Tax & Exchange Control

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KIETI LAW LLP, KENYA

Special Edition Alert

Budget Speech

22 February 2023

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The repeal of Practice Note 31 and the impact on the deductibility of interest

Practice Note 31 (PN31), released on 3 October 1994, survived almost 30 years in circumstances where both SARS and taxpayers attacked its validity over time. Ironically, when a taxpayer has relied on the validity of PN31, SARS has queried the legal justification thereof, and vice versa. It is still not clear why taxpayers wanted to attack the validity of PN31 as it only benefits a taxpayer. In any event, since the judgment of the Constitutional Court in *Marshall v CSARS 80 SATC 400* it is clear that interpretation notes (and for that matter practice notes) would only bind SARS and not necessarily taxpayers. In that case, the Constitutional Court held that a unilateral practice of one part of the executive arm of Government should not play a role in the determination of the reasonable meaning to be given to a statutory provision. As such, the relevant provisions should be interpreted independently of the interpretation note/practice note.

Some reprieve has been given to taxpayers on the basis that the repealing of PN31 will be postponed such that one could consider whether changes can be made in the tax legislation to accommodate legitimate transactions. Accordingly, the withdrawal of PN31 will be delayed until new legislation has become effective.

PN31 only consists of two short paragraphs. The first paragraph indicates that one can only claim a deduction of expenditure in terms of section 11(a) of the ITA if they are carrying on a trade. Should one therefore borrow money at a certain rate of interest (say 5%) with the specific purpose of making a profit by lending it out at a higher rate of interest (say 6%), PN31 indicates that "*it may well be*" that a person has entered into a venture and is thus carrying on a trade.

Firstly, it is clear that a person will in those circumstances have entered into a venture and thus be carrying on a trade. In *ITC 1429* 50 SATC 40 this type of scenario was specifically considered by the Tax Court and it was confirmed that the taxpayer incurred the interest in these circumstances for purposes of trade. A once-off borrowing of funds and the on-lending thereof at a profit would thus constitute a trade resulting in the deduction of interest.

The repeal of Practice Note 31 and the impact on the deductibility of interest *...continued*

The importance of PN31 to taxpayers is found in the second paragraph. It indicates:

> *"While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. This practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate".*

The first issue for consideration in this statement is that there seems to be a confusion between the test whether an expense is on capital account and whether an expense has been incurred for purposes of trade. The test of whether one is a moneylender is used to determine whether an expense or loss has been incurred on capital account or on revenue account. This element plays a role in determining whether one can claim a loss should the borrower fail to repay the capital amount, but not whether the interest is deductible. Whether one is a moneylender does not play a role to determine whether an expense has been incurred for purposes of trade. A trade is defined very widely in section 1 of the ITA to include a once-off venture. The issue, however, is whether one is conducting a trade to the extent that no profit is derived from the venture (for instance borrowing at 6% and on-lending at 5%). To the extent that one therefore enters into a venture without the expectation to make a profit and there are no other reasons why the ostensible loss is derived (for instance to support an existing business), there is no reason to allow the deduction of the interest in these circumstances. Nevertheless, SARS did allow the deduction of interest to the extent that it did not exceed the income.

However, a wider interpretation evolved over time as to the meaning of this paragraph. For instance, if one received R100 of interest and incurred R90 of interest on a different transaction, the argument was that one should still be entitled to claim a deduction of the R90 even though there is no ostensible link between the earning of the interest and the incurring of the interest. For instance, to the extent that interest has been incurred in order to derive exempt income (for instance dividends), the argument was that one should still be entitled to claim a deduction to the extent that interest has been received on a different unrelated transaction or investment. In such an instance the question is not whether one is a moneylender or not, but what the purpose of the relevant expenditure

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may be and what it affects. That is the first hurdle to determine whether the expenditure has been incurred in the production of income of the taxpayer. Only thereafter does one need to consider whether the expenditure has also been incurred for purposes of trade.

The requirement that income should be received by a taxpayer and that there should be an expectation to derive a profit has become quite relevant in the context of a holding company advancing funds to subsidiaries. The argument has been made by taxpayers that the loans to the subsidiaries would be part and parcel of the investment made into the subsidiary and that interest should therefore be deductible whether or not the loans to the subsidiaries are made on a profitmaking basis. This clearly becomes a problem to the extent that one cannot show a direct link between any borrowing by the holding company and the lending of funds to the subsidiaries.

One should not confuse the purpose of making a profit with a scenario where one conducts treasury operations. In the case where one conducts treasury operations, the general purpose of the treasury company would be to borrow monies and to on-lend to group companies. Even to the extent that one or two loans to group companies may not be at a profit (taking into account the average borrowing rate of the treasury company), the interest incurred by the treasury company may still be deductible to the extent that the treasury company overall derives a profit. This follows from the principle that one can borrow money generally in order to on-lend at a profit without necessarily being required to link the relevant transactions. However, in these circumstances one would then need to show that one is in fact conducting treasury operations and that one is effectively acting as a moneylender (such that the transactions are all on revenue account on the part of the moneylender). The risk for a treasury company is that it enters into transactions for the benefit of the group, as opposed to itself. In the well-known *Solaglass* case it was held that the taxpayer was a moneylender, but that the expenditure was incurred for the benefit of the group as opposed to considering the position of the treasury company itself. Given the fact that South Africa has not adopted a group taxation basis, each transaction needs to be considered from the taxpayer's perspective, irrespective of whether it is also intended to benefit the group.

The withdrawal of PN31 may also impact upon a scenario where a taxpayer does generate cash form its business operations and does not use that within the business, but generally borrows money in order to fund its trading stock. Generally, taxpayers in these circumstances would take most of the cash that is generated by the business activities in order to settle an investment in, say, shares that derives exempt income investment which would otherwise be unproductive. The argument for taxpayers is that, for as long as the taxpayer borrows money in order to acquire trading stock, the interest should be deductible even though the cash that is generated from the trading activity is not used to bulk up the trading stock, but to fund a different transaction. One should be careful that, in those circumstance, the purpose of the borrowing is not ultimately found to be for the non-productive purpose (to derive dividends) in circumstances where the funds so generated are all used to pay for the non-productive asset and where one has to borrow money each time to acquire trading stock.

Emil Brincker

The lights are still not on, but someone has finally come home

Every South African is currently faced with the ongoing negative effects of rolling electricity blackouts, which Government euphemistically refers to as "*loadshedding*". It affects our businesses, our homes, our livelihoods, our safety and our faith in the future of our country. It is no wonder that the theme on everyone's lips leading up to this year's Budget was whether Government would come to the party and provide some type of incentive or initiative that would help alleviate the pressure on the national grid and return the country's energy supply to some semblance of normality.

Vietnam is a case in point. While electricity consumption in Vietnam has increased substantially since the early 1990s, it has enacted various reforms to keep up with this increased consumption, thereby ensuring no electricity crisis. Included in these reforms are various tax incentives such as preferential tax rates for income derived from renewable energy, import duty incentives and other indirect tax incentives. On the other side of the spectrum is Venezuela, which suffered a complete collapse of its national grid that took a week to restore due to the ongoing neglect of infrastructure and rampant corruption.

While National Treasury and SARS have already played a role by granting renewable energy incentives, the most well-known of which is the ITA's section 12B accelerated capital allowance on renewable energy assets, many South Africans have increasingly called for an expansion of the existing incentives and initiatives to fast track the uptake in rooftop solar and wind energy. Those listening to the Budget today therefore breathed a collective sigh of relief, followed by a broad "*Colgate*" smile when learning of the various announcements made by Government. We highlight some of the key announcements in this article.

