

# TAX AND EXCHANGE CONTROL ALERT

## SPECIAL EDITION:

Our experts' views on the 2017 Draft Taxation Laws Amendment Bill and the 2017 Draft Tax Administration Laws Amendment Bill

Yesterday National Treasury and the South African Revenue Service published for public comment the 2017 Draft Taxation Laws Amendment Bill and the 2017 Draft Tax Administration Laws Amendment Bill. 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 yesterday include most of the more complex and administrative tax proposals but exclude the proposals dealt within the 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). Our experts discuss some of the most important proposed changes.

## IN THIS ISSUE

THE DEATH OF SHARE BUY-BACKS?

ASSUMPTION OF CONTINGENT LIABILITIES  
UNDER THE CORPORATE REORGANISATION  
RULES

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

FOREIGN EMPLOYMENT INCOME  
EXEMPTION – IS THIS THE END?

TRUSTS: MORE BAD NEWS, WITH ONE  
SILVER LINING

SOME PROPOSED AMENDMENTS TO THE  
VAT ACT

# THE DEATH OF SHARE BUY-BACKS?

*The current anti-avoidance provisions were limited to a scenario where there was a share buy-back linked with a subscription of shares by the purchaser of the target company. In other words, it only applied to very limited circumstances.*

*In terms of the Draft Taxation Laws Amendment Bill 2017 drastic anti-avoidance measures are introduced.*



Share buy-backs have become very popular over the last few years in circumstances where a taxpayer intended to dispose of his shareholding in a company. This was especially the case to the extent that the seller is also a company. The reason is that, should one consider the definition of a dividend in s1 of the Income Tax Act, No 58 of 1962 (Act), the proceeds from a share buy-back will be deemed to be a dividend to the extent that it is not funded out of so-called share capital or contributed tax capital (CTC). To the extent that the seller is a company, such dividend would also not be subject to dividends tax at the rate of 20% given the fact that a dividend to a resident company is exempt from dividends tax. Instead of thus paying capital gains tax (CGT) at normal company rates of 22,4%, the seller effectively divested itself of the shares in the target company and in the process received an exempt dividend.

Ironically, non-resident shareholders and individual shareholders did not opt for the share buy-back alternative given the fact that:

- a non-resident shareholder is more often than not, not subject to CGT given the fact that the proceeds will not be taxable in South Africa unless one is dealing with a so-called property rich company;
- an individual pays CGT at the rate of 18% compared to the 20% dividend withholding tax that would arise had the individual received a dividend; and
- billions of Rand of transactions have been entered into in this manner on the basis that any conceivable reason was advanced to enter into a share buy-back arrangement as opposed to an outright sale of shares. It must be noted, however, that in both instances securities transfer tax at the rate of 0,25% would be payable.

## The legislature acts

In terms of the Draft Taxation Laws Amendment Bill, 2017 (Bill) drastic anti-avoidance measures are introduced. The current anti-avoidance provisions were limited to a scenario where there was a share buy-back linked with a subscription of shares by the purchaser of the target company. In other words, it only applied to very limited circumstances. The new anti-avoidance measures which will apply with reference to disposals on or after 19 July 2017 are aimed to take into account the following:

- variations to the share buy-back structure pursuant to which sellers avoided income tax or CGT on the outright sale of shares;
- the limited scope of the current anti-avoidance provisions that only focused on debt funding advanced or guaranteed by a prospective purchaser or a connected person in relation to the prospective purchaser to fund the share buy-back; and

# THE DEATH OF SHARE BUY-BACKS?

CONTINUED

*Essentially the proposal is that dividends that are received within 18 months of the disposal, must be added to the proceeds and thus are subject to CGT or income tax, as the case may be.*



- the limited scope of the dividend stripping rules in the sense that they only applied to a scenario where a seller held more than 50% of the shares in the target company.

#### The proposal

The proposal contained in the Bill is aimed at a scenario where the shares are both held as trading stock as well as on capital account. Essentially the proposal is that dividends that are received within 18 months of the disposal, must be added to the proceeds and thus are subject to CGT or income tax, as the case may be. The dividends are thus not exempt from tax. However, at least there will not be an additional dividends tax that will apply.

