensuring that the fiscus is not prejudiced by delay in obtaining finality in any dispute.

(iii) That the anchor to the provisions on recovery of tax is section 36 of the VAT Act which excludes the suspension of payment of tax upon the noting of the appeal.

(iv) That Packers had lodged an objection in terms of section 32 of the VAT Act and when the objection did not wholly succeed, it filed an appeal after the garnishee order had been placed against its account. The learned judge in the court a quo had found that although Packers was challenging the appointment of an agent by ZRA to collect the VAT assessed as being due and owing, ZRA had acted lawfully in relation to the appointment of FBC bank as such agent for the collection of tax.

(iv) That the issue of the appointment of the agent and the garnishee order were intrinsically linked and the law in respect of the two was critical in the resolution of this inquiry.

(v) That the sharp end of the VAT system is section 48 of the VAT Act which allows the appointment of an agent. In a proper and logical construction of the provision, payment by the agent was by means of a garnishee against any account to the taxpayer's credit held with the agent. In any event, tax under the VAT Act consists of monies that have been taxed on goods and services paid by consumers for onward transmission to the Commissioner. All that is required of an operator is to calculate the amount so paid, submit a return and make payment. A refusal to pay or failure to do so on the part of the operator would result in the imposition of a garnishee and, therefore, once the tax assessment was made, the imposition of the garnishee was a possibility and no other conclusion is possible and this finding by the court ought to have put paid to the enquiry into the lawfulness of the garnishee.

(vi) That Packers had alleged before the court a quo that the garnishee had imposed a hardship on its operations. In the court's view section 36 of the VAT Act created a remedy for the amelioration of possible financial hardship faced by an individual taxpayer and allowed ZRA to suspend payment pending an appeal. However, ZRA cannot exercise the discretion mero motu. He can only do so upon consideration of facts presented to him by a taxpayer who wishes to benefit from the exercise of discretion by ZRA. As a consequence, the taxpayer bears the onus to place the necessary facts before ZRA regarding the hardships facing him should the obligation to pay not be suspended.

(vii) That it followed therefore that, whilst section 48 of the VAT Act was concerned with ZRA's power to appoint an agent for purposes of collection or recovery of tax, section 36 of the same Act enshrined the taxpayer's duty to pay tax. The two were inextricably linked in that the decision to use one method of recovery was determined by whether or not any facts had been placed before ZRA on whether or not there existed hardships which would justify a suspension of the obligation to pay assessed tax by a taxpayer.

(ix) That what was before the court a quo was a plea for mercy as opposed to the enforcement of an existing right. Once the discretion in section 36 is exercised in favour of the suspension of the obligation to pay tax, then by parity of reasoning, it followed that the discretion to appoint an agent in terms of section 48 fell away.

(x) That the obligation to pay the amount of tax assessed as being due and payable is imposed by section 38 of the VAT Act. Section 36 does not serve to protect any right of the taxpayer but to preserve the right of ZRA to be paid and to collect the revenue. It also secures the obligation of the operator to pay unless such obligation is suspended by ZRA upon request and, as a consequence, the discretion to suspend payment in terms of the said section is that of ZRA.

(xi) That it was not in dispute that the court a quo made a finding that the actions of ZRA were lawful and, as a consequence, it should have been

obvious that there was no legal basis upon which to grant an interdict.

(xii) That section 48 was not subject or subservient to any other law and this was clearly expressed in the provision itself. Therefore, that in terms of the wording of the section, ZRA's power under section 48 cannot be subject to section 14 of the Fiscal Appeal Court Act. Moreover, once a person is declared an agent in terms of section 48, the person so appointed was duty bound to pay the assessed taxes notwithstanding the provisions of any other law.

(xiii) That, as a consequence, it followed that ZRA was entitled not only to appoint an agent for the collection of assessed tax but it was also entitled to garnishee the taxpayer's account through the agent for the collection of tax.

(xiv) That, accordingly, the decision by the court a quo to discharge the garnishee in the circumstances of this case was contrary to the law and constituted a misdirection.

Whether the court was entitled to pick a dispute on behalf of the parties

(xv) That it had been contended on behalf of ZRA that the court a quo went beyond what was asked of the court and had reframed the issues for determination on behalf of the parties in that it had considered that it was necessary to review the actions of Packers. It seemed that the criticism of the approach taken by the court a quo was not entirely unwarranted. Having dealt with the lawfulness of the actions of ZRA, the court a quo then deviated and sought to review the imposition of the garnishee on the basis of alleged unreasonableness.

(xvi) That the basis of the application in the High Court was that ZRA had bestowed upon itself powers that it did not have and that it was as a result acting as if it was a court of law in issuing a garnishee. It was further alleged that in issuing the garnishee ZRA was acting in an unconstitutional manner as the figure upon which the garnishee was premised had been arrived at in an arbitrary manner. It was alleged that there was no law that empowered ZRA to act in the manner that it did and that if such law existed then the law required realignment with the constitution. An application such

as the one before the court a quo must be disposed of on the basis upon which it is made and, thus, it stands or falls on its founding affidavit. The application sought to challenge the lawfulness of the garnishee of Packers' accounts and it was evident that Packers did not make an application to the High Court to review ZRA's decision to impose a garnishee.

(xvii) That notwithstanding the fact that Packers did not at any stage of the dispute claim a right founded on administrative law, which was evident from the nature of the pleadings, the court a quo on its own went on to determine the issue on that basis and it was never contended by Packers that the decision by ZRA to impose a garnishee was procedurally unfair.

(xviii) That a court of law cannot go outside the pleadings on a dispute before it and pick a dispute for the litigants completely and utterly unrelated to the papers before it and nor can it dispose of the matter on the basis of the issue so raised by it. Packers did not raise an alleged violation of a constitutional right and yet the court a quo went on to invoke the provisions of section 68 of the Constitution and fashioned a remedy in favour of Packers out of the same. There is persuasive authority to support the principle that a court cannot at law pick a dispute on behalf of litigants.

(xix) That the court a quo proceeded on the premise that the question of the reasonableness or otherwise of ZRA's lawful actions in performing a lawful function was before it but it was not. Therefore, the question of substantive fairness adverted to by the court a quo had no basis at law. Packers did not challenge the administrative functions of ZRA by way of review. The 'reasonableness' upon which this case was decided was not an issue before the court because the issue was never about ZRA being an errant administrative authority. The Administrative Justice Act [Chapter 10:28] was not the basis of the application before the court a quo and the court a quo ought not to have determined it on that basis and its determination of the dispute on an issue not properly before it was a gross misdirection.

(xx) That the whole judgment of the court a quo was underpinned by findings which constituted a misdirection warranting interference by the court.

<u>As to whether the court a quo was empowered to remove the garnishee order</u>

(xxi) That the power to make the assessments which were the substance of the dispute in issue was not in doubt and, indeed, the court a quo had made a finding that the actions of ZRA right up to the appointment of an agent under section 48 of the VAT Act were lawful. However, notwithstanding the finding by the court a quo that ZRA had acted lawfully in all respects, the court went ahead and imposed an interdict against the collection of any sums in excess of USD xxxxxx and, in addition, ZRA, in consequence of the order by the court a quo, could not collect on the stated sum before the expiry of a week from the date of the order.

(xxii) That ZRA had correctly contended that by the court a quo stating that there had been an irrational exercise of the discretion bestowed upon ZRA under the VAT Act, it had misdirected itself.

(xxiii) That an interdict served to protect a right and not an obligation. The papers filed on behalf of Packers did not identify any right that ZRA had threatened. The court a quo had found as a matter of fact that ZRA had acted in terms of the law in assessing VAT which remained unpaid. Once this finding was made, including the further finding that the agent had been appointed lawfully, there was no lawful justification at law for suspending payment for a week.

(xxiv) That the court could only act to protect a litigant if it was established that ZRA had acted illegally in assessing taxes, imposing a garnishee and appointing an agent for the collection of the tax so assessed. In addition the appeal was launched after the garnishee was imposed and, even assuming that the garnishee was illegal, the interdict could not serve to protect conduct that had already been effected and was thus in the past.

(xxv) That the issue of the quantum of tax due was not before the court a quo, and as a consequence, it could not lawfully replace the garnishee properly issued with one for a lesser sum.

(xxvi) That, accordingly, the court a quo, having found that the actions of the ZRA were lawful, could not then bar ZRA from performing a lawful function and

thus the interdict issued against ZRA was an unlawful interference with its powers under the VAT Act.

Appeal allowed with costs.

5.3. *ITC 1893*

The taxpayer, being an automotive manufacturer, had received an incentive, known as the Productive Assets Allowance ('PAA'), payable in terms of the Motor Industry Development Programme ('MIDP') under the auspices of the Department of Trade and Industry ('DTI').

It was an incentive to the motor industry to encourage streamlining the production of light motor vehicle assembly plants into a limited number of models, improving international competitiveness and improving the contribution to the economy in terms of employment, investment and supporting the consumer while reducing the net foreign currency usage.

From the evidence led before the court there were too many different models of motor vehicles in South Africa and the PAA incentive was introduced as part of the MIDP.

The PAA incentive was in the form of a rebate certificate to the maximum of 20% of the total investment in qualifying productive assets and spread equally over five years. A PAA certificate reduced the amount of import duty payable on the import of motor vehicles tax to the extent of the certificate value, allowing that only the remaining amount of duty owing on clearing the imports would be payable in cash and these certificates could only be used to rebate duties on imported motor vehicles, within a stipulated time frame and were not tradable. This was done to ensure that the range of products offered to the consumer was sustained.

In order to qualify for the PAA the taxpayer had to invest a minimum value in qualifying assets and submit a business plan to the DTI. The business plan had to be 'in respect of a project to invest in productive assets with a view to producing specified motor vehicles . . . of sufficient quality, quantity and competitive prices to supply to the common customs area and international markets in line with the

guidelines issued by [DTI].'

The business plan had to demonstrate that the investment would result in the rationalisation of models produced; an increase in production of units within two years; increased international competitiveness; contribute to development of domestic manufacturing; a favourable effect on the long term balance of payments; and consumer interest supported.

The productive assets, for purposes of the PAA, included 'Buildings erected for the sole purpose of manufacturing specified motor vehicles or automotive components, and new or unused plant, machinery, tooling, jigs, dies and moulds, in-plant logistics, testing, design and production IT equipment and supporting software.'

The PAA incentive rewarded automotive manufacturers for investing capital in qualifying productive assets and manufacturers were incentivised to concentrate their efforts on platform rationalisation to ensure a smaller number of models and to import low volume niche models rather than manufacture these locally.

The taxpayer had received or accrued amounts under the PAA scheme for the years of assessment 2008 to 2010 and had submitted tax returns for the aforesaid period wherein the amounts it had received under the PAA had been reflected as 'gross income' and in 2010, due to a re-assessment and after obtaining legal advice and after an *Interpretation Note* pertaining to the taxability of government grants had been issued, it had concluded that those amounts were actually receipts or accruals of a capital nature and had accordingly objected to the aforementioned assessments.

SARS had dismissed the taxpayer's objection and as a result the taxpayer's instant appeal to the Tax Court.

The only issue in dispute in this appeal was whether the compensation received by the taxpayer in the form of amounts received or accrued under the PAA scheme constituted gross income as defined in section 1 of the Income Tax Act or were of a capital nature and therefore excluded from the definition of gross income.

The taxpayer contended that the question that the court should ask was, when determining whether the grant was of a capital or revenue nature, 'why was the

grant made?' and in none of the cases referred to by the taxpayer did the court pay any attention to the use that the grants were put after their receipt.

Judge Schoeman held the following:

(i) That, from the definition of 'gross income' in section 1 of the Income Tax Act, it was clear that gross income is any amount that is received by or accrues to a resident that is not of a capital nature and there was no definition of receipts or accruals of a 'capital nature' in the Income Tax Act.

(ii) That, usually, the 'most important 'test' employed by the courts in deciding whether the proceeds arising upon the disposal of an asset are in the nature of income or capital is the test of 'intention': with what intention did the taxpayer acquire and hold the asset?' This would not be helpful in the instant matter as it was common cause that initially the taxpayer had held and acquired the asset as income.

(iii) That on 10 December 2010 *Interpretation Note No 59* was issued and dealt with the tax implications of, *inter alia*, the receipt or accrual of government grants and it also approved the definition of the term 'grant' as 'a sum of money given by a government or public body for a particular purpose' and this definition accords with the PAA and it was further common cause that the PAA was a grant.

(iv) That the court approved the approach of Zulman J in *ITC 1572* (1993) 56 SATC 175 at 186 in regard to the weight that should be given to an interpretation note and, in particular, that while departmental practice is not necessarily an indication of what the law means, it is a very sensible approach to what should be done in this type of case and plainly the procedure and the practice laid down by SARS is, if nothing else, commercial wisdom and good sense.

(iv) That *Interpretation Note No 59* stated that whether an amount received or accrued was of a capital or revenue nature depended on its character in the hands of the recipient and the nature of the grant received and the relationship which existed between the grant received and the recipient's activities needed to be examined.

(v) That it was the taxpayer's case that to determine whether the grant was revenue or capital, the predominant focus was on the purpose or cause of the grant and the taxpayer referred the court to three cases where the courts asked 'What was the origin of the claim?' and that the grant was to assist the taxpayer with the capital expenditure involved and therefore the grant was of a capital nature.

(vi) That in the instant matter the grant was made due to capital expenditure. However, if the PAA certificate was not utilised within a stipulated period as payment for customs duties on imported motor vehicles, the PAA certificate would lapse and the certificate was not tradable. The certificate was conditional and did not accrue until there were imports and if there were no imports within the necessary time frame, the condition had not been fulfilled and the certificate could not be used. The certificates only had value upon import of motor vehicles and not when the capital expenditure was incurred. The grant was to assist the taxpayer with the revenue expenditure, being customs duty payable on imports.

(vii) That the incentive with the PAA was to have fewer locally produced models and to invest in infrastructure, but that was not the sole motivation for the grant. It was also to see to it that with the importation of motor vehicles the range of products available to the consumers was sustained. The investment in infrastructure was a pre-requisite for the grant, but the PAA certificates could only be redeemed by payment of customs duties, that is, against revenue.

(ix) That it was clear that the certificate and grant could not be utilised to fill the capital 'hole' but only the revenue and income 'hole' and the diminished payment of customs duty was clearly related to the gross income of the taxpayer.

(x) That, accordingly, the PAA certificates were not of a capital nature but were to be included in the definition of gross income in terms of section 1 of the Income Tax Act 58 of 1962.

Appeal dismissed.

5.4. ITC 1894

The taxpayer company was part of the ABC Group, a world-wide organization that required its various operations throughout the world to operate on a similar basis and to apply similar standards.

As part of its global business imperative, employees of the ABC Group were required to work for short or medium term periods in foreign countries and these expatriate employees invariably remained residents in their own home countries and continued to submit tax returns there.

The standard employment relationship within the ABC Group operated on an agreed 'tax equalisation' basis which entailed the expatriate employee paying the exact same effective rate of tax in his or her host country as he or she would have paid had they remained in their home country.

The expatriate employee's employment package was determined with reference to the home country net pay and the taxpayer had agreed that it would take responsibility for the payment of the employee's tax in the host country, in this case, South Africa.

In order to protect the interests of the taxpayer and the ABC Group, the taxpayer made certain payments to identified tax consultancy firms for services rendered in respect of the taxpayer's expatriate employees.

