SOUTH AFRICAN 2017 BUDGET

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TAX PROPOSALS

On Wednesday 22 February, the Minister of Finance delivered the 2017 Budget. The Budget proposes to raise an additional R28 billion mainly through collecting R16.5 billion more in personal taxes and R6.8 billion through an increase in the dividend withholding tax rate. Although no changes were proposed to corporate tax rates, a number of proposals likely to increase tax payable by companies were also announced. Many of these are targeted at perceived tax avoidance strategies. In this newsletter, we discuss the impact of key tax issues covered in the speech and the accompanying Budget Review document.

CORPORATE TAX

Avoidance schemes in respect of share disposals
Author: Graham Viljoen

In the 2016 Budget it was announced that additional measures might be considered to circumvent transactions where investors choose to realise their share investments by means of having the shares they hold in a company bought back and paid for by means of a new investor subscribing for shares in the same company. Following the announcement in 2016, no specific countermeasures were introduced. However, in the 2017 Budget it has been proposed that specific countermeasures (legislation) will be introduced to curb the use of share buyback schemes.

Assumption of contingent liabilities in corporate reorganisations
Author: Brian Dennehy

Certain corporate reorganisation rules (such as the asset-for-share rules and amalgamation rules) only provide tax roll-over relief where, for example, assets are transferred in exchange for either shares in the acquiring company or the assumption of actual debt. The assumption of contingent liabilities (such as provisions for bonuses, leave pay, etc.) have often created uncertainty and been problematic. Although SARS has in some cases taken a pragmatic approach and treated contingent liabilities as debt for purposes of these roll-over provisions, it was announced in the Budget that this will now be specifically legislated, providing some most welcome clarity on the point.

Increase in dividend withholding tax - impact of effective date
Author: Des Kruger

The Minister announced in his Budget that dividends withholding tax (DWT) would increase from the then rate of 15% to 20%. According to the Rates and Monetary Amounts and Amendment of Revenue Laws Bill (the Bill) that was tabled in Parliament at the time of the Budget the increase "is deemed to have come into operation on 22 February 2017 and applies in respect of dividends paid on or after that date" (clause 11(2) of the Bill).
The reason advanced for the increase is to "reduce the difference between the combined statutory tax rate on dividends and the top marginal personal income tax". Had the DWT rate not been increased, the top marginal rate would have been 45%, while the combined statutory tax rate would have been 38.8%, a difference of 6.2% that no doubt would have encouraged some to arrange their affairs to benefit from this tax arbitrage. With the increase in DWT rate to 20%, the combined statutory tax rate will be 42.4%, a difference of 2.6%.

The major issue is the effective date of the change in DWT rate. As mentioned, the increase applies in respect of any dividends "paid" on or after 22 February (the date the Minister presented his Budget). It is apparent that the reference to "paid" must be considered in the context of the DWT provisions. DWT is imposed in respect of any dividend "paid" (section 64E(1) of the Income Tax Act), which aligns with the effective date of the increased rate of tax. As to the meaning of "paid", section 64E(2) of the Income Tax Act then provides specific rules which differ depending on whether the dividend is an ordinary dividend or a dividend in specie, and whether the dividend is declared by a listed or non-listed company. In essence, a dividend is regarded as having been "paid" for DWT purposes:

- If the dividend consists of a distribution in specie (whether declared by a listed or non-listed company), the dividend is deemed to be paid on the earlier of the date on which the dividend is paid or becomes payable;
- If the dividend does not consist of a distribution in specie, then if declared by a listed company, the dividend is deemed to be paid on the date the dividend is paid, while if declared by a non-listed company, the dividend is deemed to have been paid on the earlier of the date on which the dividend is paid or becomes payable.

SARS in its Comprehensive Guide to Dividends Tax (23 February 2015 – SARS Guide) notes (at page 60) in relation to the meaning of "due and payable" that:

"…an amount may be due under a contract (dies credit) but not payable (dies venit). An amount will only be payable when the time for payment arrives. For an amount to be 'due and payable' the amount must not only be owing, but the person must have the right to claim payment."

Issues arise as regards the meaning of "paid" where payment of an amount is made otherwise than in cash. As noted in the SARS Guide, the court in ITC 1688 provides some useful guidelines. There was much debate as to the meaning of "paid" on introduction of the now repealed secondary tax on companies (STC) that became effective in respect of dividends "paid" after the stipulated date. At issue was whether the crediting of a loan account meant that the dividend had been "paid".

In summary, the judge in ITC 1688 held that the dividend that had been declared and credited to a loan account had in fact been "paid" in the specific circumstances. In essence, this finding was based on the fact that set-off had been found to have occurred. Importantly, the court held that:

"If the debt owing by the shareholder is recorded in a loan account with the company, then the set-off will be recorded by crediting the taxpayer's (shareholder's) loan account in the amount concerned".

The judge did, however, caution that his finding did not automatically mean that where declared dividends are left outstanding on loan account that the dividend has been "paid", which on its own "is no more than a recording of a pre-existing fact" (i.e. the declaration of the dividend). Rather, it will be necessary to show that set-off has occurred such that the reciprocal obligations of the shareholder and company have been discharged.

While the DWT rate has been increased, non-resident shareholders resident in a country that has entered into a tax treaty (DTA) with South Africa will generally be entitled to some relief.

