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Werksmans Tax Brief

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2020 Tax Amendments

Introduction

On 28 October 2020, when the Minister of Finance presented his Medium Term Budget Policy Statement to Parliament, he also tabled the Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2020, the Tax Administration Laws Amendment Bill, 2020, and the Taxation Laws Amendment Bill, 2020. Only the last-mentioned is discussed herein.

As has been the trend in recent years, the number of significant amendments each year has been reduced, and the majority in number of the amendments are of a highly technical or esoteric nature, many of which are more of interest to tax professionals than to business people in general. Additionally, Treasury was under greater drafting pressure this year as there was also the tax legislation that had to be prepared and passed by Parliament relating to the tax relief measures given arising from Covid-19.

Accordingly we limit our discussion to those amendments which are likely to be of interest in the general business environment.

One of the "victims" of Covid-19 – and it was probably as a result of inadequate resources owing to the need for additional tax legislation as described above – was the deferral to 2022 of two major tax measures to be introduced into the Income Tax Act, 1962 (the Act). These were:

- the intention to limit the amount of interest which may be deducted by a corporate taxpayer to an amount equal to 30% of (tax) EBITDA where that taxpayer forms part of a group that operates in more than one country; and
- to limit the extent to which a current year's taxable income may be sheltered by an assessed loss brought forward to 80% of that taxable income, so that, despite the loss, there will still be tax payable on 20% of the current year's taxable income.

Corporate Taxpayers

Corporate restructuring rules

Section 45 of the Act is one of the corporate restructuring provisions which allows assets or businesses to be sold intragroup without tax consequences, and where the purchase price can be in the form of cash or either by the issue of debt or a share which is not an equity share as defined (an equity share is one that has an unlimited right to participate either in dividends or in capital, or both).

There are certain anti-abuse provisions in the section, but two of them, which potentially carry the most risk, are as follows:

- The first is the so-called degrouping provision, which, in a nutshell, states that if the transferee and transferor companies cease to form part of any group (being a group for tax purposes) within six years of the transferee acquiring the asset under section 45 of the Act, in short the transferee is deemed to sell the asset at market value (usually) at the date on which the transaction took place, and then to repurchase it at that price, thereby triggering a taxable recoupment of depreciation and/or a capital gain subject to CGT. This is colloquially known as the "degrouping charge".

- The second is that if debt or a non-equity share was issued (typically) to the seller to fund the acquisition of the asset, in the holder's hands the debt or share will have no base cost. This means that any repayment of the debt or any reduction of capital on the share will represent a capital gain subject to CGT. However this gain is disregarded for so long as the debtor and creditor/issuer and holder remain part of the same group for tax purposes. Unfortunately, there is no longstop date after which this provision ceases to apply, such as the six-year period applicable to degrouping.

A new subsection (3B) has now been introduced to take effect in respect of years of assessment commencing on or after 1 January 2021. In summary, what it provides is that if the creditor under the debt, or holder of the share, ceases to form part of the same group as the issuer, which cessation triggers the degrouping charge, the holder of the debt or share is effectively deemed to acquire a base cost equal to the original face value or issue price, reduced by the amount of any subsequent repayment of capital, thereby eliminating the zero base cost situation.

This amendment makes no sense to us whatsoever. The purpose of having a zero base cost is to create a potentially punitive situation if the parties seek to abuse the benefits of section 45 of the Act. On the other hand, parties who genuinely use the section for which it was intended, should not be prejudiced. It therefore makes no sense whatsoever that:

- the holders have a zero base cost and suffer capital gains, which are then disregarded, provided the parties remain part of the same group;
- when they cease to form part of the same group within six years, which is a minimum period for non-abuse, the base costs are restored without any tax being suffered, and therefore one must ask why the legislature bothered to introduce this anti-abuse provision in the first place; but
- no relief is given for the holder of the debt or share if there is no degrouping within the six-year period, or if the parties degroup after the period of six years, and one would have expected that this is precisely the time when the reinstatement of base cost should have occurred instead, but it does not,

so that relief is given to the holder in a non-compliant scenario, but not to a holder in a compliant scenario!