The aforementioned employees had no choice in this regard as it was one of the conditions of their secondment.

SARS had addressed a PAYE Letter of Enquiry to the taxpayer in which it had queried the payments made by the taxpayer on behalf of its expatriate employees and in October 2010 SARS issued PAYE assessments for the respective years of assessment subjecting the payments made by the taxpayer to the consultancy firms on behalf of its foreign employees in respect of payments to tax consultants who performed various tax-related services in respect of the expatriate employees to fringe benefit tax in terms of par. (i) of the definition of 'gross income' read with par. (*e*) and (*h*) of the Seventh Schedule to the Income Tax Act.

SARS had estimated the employee's tax in respect of these payments to be R2 378 407,72.

The taxpayer objected to the aforementioned assessments and when SARS had disallowed the objection it lodged the present appeal to the Johannesburg Tax Court.

The issues in dispute before the court were:

- Do the payments made by the taxpayer to the tax consultants fall within the ambit of par. (i) of the definition of 'gross income' in section 1 of the Income Tax Act and, if so,
- Do they fall within the ambit of par. 2(*e*) or 2(*h*) of the Seventh Schedule to the Act?

The taxpayer submitted, in the first instance, that its expatriate employees received no benefit or advantage, within the meaning of the definition of 'gross income' in section 1 of the Act, through its payment of the tax consultants' fees and, accordingly, the assessment raised by SARS in this regard must fall at the first hurdle.

The taxpayer submitted further that there was no such benefit or advantage because the expatriate employees' salary and tax obligations remained the same as a result of the tax equalisation arrangement and hence their position was not improved as a result of the taxpayer's payments to the tax consultants.

The taxpayer submitted in the second instance, and in the event that the taxpayer's first submission was rejected, that the payment of the fees did not fall within the categories of taxable benefits identified in par. 2(*e*) or (*h*) of the Seventh Schedule to the Act.

SARS submitted that the correct question to ask was whether the tax consultancy fee paid by the taxpayer in respect of the expatriate employees was a benefit for which they otherwise would have had to pay had the agreement between the taxpayer and these employees not provided differently.

Judge Keightley held the following:

<u>As to whether the expatriate employees received any benefit or advantage from the taxpayer's payment of the tax consultancy fees</u>

(i) That the taxpayer had contended that in order to fit in with the definition of 'gross income' in section 1 of the Act, the expatriate employees must be placed in a better or more advantageous position than they otherwise would have been as a result of the taxpayer's payment of the tax consultancy fees on their behalf, but in the instant case there was no such benefit or advantage because the expatriate employees' salary and tax obligations remained the same as a result of the tax equalisation arrangement and hence their position was not improved as a result of the taxpayer's payments to the tax consultants.

(ii) That SARS' submission rightly was that the correct question to ask was whether the tax consultancy fee paid by the taxpayer in respect of the expatriate employees was a benefit for which they otherwise would have had to pay had the agreement between the taxpayer and these employees not provided differently and this approach was consistent with the dicta already cited.

(iii) That as a consequence of the contractual arrangement between the taxpayer and the expatriate employees, the latter became entitled to the services of a tax consultant free of charge but the same benefit was not bestowed on local employees. Whether the tax consultants' services actually resulted in a further benefit to the employees concerned, or to the taxpayer was irrelevant. The service itself, which was provided free of charge to the expatriate employees, was the benefit. It had a monetary value, and accordingly fell within the definition of 'gross income' for purposes of the first issue in dispute between the parties.

<u>As to whether the benefits were taxable under either par. 2(e) or 2(h) of the Seventh Schedule</u>

(iv) That, as regards par. 2(e), a benefit is taxable if it is in the form of any service rendered to the employee, at the expense of the employer and where the employee has used the service for his or her 'private or domestic

purposes.' The dispute in the present matter is whether the tax consultancy services were used for the expatriate employees' 'private or domestic purposes.'

(iv) That both parties were agreed that this issue must be determined on the basis of a factual inquiry regarding the nature of the service rendered rather than on the basis of the intention behind the rendering of the service. In addition, the parties are agreed that if the use to which the service is put is not wholly for the employees' private use but also for the use of the employer's business, then it fell outside of par. 2(e).

(v) That both of the taxpayer's witnesses conceded, quite correctly, that regardless of the contractual arrangement between the taxpayer and their expatriate employees, South Africa's tax regime gave rise to direct obligations between the employees and SARS in relation to the payment of PAYE. It was also clear from the evidence that local employees of the taxpayer who wished to employ the services of tax consultants to assist in complying with their tax obligations would have to do so in their private capacities, i.e. with no assistance from the taxpayer.

(vi) That as between SARS and the individual taxpayer, the general purpose of tax consultancy services was to facilitate the taxpayer's individual and hence private, income tax obligations and this is what defined the nature of the service.

(vii) That if one has regard to the actual nature of the services rendered, they were for the employees' private use, i.e. to comply with the individual tax obligations of the employees vis-à-vis SARS.

(ix) That it may be so that as between the taxpayer and its expatriate employees the intention of obtaining the services was also to assist the taxpayer to fulfil its contractual obligations to those employees. However, as stated already, this intention is not the determinative factor. The correct approach was to consider the nature of the service from the perspective of the tax relationship between the employees and SARS, and not from the perspective of the contractual relationship between the employees and the

taxpayer and this private, contractual relationship cannot re-define the nature of a service.

(x) That in C: SARS v Brummeria Renaissance (Pty) Ltd and Others 69 SATC 205 the Supreme Court of Appeal dealt with the question of how to determine whether accruals or receipts in a form other than money have a monetary value and hence ought to be included in the definition of 'gross income'. Applying the principle in the Brummeria judgment to the present case, the question of whether tax consultancy services are for private use must be determined objectively. They are manifestly for the private use of locals and, consequently, and objectively, they remain so in respect of expatriate employees as well.

(xi) That it is pointed out that the position of the individual taxpayers is not adversely affected nor is the contractual relationship ignored. The effect of the approach adopted by the court is simply that the taxpayer will be required in terms of its contractual obligations to its expatriate employees, to shoulder the additional tax burden associated with the tax consultant's fees. However, this remains a private matter between the taxpayer and its expatriate employees.

(xii) That, accordingly, SARS was correct in assessing the fees paid to the tax consultants as being taxable benefits in terms of par. 2(e) of the Seventh Schedule to the Act and, that being the case, it was not necessary to consider the correctness of the assessment in terms of par. 2(h) of the Seventh Schedule.

Appeal dismissed.

5.5. ITC 1895

The taxpayer was a qualified solicitor in England and Wales, currently in the employ of Y Attorneys, an incorporated firm of attorneys.

The taxpayer was not a qualified attorney in South Africa and thus not eligible for the position of an equity director which position was only open to persons who had

been admitted as attorneys in South Africa.

The taxpayer, although not eligible for the position of an equity director, enjoyed the same remuneration package as an equity director and, being in this position, was obliged to assist with the on-going working capital requirements of his employer through maintenance of a credit balance on his loan account for which his employer paid interest on the loan at prime.

The aforementioned loan account arose from the contract of employment concluded between the taxpayer and his employer and in terms whereof the taxpayer was obliged to contribute a predetermined amount to the director's loan account deductible from his gross remuneration. The amount required to be retained in the loan account would be deducted proportionately from the taxpayer's monthly remuneration until the predetermined amount was reached.

The source of funds contributed to the loan account thus derived from the taxpayer's accrued income. Occasionally, when there were sufficient funds available, the finance director would recommend occasional distributions, in the form of interest, to the holder of the loan account. Interest accrued on the balance of the director's loan account at the rate of prime, such interest constituting taxable income in the hands of the taxpayer.

In terms of the aforementioned agreement the taxpayer was not entitled to withdraw the outstanding balance of the director's loan at any point in time, unless he resigned.

The taxpayer, during 2005, had purchased a property secured by a mortgage bond from Z Bank.

The taxpayer had purchased the property for his own use and the nature of the home loan with Z Bank was ultimately converted to a so-called access bond which, in effect, was a facility to access available funds in the home loan account and, as a consequence of funds in the facility being accessible to the taxpayer, rendered the account being capable of fluctuating between a zero amount to the maximum amount for which the facility was granted.

The taxpayer, through this facility, could repay the portion of the capital borrowed

and simultaneously draw on the facility to fund any of his expenses.

The amount outstanding on the mortgage loan was, at all times, greater than the amount outstanding on the loan account and the balance outstanding in the home loan account attracted interest at prime less 1,85% *per annum*.

The taxpayer, in his income tax returns for the 2010, 2011 and 2012 years of assessment, had claimed as deductions amounts in respect of interest incurred on the mortgage loans on the basis that such interest was incurred in the production of interest income earned from his law firm.

SARS had disallowed the interest deductions claimed and the taxpayer noted an appeal to the Tax Court.

The issue to be determined by the court was whether or not the taxpayer was entitled to deduct from the interest income earned on the loan account a portion of the interest expended on the mortgage loan account for each of his 2010, 2011 and 2012 years of assessment.

The taxpayer contended that the interest incurred on his mortgage loan account was sufficiently close to the interest income earned on his loan account to justify a conclusion that the interest expenditure incurred on his mortgage loan account had been incurred in the production of interest income.

The taxpayer contended that this was so because each portion of interest income levied on the loan account and distributed to the taxpayer was applied to repay the mortgage loan.

The taxpayer finally contended that the retention by his employer of the amounts owing under the loan account had, as a direct consequence, the taxpayer being unable to repay an equivalent amount on the mortgage loan account resulting in him having to pay on the mortgage loan account a larger interest than he otherwise would have had to pay had the amount in credit on his loan account been available to him and this approach he contended was consistent with *Practice Note 31* which dealt with the practice of SARS of permitting the deduction of the interest incurred on monies borrowed in the production of interest income and limiting the interest expenditure to the amount of the interest income earned.

SARS had disallowed the taxpayer's objections on the basis that *Practice Note 31*, on which the taxpayer relied for the proposed deductions, required that the funds, on the basis of which interest was paid and the deductions are claimed, should be borrowed and be advanced to a third party from whom interest income earned is derived and that the interest on the basis of which the deduction is claimed must be expended in the production of interest income.

SARS contended that such expenditure was not incurred in the production of interest earned from the employer.

In the light of the provisions of *Practice Note 31*, the significant dispute was whether a portion of the interest paid on the mortgage loan account constituted an expense incurred in the production of interest income earned on the loan account with the taxpayer's employer.

Practice Note 31 provided that while it was evident that a person, not being a moneylender, earning interest on capital or surplus funds invested did not carry on a trade, and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it was nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it did not exceed such income.

Judge Yekiso held the following:

(i) That what the court needed to determine in this appeal was whether interest expended by the taxpayer on his home loan account constituted expenditure in the production of income, in the form of interest income, on the taxpayer's loan account with his employer.

(ii) That in considering whether the interest paid on the taxpayer's mortgage loan account constituted an expenditure in the production of interest income, it was necessary to deal with the provisions of section 11(*a*) of the Income Tax Act and, accordingly, a taxpayer will be permitted to deduct expenses from its gross income provided that such expenses are actually incurred in the production of income.

(iii) That there was, however, an exception in relation to the 'trade' aspect as

required by section 11(*a*) of the Income Tax Act as *Practice Note 31* dealt with the practice of SARS of permitting the deduction of the interest incurred on monies borrowed in the production of interest income and limiting the interest expenditure to the amount of the interest income earned.

(iv) That when the taxpayer acquired a mortgage bond to finance the purchase of his residence, he knew that the amount in credit on his loan account with his employer was structured in such a way that it never would have been available to him to reduce the balance outstanding on his mortgage loan account during his term of employment; that interest expenditure incurred on the mortgage loan account would be incurred independently of his loan account and interest income derived on his loan account; and, this being so, it could thus never be said that interest expenditure incurred on his mortgage loan account was incurred in the production of interest income on the taxpayer's loan account.

(iv) That interest earned on capital or surplus funds invested, as contemplated in par. 2 of *Practice Note 31* contemplates interest earned on capital or surplus funds which would have accrued to the investor but, once such capital or surplus funds are received, the investor, of his own volition, invests such capital or surplus funds on interest and, any interest incurred as a consequence of investment of such capital or surplus funds, is incurred in the production of interest income from the capital or surplus funds so invested.

(v) That in the instance of this matter, interest income earned by the taxpayer on his loan account was not interest income on capital or surplus funds invested, but simply interest income earned on his loan account on funds retained by the taxpayer's employer in terms of the contract of employment.

(vi) That expenditure, to qualify as an allowable deduction, should be incurred in the production of income, has been confirmed by several authorities and it has been held that in the determination of the question as to whether an expenditure has been incurred in the production of income, the test that has

to be applied involves a determination of whether the expenditure was so closely related to the trade that it can be said that it is part of the costs of running the business. (See *Port Elizabeth Electric Tramway Co Ltd* v *CIR* 8 SATC 13)

(vii) That taxpayer relied heavily on the authority of *CIR* v *Standard Bank of South Africa Ltd* 47 SATC 179 for his contentions but the facts of that case were clearly distinguishable from the facts of this case. The facts of the matter in the instant case fell within the first distinction referred to by Corbett JA, namely, an instance where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose.

(ix) That in the present matter the taxpayer had acquired a home loan from Z Bank for purposes of purchasing his residence. The proceeds of the loan were utilised for the payment of the purchase price. That was the taxpayer's intention in acquiring the loan from Z and there was no indication on the record of evidence of a change of intention, or, if his initial intention had changed at some point, at what point was there a change of intention. It therefore followed that whatever interest the taxpayer paid on the mortgage loan account, was interest incurred in the acquisition of a capital asset and, as such, the expenditure thus incurred was expenditure of a capital nature as it was not borrowed for the purpose of earning interest income, nor did it have the effect of earning interest income.

(x) That the taxpayer had failed to prove, as a matter of fact, that the purpose and the effect of the acquisition of a mortgage loan from Z Bank were for purposes of production of interest income. The interest incurred on the mortgage loan account with Z Bank was not sufficiently close to the interest income earned on the loan account to justify a conclusion that the interest so incurred was incurred in the production of interest income.

(xi) That, accordingly, the taxpayer had failed to discharge the *onus* on him as there was no sufficiently close connection between the interest paid to the mortgage loan account and the interest income received on his loan account in respect of the relevant years of assessment.

(xii) That, furthermore, the interest incurred in the access facility when the taxpayer had changed his bond account into an access facility, was not closely linked to the interest earned on the loan account with the taxpayer's employer.

Appeal dismissed.

5.6. ITC 1896

The taxpayer, being X (Pty) Ltd, and three other related companies, S (Pty) Ltd, A (Pty) Ltd and L Ltd, were all subsidiary companies of Z Limited ('Z') and Z was the holder of 100% of the ordinary shares in all of them and by agreement between the parties the outcome of this appeal would be decisive of the disputes in respect of these three subsidiary companies.

The taxpayer and the other three aforementioned subsidiaries of Z had, at all relevant times, operated redeemable preference share businesses.

The taxpayer had raised preferent share capital from investors who subscribed for redeemable preference shares issued by it and the taxpayer was then obliged to pay dividends to such investors in respect of the redeemable preference shares. The proceeds raised were utilised to invest in redeemable preference shares issued by corporate entities with acceptable credit standings, on the basis that such investment would yield greater dividends than the dividends paid to the preferent shareholders, thereby making a profit of the difference between the dividends earned and the dividends paid and given the nature of the business these preference share companies would, according to the taxpayer, at times find themselves either with surplus cash requiring to be invested in preference shares or with a shortfall of capital while it tried to find new investors to raise the necessary capital.