The following circumstances must exist before the anti-avoidance rules will apply:

- the seller must be a resident company. In other words, if one is dealing with a non-resident shareholder, the aim is that it will receive a dividend which is subject to dividends tax at the rate of 20% or such other rate as may be applicable in terms of the relevant treaty. If one had extended the anti-avoidance rules to a non-resident shareholder, it would effectively have meant that the non-resident
- the seller (together with connected persons in relation to the seller) must hold at least 50% of the equity shares or voting rights in the target company or at least 20% of the equity shares or voting rights in the target company if no other person holds the majority of the equity shares or voting rights. In other words, the scope is now much wider as the anti-avoidance rules could also be applicable if one holds 20% of the shares in the target company and nobody holds the majority of the equity shares (ie more than 50%);
- a dividend is received or accrues within 18 months prior to the disposal of the shares in the target company or is received or accrues, regardless of the time of the receipt or accrual, by reason of or in consequence of the disposal of the target company shares. In other words, even if one receives a dividend subsequently and it is linked to the overall disposal, the dividend will still be added to proceeds.

shareholder would not pay any tax given the fact that it is not liable to tax on the proceeds of the sale of shares in a company unless the company is a property rich company;

# THE DEATH OF SHARE BUY-BACKS?

CONTINUED

*Taxpayers will thus have to consider their agreements urgently so as not to fall foul of the proposals.*



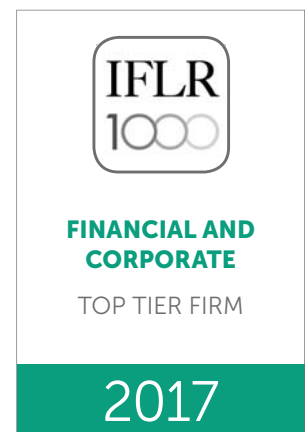
It is important to appreciate that there is no longer a focus on the way in which the dividend is funded or whether there is also a subscription for shares. The only test now is whether one has received an exempt dividend within an 18 month period, in which event the dividend will be added to proceeds.

Given the fact that the amendment applies with effect from 19 July 2017, agreements that may have been entered into prior to this date but have not become unconditional, will also be covered by the anti-avoidance provisions. The reason is that a disposal is understood to be an agreement which is unconditional or an agreement the suspensive conditions of which have been fulfilled. Taxpayers will thus have to consider their agreements urgently so as not to fall foul of the proposals.

It should be appreciated that comments are still awaited in respect of the proposals. National Treasury can expect to be flooded with comments on this provision, even though taxpayers have been warned about this potential abuse for a number of years.

It should be appreciated that, even in its current format, the proposal has limited application. The reason is that, to the extent that one is dealing with a minority shareholder, a buy-back can still be implemented. It is only if one holds more than 50% of the shares in the target company or more than 20% if no other person holds the majority of the equity shares, that the proposal will become applicable.

*Emil Brincker*



# ASSUMPTION OF CONTINGENT LIABILITIES UNDER THE CORPORATE REORGANISATION RULES

*The South African Revenue Service (SARS) previously issued Interpretation Note No. 94 dated 19 December 2016, which addressed the tax implications of contingent liabilities assumed in the acquisition of a going concern.*

*In terms of s42 of the Act and s44 of the Act, a person may dispose of assets to a company that is a resident in exchange for the issue of equity shares or the assumption of debt.*



On 19 July 2017 National Treasury published the Draft Taxation Laws Amendment Bill, 2017 (Bill) in terms of which it proposes to clarify the tax implications arising when a person assumes contingent liabilities under the corporate reorganisation rules contained in s41 to s47 of the Income Tax Act, No 58 of 1962 (Act) (Corporate Reorganisation Rules).

The South African Revenue Service (SARS) previously issued Interpretation Note No. 94 dated 19 December 2016, which addressed the tax implications of contingent liabilities assumed in the acquisition of a going concern (Interpretation Note). In paragraph 3 of the Interpretation Note, SARS explained their understanding of a “contingent liability” as follows:

A contingent liability means an obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events and, if confirmed, will result in expenditure being incurred to settle the confirmed obligation.

To explain the concept of a “contingent liability”, SARS used the example of a provision for bonuses that will be paid out to employees if they are still employed by the employer on a specific date. In such instance, the Interpretation Note stated that:

- there is a distinct obligation to pay the bonus under specific circumstances;
- the existence of the liability can be confirmed only on a specific date; and

- to the extent that it is confirmed, it will result in expenditure being incurred to settle it.