Expanded 125% renewable energy tax incentive for businesses

Currently, the section 12B allowance provides that businesses can deduct the costs of certain renewable energy installations over a one or three-year period, which creates a cash flow benefit in the early years of a project. Under the expanded incentive announced in the Budget today, businesses will be able to claim a 125% deduction in the first year for all renewable energy projects with no thresholds on generation capacity. This means, irrespective of the capacity of the renewable energy assets (i.e. less than or more than 1MW), one will be able to claim the 125% deduction. This is a departure from the existing incentive, which made a distinction between projects generating less than 1MW (which could be depreciated by 100% in year one) and those generating more than 1MW (which could be depreciated over a three-year period). This also aligns with the recent increase in the licensing threshold for embedded generation to 100MW.

The adjusted incentive for business will only be available for investments brought into use for the first time between 1 March 2023 and 28 February 2025. If, for example, a renewable energy investment of R1 million is made by a business, that business will qualify for a deduction of R1,25 million. According to National Treasury, this deduction could reduce the corporate income tax liability of a company by R337,500 in the first year of operation.

The lights are still not on, but someone has finally come home*...continued*

Renewable energy incentives for private households

A further welcome proposal relates to rooftop solar incentives for individuals to invest in solar PV. Individuals will be able to receive a tax rebate to the value of 25% of the cost of any new and unused solar PV panels. Notably, to qualify for the allowance, the solar panels must be purchased and installed at a private residence, and a certificate of compliance for the installation must be issued between 1 March 2023 and 29 February 2024.

Even though inverters and batteries form a substantial cost of any home energy installation, the rebate will be limited to solar PV panels, and not inverters or batteries. National Treasury states that this is to ensure a focus on the promotion of additional generation of energy. This is likely to be in anticipation of allowing homeowners to sell electricity back into the grid to alleviate pressure on Eskom. In fact, it was also announced that the start of feed-in tariffs in some municipalities (e.g. the City of Cape Town) may require adjustments to the Income Tax Act 58 of 1962 (ITA) to cater for additional revenue from electricity sales.

Practically, it has been proposed that the private solar energy incentive can be used to offset an individual's personal income tax liability for the 2023/24 tax year up to a maximum of R15,000 per individual.

Impact on the fiscus

National Treasury has indicated that tax relief amounting to R13 billion in 2023/24 will be provided to taxpayers. Notably, R9 billion of this amount is provided to encourage households and businesses to invest in renewable energy, supporting the clean energy transition and addressing the electricity crisis. More specifically, R4 billion in relief is provided for households that install solar panels and R5 billion to companies through the expansion of the existing renewable energy incentive.

In comparison to the negative impact that loadshedding has on South Africa's economy and its people's psyche, this is a small price to pay. While more details will emerge in the coming weeks, every South African will welcome these announcements with a view to hopefully having the lights being switched back on.

Jerome Brink

Review of "*qualifying purpose*" in the context of third-party backed shares

Readers may recall Binding Private Ruling 379, which was issued by SARS on 3 October 2022.

The facts were briefly as follows. A certain company, Company A, had issued redeemable preference shares to another company in order to raise funds. The purpose of raising the funds were for Company A to make a loan to its holding company, which would in turn acquire shares in a locally listed company.

It was accepted that the preference shares could constitute "*hybrid equity instruments*" for purposes of section 8E of the ITA, or "*third-party backed shares*" for purposes of section 8EA of the ITA.

Sections 8E and 8EA are anti-avoidance provisions which effectively deem any dividends received on certain instruments to be income in the hands of the recipient, unless in certain circumstances the shares were issued for or applied for a qualifying purpose.

A qualifying purpose generally refers to the direct or indirect acquisition of shares in operating companies (and other relevant permutations involving re-financing of such acquisitions).

It appears that in this particular case, the preference shares were initially issued or applied for a qualifying purpose because the listed company was assumed to be an operating company.

Preference dividends paid would therefore not have been deemed to be income.

However, the holding company subsequently disposed of the shares due to unfavourable market conditions.

After this disposal event, Company A wanted to pay a dividend in respect of the preference shares. The question that arose was whether one would still be dealing with a qualifying purpose after the shares had been disposed of. If not, the preference dividend would be deemed to be income for the recipient.

The South African Revenue Service (SARS) ruled that sections 8E and 8EA would not apply, and would not recharacterize the preference dividends as income.

In the Budget, it was indicated that SARS will be reconsidering the rules in relation to "*qualifying purpose*" in the context of third-party backed shares, and specifically in circumstances where the shares in the operating company are no longer held by the person who initially acquired them.

It appears therefore that SARS is either backtracking on the ruling or will be making legislative amendments that would make the ruling redundant.

Heinrich Louw

Closing a targeted scheme abusing the tax implications inherent to contributed tax capital

The "*contributed tax capital*" (CTC) of a company is a notional tax concept that denotes an amount derived from the value of any contribution (typically a subscription price) made to a company as consideration for the issue of a specific class of shares. CTC is reduced by any part that is allocated by the company in a subsequent transfer to one or more shareholders if the board specifically resolves that a distribution will give rise to a reduction of CTC.

A key feature of CTC is that although, like a dividend, it amounts to a distribution to a shareholder by a company in respect of a share, because the definition of "*dividend*" contained in the ITA excludes amounts resulting in the reduction of CTC, CTC distributions do not attract the tax implications which a "*dividend*", for tax purposes, would typically attract.

National Treasury has identified of the misuse of the CTC provision in schemes involving the interposition of a foreign company which becomes South African tax resident, between a South African company desiring to effect a dividend distribution to its foreign shareholder.

Under the recognised arrangement:

- A distribution is to be affected by a South African company (SA issuer) to a foreign company (foreign beneficial owner).
- Prior to such distribution another foreign company is interposed between the SA issuer and the foreign beneficial owner (intermediary company).
- The intermediary company becomes South African tax resident. When this takes place, in terms of the definition of "*contributed tax capital*" contained in section 1 of the ITA, the CTC recognised as an amount equal to the market value of the shares in the intermediary company.
- The SA issuer will thereafter proceed to affect the dividend distribution to the intermediary company, and such dividends are exempt from dividends tax under the SA tax resident-company-to-company exemption contained in section 64F(1)(a) of the ITA.
- When the intermediary company on-distributes the funds to the foreign beneficial owner, the distribution is affected out of CTC and is therefore not subject to dividends tax by virtue of the "*dividend*" definition which excludes amounts resulting in the reduction of CTC.

To prevent these schemes from being implemented to avoid dividends tax, National Treasury proposes introducing legislation. Amendments are also intended to be introduced to deal with the conversion of amounts denominated in foreign currency to rands by foreign entities which change their tax residency to South African i.e. presumably the intermediary company, in the context, of the arrangement outlined above.

Stephan Spamer and Howmera Parak

Section 23M caught SARS' interest

Section 23M of the ITA applies where tax-deductible interest is incurred by a taxpayer on a loan advanced by a person not subject to tax (i.e. where that interest will not be caught by the South African income tax net in the creditor's hands). In effect, this section limits the amount of this interest which that taxpayer may claim as a tax deduction, which aligns with Government's Base Erosion Profit Shifting (BEPS) initiatives. National Treasury has now proposed amendments to section 23M to clarify its application and interaction with other sections of the ITA.

Section 23M(1): Adjusted taxable income

Section 23M limits the deductibility of interest to an amount calculated as a portion of a taxpayer's *"adjusted taxable income"*, a term defined in section 23M(1). Therefore calculating a taxpayer's *"adjusted taxable income"* is integral to applying this section.

Currently, this *"adjusted taxable income"* must be calculated after taking into account all other sections of the ITA, and then adding back any assessed losses already deducted under section 20 of the ITA. Given that section 20 itself requires all other sections of the ITA to have been taken into account in determining a taxpayer's deductible assessed losses for a year of assessment, there is a potential conflict between section 20 and section 23M.