In about the year 2000, companies involved in the financial services industry commenced establishing investment offerings aimed at providing dividend returns to investors. These generally contained dividend cessions as a feature where dividends were ceded antecedently, after the date of the declaration of such

dividends, but prior to the last day for registration as shareholder (the 'LDR' or 'record date'), in order to qualify for the dividend.

During the period 2000 to 2005 a number of dividend income funds were considered and/or implemented, for example, Firstrand Limited Share Trust, Gryphon-Imperial Dividend Fund, Sanlam Dividend Income Fund, Nedbank Dividend Income Fund, Stanlib Dividend Income Fund and Prudential Dividend Income Fund.

Because Z, the taxpayer and Z's employee, G, were aware of the favourable treatment of the Stanlib fund and some of the other dividend income funds, the taxpayer and Z proceeded with plans for a similar structure, in terms of which Z would purchase rights to future dividends declared by listed companies from Sanlam and/or Old Mutual and on-cede same to the taxpayer before the last day of registration ('LDR' or 'record date').

The perception was that such dividends would be tax-exempt in terms of section 10(1)(*k*)(i) of the Income Tax Act and the dividend rights would therefore not constitute income subject to tax in the hands of a preference share company such as the taxpayer. Furthermore, that the dividends received by the taxpayer under such circumstances would confer a secondary tax on companies ('STC') credit that would offset the liability for STC arising when a preference share company declared dividends to its shareholders and the envisaged structure would obviously have tax advantages for the taxpayer.

Prior to the aforementioned, the taxpayer had lent its surplus funds to Z at zero interest and, pursuant to this structure, the taxpayer would therefore go from a zero interest (zero tax) return to an exempt (zero tax) dividend return, thereby assisting in creating reserves and liquidity to enable the taxpayer to declare and pay dividends on the preference shares that it had issued and the idea was to earn tax-exempt dividend income and pay non-tax deductible dividends to its preferent shareholders and in Z and the taxpayer's opinion, this structure would achieve valuable commercial purposes.

The underlying contracts to establish the envisaged structure were entered into in 2007 and Z entered into agreements with Sanlam and Old Mutual and a further

agreement with the taxpayer and the other Z subsidiaries referred to above.

The structure established under the aforementioned agreements entailed the taxpayer making an investment with Z by paying it the 'issue price' of a note, the effect of which was that the taxpayer paid a capital amount to Z for the note and Z undertook to repay an identical capital amount to the taxpayer by a specified date. The note entitled the taxpayer to a return on such investment transaction in the form of dividend rights antecedently ceded by Z to the taxpayer. Z was obliged to redeem the note and repay the issue price on certain specified dates. Z satisfied its obligations in respect of the 'dividend amount', as it was required to do, by acquiring from Sanlam and/or Old Mutual, and on ceding to the taxpayer, rights to future dividends declared by listed companies.

The taxpayer, in its tax returns, had included the dividend income received on the exercise of its dividend rights in its gross income as defined in section 1 of the Act in the years of assessment in which they were received, and had deducted the said amounts from its gross income by virtue of the dividend exemption provision in terms of section 10(1)(*k*)(i) of the Act.

The reserves as well as the cash flow arising from the accrual and subsequent receipt of such dividends were then utilised to pay dividends to the taxpayer's preference shareholders, in respect of which payment no income tax deduction was claimed by the taxpayer.

SARS had duly assessed the taxpayer on the above basis in the original assessments for 2008 and 2009 dated 13 August 2008 and 31 March 2010 respectively.

However, in subsequent additional assessments made by SARS on 2 December 2011 in respect of the taxpayer's income tax assessments for 2008 and 2009, the taxpayer's taxable income was adjusted by the inclusion of further amounts that corresponded with the aggregate annual total amount of so-called dividend rights, ceded by Z to the taxpayer in its 2008 and 2009 years of assessment, which were included in the taxpayer's gross income for those years.

Similar assessments were made on the three other related companies, S (Pty) Ltd, A (Pty) Ltd and L Ltd.

The taxpayer objected to the aforementioned additional assessments but the objections were disallowed and the taxpayer then appealed to the Tax Court against the additional assessments for the 2008 and 2009 years of assessment.

The basis for the additional assessments in respect of the 2008 and 2009 years of assessment were identified as including the following:

- The dividend rights and the income rights received by the taxpayer from Z constituted interest as defined in section 24J(1) of the Income Tax Act, and the amounts accruing to the taxpayer were included in the taxpayer's gross income and taxable by virtue of section 24J(3) of the Act.
- In the alternative SARS contended that the dividends fell to be included in gross income on the basis that they accrued to the taxpayer as a compensation for monies lent to Z and not by virtue of it being a dividend having an exempt character in terms of par. (*k*) of the definition of 'gross income'. SARS therefore contended that the amounts accrued to the taxpayer did not fall to be exempt from normal tax in terms of section 10(1)(*k*) of the Act.

SARS' case, in essence, was that the receipt by the taxpayer of the right to dividends prior to the LDR, in contrast to the accrual of the dividends themselves, constituted an 'amount' which was taxable, either as 'interest' under section 24J of the Act, or as 'gross income' under the definition of that term in section 1 of the Act.

SARS' approach was that the dividend rights were a separate and distinct accrual in the hands of the taxpayer, which occurred at an earlier point in time, and that this accrual was taxable on the basis that it was of a revenue nature and not subject to any exemption.

The issues to be determined by the Tax Court in this appeal were the following:

- Whether the value of the dividend rights, ceded by Z to the taxpayer, constituted 'gross income' in the hands of the taxpayer, as an amount of interest accruing to the taxpayer by virtue of the provisions of section 24J(3) of the Income Tax Act 58 of 1962;
- Whether, in the alternative, and in the event of a finding that section 24J of

the Act was not applicable, the value of the ceded dividend rights, in any event, constituted 'gross income' in the hands of the taxpayer.

It was not in dispute that:

- An amount can only accrue to a taxpayer once such taxpayer became unconditionally entitled to it;
- The dividends acquired by the taxpayer as cessionary became unconditional and accrued to the taxpayer on the LDR and were exempt in terms of section 10(1)(*k*)(i) of the Act.

Judge Van Staden held the following:

(i) That this matter concerned the interpretation of 'gross income', the words 'accrued to' or 'received by' referred to in the definition of 'gross income' and the provisions of section 24J of the Income Tax Act 58 of 1962, more specifically the concept of 'interest'.

(ii) That the decisive question in this appeal was whether the taxpayer's right to dividends, pursuant to the antecedent cession of the dividends, but prior to the LDR, as opposed to the dividends themselves, was conditional or not and whether it constituted an amount that accrued to the taxpayer, either as a deemed accrual in terms of section 24J(3), or in terms of the definition of 'gross income'.

(iii) That it was not in dispute that the taxpayer was not assessed on the basis of the general anti-avoidance provisions of the Income Tax Act (section 80A), but on the basis that an amount of interest had accrued to it under section 24J and whether or not the overall transactions were 'tax-driven' played no role in the assessment.

(iv) That legislation must be interpreted positively, properly contextualised and in a manner that best promotes the values of the Constitution. Where two or more interpretations of a statutory provision are possible, a court must adopt the interpretation which better promotes the spirit, purport and objects of the Bill of Rights and this is so even if neither interpretation would render the provision unconstitutional. It is trite that the process of

interpretation, including the interpretation of legislation, is a unitary exercise in which one objectively considers the words utilised in the context of the document as a whole and consideration must also be given to the purpose of the legislation, and the material known to the legislator at the time of promulgation and the presence of ambiguity warrants a resort to so-called secondary aids to construction.

(iv) That questions of interpretation are matters of law and courts do not receive opinion evidence as to the meaning of a statutory provision. On such questions the opinions of a witness, however eminent or highly qualified (except in regard to words which have a special or technical meaning) are inadmissible.

(v) That SARS had relied *inter alia* on *C: SARS* v *Brummeria Renaissance* (*Pty*) *Ltd and Others* 69 SATC 205 in support of his stance but the *Brummeria* case could be distinguished since the taxpayer in that matter provided accommodation rent-free, and as a *quid pro quo* had obtained the right to use money advanced by the occupiers of the rent-free accommodation, interest-free. The difference in that case was that the taxpayer's right to use the money interest-free was an unconditional right, whereas the contingent rights to dividends acquired by the taxpayer were conditional on it being the shareholder when the accrual date arrived, which was at a later stage.

(vi) That SARS agreed, as confirmed in *Mooi* v *SIR* 34 SATC 1, that for accrual to occur, the taxpayer's right to claim payment in respect thereof must be unconditional and he, however, contended that the receipt of the dividend rights by the taxpayer was unconditional. In respect of *Mooi*'s case, SARS' contention was that the court in that matter distinguished the situation where the right in question did not come into existence at all until a condition had been fulfilled and the situation where the right vests immediately and he contended that the matter under consideration fell into the latter category, since the dividend rights, as opposed to the dividends themselves, were unconditionally ceded to the taxpayer on an out-and-out basis by Z.

(vii) That the effect of *Mooi*'s case was that a contingent right, conditional upon the fulfilment of conditions, was not an 'amount' for purposes of the definition of gross income in the Act, despite the fact that such right had a money value at the time that it was acquired by a taxpayer and it becomes clear that the matter under consideration was on all fours with *Mooi*. It could certainly not be said that the contingent rights to dividends acquired by the taxpayer from Z by antecedent cession were rights which vested immediately, but related to a payment in future. The rights were contingent rights, and an unconditional right only came into existence once the condition was fulfilled.

(ix) That in the *Mooi* judgment it was furthermore found that it was necessary in a case such as the present to distinguish between the 'real and true benefit' for which the taxpayer contracted (to which tax consequences attach) and the contractual machinery set up to deliver that benefit (to which tax consequences do not attach). The cession of the contingent dividend rights in this matter can be regarded as a mechanism for the delivery of dividends and the setting up of a mechanism in terms of which a shareholder receives a dividend when it will in due course accrue, differs wholly from both the incurral and the accrual of interest in terms of section 24J of the Act.

(x) That what had occurred between Z and the taxpayer was merely the cession of contingent rights to future dividends which gave rise to neither taxable accruals nor amounts receivable when they were ceded. The taxpayer did not become 'unconditionally entitled' to the contingent dividend rights – it simply acquired them as cessionary by way of an antecedent cession, and they did not then give rise to any unconditional entitlement. That came later when the dividends accrued. Akin to what was held in *Mooi*'s case, this was simply the setting up of the machinery for the accrual of the dividends that would follow.

(xi) That SARS' inclusion of the alleged value of the so-called 'dividend rights' in the taxpayer's gross income represented, in the language of Ogilvie Thompson CJ in *Mooi* 'the artificial concept of valuing the taxpayer's contingent right as at its initial, inchoate, stage.'

(xii) That there was merit in the taxpayer's contention that the effect of the SARS assessment was that two accruals were included in 'gross income' when there were not two separate commercial accruals. This SARS approach was commercially insensible. There should be a focus on the true commercial benefit, which was the single accrual of a dividend and in this respect reference is made to *C: SARS* v *Capstone 556* (*Pty*) *Ltd* 78 SATC 231 where it was stated that 'the correct approach in a matter of this nature is not that of a narrow legalistic nature. What has to be considered is the commercial operation as such and the character of the expenditure arising therefrom. This is perhaps but another way of expressing the concept that it is the substance and reality of the original loan that is the decisive factor'.

(xiii) That in respect of cession it must be remembered that the consequences of cession were that the cessionary succeeds the cedent as creditor of the right and as such is the only one entitled to administer and enforce such right. Cession is a legal manner in which rights are transferred, or delivered, and where what is transferred is a contingent right, an out-and-out cession thereof is merely the manner in which the contingent right is transferred by the cedent to the cessionary, which receives no less and no more than what was ceded, in this case a contingent right.

(xiv) That the court did not agree with the SARS' contention that the uncertainty about the identity of the owner of the dividend right, prior to the LDR, did not render the right conditional. The fact of the matter was that the conditionality or contingency of the right must be determined in relation to the accrual of the right in question. Although the right, divorced from the holder of the right, may not be contingent, the accrual of the right depends on the identity of the holder and is conditional and/or contingent in that respect. The fact of the matter is that 'gross income' is defined as an amount received by or accrued to a resident of the Republic of South Africa, a specific person or entity and it has been pointed out that a right accrues when all the conditions for its existence in relation to the particular beneficiary are met and in this instance the particular beneficiary in respect of a dividend right registered as the shareholder at the time of the LDR.

(xv) That the contingency of the dividend rights, as was the case with the dividends themselves, arose pursuant to the following circumstances: Since the LDR had not yet arrived, the payment of a dividend was conditional on the identity of the shareholder entitled to the dividend being established on the LDR and section 90(2) of the previous Companies Act 61 of 1973 in force at that relevant time, in terms of which the payment of dividends was prohibited if a company was unable to pay its debts or its liabilities would be more than its assets after the payment, embodied a statutory condition that had to be fulfilled before a company could lawfully pay a dividend.

(xvi) That the dividend rights, as separate and discrete from the dividend itself, could not have the same value as the dividend, because it was known that the dividend right would disappear as soon as the dividend accrues and applying the face value of the dividend to the moribund dividend right in the taxpayer's hands was uncommercial and incorrect.

(xvii) That the contingent dividend rights obviously had a value in the hands of Sanlam or Old Mutual, but when that contingent right arrived in the hands of the taxpayer, it had no value apart from the value of the dividend that would follow. It was absurd to accord the same value to both. The true position was that the conditional dividend rights lost whatever value they may have had before the end of the relevant year of assessment. It was only at the end of the year of assessment that it was possible, and imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other.

(xviii) That, viewed from the correct vantage point, namely the end of the year of assessment, it was clear that the conditional dividend rights had been replaced by the unconditional dividend rights and indeed the cash dividends themselves. So viewed, the value of the conditional dividend rights was nil. From the vantage point of the end of the tax year, the contingent rights to the dividend therefore had no value whatsoever.

(xix) That the mere fact that a conditional right to any payment has value does not necessarily give rise to an entitlement constituting either an 'accrual' (as

contemplated in the definition of 'gross income') or an 'amount receivable' (as contemplated in section 24J of the Act). An 'accrual' only occurs, and an amount only becomes 'receivable', if and when the contingency disappears, or the condition is fulfilled, and the taxpayer thereby acquires an unconditional right to payment.

(xx) That to the extent that there was ambiguity or uncertainty about the correct interpretation of 'gross income' or section 24J, the principles of interpretation referred to above supported the taxpayer's contentions. An interpretation and application of the Income Tax Act that recognises two separate accruals of gross income where only one commercial accrual exists is plainly insensible and unbusinesslike and gives rise to absurd consequences. The effect of the assessment was to include two accruals in gross income when there were not two separate commercial accruals. This artificial and commercially insensible approach is avoided by simply focusing, as the authorities require, on the true commercial benefit, which is the single accrual of a dividend.