Third-party backed shares: Expanding the "qualifying purpose" definition
Author: Kyle Beilings

Section 8EA which seeks to re-categorise dividends as ordinary income, applies to preference shares if they are subject to "enforcement rights" or "enforcement obligations". If the preference shares fall within the provisions of section 8EA, the preference shares will constitute a "third-party backed share" and the dividends will be deemed to be income in the holder's hands, unless the "qualifying purpose" exemption applies.

Simplistically, a "qualifying purpose" constitutes the direct or indirect acquisition of an equity share in an operating company.

Concerns have been raised that the "qualifying purpose" definition is too narrowly defined, and it has been proposed in the 2017 Budget that such definition be expanded as the current definition may impede legitimate transactions.

While it is not clear what the "qualifying purpose" definition will be expanded to cater for, we hope it is expanded to include the acquisition of income-producing assets.

Dividend-stripping rules: Additional measures to curb dividend-stripping where third party debt utilised
Author: Kyle Beilings

Paragraph 43A of the Eighth Schedule and section 22 reclassifies otherwise exempt "dividends" as proceeds for capital gains tax purposes, or ordinary income for income tax purposes where, inter alia, a company borrows funds from its prospective purchaser to enable it to declare a dividend to its shareholder (seller) prior to the sale of the shares in the company by the seller to the purchaser.

It has been noted that the dividend stripping rules are circumvented by raising funding from a third party. Paragraph 43A of the Eighth Schedule and section 22 are therefore likely to be expanded to include funding provided by third parties.

Mining Rehabilitation Trusts
Author: Nina Keyser

A company that holds a mining right under the Mineral and Petroleum Resources Development Act ("mining right holder") can claim an income tax deduction for a contribution made to a mining rehabilitation company or trust which has been set up for the sole purpose of environmental rehabilitation on closure of a mine ("section 37A trust"). A section 37A trust is exempt from income tax, but if it uses its assets for anything other than closure rehabilitation, post closure rehabilitation or transferring its assets to another section 37A trust, it will have to pay tax on an amount equal to the value of the assets which were used for an impermissible purpose. In fact, if a section 37A trust contravenes any part of section 37A of the Income Tax Act, SARS may tax the section 37A trust on twice the market value of all the assets held on the date of the contravention and, in addition, include that same amount in the income of any mining right holder who contributed cash to the Section 37A trust, in respect of which the contravention was committed.

In November 2015, the Department of Environmental Affairs published regulations in terms of the National Environmental Management Act ("NEMA"), which included a draft trust deed to be adopted by existing mining rights holders by the end of February 2017. The draft trust deed did not comply with section 37A and therefore, any section 37A trust which amended its trust deed to comply with NEMA, would automatically have been in contravention of section 37A and would incur the penalties described above. It

In October 2016 a Government Gazette confirmed that existing holders of mining rights could defer compliance with the NEMA regulations until February 2019.The Minister of Finance announced in the Budget that the Income Tax Act will be amended to take the provisioning requirements in the NEMA regulations into account.

Consequently we anticipate that section 37A will be amended to prevent a situation where compliance with the NEMA regulations will trigger penalties under section 37A.

The Minister further announced that the provisions dealing with the use of assets in section 37A trusts for impermissible purposes will be strengthened to prevent abuse. Given that under the current provision, the section 37A trust will already be taxed on the value of the assets that were used for an impermissible purpose, we can only assume that the amount that will be subject to tax is likely to be increased.

We caution mining right holders to keep an eye on any developments in this regard as failure to comply with either NEMA or section 37A could result in heavy penalties.

Contributed tax capital ("CTC") and its application in respect of non-resident shareholders
Author: Denny Da Silva

In its simplest form, the CTC of a company is determined separately in relation to each class of share and equals the consideration received or accrued for the issue of such shares, less any determined returns of CTC by the company on or after 1 January 2011.

When the board of directors elects to return CTC to a shareholder, this amount will represent a "return of capital" for tax purposes and not a "dividend". The result is that the shareholder will need to reduce the base cost of the relevant shares by the amount of the "return of capital". Where the return of capital exceeds the base cost of the share, the excess is deemed to be a capital gain derived by the shareholder.

The Budget mentioned that Government has identified certain avoidance arrangements whereby non-residents create "stepped up" CTC in South African subsidiaries, which is then distributed offshore free of dividends tax. This could be done, for example, by a non-resident disposing of its shares in a South African subsidiary (Co A) to a newly interposed South African company (Co B). This could be done free of any tax, with Co B also creating CTC equal in value to the Co A shares acquired.
Co B could then arguably distribute this CTC to the non-resident shareholder in due course free of dividends tax.

Curbing potentially abusive arrangements such as this clearly understood. It is however important that any specific anti-avoidance measures introduced do not inadvertently affect bona fide commercial transactions. In any event, the Commissioner would surely be in a strong position to successfully attack any such abusive schemes using the general anti-avoidance rule, rather than introduce any additional specific countermeasures.

Debt Reduction: The Good, the Bad and the Ugly
Author: Denny Da Silva

Whilst the financial crises may have come and gone in certain respects, its effects are still lingering. This, coupled with a stagnating economy has led to either debt being forgone or taxpayers seeking other means of settling the debt.

When looking at any scenario where debt is to be waived or settled by some means other than paying cash, the tax consequences thereof need to carefully considered. The IT Act contains specific provisions that deal with situations where the debtor is released from the obligation to repay debt. Where nominal or no consideration is provided by the debtor in respect of the amount of the debt reduced, negative tax implications may arise for the debtor.