National Treasury now proposes that section 23M(1) be clarified to indicate that only the balance of assessed losses carried forward from a taxpayer's prior year of assessment be added back when calculating that taxpayer's *"adjusted taxable income"*. This would mean that a taxpayer's *"adjusted taxable income"* for a current year of assessment would be calculated with reference to its assessed losses carried forward from its prior year of assessment only, and not its assessed losses from its current year of assessment as well.

Lacking a definition of *"creditor"* to date, National Treasury has also proposed including a definition of this term in section 23M(1).

Section 23M caught SARS' interest*...continued*

Section 23M(2): Interest withholding tax

Also integral to applying section 23M is the amount of interest incurred by a taxpayer, the deductibility of which is being limited. Here section 23M reduces this interest by the amount of interest withholding tax paid on it. National Treasury proposes this be clarified so that this withholding tax reduction is only applicable where the interest is paid to a non-resident creditor.

Section 23M(6): Funding sourced from South African banks

Section 23M(6) provides the various exemptions from the interest limitation rules in section 23M. One of these is where a creditor lends funds to a taxpayer, but itself procured these funds from a "*lending institution*" (i.e. a foreign bank). National Treasury now proposes that this be amended to clarify that where a creditor obtains funds to on-lend to a taxpayer from a South African bank, this will also qualify for the exemption provided in section 23M(6)(a).

Section 23M(7): Foreign exchange gains and losses

Losses made on foreign exchange instruments are currently taken into account under section 23M(7) in so far as these losses have qualified for a tax deduction in a taxpayer's hands. Currently, no similar treatment exists for gains made by a taxpayer on foreign exchange instruments. Therefore, National Treasury proposes section 23M(7) be amended so that any foreign exchange gains included in a taxpayer's income under the ITA for a year of assessment be regarded as interest received by that taxpayer for purposes of section 23M.

Nicholas Carroll

Asset-for-share exchanges: Relief where anti-avoidance provisions bite

Where a person transfers an asset to a company in return for shares, various sections of the ITA come into play.

If the value of the asset transferred to the company exceeds the value of the shares issued by the company, the company incurs a capital gain equal to the excess value (section 24BA(3)(a)).

Section 40CA allows the company to add the capital gain under section 24BA(3)(a) to the tax cost of the asset. This restores tax symmetry for the company, as the company will get a tax benefit for the increased cost of the asset, either by way of additional allowances (such as wear and tear) or by way of a reduced capital gain when the company sells the asset.

However, a problem arises where section 42 also applied to the asset-for-share transaction. Section 42 allows a tax-free asset-for-share transaction in certain circumstances. Where section 42 applies, the company must claim allowances on the asset on the same basis as the transferor claimed such allowances. This means that the company may not be able to claim allowances on the increased amount for the asset established under section 40CA.

It is proposed that these provisions be amended to make it clear that the allowances can be claimed on the increased cost of the asset in these circumstances.

Mark Linington

Fine-tuning the debt forgiveness rules for dormant group companies

Where a person forgives a debt owed by another person, there are adverse tax consequences for the person who owed the debt. These adverse tax consequences are provided for in section 19 of the ITA and paragraph 12A of the Eighth Schedule to the ITA.

The exact nature of these tax consequences for a particular borrower depends on how the borrower used the loan proceeds. For example, if the borrower used the loan to buy a business asset and a wear and tear allowance was claimed on the cost of the asset, the borrower must recoup the wear and tear allowance in the year the debt is forgiven, and the remaining tax value of the asset must be reduced to nil.

The legislation provides for specific circumstances where these adverse tax consequences do not apply. One of these circumstances is where the debt is owed by a company to another company which falls into the same group of companies, and the borrower company has not carried on trade for two years before the debt is forgiven.

However, this relief is denied where the borrower company used the loan to buy an asset, and the borrower transferred the asset to another company within the same group under the corporate rollover relief rules. These rules allow for tax-free transfers of assets within a group of companies.

There is some uncertainty on how to interpret this: Is the relief denied where the debt is forgiven after the asset was transferred under the corporate rollover relief rules, or is it denied where the debt is forgiven before the asset is transferred under the corporate rollover relief rules?

The policy intention was that the relief would be denied in both circumstances. The Minister has proposed that the legislation be amended to make this clear.

Mark Linington

A more equitable outcome for unbundling transactions

Unbundling transactions unlock value for shareholders and fiscal benefits for the economy. Transactions of this nature generally comprise an unbundling company transferring its equity shares in an unbundled company, by way of an in-specie distribution, to its shareholder and enabling shareholders to hold the shares in the unbundled company directly.

Unbundling transactions, in the absence of rollover relief, trigger adverse tax consequences for the company making the in-specie distribution. These could arise because the distribution constitutes a disposal, and the market value of the unbundled company shares exceeds the base cost of the shares. A dividend withholding tax liability can also manifest in the hands of the unbundled company if the distribution constitutes a dividend and none of the dividend withholding tax exemptions apply.

The rollover relief can be found in section 46 of the ITA which provides qualifying transactions with tax neutral outcomes.

It is possible that an unbundling only partly qualifies for the rollover relief and that adverse tax consequences are triggered in the unbundling company. Through their shareholding in the unbundling company, the tax costs are economically borne by all shareholders, regardless of whether the rollover relief applied to the distributions in which they participated.

The rollover relief, however, provides that a portion of the tax costs economically borne by shareholders who qualified for the rollover relief provisions can be allocated to the tax cost of their unbundled shares. The allocation ratio is calculated with reference to the market value of the unbundled shares, as at the end of the day after that distribution, in relation to the sum of the market value as at the end of that day, of the unbundling shares and the unbundled shares. The balance of the tax costs is forfeited and cannot be allocated to the unbundling company's shares.

The Budget refers to changes made in 2020 to curb tax avoidance where unbundling transactions are used to distribute shares of unbundled companies to tax-exempt persons or non-resident investors, an issue which was the subject of much debate during the hearings hosted by National Treasury. It notes that these changes ensured a more equitable outcome in unbundling transactions, because only shares distributed to persons who are not disqualified persons will benefit from rollover relief.

The Budget further states that in 2021, further changes were made to the rules to allow shareholders in an unbundling company that only partially qualify for tax deferral to benefit from an increase in the base cost of the shares in the unbundled company, to the extent that the unbundling company did not qualify for tax deferral in accordance with its respective shareholding.

It is encouraging that the Minister now proposes that further consideration should be given to whether it is appropriate to only apportion the tax costs to the unbundling company and whether an allocation should not also be made if the tax consequences are absorbed by the unbundling company's capital losses or assessed losses.

Dries Hoek

South African shareholders in businesses with offshore operations beware

A few weeks ago, in the case of *CSARS v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (07 February 2023), SARS continued its winning streak in the Supreme Court of Appeal (SCA). The SCA held in that case that an Irish company, forming part of the Coronation group of companies, was not conducting its primary business operations in Ireland and therefore the South African holding company of the Coronation group had to impute the profits of that Irish entity for South African tax purposes.

This was because of the SCA's interpretation and application of the controlled foreign company (CFC) rules to the specific facts of the case. It is therefore notable that on the back of this victory, it was announced in the Budget that certain additional amendments to the CFC regime would be introduced that will provide further clarity to the findings in the Coronation case.

Context: Controlled foreign company regime

Section 9D of the ITA contains anti-avoidance rules aimed at taxing South African residents on the net income of a CFC. The purpose of this provision is to strike a balance between protecting the South African tax base and enabling South African multinationals to compete offshore. Given this, the CFC rules contain various exclusions and exemptions for certain types of income. For instance, if the CFC is located in a high-tax jurisdiction then the CFC's net income will not be imputed in the hands of the South African tax residents.