(xxi) That as far as the dispute about double taxation was concerned, what was relevant was whether it was permissible to include what amounts to the same amount in 'gross income' twice and that the prohibition against double taxation does not operate only if the double inclusion in 'gross income' would result in double taxation. It operated *ab initio*, at the level of 'gross income', which is the starting point of the tax computation. An agreement to avoid or prevent double taxation need not be confined to therapeutic measures but may include prophylactic measures as well. The *Brummeria* case, *supra*, relied upon by SARS, was distinguishable because two separate accruals arose in that matter, the right to use money interest-free on the one hand, and interest on the money obtained interest-free on the other hand. In the matter under consideration the accrual of the dividends replaced and eclipsed the contingent right to dividends, so that there was only one accrual.

(xxii) That, therefore, the concept of unconditionality formed part and parcel of the very fabric of the Act and that entitlement to a contingent right did not

give rise to an accrual as envisaged in the definition of gross income. The question arises how one can be 'entitled' to a contingent right. It is only when such a contingent right is ever sold that gross income can arise in the form of an amount received. In this instance the contingent right, acquired by the taxpayer when the antecedent cession took place, could not have given rise to 'gross income' – because nothing had yet accrued. The right was still contingent. SARS suggestion that the taxpayer acquired an unconditional right to dividends, the subject matter of which was a conditional right to the payment of a dividend and that the right to dividends had a value equal to the dividends, was not persuasive.

(xxiii) That in respect of section 24J of the Act, the SARS purported to include the contingent dividend rights in the gross income of the taxpayer as amounts receivable constituting interest in terms of section 24J, alternatively as an accrual in terms of the definition of 'gross income'. It however bears noting that section 24J(3) gives rise to an inclusion in 'gross income'. It stands to reason that only an amount unconditionally receivable can trigger an inclusion in gross income in terms of section 24J(3) on the basis that it embodies an amount receivable. The contingent right received by the taxpayer could therefore not constitute an amount receivable for the purposes of section 24J of the Act. It was not, at that stage, an amount receivable because there was no unconditional entitlement to any amount.

(xxiv) That the above conclusion in respect of the contingency of the so-called dividend rights is therefore the final answer to the disputes between the parties, because reliance on section 24J cannot trump the finding that the dividend rights were conditional and could not trigger inclusion in gross income.

(xxv) That SARS' grounds of assessment in this appeal were unreasonable if the background facts referred to above are taken into consideration. This is especially so because it ran counter to the manner in which dividend cession transactions had been routinely assessed over a long period of time. The very issues which SARS raise in this appeal as the basis for the assessment had been expressly considered by SARS' office on numerous

occasions and had not given rise to any different tax treatment. The fact that SARS and the National Treasury have taken steps to have the Act amended is also a relevant consideration and, in the exercise of the court's discretion in this respect, SARS should pay the taxpayer's costs of appeal and an order including the costs of two counsel is justified.

Appeal upheld and the additional assessments for the 2008 and 2009 years of assessment were set aside and the taxpayer's original assessments for those years of assessment were reinstated.

5.7. ITC 1897

The taxpayer was a close corporation and registered for value-added tax (VAT) and carried on business in the courier industry.

SARS had made certain findings pursuant to an audit of the taxpayer's tax affairs during July 2011 to August 2011 assessed tax periods.

During the course of the audit it was found that the taxpayer had claimed input tax in respect of the acquisition of a 2007 Mercedes Benz 115 CDI Crew Cab vehicle ('the vehicle') and the claim had been made on the basis that the vehicle had been acquired for the purposes of making taxable supplies.

SARS had disallowed the claim on the basis that the vehicle was regarded as a 'motor car' as defined in section 1 of the VAT Act and accordingly a deduction of input tax was not permitted with respect to the acquisition of a motor car, in terms of section 17(2)(*c*) of the VAT Act, subject to certain limitations not relevant to this matter.

The taxpayer had objected to the assessment on the basis that the input VAT was claimed on a qualifying vehicle, which was not a passenger vehicle and according to it the vehicle had been used solely in the courier business to deliver many different kinds of packages and that no passengers were ever transported.

The taxpayer requested SARS to reconsider the input VAT claim but he had disallowed the objection against the assessments.

The taxpayer then took the matter on appeal to the Tax Board where the issue was decided against the taxpayer and the matter was consequently referred to the Tax Court in terms of section 115 of the TA Act for a hearing *de novo*.

The issue before the Tax Court turned on whether the taxpayer's vehicle was a motor car as defined in the VAT Act.

It was not in dispute that the taxpayer's vehicle was not a station wagon, mini bus or a double cab light delivery vehicle and that it was of a kind normally used on public roads, which had three or more wheels.

The only issue remaining was whether the vehicle was constructed or converted wholly or mainly for the carriage of passengers.

The definition of 'motor car' in section 1 of the VAT Act provides, *inter alia*, that a 'motor car' includes a 'motor vehicle of the kind normally used on public roads, which has three or more wheels and is constructed or converted wholly or mainly for the carriage of passengers.'

The taxpayer contended that the vehicle was not a passenger vehicle as it was purchased and used solely in the courier business to deliver different packages and it alleged that the characteristics of the vehicle showed that it was constructed mainly for the transportation of goods and the issue of whether the taxpayer used the vehicle to carry goods was not in dispute.

The taxpayer contended further that the floor area of the vehicle should not be the test to determine whether it was mainly used to carry passengers, but rather the load capacity of the vehicle which in this instance was weighted towards the carriage of goods. The vehicle's second row of seats was used to load goods for carriage.

SARS contended that the characteristics of the vehicle in question showed that it was constructed mainly for the carriage of passengers, as there were two rows of seating for passengers, with access to the second row available through a dedicated, windowed, sliding door on each side and this proved that the conveyance of passengers was the intention for the second row of seats, rather than the transport of labour purely for the purpose of attending to cargo and it was

indisputable that the passenger area was larger than the cargo area.

Judge Boqwana held the following:

(i) That the effect of section 17(2)(*c*) of VAT Act, as found in *ITC 1596* 57 SATC 341 at 346, was that, in general, no input tax was deductible in respect of the VAT incurred by vendors on the acquisition of a 'motor car' and this provision disallowing input tax was only in respect of motor cars as defined in the VAT Act.

(ii) That it was not in dispute that the taxpayer's vehicle was not a station wagon, mini bus or a double cab light delivery vehicle and that it was of the kind normally used on public roads, which had three or more wheels. The only issue remaining is whether it was constructed or converted wholly or mainly for the carriage of passengers.

(iii) That the word 'mainly' was not defined in the Value-Added Tax Act and the court held in *ITC 1596*, *supra*, at 346, that in the normal use of the word a quantitative measure of more than 50% was intended. The test to be applied was an objective test and it was therefore irrelevant for what purpose the vehicle was acquired or for what purpose it was to be used. It further held that in order to determine whether the vehicle was intended mainly to be more than 50% for the carriage of passengers, the following factors must be taken into account: the total construction, assembly, appearance, space or surface of the vehicle.

(iv) That the aforementioned test was approved in the subsequent case *ITC 1693* 62 SATC 518 where it was held that the objective facts showed that the vehicle in question which was a Nissan Double Cab had indeed been constructed and designed for the carriage of passengers and that was the decisive objective test.

(iv) That the issue of whether the taxpayer used the vehicle to carry goods was not in dispute and the purpose for which the vehicle was purchased was irrelevant as was its use.

(v) That the *onus* was on the taxpayer to show that the vehicle was not wholly

or mainly constructed for the carriage of passengers but the taxpayer in this case has not discharged this *onus*.

(vi) That the usefulness presented by the design of the seats and the styling thereof as well as the alleged discomfort that passengers who use the seats might experience than in an ordinary motor car are all inconsequential. Those factors do not detract from the fact that the vehicle was constructed mainly for carriage of passengers for the purposes of the definition of a motor car in the Value-Added Tax Act, if one applies the objective test suggested in the cases referred to above read with SARS *Interpretation Note No 82*.

(vii) That SARS *Interpretation Note No 82* expanded on the objective test to be used and stated that the objective test required a one dimensional measurement of the length of the area designed for the carriage of passengers in relation to the dedicated loading space in a vehicle and in applying the objective test, one must determine which area measures more in length; the passenger area or the dedicated loading space.

(ix) That in applying the objective test the court considered the diagrams and dimensions of the vehicle as well as photographs of the vehicle and these diagrams were important because they provided a picture of how a Mercedes Benz Vito 115 CDI Crew Cab was constructed. These diagrams illustrated that the length of the vehicle's passenger space constituted 65% of the vehicle length excluding the engine area and, therefore, if one has regard to SARS *Interpretation Note No 82*, the one dimensional passenger space is greater than the load space and the vehicle should be regarded as a 'motor car'.

(x) That, as to costs, the court was not convinced by the contention that the taxpayer was unreasonable in bringing this matter on appeal. Whilst the legal position of what constitutes a motor car seems to be settled, it was not clear to the court whether the taxpayer had clearly understood the law and carried on regardless. The taxpayer may have misconstrued and misinterpreted the law and laboured under the misapprehension that if it

purchased and used the vehicle to load cargo it could deduct input tax, which was not the case but the court was not persuaded that the taxpayer's conduct was unreasonable.

Appeal dismissed with no order as to costs.

5.8. New Adventure 122 (Pty) Ltd v C:SARS

New Adventure had purchased a property at a price of R185 000 in 1999 and, subsequently, on 20 September 2006, a date which fell within New Adventure's 2007 tax year of assessment, it concluded a written deed of sale in terms of which it had sold the property to Kalipso at an agreed price of R17 720 000.

The deed of sale required Kalipso to pay the purchase price by way of a deposit of R1 200 000 with a further sum of R1 million to be paid on the date of registration of transfer and it provided for Kalipso to register a bond over the property on transfer in order to secure payment of the balance of R15 520 000 and this was to be paid by way of three equal annual instalments of R500 000 commencing on 31 October 2007, with a final payment of R14 020 000 to be made on 31 October 2010.

Pursuant to the aforementioned agreement the property was duly transferred to Kalipso and the envisaged bond was registered over it.

New Adventure, in the light of the events described, in respect of the 2007 tax year had declared a taxable gain of R9 746 875 as envisaged in the Eighth Schedule to the Income Tax Act derived from the agreed sale price.

SARS in an assessment issued on 1 August 2008 had accepted the above as being correct and had assessed New Adventure as being liable to pay tax of R1 587 277,54 for the 2007 tax year and, of this, R1 413 006,73 related to 'normal tax' – being the amount levied on the capital gain less R1 000 in respect of a loss – with the balance, an amount of R174 270,81, being interest imposed under section 89*quat* of the Act.

New Adventure had accepted that these amounts were correctly calculated and, importantly, it had raised no objection to the assessment which therefore became

final and conclusive under section 81(5) of the Income Tax Act.

Kalipso had purchased the aforementioned property for purposes of effecting a residential development and for various reasons, including a failure to have the property rezoned, these plans went awry and, more importantly for present purposes, it did not honour its obligations in regard to payment. Despite an extension having been granted, by November 2011 Kalipso had paid New Adventure only R4 549 082 rather than the full purchase price of R17 720 000.

The aforementioned breach led to New Adventure negotiating a written agreement with Kalipso on 18 November 2011, in terms of which the sale was cancelled, with Kalipso undertaking to restore registered title of the property to New Adventure and further provision was made for New Adventure to retain the payments Kalipso had made as agreed damages and for no further amount due to the cancellation.

New Adventure, as a result of this saga, had in fact received only R4 549 082 from the sale and not the R17 720 000 Kalipso had agreed to pay.

New Adventure's problem was that it had been taxed on a capital gain that it had not received and that all it could obtain as a result of the cancellation of the sale was an assessed capital loss, with no corresponding gain to set off against the loss.

New Adventure in these circumstances had in fact received much less than the agreed price at which it had sold the property and therefore attempted to persuade the SARS to withdraw its tax assessment for the 2007 tax year and to reduce its tax liability for that year.

New Adventure, by way of what purported to be an objection to the 2007 assessment, essentially applied to SARS to withdraw that assessment under section 98(1)(*d*) of the Tax Administration Act – which at the time provided for an assessment being withdrawn should SARS be satisfied, *inter alia*, that it had imposed 'an unintended tax debt in respect of an amount that the taxpayer should not have been taxed on' or that the recovery of the debt under the assessment 'would produce an anomalous or inequitable result.'

SARS was not prepared to withdraw the assessment as he took the view that the

2007 assessment had to be regarded as final and could not be re-opened.

New Adventure then took various further steps to obtain relief including approaching the Legal Delivery Unit of SARS and the Tax Ombud and both sides placed considerable reliance upon the Tax Administration Act but they subsequently accepted that the relevant events in this case occurred before that Act came into effect on 1 October 2012 and that its provisions did not apply to their current dispute.

New Adventure, after negotiations had come to nought, gave notice under section 11(4) of the Tax Administration Act of its intention to institute proceedings in the High Court and in due course it instituted review proceedings in the Western Cape Division of the High Court (see *New Adventure Shelf 122 (Pty) Ltd* v *C:SARS* 78 SATC 190) where its application seeking an order setting aside the assessment for the 2007 tax year and certain ancillary relief was dismissed and New Adventure then appealed to the Supreme Court of Appeal with the leave of the court *a quo*.

The issue in this appeal related to the consequences in regard to capital gains tax where the sale of an asset is cancelled before the seller has been paid in full, with the unpaid balance of the proceeds of the sale being forfeited and the asset being returned to the seller.

SARS argued on appeal that under section 81(1) of the Income Tax Act, as more than three years had elapsed from the date of the 2007 assessment of New Adventure 's tax, such assessment was final and conclusive and could not be revisited.

New Adventure contended that on the facts described above its 2007 tax assessment ought to have been re-opened, revised and reduced.

New Adventure contended, however, that section 81(1) was not applicable in that it did not apply in respect of the tax levied on the capital gain and this argument was founded in the main upon the provisions of par. 35 of the Eighth Schedule to the Income Tax Act.

New Adventure had relied on par. 35(3)(*c*) of the Eighth Schedule which provided as follows:

'The proceeds from the disposal of an asset by a person, as contemplated in subparagraph (1) must be reduced by –

(*c*) any reduction, as the result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event, of an accrued amount forming part of the proceeds of that disposal.'

Judge Leach held the following:

(i) That the parties were agreed that although New Adventure had bought the property for R185 000 in 1999 (it was therefore a pre-valuation date asset), its base cost for purposes of determining its taxable capital gain when sold to Kalipso in the 2007 tax year was a sum in excess of R7 million and although certain of the instalments due in respect of the purchase price were to be paid after the conclusion of the 2007 tax year, by reason of par. 35(4) of the Eighth Schedule, these fell to be 'treated as having accrued to [the New Adventure] during that year' and this led to the calculation of the New Adventure's capital gains tax liability for the 2007 year.

(ii) That in the light of New Adventure's failure to object to its 2007 assessment for more than three years, the initial obstacle that New Adventure had to overcome was to be found in section 81 of the Income Tax Act which provided that a taxpayer aggrieved by an assessment may object 'in the manner and under the terms and within the period prescribed by this Act.' Section 81(2)(*b*) goes on to provide that the prescribed period for objections may not be extended 'where more than three years have lapsed from the date of the assessment' whilst, as already mentioned, section 81(5) provides that should no objections be made to an assessment, it 'shall be final and conclusive.' Consequently, the now disputed assessment seemingly had become final and conclusive under section 81, and if that is so it is fatal to the relief New Adventure had sought and this was SARS' simple answer to New Adventure's claims.