The Interpretation Note focused on the treatment of “free-standing contingent liabilities”, which are independent of the assets disposed of, in the hands of both a seller and purchaser when a business is transferred as a going concern. Examples of free-standing contingent liabilities include warranty claims and employee-related provisions such as bonus provisions, leave pay and post-retirement medical aid provisions.

In terms of s42 of the Act (asset-for-share transactions) and s44 of the Act (amalgamation transactions), a person may dispose of assets to a company that is a resident in exchange for the issue of equity shares or the assumption of debt. The debt must have been incurred more than 18 months prior to the disposal of the assets. In the event that the debt was incurred within a period of 18 months prior to the disposal, the debt must for instance have constituted refinancing of a debt incurred more than 18 months prior to the disposal or the debt must have been attributable to and arose in the ordinary course of a business undertaking disposed of as a going concern.

# ASSUMPTION OF CONTINGENT LIABILITIES UNDER THE CORPORATE REORGANISATION RULES

CONTINUED

*The proposal is to insert a new definition in s41 of the Act which expressly states that debt for purposes of the Corporate Reorganisation Rules includes contingent debt.*



In the context of a transfer of a going concern, the Interpretation Note stated that SARS accepts that "debt" as used in s42(8)(b) of the Act includes free-standing contingent liabilities. It was stated that s42(8)(b) specifically deals with the transfer of a business as a going concern and that the legislature clearly envisaged that such a transfer would include the assumption of free-standing contingent liabilities as other consideration. Similarly, it was stated that SARS accepts that debt in the context of s44(4)(b)(i)(bb)(B) will be interpreted to include free-standing contingent liabilities which are assumed as other consideration for assets acquired as part of the acquisition of a going concern.

However, the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2017 (2017 Memorandum) that was published with the Bill, states that the concept of debt as contemplated under the Corporate Reorganisation Rules refers

to an existing and real obligation to pay another party and that the other party must have a legal right to collect or receive the payment. It is therefore proposed to expand on this concept of debt for purposes of the Corporate Reorganisation Rules. The proposal is to insert a new definition in s41 of the Act which expressly states that debt for purposes of the Corporate Reorganisation Rules includes contingent debt. This will accordingly clarify the position.

According to the 2017 Memorandum, all restrictions that currently apply to debt for purposes of the Corporate Reorganisation Rules (for example the 18-month rule) will also apply to contingent debt.

It is proposed that the amendment will come into effect on the date of promulgation of the Bill.

*Mareli Treurnicht*

CHAMBERS GLOBAL 2011 - 2017 ranks our Tax and Exchange Control practice in Band 2: Tax.

Emil Brincker ranked by CHAMBERS GLOBAL 2003 - 2017 in Band 1: Tax.

Mark Linington ranked by CHAMBERS GLOBAL 2017 in Band 1: Tax.

Ludwig Smith ranked by CHAMBERS GLOBAL 2017 in Band 3: Tax.

Gerhard Badenhorst ranked by CHAMBERS GLOBAL 2017 in Band 1: Tax.



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

*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.*

*The Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017 states that 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 Income Tax Act, No 58 of 1962 (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. The tax implications arising in respect of the reduction of a debt, depends mainly on whether the loan funding was used to fund tax deductible expenditure such as operating expenses or alternatively capital or allowance assets. The debt reduction rules apply only to the extent to which the waiver, cancellation, reduction or discharge of a debt gives rise to a "reduction amount", in other words, the amount, by which the decrease in debt exceeds the consideration received by the creditor in return.

## Background to the proposed change

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. A company may, for example, reduce its debt by:

- issuing shares directly to a creditor in full and final settlement of the debt;
- issuing shares for an amount payable in cash and setting off the subscription price owed by the subscriber against an amount owed by the company;
- converting debt to shares in fulfilment of the conversion rights attaching to the debt (such as convertible debentures); or
- issuing shares to the creditor in exchange for cash and then applying the cash against the debt owed by the company.

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 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 most recent rulings include Binding Private Ruling 246 and Binding Private Ruling 255.

## Reasons for the change

The Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017 (2017 Memorandum) states that 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. It states further that the shareholder/creditor envisages, 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. As a result thereof, the

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

CONTINUED

*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.*



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 way of a loan.

#### **Proposal: Exclusion of debt to equity conversions from the application of the debt reduction rules**

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. It is therefore proposed in the Draft Taxation Laws Amendment Bill, 2017 (Bill) that the rules dealing with debt that is cancelled, waived, 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 s1 of the Act in order to include multinational groups of companies). The Bill therefore proposes the insertion of a further exclusion from the application of s19 of the Act where one group company is indebted to another and the debt is reduced or settled, indirectly or directly, by means of shares issued by the debtor group company.