Furthermore, amounts that are attributable to a foreign business establishment (FBE) of a CFC, as defined in section 9D, are excluded from the net income of the CFC. This aligns with the thought that if the foreign company has a suitable physical presence in the foreign country that has sufficient substance, then it should only be taxed in the source country. In simple terms, an FBE consists of a fixed place of business located outside South Africa that is used or will continue to be used for the business of the CFC for at least one year.

However, to fully benefit from the FBE exemption, an FBE must also satisfy requirements relating to the nature of the business. In this context, the fixed place of business should be suitably staffed with onsite managerial and operational employees of that CFC and its offices should be suitably equipped and have suitable facilities for conducting the "*primary operations*" of the business. Determining what constitutes the "*primary operations*" of the business is therefore critical.

Coronation case

In the Coronation case, the SCA had to determine whether the Irish Coronation group company had sufficient substance to its operations and complied with all the requirements of the FBE definition. To the extent that it did not qualify for the FBE exemption, the Coronation holding company in South Africa would have to impute profits of the Irish entity in its South African tax return.

South African shareholders in businesses with offshore operations beware...*continued*

It was accepted that the Irish entity had a fixed place of business that was staffed by on-site operations and managerial employees. However, the key issue was whether the office was suitably equipped and staffed for conducting the *"primary operations"* of the Irish entity. Coronation contended that its primary operation in Ireland was *"fund management"* which included the active management of its service providers, plus regulatory compliance.

It furthermore submitted that the functions that it outsourced and did not conduct in Ireland comprised the larger fund management services (i.e. *"investment management"*) provided to investors in conjunction with the investment manager, which was not its primary operation. The argument was therefore that because it outsourced its investment management functions to other entities, that was not its primary business operation and therefore its FBE in Ireland did not need to be suitably staffed by individuals conducting the *"investment management"* services.

The SCA disagreed with Coronation's submissions and held that the argument that *"investment management"* is not the Irish entity's core business was at odds with what was stated in its founding documents, which specifically referred to establishing specified collective investment undertakings and carrying on the business of investment and financial management. In addition, the fact that the Irish entity's primary source of income was from investment was, according to the SCA, another indication that its core function was investment management.

Outsourcing

The SCA also discussed the concept of outsourcing and commented that even though the Irish entity was permitted to outsource functions, this did not mean that the scope of its business was confined to the supervision of the functions which it has outsourced, together with regulatory compliance. Instead, its operations must be determined with reference to the activities under which it was granted its licence. If it chooses to outsource those activities to another entity, this does not mean those functions fall outside of its business. It was specifically held as follows:

> *"These functions had to fall within the ambit of its business in order to be outsourced. An agent cannot perform a function which does not form part of the business of the principal. In other words, [the Irish entity] could not outsource a function that it did not possess in the first place."*

South African shareholders in businesses with offshore operations beware...*continued*

The SCA thus determined that the primary operation of the Irish entity's business (and, therefore, the business of the CFC as defined) was that of "*fund management*" which included "*investment management*" and that these operations were not conducted in Ireland. It was commented that such an interpretation would give credence to the rationale that the CFC regime is in force for purposes of limiting a situation where a tax exemption is obtained in relation to earnings in a low-tax jurisdiction when the primary operations of the business are not conducted there.

Tightening of the screws on outsourcing of operations by CFCs

Despite SARS' victory in the SCA, it was announced in the Budget that Government has identified that some taxpayers are retaining certain management functions but outsourcing other important functions for which the CFC is also being compensated by its clients. National Treasury states that this is against the policy rationale of the definition of an FBE. It has therefore been proposed that tax legislation be clarified such that, to qualify as an FBE, all important functions for which a CFC is compensated need to be performed by the CFC or by the other company meeting certain conditions.

In this manner, National Treasury states that the definition of an FBE does allow for the structures, employees, equipment and facilities of another company to be taken into account if these are all located in the same country as the CFC's fixed place of business; the other company is subject to tax in the same country where the CFC's fixed place of business is located; and it forms part of the same group of companies as the CFC. In other words, outsourcing of certain functions is theoretically allowed but only under certain conditions.

While the judgment in the Coronation case may have been a bitter pill to swallow for many taxpayers, their medication just got even more unpalatable. It is anticipated that the proposed amendments will build on the commentary and findings in the Coronation case to ensure that outsourcing in the context of the CFC regime is only allowed under certain strict conditions and circumstances. All South African tax resident shareholders with CFCs would be well advised to analyse their existing offshore operations in light of these developments.

Jerome Brink

Post MLI Ratification – developments regarding pillar one and pillar two

In 2022, South Africa finally ratified the multilateral instrument (MLI), marking a significant event in a long-running process. The effect of the MLI was to amend a number of South Africa's double tax agreements, but how South Africa will implement OECD/G20 Inclusive Framework, comprising Pillar One and Pillar Two, remains to be seen.

Pillar One

To provide context - with the advent of technology companies with an international reach and our increasingly globalised world, it became necessary to introduce tax measures that would ensure that the profit of these technology companies are appropriately taxed and that the countries in which their goods are sold, also receive their due. This is also referred to as base erosion. The issue is that the traditional international tax framework, which was based on principles such as tax residency and further regulated in double tax agreements between countries, did not adequately address this issue. Companies outside South Africa can therefore sell their goods in South Africa without having a physical presence here that would create a permanent establishment, thereby resulting in little to none of their profits derived from sales to South Africans being subject to tax in South Africa. The Budget explains that to address this issue, the Pillar One principles of the OECD/G20 Inclusive framework were proposed to establish a coherent and integrated approach to the tax treatment of multinationals, with the allocation of taxing rights among jurisdictions based on their market share. Although it was previously indicated that a position paper would be established on this, nothing has been forthcoming from National Treasury and the Budget indicates that no final agreement has been reached on Pillar One and OECD Guidelines for this Pillar have not been finalised and therefore the proposed legislative amendments mentioned in the 2022 Budget, seem to be on hold.

Pillar Two

In a nutshell, the Budget explains that this pillar focuses on the remaining base erosion and profit shifting matters to ensure that all internationally operating businesses with global annual revenue of more than EUR750 million pay an effective tax rate of at least 15%, regardless of where they are headquartered or which jurisdictions. The Budget further notes that a minimum effective tax rate for large multinationals is expected to apply in a number of countries from December 2023.

From a South African perspective, certain multinationals are subject to country-by-country (CbC) reporting obligations to SARS, but no formal legislation has been proposed in relation to Pillar One. The Budget states that government will publish a draft position on the implementation of Pillar Two for public comment and draft legislation will be prepared for inclusion in the 2024 Taxation Laws Amendment Bill. During the most recent Annexure C hearings, the question raised by National Treasury was whether South Africa should be a first mover, considering that many countries in the Global North have not yet implemented legislation to give effect to this pillar. The timing here seems to suggest that South Africa might have regard to what is done in other countries, which may then inform the 2024 proposals.

Louis Botha

Amendments in relation to purported loopholes in foreign capital participation exemption

Like many countries South Africa has a "*participation exemption*" which exempts returns in the form of both foreign dividends or foreign capital realised by South African residents, upon certain conditions being met. Under the foreign capital participation exemption, subject to certain exclusions, a person, other than a headquarter company is required to disregard any capital gain or capital loss determined in respect of the disposal of any equity share in a foreign company if certain requirements are met.