(iii) That New Adventure's argument was however that the above approach of

New Adventure did not apply in respect of tax levied on a capital gain and this argument was founded in the main upon par. 35 of the Eighth Schedule and in the light of the provisions therein New Adventure argued that the capital gain received or accrued was to be calculated in terms of par. 35(1) of the Eighth Schedule and that paragraph included sub-par. 35(3) which stated that the gain was to be reduced by certain amounts and one of these was that contained in par. 35(3)(*c*), namely, any reduction in those proceeds as the result of the cancellation, termination or variation of an agreement and that is what occurred here and New Adventure argued that it was the original assessment that must be re-opened and revised in the light of the redetermination of the base cost and the amount of the capital gain, the mechanism of which lay in par. 25 of the Eighth Schedule.

(iv) That there were a number of difficulties confronting New Adventure 's argument: bearing in mind the provisions of the basic scheme under which capital gains tax was levied, the assessment of capital gains tax was an annual event in the sense that, if any occurrences during a tax year rendered the provisions of the Eighth Schedule applicable to an accrual of a taxable capital gain, the amount thereof was to be included in the taxpayer's taxable income for that year and this was in line with the general principle that income tax is an annual fiscal event.

(iv) That, consequently, the fact that in a particular year there may not be any events which lead to the accrual of a taxable capital gain is no reason to find that when they do occur, and when a taxable capital gain is included in a taxpayer's taxable income, provisions relating to an assessment of tax liability such as those in section 81 of the Act should not apply.

(v) That New Adventure's argument required par. 35 of the Eighth Schedule to be construed as applying not only to the determination of capital gains in a particular year, but also to require a redetermination in a later year of a capital gain already accrued. But that was inconsistent with the overall scheme of par. 35(3) as the sub-par. related to the determination of the proceeds of a disposal 'during a year of assessment'. It provided that the proceeds in that year, and that year alone, were to be reduced by three

items.

(vi) That the first item was any amount of the proceeds of the disposal of the asset that have already been taken into account in the taxpayer's gross income and that could only apply during the year in which the disposal occurred. It was directed at the situation where the accrual constituted gross income as would be the case with a disposal by a person who deals in shares or the disposal by a property developer of all or part of the development. As that was the income-earning activity of those taxpayers the proceeds from such disposals constituted gross income. They must accordingly be excluded from the calculation of capital gains.

(vii) That the second item dealt with the situation where the taxpayer had to repay part of the price, or other proceeds of disposal, to the party to whom the disposal was made. This dealt with a number of commonplace situations, such as the redetermination of the purchase price of a business in the light of a post-sale determination of the value of stock on hand or book debts. Another would be a refund of portion of the price to address a complaint that the goods sold were defective. A third would be the need to meet warranty claims. Again, these are events that will ordinarily come to light in the year in which the disposal occurs.

(ix) That the third item, a reduction of the proceeds of the disposal caused by a cancellation or variation of an agreement, was also likely to occur in the same year as the disposal. Thus all three situations envisaged by the subparagraph are directed at ensuring that where a disposal occurs in a particular tax year, events during that year that operate to diminish the proceeds received by the taxpayer in that year are taken into account to reduce those proceeds and hence the capital gain arising from the disposal. That is the ordinary and natural construction to be given to par. 35 and the court agreed with the argument by SARS that the amendments effected in 2015 with effect from 2016, which clearly spell that out to be the case, are confirmatory of that construction.

(x) That, moreover, the provisions of par. 3, 4 and 25 of the Eighth Schedule

did not support New Adventure 's argument. As set out in par. 25(2), the base cost of a pre-valuation date asset which was disposed of during any prior year of assessment, as well as the capital gain or capital loss from the disposal of that asset, is to be redetermined 'in the current year of assessment' should certain events occur. Par. 25(3) further provides that if such events take place, the amount of the redetermined capital gain or capital loss 'in the current year of assessment . . . must be taken into account in determining any capital gain or capital loss from that disposal in that current year, as contemplated in par. 3(*b*)(iii) or 4(*b*)(iii).' As appeared from this, should there be a redetermination of a capital gain or a capital loss that occurred in a prior year of assessment, that redetermination was to be taken into account in the determination of a capital gain or a capital loss, not in the prior year but in the current year i.e. in the tax year in which the events giving rise to the redetermination take place.

(xi) That the aforementioned conclusion is reinforced by the provisions of par. 3 and 4 to which par. 25(3) referred. As clearly appeared from their terms, the provisions of paras 3(*b*) and 4(*b*) were of application only in a current year of assessment. They established convincingly that should any events occur which required the redetermination of a capital gain or a capital loss which accrued in a previous year, such redetermined capital gain or capital loss was to be taken into account in determining the taxpayer's capital gain or capital loss in the current year in which those events occurred. That being so, the argument that par. 35(3) entitled the taxpayer to have a confirmed tax assessment of a previous year re-opened as a result of a cancellation, termination or variation of an agreement which reduces an accrued amount forming part of the proceeds of an earlier disposal of an asset, was wholly inconsistent with the provisions of the Eighth Schedule and was, quite simply, unsustainable.

(xii) That the court *a quo* dealt extensively with the manner in which the cancellation agreement was to be taken into account in respect of the 2010 tax year for purposes of the assessment of capital gains tax. In doing so it endorsed a calculation of New Adventure's capital gains tax liability for that

year handed up in argument by SARS to the effect that as a result of the cancellation a capital loss of some R7,7 million had accrued to New Adventure . It is unnecessary for purposes of this judgment either to do the arithmetic, or to express any opinion either on how it should be performed or the resultant outcome. Suffice it to say that if there is indeed an accrued capital loss arising from the cancellation which New Adventure can use to set off against any future aggregate capital gain, this to a large extent militates against New Adventure's argument that reducing its tax liability for the 2007 tax year is the only way in which it could be fairly treated. An assessed capital loss is a valuable asset in the hands of a taxpayer. Whether it is ever used to off-set a future capital gain is a matter entirely within the control of the taxpayer.

(xiii) That, in any event, even if in certain instances it may seem 'unfair' for a taxpayer to pay a tax which is payable under a statutory obligation to do so, there is nothing unjust about it. Payment of tax is what the law prescribes, and tax laws are not always regarded as 'fair'. The tax statute must be applied even if in certain circumstances a taxpayer may feel aggrieved at the outcome.

(xiv) That, in summary, the cancellation of the sale did not entitle New Adventure to have his tax liability for the 2007 year re-assessed. The cancellation and its consequences were factors relevant to an assessment of any capital gain or, more likely, capital loss that accrued during that current tax year and not the year that the capital gain had initially accrued. Consequently, the court *a quo* correctly concluded that New Adventure was not entitled to the relief that it sought and the appeal must therefore fail.

Appeal dismissed with costs, such costs to include the costs of two counsel.

5.9. ITC 1898

The taxpayer, being a family trust, had acquired shares and share options in D Ltd which, on 30 November 2009 had amounted to 16 152 142 shares and, in addition,

the trust held 12 100 000 D share options.

The trust did not have the funds to pay for the D shares and D options which it had acquired from M and consequently the parties agreed that M would make a loan to the trust in the amount of R19 450 994 being the total consideration for the shares and share options and the transaction was subsequently recorded in writing in a Loan Agreement.

The amount of R19 450 994 was apportioned as follows: R10 965 156 in respect of the D shares and R8 485 838 in respect of the D options.

The trust, on 10 August 2010, disposed of all of its shares in D Ltd on the open market in terms of a sale agreement at 0,12 Australian Dollars ('A$') *per* share and the prevailing exchange rate on that day was R6,60 *per* A$ and the total number of shares sold by the trust was 17 361 142.

The proceeds derived from the aforementioned sale were paid in full by the purchasers concerned and had been received by the trust's stockbrokers on its behalf.

The total proceeds from the sale of the shares in D Ltd had been transferred into an account held at the Dutch Bank International in the Netherlands ('the Dutch Bank Account') and the trust's portion thereof was A$2 042 605 and, in applying the R6,60 exchange rate, the South African Rand value was R13 481 190.

However, on the evidence, the amount of A$2 042 605 had been transferred out of the Dutch Bank Account allegedly, fraudulently, without the consent of the relevant signatories to that Account and on 7 December 2010 the funds held on the trust's behalf were transferred to a certain entity located in the United Arab Emirates (UAE) against the trust's wishes in what appeared to be a misappropriation of the funds.

SARS had obtained documentary evidence which was placed before the court indicating that on the basis of a false signature the Dutch bank did transfer the funds in issue to the account of an entity based in the UAE.

The issue to be determined by the court was whether the alleged fraud and embezzlement that caused the funds in issue to be removed from the control and

beneficial use of the taxpayer was an event that was covered by par. 35(3)(*c*) of the Eighth Schedule to the Income Tax Act with the result that the proceeds derived from the sale of the taxpayer's shares in D Ltd should be reduced by the amount allegedly embezzled and, in particular, the court had to consider the meaning and ambit of the words 'or any other event' as it was common cause that there was no cancellation, termination or variation of the sale agreement nor was there prescription or the waiver of a claim or a release of an obligation.

Par. 35(3)(*c*) of the Eighth Schedule to the Income Tax Act provides, *inter alia*, that the proceeds from the disposal, during a year of assessment, of an asset by a person as contemplated in subparagraph (1) must be reduced by '(*c*) any reduction, as the result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event during that year, of an accrued amount forming part of the proceeds of that disposal.'

A further question that the court had to decide was whether the cost of 12 100 000 share options that were converted into 1 210 000 shares were to be included in the base cost of the D Ltd shares or alternatively be allowed as a capital loss.

The taxpayer now sought to include the cost of the 12 100 000 share options in the total capital loss that it had sustained.

The court dealt further with the applicability of an Understatement Penalty in terms of sections 221–3 of the Tax Administration Act and whether a costs order against the taxpayer in the Tax Court was justified in terms of section 130 of the Tax Administration Act.

Judge Allie held the following:

<u>As to the applicability of par. 35(3)(c) of the Eighth Schedule to Act 58 of 1962</u>

(i) That the crucial question in this case was whether par. 35(3)(c) of the Eighth Schedule to the Income Tax Act applied to the removal of the funds from the control of the taxpayer. The court did not need to decide whether the embezzlement did in fact occur nor was it obliged to decide whether the settlement agreement applied to the alleged embezzlement.

(ii) That, unlike par. 35(1) of the Act, which refers specifically to money 'received or accrued to', a plain reading of par. 35(3) reveals that it applies to money that accrued to the taxpayer and, accordingly, it must be inferred that the legislature intended to exclude from the ambit of par. 35(3) money that was 'received' and not accrued.

(iii) That the agreement in terms of which the taxpayer had disposed of the shares it held in D Ltd on 10 August 2010 was a sales agreement and the shares were disposed of on the stock exchange and their price was paid in full and had been received on behalf of the taxpayer by its stockbrokers.

(iv) That, in casu, it was therefore common cause that taxpayer had received payment and had arranged for it to be held by N Trading temporarily but the funds had accordingly gone beyond mere accrual and, accordingly, par. 35(3)(c) could not apply to the transaction.

(iv) That, in the course of giving meaning to words, a purposive approach is the favoured method used in the interpretation of documents, including legislation. In the context of this case, more specifically, to give the correct meaning to the words used in par. 35(3)(c) of the Act: 'or any other event during that year.'

(v) That in ITC 1880 (2014) 78 SATC 103 a narrow interpretation was given to the words 'or any other event' by the court finding that the words were meant to denote similar categories as those expressed by the preceding words in the paragraph.

(vi) That the taxpayer had sought to distinguish the current case from ITC 1880, supra, on the basis that ITC 1880 had involved an unrelated damages claim against the taxpayer. In casu, the taxpayer was also seeking to deduct a loss sustained by the alleged misconduct of a person completely unrelated to the agreements to sell the shares and the court was not convinced that the facts caused the two cases to be distinguishable from one another.

(vii) That it was not for a court to identify possible scenarios where the words would find application. Having regard to the context in which the words were used and their clear purpose, it was sufficient to establish that the

words 'or any other event' applied to situations where the purchaser of an asset was partially or wholly released from the obligation to pay for the asset disposed of and, ultimately, the words were not intended to apply to an embezzlement of the nature alleged in this case, for the reasons stated herein.

(ix) That the set-off or deduction contemplated in par. 35(3)(c) was one which flowed as a consequence of extinguishing the taxpayer's right to receive payment and the payee's obligation to pay and the relevant nexus is to the event that causes such extinguishing and not to a subsequent unrelated event caused by a person who held no obligation to pay for the asset disposed of and who acted outside the agreement to dispose of the asset.

(x) That the nexus referred to cannot be a broad and vague one between the accrual and the deduction's event, irrespective of how remotely it was connected to the failure to actually retain or receive the funds. Moreover, if the legislature had intended a deduction to be available for any unrelated reason, that would have had the consequence of a reduced payment, it would have expressed itself in words conveying that meaning.

(xi) That the purpose of par. 35(3) was to provide relief in the form of a deduction from the proceeds of a disposal of an asset in certain circumscribed instances where the proceeds had as yet not been paid but had already accrued to the taxpayer and where provision for payment of the funds are varied, extinguished, waived or cancelled.

(xii) That the alleged fraud and embezzlement that caused the funds to be removed from the control and beneficial use of the taxpayer was an event that was not covered by par. 35(3)(c) of the Eighth Schedule as the funds were already received by the taxpayer and did not accrue to it and accordingly did not fall within the protection provided by par. 35(3) and, further, the alleged embezzlement was committed by a party that was unrelated to the transaction for the disposal of the shares.

(xiii) That, accordingly, the taxpayer could not claim the amount of the alleged embezzlement as a deduction in terms of par. 35(3)(c) of the Eighth

Schedule.

As to whether the cost of the share options should be included in the base cost of the shares disposed of

(xiv) That the taxpayer sought to include the cost of the 12 100 000 share options converted to 1 210 000 shares in the total capital loss that it had sustained.

(xv) That as the documentary evidence provided by both the taxpayer and SARS, and the testimony of the taxpayer demonstrated that there had been a conversion of 12 100 000 share options to 1 210 000 shares in a 10:1 ratio, it was patently clear that par. 20 rather than par. 18 of the Eighth Schedule found application.

(xvi) That, accordingly, the cost of 12 100 000 share options should therefore be included in the base cost of the D Ltd shares that were disposed of.

As to whether an Understatement Penalty in terms of the Tax Administration Act was of application

(xvii) That SARS had assessed the taxpayer with an understatement penalty of 75% in terms of section 222 of the Tax Administration Act on the basis of 'no reasonable grounds for tax position taken' and had thereafter sought an understatement penalty of 150% on the basis of 'intentional tax evasion' without having initially raised it in its Notice of Assessment and Statement of Grounds of Assessment and a trial by ambush could not be countenanced by the court and SARS was not entitled to increase its claim for understatement penalty without due notice.

(xviii) That a taxpayer cannot disavow himself or herself of tax responsibilities by relying on an accountant or tax practitioner as the tax practitioner was only obliged to declare information on tax returns as provided by the taxpayer.

(xix) That there was no intentional tax evasion in the manner in which the 2011 return had been completed but the taxpayer had failed to take reasonable care in having the returns completed and submitted and it was therefore liable for understatement penalty.

(xx) That, consequently, an understatement penalty of 50% should apply.

As to consideration of a costs order against the taxpayer

(xxi) That in terms of section 130 of the Tax Administration Act the Tax Court may, in dealing with an appeal, on application by an aggrieved party, grant an order for costs if 'the taxpayer's grounds of appeal are held to be unreasonable.'