Reductions of debt for less than full value are governed by section 19 (income tax) and paragraph 12A of the Eighth Schedule to the IT Act (capital gains). Essentially, application of section 19 can result in the recoupment of expenditure or allowances previously claimed as a deduction, while application of paragraph 12A can result in the reduction in base cost of a capital asset and/or reduction of capital losses of the debtor. Both section 19 and paragraph 12A only find application where a debt, owed by a person, is reduced by any amount and the "reduction amount" exceeds any amount that has been paid as consideration for the reduction. To the extent that no consideration is given, and the debt is cancelled; reduced or waived, the full amount of the debt will constitute the reduction amount that will trigger either an income tax or CGT implication.

As regards so-called "allowance assets" (capital assets in respect of which a deduction or allowance is allowable under the IT Act),

the reduction amount will in the first instance reduce the base cost of the asset under para.12A. Should the reduction amount exceed the base cost, then the excess is deemed under section 19 to be an amount recouped by the taxpayer under section 8(4)(a) of the IT Act. Given that mining companies are generally permitted to immediately deduct qualifying capital expenditure, should any debt relating to such capital expenditure be waived, the provisions of para.12A and section 19 are triggered. However, as the base cost of the capital assets acquired by the mine would have been reduced to nil by reason of the immediate deduction of the acquisition cost, the excess should have given rise to a recoupment under section 19. However, section 19 only deems a recoupment to arise under section 8(4)(a) in these circumstances, while mines are specifically excluded from the ambit of such recoupment provisions (the "recoupment" of such capital expenditure is instead included in "gross income" under paragraph (j) of the definition of that term in section 1(10 of the IT Act) and accordingly avoid the intended recoupment of previously allowed deductions. It has therefore been proposed that the law be amended "to address this disparity" so as to ensure that "the tax treatment of debt forgone for mining companies (is) aligned with the tax treatment applied to companies in other sectors".

It is apparent that paragraph 12A and section 19 will not apply to debt that funded unredeemed capital expenditure, as no deduction of the expenditure incurred on acquiring the relevant capital assets will have taken place at the time the debt is waived.

In order to avoid exacerbating an already strained financial scenario, debtor companies may, where permitted, issue shares in settlement of the debt owing. Alternatively, in group scenarios, a shareholder may subscribe for additional shares in a company and the amount owing for the subscription will then be set-off against the debt owing by the company. These two methods of settling debt have become more widely used and at present should not result in any adverse tax consequences.

National Treasury have recognised certain lacunae's in the legislation as well as certain instances of abuse which they have indicated they will seek to address. In particular it is proposed that:

- the intra-group relief provided by paragraph 12A (which essentially states that paragraph 12A will not apply where debt is forgone in a group scenario) will be extended to section 19 where it currently does not exist. Whilst it appears that it may only be extended to scenarios where such a group company is dormant or under business rescue, it is hoped that this extension will simply be to companies forming part of the same group of companies as with paragraph 12A;
- it be specifically legislated that the issue of shares in settlement of debt be permitted, but that any capitalised interest settled in this manner be recouped to the extent a deduction for this interest expense was previously claimed; and
- amendments be enacted so as to curb the use of structures used to avoid the application of section 19. The identified structure entails the use of the creditor to subscribe for shares in the debtor company, where after the debtor will settle its debt using the subscription proceeds. The debtor company's shareholder would then purchase the shares from the creditor at a slight premium. It is interesting to note that National Treasury concedes that it would only receive capital gains tax, whereas there is a case to be made that the debtor should be subject to income tax on the disposal of its shares given the profit motive element.

A step in the right direction - more changes to REIT legislation

Author: Denny Da Silva

A Real Estate Investment Trust, otherwise referred to as a "REIT", is a company that owns or finances income-producing real estate. REITs (listed) qualify for a special dispensation in the IT Act. A REIT provides an investor (whether institutional or an individual) with the indirect means of investing in large-scale, income producing real estate. Overall, the introduction of specific tax legislation to cater for REITs (albeit only listed REITs) has been a positive move on the part of National Treasury. The introduction of section 25BB, coupled with the provisions of section 43 (which enables an investor to swap a linked unit for a share, tax-free) and the exemption from securities transfer tax in respect of the acquisition of a share in a REIT, make investing in REITs more attractive and viable than a traditional investment in property or in an ordinary company that holds property. Furthermore, whilst an individual investor would not be able to make use of the interest exemption available to him from a tax perspective, the benefits from an economic perspective overall. In particular, as the REIT does not pay capital gains tax on the disposal of immovable property held by it, nor would it need to account for the deferred tax in this regard from an accounting perspective,

its balance sheet is strengthened and its net asset value will be higher, thus making it more attractive for the investor.

Refinements continue to be made to the REIT legislation since its enactment and this year is no different. Last year a proposal was submitted to National Treasury that section 42(3), 44, 45 and 47 (in other words the corporate reorganization rules) be amended such that the corporate reorganisation rules can also apply to REITs. As a REIT is prohibited from claiming any allowances in respect of the immovable assets acquired by it, such assets do not constitute "allowance assets", and as such the corporate reorganisation rules cannot be applied in relation to such assets. Annexure C to the 2017 Budget Review notes that an amendment will be introduced to ensure that the corporate reorganisation rules apply to REITs going forward.