A similar exclusion is proposed in respect of debt utilised to fund capital and allowance assets contemplated in paragraph 12A of the Eighth Schedule to the Act.

While several rulings issued by SARS implied that one could capitalise shareholder loans without triggering the debt reduction rules, the insertion of the specific exclusions in s19 and paragraph 12A of the Eighth Schedule to the Act, now codifies this exclusion specifically. Notably, the specific exclusion in respect of the issue of shares and the reduction of debt does not extend to a non-group context. This is based on the fact that 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. Therefore, to the extent that two non-group companies enter into a similar arrangement, one would still apply the ordinary principles which may or may not result in the trigger of the debt reduction rules depending on the specific factual circumstances.

#### **Anti-avoidance: five year de-grouping rule**

Notwithstanding the specific relief proposed within a group context, in order to counter abuse of the above-mentioned relief by taxpayers who simply wish to cancel, waive, 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. To the extent



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

CONTINUED

*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.*



that the companies "de-group" within five years, it will trigger the ordinary application of the relevant debt reduction rules. This relief will apply in respect of debt governed by both s19 of the Act and paragraph 12A of the Eighth Schedule.

#### **Further proposal: 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, ie as if the loan had always been an equity investment.

As a result, the following is proposed:

- 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;

- 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; and
- 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.

*Jerome Brink*

# FOREIGN EMPLOYMENT INCOME EXEMPTION – IS THIS THE END?

*Early this year in the 2017 Budget, it was proposed that the exemption be adjusted as it was “excessively generous” for those that still benefited from it.*

*In terms of the proposal in the Bill, the exemption is not merely being adjusted, but proposes that the entire exemption in terms of s10(1)(o)(ii) be repealed.*



Currently, s10(1)(o)(ii) of the Income Tax Act, No 58 of 1962 (Act), states that if a South African resident works in a foreign country for more than 183 days a year, with more than 60 of those days being continuous, foreign employment income earned is exempt from tax, subject to certain conditions. This exemption is only available to employees from the private sector. Early this year in the 2017 Budget, it was proposed that the exemption be adjusted as it was “excessively generous” for those that still benefited from it, ie private sector employees. It was proposed that foreign employment income will only be exempt from tax if it was subject to tax in the foreign country.

## A bit of history

In 2001, when South Africa changed from source to residence basis of taxation, s10(1)(o)(ii) was introduced to provide tax relief to South African tax residents who rendered services outside of South Africa. According to the Explanatory Memorandum on the Revenue Laws Bill, 2000 (2000 Memorandum), this move was to bring South Africa in line with internationally accepted practice. At the time, the s 10(1)(o)(ii) exemption did not apply to certain public sector employees. However, s10(1)(o)(ii) was again revisited in 2011 when the source rules were unified and s9 of the Act was significantly amended. In terms of the amendments to s9, the source of services provided to or on behalf of the various tiers of government were deemed to be from a South African source, irrespective of where those services were rendered. Consequently, s10(1)(o)(ii) was also amended by inserting a proviso excluding all public sector employees from the exemption.

## Proposal

The proposal in the Draft Taxation Laws Amendment Bill, 2017 (Bill), goes further than the proposal stated in the 2017 Budget. In terms of the proposal in the Bill, the exemption is not merely being adjusted, but proposes that the entire exemption in terms of s10(1)(o)(ii) be repealed. Relief from double taxation will still be available in terms of s6quat of the Act.

## Reasons

The reasons behind this move are twofold:

- The main purpose of the exemption was to prevent double taxation occurring, considering that a limited number of Double Taxation Agreements (DTAs) had been concluded by South Africa and other countries at the time. National Treasury has realised that this exemption creates opportunities for double non-taxation where foreign countries do not impose income tax.
- Secondly, unequal treatment has been created between public and private sector employees.