(xxii) That par. 35(3)(c) of the Eighth Schedule was widely and vaguely constructed and stood to be interpreted more broadly by a litigant before a court had pronounced on its interpretation in the context of the facts of this case and the court was unable to conclude that the taxpayer ought to have known that its objection would not fall within the ambit of par. 35(3)(c).

(xxiii) That, accordingly, the court was not persuaded that the taxpayer had no reasonable grounds for its objection in its entirety and hence no costs order was made.

The taxpayer's assessment was referred back to SARS in terms of section 129(2) of the Tax Administration Act for re-assessment.

5.10. ITC 1899

The taxpayer was a provisional taxpayer and it had delivered its return for payment of provisional tax for the 2010 year of assessment on 30 June 2011 and in this return it had estimated its taxable income for the year of assessment and had made payment of provisional tax in accordance with the estimate.

Some time after the end of the tax year it transpired that the actual income received exceeded the estimate very substantially and, as a result, SARS had imposed an underestimation penalty in terms of par. 20 of the Fourth Schedule to the Income Tax Act.

The taxpayer lodged an objection which was rejected by SARS and this rejection prompted an appeal which was decided in its favour by the Tax Board.

SARS thereafter referred the appeal to the Tax Court for a hearing *de novo* and

duly filed its statement of grounds of assessment and opposing the appeal pursuant to Rule 31 of the Tax Court Rules.

The taxpayer, in response, filed a statement of its grounds of appeal pursuant to Rule 32 of the Tax Court Rules.

The taxpayer, in its grounds of appeal, had abandoned all the grounds raised in its original objection and in its notice of appeal and sought now to rely only on a procedural ground raised *mero motu* by the chairperson of the Tax Board upon which he found in favour of the taxpayer.

SARS subsequently filed a notice of exception contending that in law the taxpayer may not now, at a hearing *de novo*, rely on a new ground of objection not previously contained in its grounds of objection.

The taxpayer appeared to acknowledge this contention and accordingly it filed an application for the amendment of its grounds of objection and it was the exception and the proposed amendment of the grounds of objection that formed the subject of the present proceedings and the issue before the Tax Court was whether SARS' exception should be upheld.

The taxpayer had submitted its return for payment of provisional tax on 30 June 2011 and it had estimated its income for the year of assessment in an amount of R431 638 and made payment in the amount of R64 905,54 in accordance with the estimation.

The taxpayer later, on 30 September 2011 made a further payment of R1 377 466,22 and this was followed by a return of income filed on 8 October 2011 in which the taxpayer disclosed a taxable income for the year of assessment in the amount of R5 050 076.

In terms of par. 20(1) of the Fourth Schedule to the Income Tax Act, if the actual taxable income of a provisional taxpayer, as finally determined under the Act, exceeds R1 million and the estimate made in the return for payment of provisional tax was less than 80% of the amount of the actual taxable income, SARS was obliged to impose a penalty, which was deemed to be a percentage based penalty imposed under Chapter 15 of the Tax Administration Act.

In view of the discrepancy between the estimated earnings in the return for payment of provisional tax and the return of income, SARS had imposed an underestimation penalty in terms of the Income Tax Act.

Paragraph 20(2) of the Fourth Schedule provided for a discretion on SARS to remit the penalty or a part thereof where he or she is satisfied that the estimate of taxable income was seriously calculated and was not deliberately or negligently understated.

The taxpayer had lodged its notice of objection against the imposition of the penalty on 18 May 2012 and had requested that the underestimation penalty be waived.

SARS duly considered the objection and on 4 June 2012 it was rejected on the ground that he had considered that no serious calculation of the taxable income had been done with due regard to the factors having a bearing thereon.

At the time of the rejection of the objection and at the time of the lodging of the notice of appeal, the Tax Administration Act had not yet come into effect.

The issue in dispute in the appeal was therefore whether SARS was correct in his decision not to remit the penalty imposed for the under-estimation of taxable income on the ground that no serious calculation of income had been done.

The Tax Board ruled that SARS was indeed correct in rejecting the objection stating that it would be inclined to dismiss the appeal on its merits. However, the chairperson of the Tax Board *mero motu* raised a procedural issue under the Tax Administration Act which, in the interim, had come into force and, accordingly, held that the reduced underestimation penalty was legally unenforceable by reason of the non-compliance by SARS with the requirements of sections 214 and 215 of the Tax Administration Act.

SARS thereafter referred the appeal to the Tax Court to be heard and that court had to consider whether the taxpayer could lawfully amend its grounds of objection even though the matter was on appeal and it also considered the various provisions of the Tax Administration Act.

Section 214(1) of the Tax Administration Act provided that a penalty imposed in

terms of section 213 was imposed by way of a penalty assessment and if such assessment was made, SARS must give notice of the assessment in the manner prescribed in section 214 of the Act.

Section 213(2) provided that in the event of a change to the amount of tax in respect of which a penalty was imposed, the penalty must be adjusted accordingly with effect from the date of the imposition of the penalty.

Judge Eksteen held the following:

(i) That at the hearing the taxpayer acknowledged that in the absence of an amendment to the grounds of objection the taxpayer was precluded from relying on new grounds not raised in the grounds of objection and, accordingly, that the exception, on the papers as they currently stood, was unassailable and it was accordingly common cause that the exception should be upheld unless the application for an amendment was granted.

(ii) That it was common cause that the Tax Court rules made no provision for an amendment of the nature in issue, i.e. an application to amend the grounds of objection. In the present matter the amendment was formulated by reference to a ruling by the Tax Board and this appeal constituted a hearing *de novo* and the proceedings before the Tax Court were irrelevant.

(iii) That the taxpayer sought to rely on Rule 28 of the High Court Rules and, as a general rule, the High Court will not grant an amendment in terms of Rule 28 until it has been properly formulated. SARS contended that the provisions of the High Court rules could only find application where the Rules of the Tax Court were silent and unless the taxpayer could bring his application within the provisions of Rule 35 of the Tax Court Rules the amendment could not be granted and Rule 35 could find no application to the amendment of the grounds of objection.

(iv) That, prior to 1989, the Income Tax Act had provided in section 83(7)(*b*) that a person who had made an objection should be limited in an appeal to the grounds stated in his notice of objection, unless SARS agreed to the amendment of such grounds, provided that a special court may, on good cause shown, permit a person to amend his notice of objection but this

provision empowering a court to grant an amendment to the notice of objection was deleted with the amendment of the Income Tax Act in 2001 and was not again repeated.

(iv) That SARS' further contention was that the Tax Board was incorrect in law in its conclusion relating to the interpretation of Part D of Chapter 15 of the Tax Administration Act and that the amendment which the taxpayer sought would therefore be excipiable, i.e. the amendment contended for could therefore not constitute a defence to the penalty imposed.

(v) That the penalty in issue was a percentage based penalty imposed under the Income Tax Act prior to the Tax Administration Act coming into force and once the Tax Administration Act came into force the administrative procedures prescribed in the Tax Administration Act took immediate effect. Section 93 of the Tax Administration Act provided for SARS to make a reduced assessment, *inter alia*, if it was satisfied that there was an error in the assessment previously made and it may make such a reduced assessment even in circumstances where no objection had been lodged or an appeal noted. Once such a reduced assessment is made a taxpayer who is aggrieved thereby is entitled to object to the reduced assessment in terms of the provisions of section 104 of the Tax Administration Act which must be lodged in the manner, under the terms and within the period prescribed in the rules.

(vi) That by virtue of the fact that the penalty which had been imposed under the Income Tax Act was a percentage based penalty, the effect of a reduced assessment was necessarily an adjustment in the penalty. The reduced assessment was made in February 2013 after the Tax Administration Act came into effect and the taxpayer was thereafter notified of the outcome of the assessment and the adjustment to the penalty through a 'notice of assessment' which reflected the 'due date' for payment of the adjusted penalty as 1 November 2011, being the date of the imposition of the original penalty.

(vii) That it was common cause before the Tax Board that a 'penalty

assessment' as envisaged in section 214(1) of the Tax Administration Act had not been issued and in these circumstances the Tax Board considered that SARS ought first to have issued a 'penalty assessment' in terms of section 214(1) of the Tax Administration Act whereafter the aggrieved taxpayer ought to have been afforded an opportunity to submit a remittance request on or before the date set for payment of the penalty and it was considered that the procedure laid down in Part D of Chapter 15 of the Tax Administration Act had not been followed and that the penalty was therefore unenforceable.

(ix) That in the present instance the penalty assessment was made under the Income Tax Act and the taxpayer was duly notified thereof under the Income Tax Act prior to the Tax Administration Act coming into force and hence the provisions of the Tax Administration Act had no bearing on the process whereby the penalty was imposed.

(x) That on a proper interpretation of the statute it seemed therefore that a 'penalty assessment' related to the original imposition of the penalty and notice of such an imposition must be given in accordance with the provisions of section 214(1) and an opportunity must be afforded to the taxpayer to request a remittance under section 215(1). A penalty adjustment, however, was a different issue and a notice of penalty adjustment must be given in terms of section 213(2).

(xi) That in these circumstances SARS was acutely aware of the provisions of Chapter 15 of the Tax Administration Act and proper notice of the adjusted penalty was given in accordance with the provisions of sections 213(2) and 214(3) and the provisions of sections 214(1) and 215 of that Act had no bearing on the appeal and the proposed amendment could therefore not succeed.

(xii) That, accordingly, SARS' exception to the taxpayer's application was upheld and the application by the taxpayer for the amendment of its grounds of objection was dismissed.

(xiii) That, accordingly, the penalty imposed by SARS on the understatement of

provisional tax by SARS was confirmed.

6. INTERPRETATION NOTES

6.1. Exemption from income tax: Remuneration derived by a person as an officer or crew member of a South African ship – No. 96

This Note provides guidance on the circumstances under which section 10(1)(*o*)(iA) exempts the remuneration, derived by a person as an officer or crew member of a South African ship, from normal tax.

Section 12Q was inserted into the Act on 1 April 2014 and applies to years of assessment commencing on or after that date. The amendment came about as part of a new tax regime that provides tax relief for South African shipping companies. The purpose of the amendments was to encourage ships to carry the South African flag by making South Africa more competitive internationally. Various exemptions from normal tax, capital gains tax, dividends tax as well as cross-border withholding tax on interest, were introduced.

Section 10(1)(*o*)(iA) was introduced simultaneously, to exempt any form of remuneration received by or accrued to any officer or crew member of a South African ship, which is mainly engaged in international shipping or fishing outside South Africa, regardless of the period or periods spent abroad. Amounts qualifying for exemption will not form part of remuneration, and would thus not be subject to the deduction or withholding of employees' tax.

The issue of double taxation and the application of various double tax treaties are not discussed in this Note, since the application of double taxation varies from treaty to treaty.

The remuneration of officers or crew members of a South African ship mainly engaged in 'international shipping' as defined in section 12Q(1), or a South African ship mainly engaged in fishing outside the Republic, is exempt from taxation.

In certain circumstances, the remuneration of officers or crew members may not qualify for the exemption in section 10(1)(*o*)(iA). It may, however, be possible that the remuneration of these officers or crew members qualify for the exemption under section 10(1)(*o*)(i) or 10(1)(*o*)(ii).

7. DRAFT INTERPRETATION NOTES

7.1. Game Farming – No. 69 (Issue 2)

This Note provides guidance on the application of selected sections of the Act and paragraphs of the First Schedule to persons carrying on game-farming operations, with its primary focus being the provisions applicable to livestock. It is not intended to deal with farming in general.

The changes in this note focus mainly on the legislative amendments affecting deceased persons and deceased estates which came into operation on 1 March 2016 and apply to persons dying on or after that date.

Section 26(1) stipulates that the taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as the income is derived from such operations, be determined in accordance with the Act but subject to the First Schedule. The First Schedule deals with the computation of taxable income derived from pastoral, agricultural or other farming operations.

The taxable income from farming operations is combined with the taxable income from other sources to arrive at the taxpayer's taxable income for the year of assessment.

The First Schedule applies regardless of whether a taxpayer derives an assessed loss or a taxable income from farming operations. The Schedule may also apply even after farming operations have been discontinued.

Section 26 and the First Schedule apply to game farming, since it comprises farming operations.

The same principles used to determine whether a person carries on farming operations apply to game farmers. The test for this purpose is based on the

taxpayer's intention.

Income from the sale of game, game meat, carcasses and skins and fees related to hunting constitutes farming income. However, income from accommodation, catering and admission charges is not farming income. Income not constituting farming income will be relevant when applying the ring-fencing provisions of paragraph 8 to game livestock. Game viewing fees may or may not constitute farming income depending on the facts and circumstances.

The rules governing the deduction of expenditure, including capital development expenditure, are similar to those applying to normal farming operations.

A farmer is required to bring to account the value of game livestock in opening and closing stock. No standard values have been prescribed by regulation for game livestock, but SARS accepts that game livestock may be allocated a standard value of nil. Game livestock acquired by donation is included in opening stock in the year of acquisition at market value under paragraph 4.

The deduction under section 11(*a*) for the cost of livestock is ring-fenced under paragraph 8, while an assessed loss or balance of assessed loss from farming is subject to potential ring-fencing under section 20A.

A farmer ceasing to carry on game-farming operations must generally continue to deal with any game livestock under the First Schedule.

Special rules apply for income tax and CGT purposes upon the death or sequestration of a farmer.

7.2. Produce held by nursery operators – No. 79 (Issue 2)

This Note provides guidance on the valuation of produce held and not disposed of by nursery operators at the beginning and at the end of each year of assessment. It also examines the capital gains tax consequences of the disposal of produce.

Section 26(1) stipulates that the taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as the income is derived from such operations, be determined in accordance with the Act but subject to the

First Schedule. The First Schedule deals with the computation of taxable income derived from pastoral, agricultural or other farming operations.

The taxable income from farming operations is combined with the taxable income from other sources to arrive at the taxpayer's taxable income for the year of assessment.

The First Schedule applies regardless of whether a taxpayer derives an assessed loss or a taxable income from farming operations. The Schedule may further apply even after farming operations have been discontinued [section 26(2)].

Both section 26 and the First Schedule apply to farming operations conducted by a nursery operator. Some nursery operators have in the past, however, failed to comply with paragraph 2 of the First Schedule to the Act. Paragraph 2 requires a nursery operator carrying on farming operations to include in that operator's return of income the value of all produce held and not disposed of at the beginning and at the end of each year of assessment.

Persons conducting the business of a nursery in the course of which plants or trees are grown for sale are regarded as carrying on farming operations. Persons in this category are taxed in accordance with section 26 subject to the First Schedule. The same tests used to determine whether a person carries on farming operations apply to these nursery operators.

The produce held at the beginning and at the end of the year of assessment of a nursery operator carrying on farming operations is specifically excluded from section 22 and must be dealt with under the First Schedule. The value of the produce held and not disposed of must be brought into account at the beginning and end of the year of assessment. The value to be placed upon the produce on hand is its fair and reasonable value under paragraph 9. The plants or trees grown by a nursery, which are not ready for sale, will fall into the category of growing crops and must not

be brought into account when the taxable income from farming operations is determined.

Any trading stock purchased from outside sources and offered for sale is not

attributable to farming operations and must be dealt with under section 22.

Special rules apply for income tax and CGT purposes upon the death or sequestration of a nursery operator carrying on farming operations.

7.3. Exemption: Foreign pensions and transfers – No. 79 (Issue 2)

This Note provides clarity on the interpretation and application of section 10(1)(*g*C)(ii) in respect of a lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic, and in respect of amounts transferred from a source outside the Republic into a local retirement fund.