Further refinements for collateral and securities lending arrangements

Author: Denny Da Silva

In 2015, National Treasury introduced tax provisions to ensure that the actual transfer of collateral in respect of a securities lending arrangement was no longer subject to securities transfer tax and capital gains tax as this negatively impacted liquidity and South Africa's ability to attract foreign direct investment.
Prior to that the relevant legislation only dealt with arrangements where there was no actual transfer of the securities- as there is no actual transfer, the arrangement would not subject to income tax or securities transfer tax. Regulatory changes in the financial sector necessitated the need for an actual transfer of collateral with the effect that, without the tax amendments, securities transfer tax and capital gains tax would have been payable on the transfer. The amendments ensured that no securities transfer tax and capital gains was payable, provided that the shares were returned within 12 months.

In response to criticism regarding the 12 month period, with stakeholders noting that it is too restrictive especially when one considers that commercially the collateral arrangement may be in place for a period in excess of 12 months. Furthermore changes were introduced to include listed government bonds as allowable instruments for securities lending and collateral arrangements. In continuation of National Treasury's theme gradually introducing measures to address concerns about the limited scope of the relief provisions, National Treasury intends extending the allowable instruments to include listed foreign government bonds.

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INTERNATIONAL TAX

Measures to protect the Income Tax base: BEPS
Authors: Anne Bennett and Karen Miller

It was widely anticipated that mention would be made in the Budget of the ongoing global OECD base erosion and profit shifting ("BEPS") initiative, targeted at strategies designed to move profits from higher tax to lower tax jurisdictions. National Treasury and SARS have been strong supporters of this project. As predicted, the Budget contained a summary of South Africa's progress in regard to the 15 different BEPS Action areas, with indications given of further steps to be taken in certain cases.

With regard to South Africa's CFC rules and Reportable Arrangements regime, Treasury appears to be comfortable that South Africa's current rules are fully compliant with - and indeed role models for - the relevant BEPS recommendations. Whether or not a developing economy such as South Africa's should have CFC rules modelled on, and in some cases stricter than, those found in established first world economies is an important debate in our view, given the risk that overly strict CFC rules can make SA headquartered multinationals uncompetitive. However in the current environment, this debate seems unlikely to get much traction.

A lot of focus was given to developments in transfer pricing, rules regarding interest deductibility and the introduction of the new multilateral instrument or "super treaty" designed by the OECD to work together with existing tax treaties to enable those treaties to be effectively updated in the short term with relevant BEPS amendments.

Transfer pricing

On the transfer pricing side, Treasury announced its focus on strengthening transfer pricing compliance as a means to combat tax avoidance and illicit flows. Country by Country reporting ("CBCR") has been identified as a mechanism to obtain information on cross border transactions. The relevant regulations on CBCR in South Africa were finalised towards the end of last year and the first filings to be made by affected SA multinational enterprises are expected by 31 December 2017.

SARS remains committed to strengthening its resources in TP. We have recently seen SARS adding to the numbers in its TP team, but generally at a relatively inexperienced level with departures occurring at the more senior level. Finding skilled TP resources in SA is a difficult challenge and it will be interesting to monitor SARS progress in this area.

SARS will be updating the Transfer Pricing Practice Note (PN7) to accommodate the BEPS recommendations around aligning transfer pricing outcomes with value creation. Specific mention was made in the Budget of the need for an agreed approach to ensure appropriate pricing of intangibles that are hard to value. In light of the Budget indications that exchange control rules relating to the export of intangibles may be relaxed (discussed further below), this guidance could become increasingly useful.

Interest deductibility

Treasury stated that Government is strengthening its efforts to curb excessive debt financing which erodes the tax base. The Income Tax Act already contains a number of different provisions which seek to limit interest deductions, resulting in some uncertainty around the order in which they should be applied. To avoid further confusion, we can only hope that these will be consolidated or even replaced entirely rather than simply added to.

The comment made that the current regime will be reviewed in light of the OECD recommendations suggests that SARS is seriously considering scrapping the existing draft Interpretation Note on thin capitalisation and possibly looking to adopt the "fixed ratio rule" and "group ratio rule" recommended in BEPS Action 4. The fixed ratio rule limits an entity's net interest deductions to a set percentage of its tax-EBITDA. The "group ratio rule" allows an entity to claim higher net interest deductions, based on a relevant financial ratio of its worldwide group. Interestingly for banks and insurance companies, if SARS really does embrace the BEPS Action 4 approach, some relief may be in sight. This report suggested that the common approach may not be suitable to deal with risks posed by entities in the banking and insurance sectors and that in certain cases, depending on some country specific factors, it might be appropriate for a country to exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional interest deductibility rules.

Interest deductibility

As mentioned above, the OECD has designed a Multilateral Instrument, officially called the "Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting". It is intended to supplement existing tax treaties to enable them

to be effectively updated with relevant BEPS amendments without those treaties needing to be renegotiated. These measures include minimum standards with regard to treaty abuse provisions and dispute resolution processes, as well as recommended provisions such as changes to broaden the definition of permanent establishment.

Treasury has indicated that SA will participate in the high level treaty signing ceremony in June 2017 where countries will officially indicate their support for the new MI. However, it will still be a while before the provisions of the MI will affect SA's existing tax treaties. SA first has to post an instrument of ratification with the OECD, a process which can only happen after Treasury has decided which of the various provisions in the MI it wishes to adopt, and this has been sanctioned by Parliament. In addition, even after SA has taken these steps an existing SA tax treaty will only be impacted by the MI if the other treaty partner has similarly completed all the necessary processes for signing up to the MI.

With regard to measures to prevent treaty abuse, the MI offers some flexibility and countries can choose:

- the combined approach of a principal purpose test (PPT) rule and a Limitation on Benefits ("LOB") rule;
- a PPT rule alone; or
- a LOB rule, supplemented by specific rules targeting conduit financing arrangements.