These requirements relate to:

- the percentage interest held by the South African resident disposer, which is required to, as a minimum, be 10% of both the "*equity shares*" and the voting rights in the foreign company (minimum interest test);
- the nature of the recipient, which is required to not (i) be a South African resident, (ii) be a "*connected person*" in relation to the disposer, and (iii) form part of the same "*group of companies*" as the disposer (recipient test); and
- a *de minimis* holding period for which the disposer is required to have held the shares in the foreign company, which is required to be a period of 18 months, unless the disposer is a company and the disposer acquired the shares in the foreign company from a foreign company that formed part of the same "*group of companies*" as the disposer, where the foreign company and group entity collectively held the shares in the foreign company for an aggregate period of 18 months (holding period test).

National Treasury has previously stated that the policy rationale for the foreign capital participation exemption was to incentivise South African's who hold a meaningful interest in a foreign investment, and to generally encourage capital inflows to South Africa.

In terms of the Budget, National Treasury has said that certain transactions have been identified which qualify for the foreign participation exemption, although these arrangements do not align with the policy intent. National Treasury

Amendments in relation to purported loopholes in foreign capital participation exemption...*continued*

made specific mention of transactions involving group restructuring whereby the sale by the disposer is to a newly formed group company *"although there is no change in ultimate shareholder"*. National Treasury intends changing the tax legislation to not avail the foreign capital participation exemption to a disposer, if the sale of shares in the foreign company is to a recipient that is a non-resident entity group company or the shareholders are substantially the same as the shareholders of any company that forms part of the same group as the disposer.

It is not entirely clear what is intended to be achieved by National Treasury in this regard, since under the current construct of paragraph 64B of the Eighth Schedule to the ITA, which governs the foreign capital participation exemption, such a disposal of shares in the foreign company by the disposer will unlikely meet the recipient test, on the basis that such targeted recipient will likely, in any event, be a "*connected person*" in relation to the disposer or form part of the same "*group of companies*" as the disposer and therefore amount to a non-qualifying recipient.

The further foreign capital participation exemption provides for the disregard of a capital gain or capital loss which arises in respect of any foreign return of capital received or accrued to the disposer by a "*controlled foreign company*" as contemplated in section 9D of the ITA if the disposer meets the minimum interest test. National Treasury has also proposed applying the holding period test to this foreign capital participation exemption to align with the prior mentioned foreign capital participation exemption. A de minimis period to align the foreign capital participation exemptions is logical and therefore welcomed.

Stephan Spamer and Howmera Parak

SA trusts and non-resident beneficiaries: proposal to address tax avoidance

The recent Supreme Court of Appeal judgment in *CSARS v Thistle Trust* (516/2021) [2022] ZASCA 153 (7 November 2022) has highlighted the interpretive challenges that section 25B of the ITA and Paragraph 80 of the Eighth Schedule to the ITA, both applicable to trusts, can create. Now the Minister proposes addressing an apparent inconsistency resulting from the application of these provisions.

Paragraph 80 of the Eighth Schedule deals with the vesting of an asset by a local South African trust to a beneficiary with the effect being that when an asset is vested by a South African trust into a resident beneficiary, the capital gain flowing from this will be attributable to the resident beneficiary. This capital gain will (in the hands of the trust) be disregarded for purposes of calculating the total capital gain or loss. On the other side of this, the Budget expresses the view (similar to what is stated in SARS' Comprehensive Guide on Capital Gains Tax) (CGT Guide) that if an asset or gain is vested in a non-resident beneficiary, the result is that the capital gain flowing from that will not be attributable to the non-resident as an individual but to the trust and taxed in the South African trust's hands. In other words, it would be taxed in South Africa at the effective rate of 36% and it is easier to ensure that the correct tax amount is paid to SARS. However, whereas Paragraph 80 distinguishes between residents and non-residents, section 25B contains no such distinction. Sections 25B(1) and (2) merely refer to the vesting of amounts in a "*person*" or a beneficiary but make no reference to the residence of such person or beneficiary.

Although section 25B contains anti-avoidance provisions, they apply to address anti-avoidance where funds are transferred to a foreign trust, with the income then being vested in resident or non-resident beneficiaries by the foreign trust. With the increase of such offshore trust structures and the Budget noting that the number of persons applying to make use of their foreign capital allowance increasing, it appears that the anti-avoidance provisions in section 25B generally address the risk of tax avoidance using foreign trusts. However, it appears that there is a concern that a South African trust vesting income in a non-resident beneficiary can create the risk of tax avoidance and challenges in collection. From a South African tax perspective, non-residents are only subject to tax in South Africa to the extent that the income is from a South African source. Therefore, if South African source income is vested by the South African trust in a non-resident beneficiary, such as

SA trusts and non-resident beneficiaries: proposal to address tax avoidance*...continued*

rental income, for example, the non-resident would need to declare such rental income in a tax return to SARS and would be taxed according to the personal income tax tables. However, as section 25B does not distinguish between residents and non-residents, it is possible that in practice, the South African trust can vest South African source income in the non-resident beneficiary, but which such beneficiary does not declare to SARS. Although SARS can take steps to collect the tax owing, including by requesting the assistance of the tax authority of the country where the non-resident resides, as provided for under some double tax agreements, it is more difficult to collect it. The Tax Administration Act 28 of 2011 does also make provision for SARS to take steps to collect tax from such non-resident beneficiaries.

Amending section 25B

Therefore, the Budget proposes that section 25B be amended so that it applies in a similar way to how Paragraph 80 is interpreted according to the CGT Guide. If that is the intention, it is possible that a South African trust would be taxed on the income at the rate of 45% where income is vested in the non-resident beneficiary, as opposed to being taxed in accordance with the marginal tax rates applicable to individuals. The tax payable would be far higher as only an individual's income in the top marginal income tax bracket is subject to 45%. If this is the way in which the amendment applies, only dividends earned by the South African trust from a South African resident company, would not be adversely affected. This is because the dividends withholding tax rate of 20% applies equally to dividends paid to South African resident and South African trust shareholders and is not affected by subsequent vesting.

The potential effects of this amendment, depending on how it is implemented (if implemented), will be far-reaching.

Esther Ooko and Louis Botha

A different kind of melting pot? Implementation of the two-pot retirement system pushed to 2024

During the 2022 legislative cycle, amendments were made to the ITA to introduce the somewhat groundbreaking two-pot retirement system. The two-pot retirement system was introduced pursuant to the initial publication of a discussion document by Government in December 2021.

The two primary concerns with the design of the retirement system, prior to the introduction of the two-pot retirement system were:

- the lack of preservation before retirement; and
- the issue that some households in financial distress have assets within their retirement funds that are not accessible even in the case of emergencies. This issue was highlighted in particular by the advent of the COVID-19 pandemic.

The Budget indicates that, following extensive public consultation during 2022, the first phase of legislative amendments to the retirement system, that is, to establish the two-pot retirement system, will take effect on 1 March 2024. The initial draft of the 2022 Revenue Laws Amendment Bill published in August 2022, had proposed that the two-pot retirement system would take effect from 1 March 2023. The Budget summarises some of the key tenets of the system, pursuant to its implementation as follows:

- Retirement fund contributions will remain deductible up to the limit of R350,000 per year or 27,5% of taxable income per year (whichever is lower), as is currently provided for in section 11F of the ITA.
- Permissible withdrawals from funds accrued before 1 March 2024 will be taxed according to the lump sum tables. In this regard, it is also noteworthy that the Budget proposes increases in the thresholds at which retirement fund lump sum benefits are attached. Whereas only the first R500,000 withdrawn is currently exempt, it is proposed that this be increased to R550,000 going forward. The 18%, 27% and 36% tax brackets of the retirement fund lump sum benefits table have also been amended, meaning that the tax paid on such withdrawals should now be lower, albeit that one must consider inflationary effects.
- Withdrawals from the "*savings pot*", which is a new concept referring to the pot from which amounts can be withdrawn prior to retirement will be taxed at marginal rates. In other words, it will be taxed in accordance with the normal income tax brackets ranging between 18% and 45%.