# FOREIGN EMPLOYMENT INCOME EXEMPTION – IS THIS THE END?

CONTINUED

*Where the resident state imposes tax in respect of the same income that the source state has a right to tax, the resident state is required to provide relief by way of a foreign tax credit or exemption.*

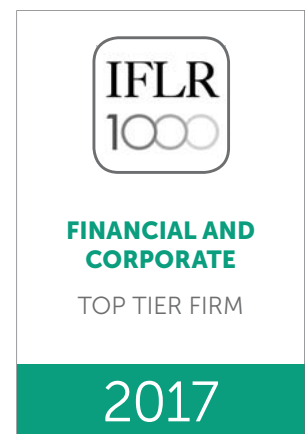


## Role of the DTAs and practical considerations

Inasmuch as the DTAs eliminate double taxation by allocating taxing rights between source and resident states, the resident state is not precluded from taxing the same income that the source state is allocated a right to tax. In instances where the resident state (the state where the taxpayer is a tax resident) imposes tax in respect of the same income that the source state (the state where the services are rendered) has a right to tax, the resident state is required to provide relief by way of a foreign tax credit or exemption. The foreign tax credit is similar to the rebate available in terms of s6quat.

In practice, it could happen that where a person employed by a South African employer renders services abroad, such person's salary will be subject tax in the source state and in South Africa, before the employee can claim the relief available in terms of s6quat. The effect of this is that employees will likely be out of pocket until such time that they can claim a refund from SARS. It is important to note that the proposed amendment will come into effect on 1 March 2019 and will apply to years of assessment commencing on or after that date.

*Nandipha Mzizi*



# TRUSTS: MORE BAD NEWS, WITH ONE SILVER LINING

*In the 2017 Budget, National Treasury noted that in response to s7C, some taxpayers attempted to circumvent this anti-avoidance measure by making low-interest or interest-free loans to companies owned by a trust and that s7C might be extended to also apply to such avoidance schemes.*

*In the Draft Taxation Laws Amendment Bill, 2017 and the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2017, Treasury has indicated exactly how it intends to address these avoidance schemes.*



On 1 March 2017, s7C of the Income Tax Act, No 58 of 1962 (Act) came into effect. One of the reasons for introducing this provision was to prevent taxpayers from avoiding estate duty, by selling assets to a trust on loan account, which loan account they would then extinguish by making use of their annual donations tax exemption of R100,000. Section 7C addresses this avoidance, by providing, amongst other things, that the trust must pay interest on such loan, advance or credit, but only where the trust and the natural person are connected persons, such as where the natural person is a beneficiary of the trust. Where the trust does not pay interest on the loan to the natural person or pays interest at a rate below the official rate of interest, as defined, a deemed donation would arise in the hands of the natural person. We discussed the provisions of s7C in our [Tax and Exchange Control Alert of 10 February 2017 \(Trusts – the new position\)](#).

In the 2017 Budget, National Treasury (Treasury) noted that in response to s7C, some taxpayers attempted to circumvent this anti-avoidance measure by making low-interest or interest-free loans to companies owned by a trust and that s7C might be extended to also apply to such avoidance schemes.

In the Draft Taxation Laws Amendment Bill, 2017 and the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2017, Treasury has indicated exactly how it intends to address these avoidance schemes.

#### **The 2017 Memorandum - reasons for change**

The 2017 Memorandum again highlights the anti-avoidance that arises where the loan, advance or credit is made by a person to a company owned by the trust, instead of to the trust. As s7C only applies to trusts, it would not be necessary for the company to pay interest on such loans or credit advanced to it by the lender. The 2017 Memorandum further notes that the companies receiving these loans, 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 (First Scheme).

Another avoidance scheme that is highlighted in the 2017 Memorandum, is one where taxpayers enter into an arrangement where 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 to whom the loan claim is transferred 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. 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 (Second Scheme).

# TRUSTS: MORE BAD NEWS, WITH ONE SILVER LINING

CONTINUED

*Importantly, the 2017 Memorandum states that these proposed amendments come into effect on 19 July 2017 (yesterday), in respect of any amount owed by a trust or a company in respect of a loan, advance or credit provided to that trust before, on or after that date.*



## Proposal – the bad news

In order to curb the avoidance that arises from the First Scheme, it is proposed that the application of s7C be extended so that it also applies to 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.

Furthermore, the 2017 Memorandum states that to address the avoidance that arises from the Second Scheme, the person who acquires the loan claim from the person who made the original loan to the trust, will be deemed to have advanced the amount of that claim as a loan on the date that person acquired that claim. In other words, the trust would have to pay interest on the loan to the person who acquired that loan and to the extent that it pays interest on the loan at a rate lower than the official rate of interest, as defined, a donation will arise in the hands of such person.