Treasury has announced its intention for South Africa to adopt the PPT rather than the detailed LOB approach commonly found in the US' tax treaties. Under the PPT, treaties will state that if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits will be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the treaty. Treasury believes the PPT approach to be appropriate in SA as this wording aligns with the purpose test found in our GAAR. The choice of the PPT rather than LOB approach could be good news for taxpayers in that detailed LOB tests are objective and can be very inflexible, whereas the PPT is more subjective and affords a taxpayer the opportunity to obtain treaty benefits provided it is able to evidence if questioned that the reason for its chosen structure is not tax driven. The other side of the coin is of course that a PPT test offers less certainty than an LOB provision.

In practice, going forward, this is likely to mean that making use of intermediary entities in appropriate tax treaty countries to achieve reduced withholding tax rates or better CGT treatment on disposal of the investment might be high risk, unless significant business substance and commercial activity exist in the intermediary entity and its use is clearly beneficial for reasons other than tax related reasons.

Domestic Treasury Management Companies
Author: Sean Gilmour

A domestic treasury management company must meet certain residence requirements in order to qualify for a relaxation of the rules relating to the taxation of foreign currency gains and losses. The company in question must, in terms of the current definition, be incorporated in South Africa (or be deemed to be incorporated in South Africa) and have its place of effective management in South Africa.

It has been noted that the residence requirements are overly restrictive and it is proposed that they be relaxed. It is envisaged that a company's place of effective management will serve as the decisive criterion, which will allow for a foreign incorporated company to qualify for the regime, provided that its place of effective management is in South Africa.

Intellectual Property reform
Author: Sean Gilmour

It was announced in the Budget that the overall regulatory framework regarding cross-border intellectual property transactions be relaxed. The relaxation is proposed as a result of practical difficulties and unintended challenges which arise for South African based infrastructure and the resultant deterioration of South Africa's competitiveness as a jurisdiction in which to develop and own intellectual property. The relaxation will involve amendments to the income tax provisions and the exchange control policies which are currently in force.

The current framework regarding the taxation of 'tainted' intellectual property was introduced in order to prevent South African taxpayers claiming a deduction for royalties paid to a foreigner in respect of intellectual property which was originally developed in South Africa. The limitation which is in place is dependent on whether the payment in question is subject to the withholding tax on royalties.

It is noted by National Treasury that a relaxation will be considered but in line with the initial policy intent, which was to prevent erosion of the South African tax base. The relief will presumably result inthe right to claim deductions on a broader scale, but within certain parameters.

Tax treatment of foreign member funds
Author: Brian Dennehy

A new foreign member fund regime will be established to enable local and foreign fund managers to establish and manage funds targeted for investments into the rest of Africa and the world. These foreign member funds will benefit from a special tax dispensation. For example, foreign investors investing in the funds for onward investment into the rest of Africa or elsewhere will be exempt from withholding tax on interest. Relief from other taxes, such as dividends tax, the controlled foreign company legislation, CGT, etc. is not yet clear.

Fees earned by local asset managers and collective investment scheme managers for investment management services will still, however, be subject to tax in South Africa. At face value, this special dispensation seems promising, but potentially quite narrow. What is ultimately needed is an expansion of the headquarter company regime in order to allow South African fund managers with offshore investors to establish investment vehicles exclusively in South Africa, without being compelled to operate parallel onshore and offshore investment structures, as is often the case.

Controlled Foreign Companies (CFCs) and offshore discretionary trusts
Authors: Leani Nortjé & Dan Foster

The introduction of specific countermeasures is proposed in relation to the treatment of foreign companies held by interposed trusts. No specific details have, however, been announced in this regard.

The CFC rules are contained in section 9D and apply where South African tax residents hold more than 50% of the total participation rights or voting rights in a foreign company directly or indirectly.

If a foreign company qualifies as a CFC, the "net income" of the company for its foreign tax year is imputed to the South African resident participants in proportion to their participation rights in that company (unless that South African resident holds, together with any connected person, in aggregate less than 10% of the participation rights and may not exercise at least 10% of the voting rights in a CFC). The amount so imputed is then included in the South African resident's income and taxed at his marginal income tax rate.

"Participation rights" in relation to a foreign company is defined to mean the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share or any interest of a similar nature, in that company, or in the absence of this, the right to exercise any voting rights in that company.

In terms of the current definition of participation rights, where a foreign discretionary trust is interposed between South African tax residents and a foreign company, that foreign company will not typically constitute a CFC. This is because the South African resident beneficiaries have no participation rights in the foreign company of which the trust is a shareholder, but merely a spes or a hope that the trustees of the discretionary trust will vest income/ capital derived by the foreign company in them. The South African resident beneficiaries also hold no voting rights in the foreign company held by the trust.

The proposal to introduce countermeasures in relation to the treatment of foreign companies held by interposed trusts presumably targets these arrangements.

This is not the first time that Treasury has announced or drafted such counter-measures. The difficulty in drafting such measures, however, is that there is no fair or reasonable way to impute the profits of the foreign company to a South African beneficiary who has no vested right to receive the profits of such company, especially where the foreign trust concerned has a number of different beneficiaries, not all of whom may be South African tax resident.
The CFC rules are designed to apply where the majority of persons who have the right to benefit from the foreign company's profits and capital, or who have the right to control the company, are South African tax residents. These rights are akin to shareholder (or similar) rights. It cannot be said that a beneficiary's personal right in relation to a discretionary foreign trust is akin to shareholder (or similar) rights in the trust's underlying company.