As we have indicated in a previous Tax and Exchange Control Alert, the amendments proposed to implement the two-pot retirement system are quite complex and would

A different kind of melting pot? Implementation of the two-pot retirement system pushed to 2024...*continued*

require substantial amendments to the Income Tax Act. Therefore, it appears sensible that the implementation of the system has been delayed, although it serves an important purpose, namely, to enable pre-retirement access to a portion of one's retirement assets, while preserving the remainder for retirement.

However, it also appears that the decision to postpone implementation might have been influenced by what was stated in the Budget regarding certain areas that require additional work. Specifically, the Budget notes that the following four areas require additional work:

1. A proposal for seed capital. It remains to be seen whether this would relate to proposed amendments to the so-called "*vested pot*", being the value in the fund that exists prior to the two-pot retirement system coming into effect, according to the 2022 draft legislation.
2. Legislative mechanisms to include defined benefit funds in an equitable manner. In this regard, one should note that most modern retirement funds are defined contribution funds, where the amount available on retirement is dependent on one's contributions. This is different from defined benefit funds, where the benefits are defined by the fund rules and benefits are generally guaranteed and are not dependent on the investment returns of the fund or on the level of member and employer contributions. As it has been proposed that the amount available in the "*savings pot*" for withdrawal prior to retirement is dependent on the amount of contributions made, it follows that the same principle cannot necessarily apply to defined benefit funds.
3. Legacy retirement annuity funds.
4. Withdrawals from the retirement portion if one is retrenched and has no alternative source of income. Within the context of the two-pot retirement system, this seems to refer to amounts that are intended to form part of the "*retirement pot*", to use the phrase in the draft legislation.

The Budget indicates that the first three matters will be clarified in forthcoming draft legislation, whereas the final matter will be reviewed as part of a second phase of implementation.

Louis Botha

Registration required for non-resident employers: PAYE

Subject to certain exclusions and exemptions, income earned for services rendered in South Africa is generally subject to South African employees' tax. The system where employees' tax is deducted and accounted for monthly is generally referred to as Pay-As-You-Earn (PAYE). PAYE is therefore a withholding tax on employment income, which will be offset against the employee's final income tax liability for the relevant year of assessment.

The obligation to withhold employees' tax is provided for in Paragraph 2 of the Fourth Schedule to the ITA which reads as follows:

> *"Every*
>
> *(a) employer who is a resident; or*
>
> *(b) representative employer in the case of any employer who is not a resident*
>
> *… who pays or becomes liable to pay any amount by way of remuneration to any employee shall, unless the Commissioner has granted authority to the contrary, deduct or withhold from that amount … by way of employees' tax an amount … in respect of the liability for normal tax of that employee … ".*

In terms of the above provision, it is clear that South African-sourced employment income that a resident or non-resident of South Africa earns is subject to employees' tax if it is paid by an employer who is a tax resident in South Africa. Further, where the employer is not a resident of South Africa, employees' tax must be deducted either by an agent or representative who has the authority to pay the remuneration to the non-resident employee.

The employees' tax so withheld must be paid over to SARS as partial (or full) payment of that employee's annual tax liability by no later than the seventh day of the next month. Should the employer fail to pay the amount due to SARS by this date, the employer will be subject to a 10% penalty as well as interest, unless a deferral arrangement is in place. The amount withheld is calculated according to the employee's level of earnings using the applicable tax rate.

The above provision, however, arguably does not adequately cater for a scenario where the employer is not a resident and does not have an agent or a representative in South Africa for employees' tax purposes.

Registration required for non-resident employers: PAYE*...continued*

In this context, National Treasury has proposed in the Budget that it will amend various provisions in the Act to ensure that non-resident employers who pay remuneration to employees who render services in South Africa register as such in South Africa, notwithstanding the fact that they may not have a representative or agent in South Africa.

Therefore, clarity will be provided that non-resident employers will also be held liable to withhold (or deduct) employees tax from remuneration that is paid to its employees in South Africa. The relevant amendments will also ensure that non-resident employers are also liable for skills development levies and unemployment insurance contributions where applicable.

The Minister of Finance (Minister), however, does not expound on how non-residents will be able to register. As it stands, registration as an employer must be done through eFiling.

Having regard to the above, it is recommended that foreign employers who pay remuneration to employees rendering services in South Africa register as employers with SARS and start withholding PAYE as contemplated in the Fourth Schedule to the ITA to avoid incurring any penalties and interest being imposed by SARS. Although the obligation to deduct PAYE rests on the employer, the income tax liability still remains for the account of the employee. Therefore, employees earning a remuneration in South Africa from non-resident employers should also ensure that their employers are duly registered as employers in South Africa and are remitting the correct amount of PAYE on their behalf to SARS.

Puleng Mothabeng

Low-interest or interest-free loans to trusts: Another chapter to clarify the anti-avoidance rules

Section 7C of the ITA was introduced in 2017 to regulate the granting of low-interest or interest-free loans by natural and juristic persons to trusts. The main function of this section is to curb the tax-free transfer of wealth to trusts.

As it stands, section 7C stipulates that any interest foregone in respect of a low-interest or interest-free loan, advance or credit transferred to a trust, will be a deemed donation and will be subject to donations tax.

Section 7C has been amended multiple times since its introduction to extend its scope of application. For example, in January 2021, section 7C(1B) was inserted to also include preference shares subscribed for by natural persons in companies where a connected person trust is the holder of at least 20% of the company's equity shares or can exercise 20% of the company's voting rights. The effect of this amendment was that any dividends that accrued to the holder of the preference shares, will be deemed to be interest in respect of the loan.

The Budget explains that section 7C(5) provides exceptions to the general position, such as where the low-interest or interest-free loan, advance or credit is used to purchase a primary residence for the person advancing that low-interest or interest-free loan, advance or credit to the trust, company or spouse of such person. In practice, what would often happen is for the person to sell their primary residence to the connected person trust or company to contemplated in section 7C, on loan account. In other words, the company or trust becomes owner of the primary residence but owes the purchase price to the seller on loan account.

In the Budget, National Treasury has proposed two clarifications to the primary residence exception in section 7C(5).

Primary residence

The Budget indicates that the exclusion in section 7C(5)(d)(i) of the ITA does not fully encompass what constitutes a "*primary residence*" in terms of the Eighth Schedule of the ITA. In Paragraph 44 of the Eighth Schedule of the ITA, a primary residence is defined to mean a residence:

- in which a natural person or a special trust holds an interest; and
- which that person or a beneficiary of that special trust or a spouse of that person or beneficiary:
  - ordinarily resides or resided in as his or her main residence; and
  - uses or used mainly for domestic purposes.

Low-interest or interest-free loans to trusts: Another chapter to clarify the anti-avoidance rules...*continued*

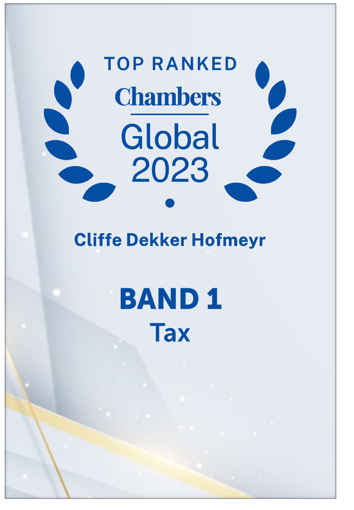
The Budget proposes that primary residence exception provision be amended to provide clarity in this regard.

Foreign currency conversion

In the Budget, National Treasury has expressed concern regarding the conversion of the low-interest or interest-free loans, advances or credit which are denominated in foreign currency, as the section does not indicate how and when this amount should be converted to South African rands.