Treasury have since indicated that they are aware of this anomaly and will seek to address it in the 2021 legislative process.

Scholarships and bursaries

Section 10(1)(q) and (qA) allow for tax-exempt scholarships and bursaries to be received by individuals, including where an employer grants scholarships or bursaries to its employees or their relatives. There are certain limits and requirements in order for the latter scholarships or bursaries to be tax-exempt.

With effect from tax years commencing on or after 1 March 2021, the exemption will no longer apply to the scholarship or bursary if any remuneration to which the employee was entitled or might in the future have become entitled was in any manner whatsoever reduced or forfeited as a result of the grant of the scholarship or bursary.

We foresee some difficulty in applying this provision given that it applies only to remuneration to which the employee was "entitled" – after all, salary sacrifice arrangements only apply properly where there is no prior entitlement. What is going to be even more problematic is to suggest that a scholarship or bursary given at a future time arose from an amount that the employee "might" in the future become entitled to.

Termination of incentives

In the documentation accompanying the Minister's Budget Speech in February 2020, it was noted that the corporate tax rate of 28% is too high in relation to South Africa's trading partners, and that there is a need to reduce this rate to make South Africa more competitive. Given the economic constraints we have, any such reduction has to be revenue neutral.

No doubt with this in mind, the Bill contains a number of provisions whereby tax incentives (which reduce the tax base, and therefore the tax revenues) will be phased out. These include the following:

Section of the Act	Incentive	Date of termination
12DA	Deduction: rolling stock	28 February 2022[1]

12F	Deduction: airport and port assets	28 February 2022[2]
12R	Special economic zones	1 January 2031[3]
12S	Deduction: buildings in special economic zones	1 January 2031[4]
13quat	Deduction: buildings in urban development zones	31 March 2021[5]
13sept	Deduction: low-cost residential units	28 February 2022[6]

International Tax

Loop

Historically the South African Reserve Bank, in administering the Exchange Control Regulations, 1961, has prohibited a so-called loop, where South African residents hold shares in a foreign company which, in turn, holds assets in South Africa. There have been relaxations over the past few years such that, without special approval for a greater proportion, it is possible for either corporates, undertaking foreign direct investment, or individuals, making personal investments, to hold interests in foreign companies which have South African assets, provided that South African residents collectively do not hold more than 40% of the shares or voting rights of the foreign company. What is still considered a breach is if a foreign company, holding interests in South African assets, is held by an offshore trust in which beneficiaries, even discretionary beneficiaries, are residents of South Africa.

Given the announcement that the current exchange control regulations are to be replaced by a new set out regulations, scheduled to be enacted on 1 March 2021, coupled with a completely new (and less restrictive) exchange control framework, the concept of a loop is to disappear. The main reason for the exchange control prohibition was, in any event, to protect the tax base. In order to compensate for the removal of the exchange control prohibition, two major amendments to the Act have been proposed in the Bill as follows.

Controlled foreign companies

The first amendment is to section 9D of the Act dealing with treatment of a controlled foreign company (CFC). The general principle is that, subject to any exemptions, the profit of the CFC is recomputed to arrive at the equivalent of taxable income under the Act, and the South African-resident shareholder's proportion thereof is effectively taxed in the shareholder's hands.

In computing the taxable income, any dividend from a South African company would obviously be treated as exempt income from an income tax perspective. An amendment now requires that, in computing the (equivalent of) taxable income of the CFC, 20/28 of the South African dividend must be included as taxable income. The effect of this is that where the shareholder of the CFC is a South African company, and 28% of this amount is taxed, the effective tax rate becomes 28% of 20/28 = 20%, which is the rate of dividends tax on a dividend from a South African company (and the effective tax rate attributable to a foreign dividend). (Of course, if an individual or a trust is the shareholder, then the effective rate is 45% of 20/28 = 32%, which is greater than the rate at which tax on South African or foreign dividends is imposed.)