Should SARS be of the view that a trust has been deliberately interposed between one or more South African tax resident and a foreign company in order to avoid the CFC rules, it already has the

remedy of the GAAR available to it.
In addition, anti-avoidance measures already exist in relation to foreign trusts with South African resident donors or beneficiaries, namely the section 7(8) and paragraph 72 donor attribution rules, and the transfer pricing rules (section 31 and section 7C) which target transactions between the trust and the donor/ beneficiaries that are not at arm's length, and which will result in some form of imputation where applicable.
Furthermore, roll-up rules exist to ensure that vested trust capital retains its original nature once received by resident beneficiaries (section 25B(2A) and paragraph 80(3)). If all these rules are not fit for purpose or not properly enforced, then perhaps amendments are required in this regard rather than changes to the CFC rules.
It is noted that the current CFC rules replaced older controlled foreign entity (CFE) rules which did include trusts, with the trust provisions moved to the current section 7 when the CFC rules were introduced.

The South African income tax regime deliberately treats trusts as persons rather than as transparent entities, despite their legal nature. If an offshore trust is controlled by a South African resident, then SARS may challenge the trust's place of effective management or indeed the substance of the trust. Any tax measures that seek to piece the veil of a trust risk significant unintended consequences.

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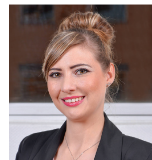

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EXCHANGE CONTROL

Author: Sean Gilmour

Intellectual Property

It has been announced by National Treasury that companies and individuals will no longer require exchange control approval for so-called 'standard intellectual property transactions'. It remains to be seen what is meant by 'standard intellectual property transactions' in this context, but it is anticipated that arm's length transactions will be those that are referred to. The policy regarding impermissible 'loop structures' is to be revised in the context of the ownership of South African intellectual property, with the rules to be lifted in all cases provided that the relevant transactions take place at market value. National Treasury's initiatives in this regard will be most welcomed by various sectors engaged in the local development of intellectual property.

Inward Listings

National Treasury has announced that it will engage in a review of new inward listings in consultation with various interested parties. The review will relate to the inward listing of a foreign company which has material assets in South Africa but little substance in the jurisdiction in which its primary listing is located. The aforementioned practice is noted as being tax driven and the policy regarding inward listings may well be revised depending on the jurisdiction in which a foreign company's primary listing is located.

INDIVIDUALS AND TRUSTS

Author: Dan Foster

Tax rates soar

A new top personal tax rate of 45% has been introduced for individuals earning taxable income over R1 500 000 per annum, from 1 March 2017. With an inclusion rate of 40%, these individuals will pay capital gains tax at 18% (up from 16.4%). The flat rate for trusts rises to 45% (income tax) and 36% (capital gains tax). Dividends Tax on local dividends has increased by 5 points to 20% from 22 February 2017. The effective rate on foreign dividends will rise to 20% from 1 March 2017. Withholding tax on property sales by non-residents has also increased, to 7.5% for individuals (from 5%), 10% for companies (7.5%) and 15% for trusts (10%).

Business owners extracting profits from companies will pay an effective rate of 42.4% (up from 38.8%), once 28% corporate tax and 20% dividends tax is accounted for.

Perhaps surprisingly, income tax rates for earnings below R1 500 000 have remained unchanged. The thresholds, however, have been increased by only 1%, lagging far behind inflation.

Foreign earnings exemption to be narrowed

Currently, employees providing services outside South Africa may qualify for tax exemption on foreign earnings if they are abroad for more than 183 days in any 12 month period, including a continuous period exceeding 60 days. There is no requirement that the employee have a foreign employer or pay tax in a foreign country, in order to qualify for the exemption in section 10(1)(o)(ii).

An employee spending more than 183 days in any single country will typically become taxable in that country, however, and would generally not qualify for relief from tax in that country under a double tax treaty. The South African exemption therefore prevents double taxation, and also prevents the administrative burden of claiming foreign tax credits in South Africa for taxes paid abroad on foreign earnings.

Double non-taxation can arise where, for instance, an employee is working abroad in a country which does not levy tax on earnings, or if they spend time in multiple countries and do not become taxable in any of them. It is proposed to limit the exemption to apply only in situations where the employee has paid tax on foreign earnings in another country, in order to prevent double non-taxation. Notably, a similar requirement is found in the Australian equivalent of this exemption (section 23AG).

It is also noteworthy that South Africa's tax rate (now 45%) is very often likely to be higher than the tax rate applicable in the country in which the employee is working.

South African expatriates working in tax-free countries such as the UAE (Dubai) will be hugely impacted by this amendment, unless they cease to be tax resident in South Africa. Non-residents do not pay tax on foreign earnings and do not need to pass the tests in section 10(1)(o)(ii).

Ceasing to be tax resident in South Africa, if the expatriate's personal and economic circumstances make it an option, will trigger a deemed disposal of the individual's worldwide assets (excluding South African real estate) and potentially generate a substantial capital gains tax (CGT) liability. Concerted pre-emigration tax planning is therefore recommended for any individual contemplating this route.