Although the ITA contains provisions providing for the conversion of foreign currency to determine one's tax liability, such as section 25D of the ITA dealing with the accrual of foreign income and Paragraph 43 of the Eighth Schedule dealing with foreign capital gains, neither section would address the scenario contemplated in the Budget. Practically, section 25D contemplates conversion of foreign income into ZAR based on the spot exchange rate or average exchange rate, depending on the circumstances. It is possible that the proposed amendment to section 7C will also indicate the use of the spot exchange rate or average exchange rate, depending on the circumstances. The Budget indicates that that the conversion would affect the calculation of the deemed donation and one would hope that the amendment would be written in such a way as to prevent currency fluctuations from unfairly increasing the amount of the deemed donation that is subject to tax.

Sasha Schermers and Louis Botha



2023 Budget summary: VAT

Specific supplies in the short-term insurance industry

SARS previously issued Binding General Ruling 14 (BGR14), which deals with the value-added tax (VAT) treatment of specific supplies in the short-term insurance industry. As a result of amendments to section 72 of the VAT Act 89 of 1991 (VAT Act) which deals with the SARS Commissioner's (Commissioner) discretion to make arrangements or decisions to overcome difficulties, anomalies or incongruities that vendors may face when applying the VAT Act as a result of the manner in which the vendor conducts their enterprise, decisions issued by the Commissioner prior to 21 July 2019, including parts of BGR14 relating to excess payments, were withdrawn with effect from 1 January 2022. It is proposed that changes be made to the VAT Act to clarify the VAT treatment of specific supplies in the short-term insurance industry.

Clarifying the VAT treatment of prepaid vouchers in the telecommunications industry

In the case of *MTN (Pty) Ltd v CSARS* (79960/2019) [2021] ZAGPPHC the High Court was required to determine whether prepaid vouchers issued for a consideration, which entitles the holder to receive any services or products to the value of the monetary value attributed to the voucher on the MTN mobile network as selected by the holder comprise section 10(18) *"monetary vouchers"* or 10(19) *"product specific vouchers"* contemplated in the VAT Act.

MTN previously applied to SARS for a private binding ruling to confirm that its multi-purpose vouchers fall within the ambit of section 10(18) of the VAT Act. However, SARS ruled that these multi-purpose vouchers fell within the ambit of section 10(19). MTN then sought a declaratory order from the High Court to confirm whether the multi-purpose vouchers indeed fall within section 10(18) of the VAT Act. The court held that the voucher is for specified goods or services and is therefore a section 10(19) voucher.

In the past, prepaid vouchers issued by mobile network provides could only be used to purchase specific services offered by that mobile network provider such as calls and short message services. However, due to evolutions in the industry; prepaid vouchers sold by mobile network providers may be used for a multitude of services offered both by the mobile network operator or by third parties, including, for example, calls, data, mobile money services, etc.

Following the issues addressed in the MTN case, and various similar industry interactions with SARS, National Treasury has recognised that the VAT Act does not provide clarity in instances where prepaid vouchers are used for services provided by a third party, or where the mobile network provider is acting as an agent, or those third-party-provided services are regarded as exempt supplies or non-taxable supply in the VAT Act. It is proposed that changes be made to the VAT Act to provide clarity on the VAT treatment in these instances.

VAT treatment of temporary letting of residential property

Clarifying the meaning of *"adjusted cost"*

Section 18D, together with sections 9(13) and 10(29) were introduced into the VAT Act with effect from 1 April 2022 to clarify the VAT treatment of the temporary letting of residential property.

2023 Budget summary: VAT*...continued*

Section 18D deals with the temporary letting of residential property by a property developer, specifically, the change in use adjustment required to be made by a developer on letting of residential property; the VAT treatment of any subsequent sale of a residential property that has been temporarily let; and the deemed input tax deduction available to developers upon the sale of the property in question.

In terms of section 18(D)(2), where a developer develops residential fixed property for purposes of sale, but temporarily lets such property as residential accommodation in a dwelling, the fixed property is deemed to be supplied by the vendor for a consideration in money equal to the adjusted cost of the property. The term *"adjusted cost"* is defined in section 1(1) and is essentially the VAT inclusive cost of the goods or services in respect of the development of the property. The developer will be required to make the output tax adjustment, being the tax fraction of the adjusted cost, in the tax period in which the lease agreement comes into effect.

At issue is whether the term *"adjusted cost"* contemplated in section 10(29) of the VAT Act also includes the cost of the land. It is proposed that section 10(29) be clarified in this regard.

Clarifying the rule dealing with recovery of the previous declared output tax

Section 18D(5) provides that the developer is entitled to claim a deemed input tax deduction equal to the adjusted cost of the fixed property, where the property:

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

As it currently reads, section 18D(5)(c) states that that the deduction is allowed upon the expiration of the 12-month temporarily applied period where the property is no longer let to supply residential accommodation, or, where a section 18(1) adjustment was applied where the property was subject to a fixed-term lease exceeding 12 months. This seems to imply that the input tax deduction may be claimed either once the 12-month period expires and the developer no longer lets the property, or once the 18(1) adjustment is performed, as the case may be, and does not clearly specify that such deduction may only be claimed when the property is subsequently sold in these instances.

National Treasury has recognised that section 18D(5)(c) refers to a situation in which section 18(1) of the act applies and that this creates an anomaly. To address this anomaly, it is proposed that section 18D(5)(c) of the VAT Act be deleted.

2023 Budget summary: VAT*...continued*

Clarifying VAT rules dealing with documentary requirements for gold exports

Gold refineries receive gold delivered from various depositors for refining or smelting purposes.

In certain instances, the refineries may act as agents and sells or exports the gold on behalf of these depositors. The exportation of goods from South Africa will generally be subject to VAT at the zero-rate provided that certain requirements, including certain documentary requirements, are complied with.

When the depositor delivers their gold to the refinery, the gold and other base metal content is determined, and the refinery issues a Sale of Gold Certificate to the depositor and the value of the gold deposited is determined using that day's morning, afternoon or spot London Bullion Market Association gold price.

The refinery and smelter require large quantities of gold to operate effectively and efficiently and no single depositor provides sufficient quantities of gold for processing on its own. It is accordingly not possible for each depositor to have its own gold containing material treated separately from the gold containing material of other depositors. Accordingly, when a specific depositor's gold containing material enters the refining/smelting process, it is co-mingled with the gold containing material of other depositors and effectively loses its identity as belonging to a specific depositor.

It is impossible to determine which depositor's gold is exported or delivered by the refinery as agent due to the fact that the refined gold cannot be identified as being the gold in the gold containing material provided by a specific depositor.

As a result, depositors find it difficult to obtain the documentary evidence as required in terms of section 11(3) of the VAT Act to support the application of the zero-rate on a transaction-by-transaction basis in relation to their gold as contemplated in the regulations issued in terms of section 74(1) of the VAT Act read with paragraph (d) of the definition of *"exported"* in section 1(1). To address this, it is proposed that changes be made to the VAT Act.

2023 Budget summary: VAT*...continued*

VAT on domestic reverse charge

In order to curb VAT fraud relating to the supply of second-hand gold, SARS introduced a domestic reverse charge regulation (DRC regulation) on 1 July 2022 which came into effect on 1 August 2022. The DRC applied to all registered vendors involved in the production and distribution chain that made supplies of "*valuable metal*" as defined.

It is proposed that further changes will be made to the DRC regulations to clarify the specific definition of "*residue*", i.e. whether it relates only to mining operations or if the definition should be broadened to include "*residue*" as a general concept.