Recognising that the South African dividend itself would have been subject to dividends tax at 20%, or possibly less under a relevant double tax agreement, the amendment includes an adjustment mechanism to ensure that, to the greatest extent possible, the tax payable by the shareholder on the CFC's profits as determined above, together with the dividends tax withheld on the South African dividend, will not exceed an effective rate of 20%. For the reason given above, this mechanism can only work properly where the shareholder of the CFC is a company.

This amendment applies to any South African dividends received by a CFC on or after 1 January 2021.

Capital Gains Tax

The second amendment relates to the so-called participation exemption applicable to capital gains, found in paragraph 64 of the Eighth Schedule to the Act. The general principle is that where a South African resident holds at least 10% of the equity shares and voting rights in a foreign company and, shortly stated, and subject to certain requirements, a capital gain arises on disposal, that capital gain is exempt from CGT.

An amendment now states that this exemption will not apply in respect of a capital gain determined in respect of the disposal of a share in a CFC, to the extent that the value of the assets of the CFC "is attributable to assets directly or indirectly located, issued or registered in" South

Africa. The formulation sounds simple, but in practice, determining the attribution could be complex, depending upon the criteria used to arrive at the sale price of the shares in the CFC.

This amendment applies to any disposal of shares in a CFC on or after 1 January 2021.

Loops and offshore trusts

Nothing is included in the Bill in relation to loops where an offshore trust with South African-resident beneficiaries holds an interest in an offshore company, which holds interests in South African assets. The Explanatory Memorandum to the Bill noted the amendments introduced in 2018, whereby distributions out of capitalised profits by an offshore trust, where those capitalised profits represented either a dividend from, or disposal proceeds of, shares in a company held as to more than 50%, would still be taxable if distributed to a South African-resident beneficiary, and that the exemption which previously applied would no longer apply. It went on to state that these amendments were sufficient to deal with this issue.

A further CFC change

Another, somewhat surprising, amendment to the CFC rules, relates to the attribution of capital gains in a CFC. Since 2001, when both CGT and comprehensive CFC rules were introduced, where a CFC made a capital gain, in determining the amount of the CFC income to be taxed in the shareholder's hands, the inclusion rate applicable to the shareholder was applied so that, using current rates, if the shareholder was an individual, the capital gain was effectively taxed at an effective rate of 18%, if it was a company it was effectively taxed at 22.4%, and if a trust, it was effectively taxed at 36%.

This rule has now been amended to remove this concession to all shareholders other than an insurer in respect of its individual policyholder fund. The effect of this is that for all other taxpayers the inclusion rate will be determined based on the company inclusion rate. This will not affect a trust, as now the inclusion rate for companies and trusts is the same at 80%, but it is double the inclusion rate applicable to individuals. The consequence of this is that where a natural person is a shareholder of a CFC any underlying capital gains made by the CFC will effectively be taxed at the rate of 36% in the shareholder's hands, instead of at 18%.

No specific commencement date is given for this amendment, which means that it will commence applying on the date of promulgation of the Taxation Laws Amendment Act, 2020.

Cessation of residence

Section 9H of the Act deals with the tax consequences inter alia when a person, including a company, ceases to be a resident of South Africa. In the case of a company, on the day before cessation of residence (a) the company is deemed to sell its assets at market value and reacquire them, thereby triggering capital gains and possible recoupments of tax allowances, and (b) the company is also deemed to have distributed a dividend in specie equal, in short and in effect, to the realised and unrealised profits of the company, which dividend is subject to dividends tax. These two charges are colloquially known as the exit tax.

This deemed dividend will, however, be exempt from dividends tax if the shareholder is a South African-resident company that either forms part of the same group for tax purposes or, if not, has submitted the required declaration and undertaking to the company which enables it to be exempt from the tax. An amendment now introduced states that in these circumstances, if the shareholder holds at least 10% of the equity shares and voting rights in the company whose residence ceases, the shareholder is deemed to have disposed of the shares on the date prior to cessation of residence for proceeds equal to market value, and then to have reacquired the shares at that value, thereby triggering a capital gain.