Section 10(1)(*g*C)(ii) exempts from normal tax any lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic.

With effect from 1 March 2017, this exemption does not apply to a lump sum, pension or an annuity paid from any local retirement fund, except to the extent that an amount is transferred to that local retirement fund from a source outside the Republic in respect of that member.

Section 10(1)(*g*C)(ii) exempts from normal tax any lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for foreign services rendered. With effect from 1 March 2017, however, this exemption will no longer apply to a lump sum, pension or an annuity paid from any local retirement fund, except to the extent that an amount that relates to foreign services rendered was transferred to that local retirement fund.

8. BINDING PRIVATE RULINGS

8.1. BPR 276 – Dividends tax and the most favoured nation clause in a tax treaty

This ruling determines whether dividends tax must be withheld when a dividend is

paid to the beneficial owner that is a resident of the Kingdom of Sweden. Sweden and South Africa concluded the SA/Sweden tax treaty which, when read with the Protocol, includes a 'most favoured nation' clause.

In this ruling references to sections and articles are to sections of the Income Tax Act and articles of the SA/Sweden treaty and the Protocol applicable as at 26 May 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act or the Protocol.

This is a ruling on the interpretation and application of:

- sections 64G(3) and 108;
- article 10 of the SA/Sweden tax treaty published in Government Gazette (GG) 16890 dated 27 December 1995 as amended by articles I and II of the Protocol published in GG 35268 dated 23 April 2012; and
- article 10 paragraph 1 of the SA/Kuwait tax treaty published in GG 29815 dated 20 April 2007.

Parties to the proposed transaction

The Applicant: A private company incorporated in and a resident of South Africa that is a wholly-owned subsidiary of Company A

Company A: A company incorporated in and a resident of Sweden

Description of the proposed transaction

Company A is the beneficial owner of the preference shares in the Applicant and of any dividends that may accrue in respect of those shares. The preference shares are redeemable fifteen years after their issue date only. Redemption is not compulsory, but subject to the express consent of the shareholder. The Applicant does not have the option to redeem the preference shares. The preference shares do not carry any right to share beyond a specified amount in capital or dividend distributions. On the facts, it is unlikely that the existence of the Applicant will be terminated within three years from the date of issue of the preference shares. The preference shares carry a preferential right to dividends before ordinary shares. The dividends payable on the preference shares are not calculated directly or

indirectly with reference to any specified rate of interest or the time value of money.

The Applicant proposes to pay a dividend to Company A.

Article II of the Protocol lays down that:

> '[i]f any agreement or convention between South Africa and a third state provides that South Africa shall exempt from tax dividends ... arising in South Africa, or limit the tax charged in South Africa on such dividends ... to a rate lower than ... [5%], such exemption or lower rate shall automatically apply to dividends ... arising in South Africa and beneficially owned by a resident of Sweden'.

In this regard, the SA/Kuwait tax treaty provides in article 10 paragraph 1 that should dividends be paid by a company that is a resident of South Africa to a resident of Kuwait who is the beneficial owner, those dividends would be taxable in Kuwait only.

Conditions and assumptions

This binding private ruling is subject to the additional condition and assumption that the ruling is applicable to preference shares currently in issue that were issued under the Preference Share Terms identified above.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- In respect of the preference shares issued by it, the Applicant will not be required to withhold dividends tax from the payment made to Company A if it complies with the documentary requirements in section 64G(3).

8.2. BPR 277 – Consequences for an employee share trust on the unwinding of an employee share incentive scheme

This ruling determines the tax consequences for an employee share trust resulting from the vesting of 'restricted equity instruments' held by its beneficiaries, and whether the trust is liable to withhold PAYE in respect of the vesting of the section

8C gain in the beneficiaries.

In this ruling references to sections and paragraphs are to sections of the Income Tax Act and paragraphs of the Eighth Schedule to the Act applicable as at 11 July 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of:

- section 8C;
- paragraph 11A of the Fourth Schedule; and
- paragraph 11(2)(*j*);
- paragraph 13(1)(*a*)(iiB);
- paragraph 38; and
- paragraph 80 of the Eighth Schedule to the Act.

Parties to the proposed transaction

The applicant: A JSE listed company incorporated in and a resident of South Africa

The trust: An employee share incentive trust founded by the applicant for the benefit of qualifying employees of companies in the group of which the applicant is the holding company

Description of the proposed transaction

The trustees made awards to qualifying employees from time to time. Beneficiaries were issued units, evidencing their respective interests in the trust.

The trustees procured that all scheme shares remained registered in the names of the trustees for the time being, but for the beneficial interest of the relevant beneficiaries, until their delivery.

The rules of the scheme state that each unit:

- was non-transferrable, but subject to forfeiture in accordance with the trust deed;
- represented a vested right to one ordinary share in the applicant;

- afforded the beneficiary the voting and distribution rights set out in the trust deed;
- afforded the beneficiary the right to the delivery of the shares as contemplated in the trust deed.

No beneficiary was entitled to:

- pledge or encumber or dispose of his or her units or the underlying shares; or
- enter into any agreement in respect of any votes attached to the units or the underlying shares.

On the final date, (as defined in the trust deed), the trustees must deliver the shares underlying each unit to the relevant beneficiary. However, a beneficiary could deliver a notice to the trustees fifteen days before the final date:

- requesting the trustees to sell the shares for and on behalf of the beneficiary; and
- indicating that the beneficiary would take delivery of the shares, with transaction costs and taxes in that event payable by the beneficiary to the trust.

The trust deed further provides that the beneficiaries may not for a period of seven business days after the final date dispose of or encumber any shares received by them.

The trust deed also provides for special arrangements applicable to good and bad leavers. Bad leavers would forfeit their units and the shares underlying those units. In the case of retrenchments or death, the good leavers or the estate of any deceased beneficiary would still benefit from the scheme until their participation termination date.

It bears emphasis that the beneficiaries acquired beneficial ownership of the scheme shares when they acquired their units.

Conditions and assumptions

This binding private ruling is subject to the additional condition and assumption that the ruling issued does not apply to any scheme shares that remained in the Trust because they were unallocated or for any other reason.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- The trust is the employer, and will be liable to withhold PAYE.
- The tax liability arising out of the vesting of either the scheme shares or cash and thus the obligation to pay over the above-mentioned PAYE arises, both in respect of beneficiaries who receive shares and those who receive cash, on the final date as defined in the trust deed.
- In terms of paragraphs 11, 13, 38 and 80 of the Eighth Schedule, despite the delivery of shares to a beneficiary or the sale of shares for his or her benefit, no disposal, and consequently no capital gain, will result in the trust.

8.3. BPR 278 – Application of section 24JB to equity – linked notes

This ruling determines the income tax consequences in respect of the issue of equity-linked notes (Notes) by a covered person.

In this ruling references to sections are to sections of the Income Tax Act applicable as at 18 July 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of:

- section 1(1) – definition of 'gross income';
- section 11(*a*) read with section 23(*g*); and
- section 24JB.

Parties to the proposed transaction

The Applicant: A company incorporated in and a resident of South Africa

Company A: A company incorporated in and a resident of South Africa

Description of the proposed transaction

The Applicant is a 'covered person' as defined in section 24JB(1).

The proposed transaction will be as follows:

- The Applicant will, from time to time, issue Notes to Company A.
- The Applicant will use the subscription amounts which it will receive from Company A on the issue of Notes to enter into hedging and other speculative activities through the use of instruments such as listed equity futures contracts traded on the JSE, equities listed on the JSE, Over-The-Counter derivatives such as interest rate swaps, corporate bonds, loans, money market instruments and negotiable certificates of deposit issued by banks. The Applicant will trade in these instruments in order to pay a return to Company A on the maturity of the Notes.

Each Note will provide Company A with a return equal to a zero percent tracking error in respect of a specified equity index to which Company A will be exposed and which cannot be changed during the term of the Note.

The material terms and conditions of the Notes will be as follows:

- The Applicant will carry all risk pertaining to the ability to provide a zero percent tracking error to the Applicant in respect of the reference index. To the extent that it is not able to achieve its obligations in terms of the Notes as a result of an under-performance in relation to the index, the Applicant will be liable for the losses. Equally, if it makes any profits by over-performing in relation to the index, it will retain those profits.
- The Notes will be issued for an indefinite term, subject to a minimum tenor of 5 years after which they will be redeemable at the option of Company A. A Note may be redeemed prior to the initial five year period only in exceptional circumstances.

Each Note that will be issued by the Applicant will be recognised at fair value in

profit or loss in accordance with International Accounting Standard 39 of the International Financial Reporting Standards or any other standard that replaces that standard.

The initial subscription amount that the Applicant will receive on the issue of a Note and the redemption amount that the Applicant will be liable to pay to the Applicant on the redemption of a Note will not be recognised in profit or loss in the statement of comprehensive income of the Applicant.

Fair value changes in respect of the Note will be recognised in profit or loss in the statement of comprehensive income of the Applicant.

Conditions and assumptions

This binding private ruling is not subject to any additional conditions and assumptions.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- The subscription amounts that the Applicant will receive on the issue of Notes will not be included in its gross income in the year of assessment in which the Notes are issued.
- The redemption amounts that the Applicant will be liable to pay on redemption of Notes will not be deductible from its income in terms of section 11(*a*) read with section 23(*g*).
- Any gains or losses resulting from any changes in the fair values of Notes during the terms of the Notes will be subject to tax in accordance with section 24JB(2).

8.4. BPR 279 – Capital gains tax participation exemption in relation to controlled foreign companies

This ruling determines that the participation exemption from capital gains tax (CGT) is available in relation to the disposal of assets by a controlled foreign company

(CFC) of the Applicant, because the parties are not connected persons in relation to each other at the time of the proposed transaction, albeit that such a relationship is created by the transaction.

In this ruling references to sections and paragraphs are to sections of the Act and paragraphs of the Eighth Schedule to the Act applicable as at 30 June 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of:

- section 1(1) – definition of 'connected person';
- section 9D; and
- paragraph 64B(1)(*b*).

<u>Parties to the proposed transaction</u>

The applicant: A vested trust established in and resident in South Africa with its main objective to invest in infrastructure development projects throughout the African continent

The co-applicant: A company incorporated and resident outside of South Africa which is a wholly-owned subsidiary of the applicant

Company A: A company incorporated and resident outside of South Africa which is a wholly-owned subsidiary of the co-applicant

Company B: A company incorporated and resident outside of South Africa which is a wholly-owned subsidiary of the co-applicant

Counterparty: A company incorporated and resident outside South Africa, which is a wholly-owned subsidiary of a multilateral development financial institution established by agreement between sovereign states, financial institutions and other investors

Newco: A new company to be incorporated specifically for purposes of the proposed transaction as a wholly-owned subsidiary of the counterparty and resident outside of South Africa

Description of the proposed transaction

Both the applicant and the counterparty act as principal investors in multinational development projects, including investments in securities of entities owning, controlling, operating or managing such projects.

They intend to merge their investments in Newco. Due to the difference in the market values of the assets to be contributed to Newco the agreement will provide for the payment of an equalisation amount to Newco in exchange for shares by the counterparty, whose contribution has a lesser market value.

The proposed merger will be achieved by the following proposed transaction steps:

- The counterparty will incorporate Newco in a foreign jurisdiction. Newco will issue and the counterparty will subscribe for one share in Newco.
- The counterparty will transfer its assets to Newco in exchange for the issue of a second tranche of shares in Newco and make payment of the equalisation amount to Newco in subscribing for a third tranche of shares in Newco.
- The applicant's contribution will be made by its subsidiary, the co-applicant, by disposing of all of the co-applicant's shares held in Company A and Company B to Newco by way of a single and indivisible transaction at the prevailing market value of the assets underlying them, in exchange for shares in Newco.

Subsequent to the abovementioned steps, the co-applicant and the counterparty will each hold 50% of the issued equity shares in Newco.

Conditions and assumptions

This binding private ruling is subject to the following additional conditions and assumptions:

- Less than 80% of the market value of Company B is attributable, directly or indirectly, to immovable property situated in South Africa.
- Newco will be effectively managed outside South Africa.

- Both Company A and Company B have their places of effective management outside South Africa.
- The counterparty must pay the equalisation amount to Newco in exchange for the issue of a corresponding amount of additional shares in Newco and such payment, share issue and updating of the share register must occur before the disposal of the shares in Company A and Company B by the co-applicant to Newco.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- The requirement in item (*b*) of paragraph 64B(1) that the Co-Applicant and Newco must not be connected persons in relation to each other at the time of the disposal of the shares in Company A and Company B, will be met.
- Any capital gain or loss arising from the Co-Applicant's disposal of the shares in Company A and Company B must be ignored when determining the 'net income' of the Co-Applicant for purposes of section 9D.

9. BINDING GENERAL RULING

9.1. BGR 43 – Deduction of input tax in respect of second-hand gold

For the purposes of this ruling, unless the context indicates otherwise –

- **'carat'** means a unit for measuring the purity of gold on the gold carat scale, which expresses the proportion of gold in parts per 241 by mass in comparison to the full mass of the item, that is, each carat indicates that 1/24th of the whole item consists of pure gold;
- **'foreign gold coin'** means any gold coin minted outside South Africa;
- **'gold'** means the chemical element with symbol AU and atomic number 79;
- **'non-taxable supply'** means a supply by a non-vendor or a supply by a

vendor, otherwise than in the course or furtherance of that vendor's enterprise;

- **'notional input tax'** means an amount contemplated in subparagraph (*b*) of the definition of 'input tax' as defined in section 1(1) of the VAT Act;
- **'solely of gold'** means at least 99,5% pure gold;
- **'sole purpose'** means the only purpose for which the vendor acquired gold;
- **'same state without further processing'** means without undergoing any transformational process which may change the purity, quality or form of the gold in any way; and
- **'substantially the same state'** means the principal essentials of the item containing gold is not changed with reference to the gold as a whole;

Purpose

This BGR sets out the circumstances under which the supply of gold is regarded as falling within the exclusions envisaged in paragraph (ii) of the definition of 'second-hand goods' in section 1(1).

Background

A vendor that acquires second-hand goods, including goods made from precious metals, under a non-taxable supply, may deduct notional input tax. This allows for the unlocking of part of the VAT on goods previously paid by final consumers as those goods re-enter the formal supply chain.

In 2014, changes were made to the VAT Act to amend the definition of 'second-hand goods' to specifically exclude 'gold' and 'goods containing gold' and thereby denying the notional input tax credit on these goods. The policy rationale for the 2014 amendments was to curb fraudulent notional input tax deductions on the acquisition of gold and gold jewellery. The amendment was not intended to have a negative impact on legitimate transactions within the second-hand goods industry.

In order to address the abovementioned concern, the 2014 amendments were revised to limit the extent of the exclusion contained in the definition of 'second-hand goods' as contained in section 1(1). This amendment came into operation on

1 April 2017.

Discussion

Vendors acquiring second-hand gold (that was previously owned and used) under a non-taxable supply, may not deduct input tax in respect thereof unless the exceptions to the definition of 'second-hand goods' are met. This definition distinguishes between three classes of supplies which are discussed hereunder.

- Goods consisting solely of gold [paragraph (*aa*)]

  Goods consisting solely of gold can only be regarded as second-hand goods if the gold is acquired for the sole purpose of supplying it in the same state without further processing.