Importantly, the 2017 Memorandum states that these proposed amendments come into effect on 19 July 2017 (yesterday), in respect of any amount owed by a trust or a company in respect of a loan, advance or credit provided to that trust before, on or after that date.

## The silver lining – exclusion of employee share schemes from s7C's application

In the 2017 Memorandum, Treasury acknowledges that 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, which could lead to the avoidance of estate duty. Currently, s7C(5) lists the following seven circumstances under which the anti-avoidance provisions in s7C, discussed above, will not apply:

- where the trust is an approved public benefit organisation in terms of s30(3) of the Act or a small business funding entity approved by the Commissioner in terms of s30C of the Act;
- in the case of a vesting trust (bewind trust), where the loan is made by a trust beneficiary to a vesting trust, provided that the four requirements of s7C(5)(b) are met;
- if the trust is a special trust created solely for the benefit of minors with a disability as defined in paragraph (a) of the definition of "special trust" in s1 of the Act;
- where the loan, advance or credit constitutes an affected transaction as defined in s31(1) of the Act (which deals with transfer pricing);

# TRUSTS: MORE BAD NEWS, WITH ONE SILVER LINING

CONTINUED

*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.*



- where the loan, advance or credit was provided to that trust in terms of an arrangement that would have qualified as a sharia compliant financing arrangement as contemplated in s24JA of the Act, had the trust been a bank as defined in that section;
- if the loan, advance or credit is subject to the anti-value extraction provisions of s64E(4) of the Act; and
- where the trust used that loan, advance or credit wholly or partly to fund the acquisition of a residence that is used by that person or their spouse as their primary residence, to the extent to which that loan, advance or credit was used to fund the acquisition.

Treasury acknowledges in the 2017 Memorandum that s7C may have a negative impact on some employee share schemes (ESOPs) 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.

In order to ensure that ESOPs are not negatively affected, it is proposed that a specific exclusion for them should be provided. However, certain requirements must be met for the exclusion to apply to ensure that business owners do not abuse

the exclusion to transfer wealth to family members employed by the business. The requirements are as follows:

- The trust should be created solely to give 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 trust's acquisition in that company's shares or in any other company forming part of the same group of companies;
- 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 a full-time employee or being a director of a company; and
- If a person is a connected person in terms of paragraph (d)(iv) of the definition of "connected person" in s1 of the Act, in relation to a company or any other company forming part of the same group of companies as that company, such person may not participate in the scheme.

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.

.....  
**Louis Botha**

# SOME PROPOSED AMENDMENTS TO THE VAT ACT

*The output tax must be accounted for in the tax period in which the leasehold improvements are completed.*

*Section 18B of the Value Added Tax Act No, 89 of 1991 provides for relief of up to 36 months for a property developer that temporarily lets such property until a buyer is found, for the developer not to be required to account for output tax.*



## VAT on leasehold improvements

It is proposed that where a lessee effects leasehold improvements to the property of a lessor for no consideration, the lessee is deemed to have made a taxable supply of goods to the lessor in the course or furtherance of the lessee's enterprise.

The value of such a supply is deemed to be nil. The lessee is therefore entitled to deduct the VAT incurred on the cost of the leasehold improvements as input tax. However, if the property is not used by the lessee for making taxable supplies, there is no deemed supply and the lessee is not entitled to any input tax deduction.

There is further no VAT implication for the lessor with regard to the leasehold improvements effected by the lessee. However, if the leasehold improvements are not applied by the lessor for making taxable supplies, then the lessor will be required to account for output tax on the higher value of the open market value of the improvements, the actual cost to the lessee to effect the improvements or the amount agreed upon for the improvements by the lessor and the lessee. The output tax must then be accounted for in the tax period in which the leasehold improvements are completed.

These proposed amendments will become effective from 1 April 2018.

## Temporary letting of residential property developed for sale

Where a property developer develops the residential property for sale and lets the properties which it is unable to sell on a temporary basis, the developer is required to account for output tax on the open market value of the property when it is first let.

Section 18B of the Value Added Tax Act No, 89 of 1991 provides for relief of up to 36 months for a property developer that temporarily lets such property until a buyer is found, for the developer not to be required to account for output tax. This relief provision ceases to apply on 1 January 2018.

The Draft Taxation Laws Amendment Bill, 2017 does not provide for an extension of this relief provision. It is not clear whether this is intentional or an oversight.

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