The definition of "*valuable metal*" will be amended to clarify what is included and excluded. It is further proposed that the definition will be amended to include gold in the form of a sponge or powder, to align the definition with that of the Precious Metals Act 37 of 2005.

There is currently uncertainty regarding the exclusion from "*valuable metal*" of goods supplied by holders of mining rights and persons contracted to such holders. It is proposed that the exclusion will be clarified.

A proposed de minimis rule will also be included to exclude goods containing minimal gold content, such as gold-plated jewellery.

Currently, the recipient of the valuable metal is required to issue a statement to the supplier detailing the percentage of the gold content within the "*valuable metal*" within 21 days after tax has been accounted and paid. The recipient is not always in a position to determine this gold content. It is proposed that the regulations be amended to transfer this from the recipient to the supplier. This will account for recipients that do not in the ordinary course of business use specialised instruments to measure the gold content in goods.

Gerhard Badenhorst, Varusha Moodaley and Tersia van Schalkwyk

Customs And Excise

[Certain sections quoted from the Budget documents].

Excisable Products

As is the case each year, Government proposes an increase in duties for excisable products in Schedule 1 Part 2A to the Customs and Excise Act 91 of 1964 (Customs Act).

Of relevance this year are the following:

Tobacco

The guideline excise tax burden as a percentage of the retail selling price of the most popular brand within each tobacco product category is currently 40%. Government proposes increasing the excise duties in line with expected inflation of 4,9% for 2023/24.

For example, the following:

Product	2022–2023 rate	2023–2024 rate
Cigars, cheroots and cigarillos containing tobacco	R4,823.22/kg net	R5,061.01/kg net
Cigarettes, containing tobacco or tobacco substitutes	R9.91 /10 cigarettes	R10.40 /10 cigarettes
Cigars, cheroots and cigarillos of tobacco substitutes	R4,823.22/kg net	R5,061.01/kg net
Water pipe tobacco	R265.24/kg net	R278.31/kg net
Pipe tobacco	R265.24/kg net	R278.31/kg net
"Homogenised" or *"reconstituted"* tobacco	R929.33/kg	R975.15/kg
Products intended for inhalation without combustion: Put up for retail sale in the form of sticks	R7.43 /10 sticks	R7.80 /10 sticks
Products intended for inhalation without combustion: Other	R929.33/kg	R975.15/kg

Customs And Excise*...continued*

Further, the rate for sparkling wine is realigned to the policy decision taken in 2016 to peg it at 3,2 times that of natural unfortified wine.

For example, the following:

Product	2022–2023 rate	2023–2024 rate
Beer	R121.41/li aa	R127.40/li aa
Sparkling wine	R16.52/li	R16.64/li
Unfortified wine: With an alcoholic strength of at least 4,5% by volume but not exceeding 16,5% by volume	R4.96/li	R5.20/li
Unfortified wine: Other	R245.15/li aa	R257.23/li aa
Fortified wine: With an alcoholic strength of at least 15% by volume but not exceeding 22% by volume	R8.36/li	R8.77/li
Fortified wine: Other	R245.15/li aa	R257.23/li aa
Ethyl alcohol	R245.15/li aa	R257.23/li aa
Brandy: As defined in Additional Note 7 to Chapter 22	R220.63/li aa	R231.51/li aa
Brandy: Other	R245.15/li aa	R257.23/li aa
Whiskey, rum, gin, vodka	R245.15/li aa	R257.23/li aa
Liqueurs and cordials: With an alcoholic strength by volume exceeding 15% by volume but not exceeding 23% by volume	R98.06/li aa	R102.89/li aa
Liqueurs and cordials: Other	R245.15/li aa	R257.23/li aa

The alcohol review paper will be published soon after the budget.

Traditional African beer:

As was the case last year, there will be no change to the excise duty on traditional African beer.

Health Promotion Levy

To enable stakeholders in the sugar industry to restructure, given the challenges from greater regional competitive pressures and the effect of recent floods and public violence, there will be no increase in the health promotion levy in 2023/24 and 2024/25.

Government will soon publish a discussion paper on the levy for consultation on proposals to extend the levy to pure fruit juices and lower the 4g threshold.

Fuel Taxes

No changes were made to the general fuel levy or the Road Accident Fund (RAF) levy in the Budget. Additional temporary relief was provided for four months at a cost of R10,5 billion. In 2023/24, Government will again keep these levies unchanged, leading to revenue of R4 billion being foregone.

Government implemented the diesel refund system in 2000 to provide full or partial relief for the general fuel levy and the RAF levy to primary sectors. The refund system is in place for the farming, forestry, fishing and mining sectors. In light of the current electricity crisis, a similar refund on the RAF levy for diesel used in the manufacturing process (such as for generators) will be extended to the manufacturers of foodstuffs. This will take effect from 1 April 2023, with refund payments taking place once the system is developed and will be in place for two years until 31 March 2025. This relief is implemented to limit the impact of power cuts on food prices.

Customs And Excise *...continued*

Carbon Tax

South Africa is committed to achieving its nationally determined contribution to reduce greenhouse gas emissions. The carbon tax plays an important role in mitigation. Effective 1 January 2023, the carbon tax rate increased from R144 to R159 per tonne of carbon dioxide equivalent. To ensure transparency and provide certainty, future adjustments to the tax rate are provided in the Carbon Tax Act 15 of 2019, as outlined in the Taxation Laws Amendments Act 20 of 2022. In line with the carbon tax rate increase, the carbon fuel levy for 2023/24 will increase by 1c to 10c/l for petrol and 11c/l for diesel from 5 April 2023. The carbon tax cost recovery quantum for the liquid fuels refinery sector increased from 0.63c/l to 0.66c/l, effective from 1 January 2023.

General

Standard 4.15 of the General Annex of the Revised Kyoto Convention provides that *"where national legislation provides for the deferred payment of duties and taxes, it shall specify the conditions under which such facility is allowed."* It is proposed that the SARS Commissioner be enabled to prescribe conditions under which deferment of duties will be allowed by rules.

Following an assessment of South Africa's approach to collecting advance passenger information (API) and passenger name record (PNR) data, it is proposed that a single window be established to collect API and PNR data. As the Department of Home Affairs is responsible for the collection of such data, carriers will be allowed to submit the required data to the Department of Home Affairs, which will distribute the information to other relevant government entities, such as SARS. An amendment is also proposed to ensure the protection of personal information in this regard.

SARS is implementing a modern online traveller management system, which has been piloted on a voluntary basis at King Shaka International Airport since November 2022. The system is aimed at strengthening SARS's capability to facilitate legitimate traveller movements, providing travellers with clarity and certainty regarding their obligations, easing compliance, detecting non-compliance and improving enforcement of legislation by SARS and other agencies. It is proposed that the Customs Act be amended to provide for the declaration of the required information before arrival in or departure from South Africa.

There are currently no provisions in the act relating to the liquidation of provisional payments that serve as security in certain circumstances and that are not claimed back by the trader. Government proposes amending the act to enhance the current processes and procedure for such payments below a specified amount or that remain unliquidated after a specified period and to introduce a prescription period for unclaimed amounts.

SARS makes it hard and costly for those taxpayers who remain wilfully non-compliant. There has been steady progress over the past three years. For the year to date up to the end of January 2023 more than 4,742 customs seizures amounting to R2,9 billion took place. Overall, customs compliance efforts secured R10,4 billion through compliance efforts, made up of R3,8 billion cash and prevented leakages of R6,6 billion. SARS has handed over 178 cases to the National Prosecuting Authority. There are 94 finalised cases with 92 guilty verdicts, of which 10 had sentences of direct imprisonment, totalling 75,5 years to be served, with two acquittals. The conviction rate is 97,8%.

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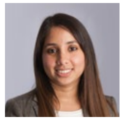

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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