  - Purity of gold

    For purposes of this BGR, 'solely' means that the goods must consist of at least 99,5% pure gold. On the basis that 100% purity is unattainable, 24 carat gold is accepted as consisting solely of gold as this designation is only allowed by industry where the gold content is at least 99,5%.

    In instances where a person acquires a piece of gold jewellery which seems to consist only of gold; that is, no other precious metals, stones or gems are attached to it, this does not mean that the item consists solely of gold. Gold is a very soft metal to which other metals are added to improve durability to make other products, for example, jewellery. These alloys, including yellow, white and rose gold, will not qualify as consisting solely of gold. Consequently, any goods consisting of less than 24carats gold, forexample,an 18carat wedding ring should be considered hereunder.

    Even though some South African gold coins[4] consist solely of gold,these coins will not be regarded as second-hand goods due to the specific exclusion contained in the definition of 'second-hand goods'.

- Purpose for which gold was acquired

  The vendor must acquire these goods for the sole purpose of supplying it in the same state without any further processing. At the date of acquisition, the vendor's only intention must therefore be to supply the gold to another person in the course and furtherance of the vendor's enterprise. Any goods acquired for a dual purpose do not qualify as 'second-hand goods'.

- Same state without further processing

  In order to qualify for the notional input tax deduction, the gold must be supplied in the same state without any further processing. The vendor may not melt the gold or subject the gold to any transformational process which may change the purity, quality or form of the gold in anyway. The vendor may however clean and polish the gold before supplying it to another person.

- Gold coins [paragraph (*bb*)]

  Gold coins contemplated in section11(1)(*k*) are specifically excluded from the definition of 'second-hand goods'.Consequently, gold coins issued by the South African Reserve Bank in accordance with section14 of the South African Reserve Bank Act 90 of 1989 (or that remain in circulation per provision (1) of that section) will not be regarded as second-hand goods.These coins include Kruger Rands and gold coins in the National Geographic, Natura, Protea and R1 series as well as any other gold coins declared by the Ministry of Finance to be legal tender.

- Other goods containing gold [paragraph (*cc*)]

  A vendor may only deduct notional input tax in respect of second-hand gold acquired under a non-taxable supply if the goods are acquired for the sole purpose of supplying those goods in the same or substantially the same state to another person.

- Other goods

  This residual category includes all other goods that contain gold, such as:

- gold jewellery, including 9 and 18 carat gold items;
- foreign gold coins that consist of less than 99% gold,such as the American Eagle series and British Gold Sovereign;
- computer components;
- medical equipment;
- electronic appliances; and
- dentures.

- Substantially the same state

  The term 'substantially' means the principal essentials of the gold contained in the goods are not altered or transformed. If the vendor therefore changes a small or nominal detail of the goods containing gold, it will not preclude the vendor from deducting notional input tax.

  In instances where the vendor acquires goods containing gold and change the nature thereof, for example, where the vendor buys gold rings which are melted before being sold as earrings, no notional input tax is allowed on acquiring the gold from a non-vendor.

Ruling

This ruling constitutes a BGR under section 89 of the Tax Administration Act.

- Goods that are regarded as 'consisting solely of gold'

  The following goods are regarded as 'consisting solely of gold' for purposes of item (ii)(*aa*) of the definition of 'second-hand goods':

  - Gold bars and ingots
  - Foreign 24 carat gold coins such as the Australian Lunar series, Chinese Panda series, One Ounce Britannia (minted since 2013), Canadian Maple series and Australian Nuggets
  - Any other certified 24 carat gold item

- Goods that are regarded as 'other goods containing gold'

The following goods are regarded as 'other goods containing gold' which are supplied in substantially the same state for purposes of item (ii)(*cc*) of the definition of 'second-hand goods':

- o Jeweller resizing a ring before resale
- o Replacing a precious stone in a gold ring before resale
- o Combining single 22 carat gold coins to form a set for resale
- o Upgrading a computer before resale
- o Replacing faulty parts before reselling medical equipment or electronic appliances

In instances where the vendor smelts (or intends to smelt) the gold acquired under a non-taxable supply, the gold will not qualify as 'second-hand goods' due to the transformational nature of the process.

- Deduction of notional input tax

A vendor may deduct notional input tax in respect of goods listed above:

- o if the goods are acquired with the only intention to supply the goods to another person in the same state without further processing;
- o if the goods are acquired only to supply the goods to another person, and

provided the goods were previously owned and used, and are acquired in the course or furtherance of that vendor's enterprise and the requirements of section 16(2)(*c*) read with section 20(8) are met.

Kruger Rands and gold coins in the National Geographic, Natura, Protea and R1 series as well as any other gold coins declared by the South African National Treasury to be legal tender are not regarded as 'second-hand goods'.12 A vendor is therefore not entitled to deduct any notional input tax where these coins are acquired under a non-taxable supply.

10. BINDING CLASS RULING

10.1. BCR 57 – Section 12J(2) deduction by partners

This ruling determines a commanditarian partner's eligibility to claim a deduction under section 12J(2) in respect of venture capital shares acquired by a partnership and whether the proposed investor certificates to be issued to the commanditarian partners will be acceptable for purposes of section 12J(4).

In this ruling references to sections are to sections of the Income Tax Act applicable as at 30 June 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of:

- section 12J; and
- section 24H.

Class

The class members to whom this ruling will apply are the commanditarian partners of the partnership described hereunder.

Parties to the proposed transaction

The Applicant: A company incorporated in and a resident of South Africa

The partnership: An *en commandite* partnership to be formed between the Applicant as general or managing partner and the class members as commanditarian partners

The class members: The commanditarian partners of the partnership

Manco: A company incorporated in and a resident of South Africa that is a manager of venture capital companies.

Description of the proposed transaction

The Applicant is engaged in the provision of trust services and it is the general or managing partner of the partnership, an *en commandite* partnership to be formed between the Applicant as general or managing partner and between ten and twenty commanditarian partners.

The partnership is formed to invest exclusively in 'venture capital companies' as defined in section 12J(1) that have been approved as such under section 12J(5). The class members will contribute cash to the partnership. There will be no third party borrowings by the partnership. A class member's proportionate share in the income and capital of the partnership will be *pro rata* to that class member's contribution to the capital of the partnership.

The partnership proposes to invest initially in two venture capital companies managed by Manco. The Applicant and Manco will arrange that, notwithstanding that the investment will be made by the partnership in each venture capital company, each individual class member will be entered into the register of investors in the books of the relevant venture capital company, and each individual class member will be issued a certificate contemplated in section 12J(4) (investor certificates), based on that class member's proportionate investment in the partnership. For this purpose, the identity of the class members will be disclosed to Manco.

Conditions and assumptions

This binding class ruling is subject to the additional condition and assumption that the investor certificates must indicate that the investment was made by the partnership and held by the class members as partners in the partnership.

Ruling

The ruling made in connection with the proposed transaction is as follows:

- Subject to section 12J(3) and (3A), each class member will be entitled to claim the deduction under section 12J(2) read with section 24H, *pro rata* to that class member's proportionate share of the investment in the partnership. The proposed investor certificates to be issued to the class members will be acceptable for purposes of section 12J(4).

10.2. BCR 58 – Consequences for beneficiaries on the unwinding of an employee share incentive scheme

This ruling determines the income tax consequences for the beneficiaries on the unwinding of an employee share incentive scheme.

In this ruling references to sections are to sections of the Act applicable as at 10 July 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of section 8C.

Class

The class members to whom this ruling will apply are the beneficiaries of the trust.

Parties to the proposed transaction

The applicant: A JSE listed company incorporated in and a resident of South Africa

The trust: An employee share incentive trust founded by the applicant for the benefit of qualifying employees of companies in the group of which the applicant is the holding company

The beneficiaries: The qualifying employees

Description of the proposed transaction

The trustees made awards to qualifying employees from time to time. Beneficiaries were issued units, evidencing their respective interests in the trust.

The trustees procured that all scheme shares remained registered in the names of the trustees for the time being, but for the beneficial interest of the relevant beneficiaries, until their delivery.

Each unit:

- was non-transferrable, but subject to forfeiture in accordance with the trust deed;
- represented a vested right to one ordinary share in the applicant;
- afforded the beneficiary the voting and distribution rights set out in the trust

deed;

- afforded the beneficiary the right to the delivery of the shares as contemplated in the trust deed.

No beneficiary was entitled to:

- pledge or encumber or dispose of his or her units or the underlying shares; or
- enter into any agreement in respect of any votes attached to the units or the underlying shares.

On the final date, (as defined in the trust deed), the trustees must deliver the shares underlying each unit to the relevant beneficiary. However, a beneficiary could deliver a notice to the trustees fifteen days before the final date:

- requesting the trustees to sell the shares for and on behalf of the beneficiary; and
- indicating that the beneficiary would take delivery of the shares, with transaction costs and taxes in that event payable by the beneficiary to the trust.

The trust deed further provides that the beneficiaries may not for a period of seven business days after the final date dispose of or encumber any shares received by them.

The trust deed also provides for special arrangements applicable to good and bad leavers. Bad leavers would forfeit their units and the shares underlying those units. In the case of retrenchments or death, the good leavers or the estate of any deceased beneficiary would still benefit from the scheme until their participation termination date.

It bears emphasis that the beneficiaries acquired beneficial ownership of the scheme shares when they acquired their units.

<u>Conditions and assumptions</u>

This binding class ruling is not subject to any additional conditions and assumptions.

<u>Ruling</u>

The ruling made in connection with the proposed transaction is as follows:

- The 'restricted equity instruments' will vest in both the beneficiaries who elect to receive shares and those who receive cash, in terms of section 8C(3)(*b*)(i) on the final date as defined in the trust deed.
- The gain to be included in the income of each beneficiary under section 8C(2)(*a*)(ii) will be the market value, that is the volume weighted average price of the shares on the JSE, on the final date as defined in the trust deed.

11. GUIDES

11.1. Guide on determination of medical tax credits (issue 8)

This guide provides general guidelines regarding the medical scheme fees tax credit and additional medical expenses tax credit for income tax purposes. It does not delve into the precise technical and legal detail that is often associated with tax, and should, therefore, not be used as a legal reference.

Expenditure of a personal nature may generally not be taken into account in determining a taxpayer's income tax liability, under South Africa's tax system. One of the notable exceptions relates to medical expenditure. South Africa is aligned with the practice in many other countries of granting tax relief for medical expenditure.

There are a number of reasons that tax systems provide such relief. One of the reasons is that serious injury or illness can present taxpayers with disproportionately high medical bills in relation to income, which can be difficult to meet. The resulting hardship affects a number of economic areas for taxpayers, including the ability to settle obligations to the *fiscus*, such as a tax bill.

Historically, South Africa utilised a deduction system to facilitate tax relief for medical expenditure. Allowances, subject to certain limits, were permitted to be

deducted from income for contributions to medical schemes, as well as for out-of-pocket medical expenditure.

In 2012, tax relief for medical expenditure began a phased-in conversion from a deduction system to a tax credit system. The reason for the change was to eliminate vertical inequity relating to medical contributions: those at higher marginal tax rates received a larger reduction of tax payable than those on lower marginal rates, in respect of the same amount of medical expenditure. The purpose of the change was to spread tax relief more equally across income groups, thus bringing about horizontal equity – those who pay equal values for medical expenditure receive absolute equal tax relief.

A tax credit system differs from a deduction system in that, instead of permitting a deduction of the medical allowance against a taxpayer's income, the relief is granted as a reduction in tax payable. It therefore operates as a tax rebate.

The new dispensation consists of a two-tier credit system:

1. A **medical scheme fees tax credit (MTC)** that applies in respect of qualifying contributions to a medical scheme; and
2. An **additional medical expenses tax credit (AMTC)** that applies in respect of other qualifying medical expenses.

The application of the additional medical expenses tax credit system falls into three categories:

- Taxpayers under 65 years of age
- Taxpayers aged 65 years and older
- Taxpayers with a disability

In order to qualify for the AMTC in the '65 years and older' category, the taxpayer must be 65 years or older on the last day of the relevant year of assessment or, had he or she lived, would have been 65 years or older on the last day of the relevant year of assessment.

12. DRAFT GUIDES

12.1. Draft comprehensive guide to dividends tax (issue 2)

The purpose of this guide is to assist users in gaining a more in-depth understanding of dividends tax. While this guide reflects SARS' interpretation of the law, taxpayers who take a different view are free to avail themselves of the normal avenues for resolving such differences.

The foundation for this guide can be found in the various *Explanatory Memoranda* which supported the dividends tax legislation. The explanations contained in these *Explanatory Memoranda* have been expanded with additional explanations and examples.

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Chapter 1 Introduction to dividends tax

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Chapter 4 Exemption from dividends tax and relief from double taxation (ss 64F, 64FA and 108)

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Chapter 8 Refund of dividends tax (ss 64L, 64LA and 64M; and s 190 of the TA Act)

Chapter 9 Rebate against normal tax or dividends tax in respect of foreign taxes on dividends (ss 6*quat* and 64N)

Chapter 10 Company reorganisation rules – CTC and dividends tax [ss 42(3A),

44(4A), 44(6)(*c*), 44(6)(*e*), 44(9)(*a*), 44(10), 46(3A) and 46(5)]

12.2. Draft comprehensive guide to capital gains tax (issue 6 – chapter 6)

A number of significant amendments affecting deceased persons and their deceased estates came into operation on 1 March 2016 and apply to persons dying on or after that date. For the position before 1 March 2016, see the previous issue of this guide.

The changes affecting CGT involved moving some of the rules in par. 40, 41 and 67 to the main body of the Act in the form of a new section 9HA and a redrafted section 25. Section 9HA deals with the deceased person, while section 25 deals with the deceased estate and heirs or legatees, including a surviving spouse.

12.3. Draft guide to the employment tax incentive (issue 2)

The employment tax incentive was introduced by the Employment Tax Incentive Act which was promulgated on 18 December 2013. This Act has since been amended on a number of occasions. This guide provides general guidance on the incentive.

The ETI is a temporary tax incentive that may be claimed by eligible employers and is aimed at encouraging such employers to employ young employees between the ages of 18 and 29, and employees of any age in special economic zones and in any industry identified by the Minister by notice in the *Government Gazette*. Payment of the incentive is effected by eligible employers being able to reduce the employees' tax due by them by the amount of the ETI that they may claim - provided of course that they meet the requirements of the ETI Act. The ETI is administered by SARS through the employees' tax system that is deducted and withheld and accounted for to SARS (usually monthly) via the Pay-As-You-Earn (PAYE) system.

As mentioned, the ETI is a temporary programme initially covering a period of three

years but has been extended for a further two years and two months. During this period an eligible employer may claim the ETI for a maximum of 24 months per qualifying employee. The ETI will be subject to continuous review of its effectiveness and impact in order to determine the extent to which its core objective of reducing youth unemployment is achieved. The ETI commenced on 1 January 2014 and will end on 28 February 2019. It applies to qualifying employees employed on or after 1 October 2013 by eligible employers.

Guide's contents:

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  - o Late payment penalty and interest
- Roll-over amounts (section 9)
- Reimbursement (section 10)
- Cessation of the employment tax incentive
- Implications for other taxes
  - o Value-added tax
  - o Income tax

13. INDEMNITY

Whilst every reasonable care has gone into the preparation and production of this update, no responsibility for the consequences of any inaccuracies contained herein or for any action undertaken or refrained from taken as a consequence of this update will be accepted.