The amendment will also impact resident employees carrying out regional roles in Africa and using South Africa as their base. If the earnings relating to the non-South African role are currently exempt, but not taxed in any other African country (because the days spent in each country are low), the exemption will be lost in future. The current exemption is one of the advantages for multi-nationals using South Africa as a regional hub. This proposal therefore runs contrary to efforts to make South Africa a gateway to Africa. It may become even more attractive in future for African regional executives to emigrate and be based out of locations such as Dubai or Mauritius, with a consequent permanent loss of revenue to the fiscus.

This proposal comes on the heels of recent amendments to the foreign service pension exemption, which is now denied to pensioners paid by a South African fund. Again, that amendment will only drive pension funds, and some pensioners, permanently offshore.

Deemed donation on interest-free loans to companies held by a trust

From 1 March 2017, in terms of the new section 7C, the interest forgone on loans to trusts by connected persons (or connected companies) will be a deemed donation, with limited exceptions. The reference rate for this deemed donation will be 8% (the "official rate" for rand loans). This rule does not currently apply to loans by connected person to companies owned by trusts. It is proposed that section 7C be extended in future to include such arrangements. This will mean that section 7C will apply even if a beneficiary of a family trust loans funds to the underlying family company, and not just to the trust directly.

Currently, loans by companies to shareholders are subject to a deemed dividend provision (also referenced to the "official rate"). This rule does not, however, have any impact on loans to the company from shareholders or connected persons.

This is a significant extension of the deemed donation rules and has the potential to yield many unintended consequences. It will also require a new approach to section 7C before the section even comes into force. Planning that has already gone into restructuring family trusts will need to be revisited.

It is proposed that an exemption from section 7C be extended to certain trading trusts. This may be good news for some family businesses held via trusts, but it is unlikely to provide relief for typical passive investment holding trusts.

Employee share trusts and double tax

Amendments in 2016 to paragraph 80(1) and 80(2A) of the Eighth Schedule created the real potential for double taxation in employee share trusts where the trust vests shares or share gains in employees who also pay income tax on the share or gain as remuneration. The inequity when applying these provisions in practice has been demonstrated by Webber Wentzel in two recent successful SARS Rulings for clients. Based on the Rulings, it appears that the double tax was not intended.

The problem will be exacerbated from 1 March 2017 when the amended section 8C(1A) comes into effect and gains and non-exempt dividends vested by employee share trusts are taxed as income in the hands of beneficiaries. It was proposed in the Budget that these CGT rules be "clarified" to prevent any unintended consequences. Webber Wentzel has proposed to National Treasury that paragraph 64C be amended so that share gains in such trusts are disregarded whenever section 8C applies to the same amount, either in the form of an amount taxed under section 8C(1A) or a non-exempt dividend in terms of the new section 10(1)(k)(i) proviso (jj).It is also noted that non-exempt dividends and other amounts subject to income tax in terms of section 8C and related provisions will now face a tax rate of up to 45% in the hands of the beneficiary and 36% in the trust.

TAX ADMINISTRATION

Author: Joon Chong

Approval process for public benefit organisations that receive tax-exempt donations

The Budget proposes to amend the Income Tax Act to confirm the current approval process of public benefit organisations ("PBOs") receiving tax-deductible donations. Currently, the practice of the SARS Tax Exemption Unit ("TEU") is that there is an additional approval process in order for PBOs to issue the section 18A certificates to their donors. An entity may be granted PBO status and receive a certificate confirming this status. However, the PBO certificate will not automatically state that the entity is able to issue section 18A certificates to its donors. The TEU carries out a further analysis of the activities of the PBO to determine whether the PBO will mainly carry on activities listed in Part II of the Ninth Schedule of the Act (in regard to which the PBO is able to issue section 18A certificates). There is thus uncertainty as to whether a PBO is able to issue section 18A certificates if it carries on a combination of Part I and Part II activities. Part 1 activities comprise all the public benefit activities which a PBO may carry on but only donations received and used for the listed activities in Part II will enable donors to claim tax deductions. The proposal in the Budget is welcomed and it is hoped that the amendment will clarify the process and also the interpretation of section 18A, particularly for PBOs that carry on both Part I and Part II activities.

PAYE on reimbursement of travel expenses greater than rate or distance set in Gazette

The current rate per business kilometre using the simplified method in the Gazette for annual business distances of less than 8 000 kilometres is 329 cents per kilometre.

The rate in the 2017/2018 year of assessment will be 355 cents per kilometre for distances less than 12 000 kilometres.

The Budget proposes that the reimbursement of rates per kilometre higher than the rate or distances in the Gazette to be regarded as remuneration to be subject to PAYE.

Currently, the reimbursement of travel expenses is not subject to PAYE.

Cap on deductible retirement fund contributions to be spread over year of assessment

For the 2016/2017 year of assessment, individuals who contribute to pension funds, provident funds or retirement annuity funds were able to claim deductions limited to the lesser of:

- R350 000; or
- 27.5% of the higher of:
    - a) the person's "remuneration" (excluding retirement fund lump sum benefits, retirement fund lump sum withdrawal benefits or severance benefits) as defined in the Fourth Schedule; or
    - b) "taxable income" as determined before allowing this deduction or section 18A deduction for donations to public benefit organisations.

Currently, there is uncertainty when determining the application of the R350 000 cap amount and the calculation of the PAYE to be withheld for each month.

The Budget proposes to clarify the uncertainty by allowing the R350 000 cap to be spread evenly over the year of assessment, thus providing for a cap of R350 000/12 for each month in the year of assessment.

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DISPUTE RESOLUTION

Author: Nina Keyser

Accounting for interest received from SARS

Whenever SARS pays interest to a taxpayer, that taxpayer must declare that interest as income in its tax return. In a situation where, for example, a taxpayer disputes an income tax assessment, and has to pay that amount under the "pay now argue later" rule, it is impossible for the taxpayer to know whether the amount paid will be refunded - with interest - until the dispute is resolved (whether by a settlement or a decision by a court). Before the dispute is resolved, SARS would not be in a position to insist that the taxpayer declares the interest that could potentially accrue on the disputed amount, as SARS' position is that the amount is not refundable and, consequently, interest is not repayable.

If the taxpayer therefore pays the disputed amount in year 1, the court finds in the taxpayer's favour in year 2; and SARS finally refunds the amount in year 3, the position will currently be as follows:

In year 1, the taxpayer does not declare any interest. In year 2, the debt due by SARS is no longer in dispute and the taxpayer must start accounting for interest in its tax return for year 2. The taxpayer must include the interest earned in respect of year 1 in its income tax return for year 2 as well.

In year 3, SARS pays the amount with interest and the taxpayer must account for that portion of the interest which accrued in year 3.

The Minister of Finance has proposed that interest payable by SARS will in future be deemed to accrue when it is paid to the taxpayer. Therefore, in our example, the taxpayer will not have to account for any interest in year 1 and 2, but will have to declare the amount of interest paid by SARS as income in year 3. We assume that the new legislation will address the possibility that the taxpayer may already have declared interest in the previous year (before the effective date of the amendment) and provide that interest that has already been taxed will be excluded.

Decisions by SARS that do not result in assessments.

A taxpayer may not take a decision of SARS on review to the High Court until all internal remedies have been exhausted. Section 9 if the Tax Administration Act provides that a taxpayer may request SARS to withdraw or amend any decision that is not given effect to in an assessment. If the decision is given effect to in an assessment, the taxpayer's remedy is to file an objection. Therefore, before a taxpayer takes a decision of SARS, which is not subject to the objection and appeal procedure, on review to the High Court, it is prudent to first make a request under section 9 of the Tax Administration Act for the decision to be withdrawn. The Minister of Finance has announced that all decisions that are not subject to objection and appeal should be subject to remedies under section 9 of the Tax Administration Act. Given that section 9 of the Tax Administration Act already deals with decisions that are not given effect to in an assessment, we anticipate that section 9 will be expanded and refined.

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VALUE-ADDED TAX (VAT)

VAT base broadening: VAT on fuel supplies and foreign supplied electronic services
Author: Des Kruger

While not specifically alluded to in the Budget, the 2017 Budget Review notes that the Government will be looking to expand the VAT base in 2017. Specifically mentioned are the withdrawal of zero-rating on fuel and the broadening of the scope of foreign supplied electronic services that are subject to South African VAT.

As regards the proposed withdrawal of the zero-rating of fuel supplies, the Budget Review notes that consultations in relation to this proposal will be held prior to the 2018 Budget. There is acknowledgment that the proposed step will have an adverse effect on transport costs and that this will need to be mitigated. The Budget Review notes that Government will need to either freeze any increases in the fuel levy, or even consider a decrease in the levy. The reason why fuel supplies are zero-rated is because to have imposed tax as well as the fuel levy amounts to double taxation. There cannot be any cogent reason why this rationale is no longer valid. Private individual and entities will bear the brunt of any such proposed imposition of VAT on fuel, as most VAT registered businesses will be able to claim input tax relief any VAT paid by them on fuel purchases. Private individuals and entities generally also bear the brunt of the fuel levy. Such additional tax burden does not seem justified or fair.

Tax on sugary beverages
Author: Chetan Vanmali

As announced in the 2016 Budget speech, Government intends to implement a tax on sugary beverages. Despite numerous concerns and objections raised by industry and other parties affected by the implementation of the tax relating, inter alia, to job losses over the past year, the Minister announced in his 2017 Budget speech that Government remains committed to proceed with its plan to implement the tax on sugary beverages. This is in line with National Treasury's draft policy paper and consultations held with industry and other interested parties.

The proposed rate will be 2.1c/gram for sugar content in excess of 4g/100m. Sugar content remains the base on which the tax will be applied as it is, it is argued, well suited to public goals.

Amending the definition of "resident of the Republic" for VAT purposes
Author: Chetan Vanmali

Presently the definition of "resident of the Republic" in the VAT Act includes any person who is regarded as a "resident" for income tax purposes. The definition of "resident" in section 1(1) of the IT Act includes any foreign incorporated or established person, other than a natural person, which has its place of effective management in South Africa. Consequently, if, for example, a foreign company is effectively managed from South Africa it will be regarded as being a "resident of the Republic" for VAT purposes, notwithstanding that it might not have any actual presence in South Africa. Thus, while the consumption of goods or services by such a foreign person may take place outside South Africa, and on that basis should escape any South African VAT impost by the application of the zero rate, the zero-rating provisions are in effect negated by virtue of the foreign person not being treated as non-resident for VAT purposes. The foreign person in this instance will also in all probability not be able to register as a vendor in South Africa, and would not want to, and the VAT charged to it by a South African vendor will accordingly not be deductible as input tax.
The VAT will thus be an absolute cost for any foreign person which is effectively managed in South Africa.

Annexure C to the 2017 Budget Review notes that an amendment will be introduced to eliminate any uncertainty with regard to the VAT status of foreign persons in these specific circumstances. We can only assume that these foreign persons will be treated as non-resident for VAT purposes notwithstanding that they have their place of effective management in South Africa.

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