One can understand the logic but it is not necessarily so that the amount of the gain would equal the amount of what the dividends tax would have been but for the exemption; nor is the tax rate the same (20% for dividends tax and an effective 22.4% CGT). Also, the party being taxed is different – it is the company which ceases residence that bears the exit tax in the form of CGT and dividends tax, but now, because there is no dividends tax, the shareholder has to pay a tax when the shareholder is not taking any action itself! It might have been better rather to say that, in these circumstances, the relevant exemption from dividends tax would not apply, thereby putting all shareholders on the same footing.

Individuals

Section 7C

As is now widely known, any person who has, broadly speaking, made an interest-free or low-interest loan to a local or offshore trust, or to a local or offshore company owned by a local or offshore trust, is subject to donations tax on a deemed donation. The donation is calculated by multiplying the loan by the "official rate of interest" as defined in section 1 of the Act, and deducting any interest actually accrued on the loan, and multiplying the result by the rate of donations tax. The tax is payable in March of each year.

It did not take long for planners to realise that a way around this problem was to finance the structure, onshore or offshore, by means of having the company owned by the trust issuing preference shares, which could be zero-coupon preference shares or, if not, certainly not cumulative preference shares.

To counter this, an amendment is made, which in short:

- deems any such preference share to be a loan; and
- deems any dividend or foreign dividend to be interest.

The expression "preference share" is given the same meaning as in section 8EA(1) of the Act, and therefore means (a) any share which is not an equity share (see above), or (b) any equity share if any amount of a dividend or foreign dividend is based on or determined with reference to a specified rate of interest or the time value of money.

The amendment comes into operation on 1 January 2021 and applies in respect of any dividend or foreign dividend accruing during any tax year commencing on or after that date. In other words it will apply for the first time in the year ending 28 February 2022. This is a rather strange formulation, because what happens if there is no dividend at all? What is a taxpayer supposed to do in determining a donations tax liability at 28 February 2022?

Transfer of a listing

Once again, motivated by the relaxation of the exchange controls pursuant to next year's adoption of new regulations, a new section 9K has been introduced, which applies only to a natural person or trust that holds a security (not defined) which is listed on a South African exchange.

If the listing of this security ceases on the local exchange and thereafter it is listed on a foreign exchange, the holder is deemed to dispose of the security for proceeds equal to market value on the day that the security lists on the foreign exchange, and then to reacquire it at the same market value, thereby triggering a capital gain. This provision applies in respect of any security listed on a foreign exchange on or after 1 March 2021.

Frankly, this is a most puzzling amendment. A South African resident is subject to CGT on worldwide assets, and if a security's listing is transferred from a local to a foreign exchange, it is still the same asset held by the same shareholder in the same issuer, acquired at the same cost, and when sold will trigger the same capital gain. It makes no sense that this transfer of a listing, which has nothing to do with the economic nature of the asset acquired and which is continued to be held, nor has anything to do with the tax laws, should give rise to a cashless (deemed) sale on which cash tax is payable.

The justification for the amendment is, once again, the loosening of exchange controls, but one fails to see the link between the fact that even a local issuer of shares or debt can transfer the listing to a foreign exchange as being a reason to trigger a notional capital gain resulting in actual tax payable.

Expatriate tax

As is well known, when a resident works abroad for a lengthy period, the remuneration is exempt from tax in South Africa (the exemption to be limited to R1.25 million from next year). The requirements for the exemption are that the individual must be outside South Africa (i) for a period or periods exceeding 183 full days in aggregate during any period of twelve months, and (ii) for a continuous period exceeding 60 full days during that period of twelve months.

Given the fact that individuals could have been prevented from leaving South Africa during the lockdown, with the result that they might not have met the 183 day threshold, an amendment has been made, effective 29 February 2020, stating that, in respect of any tax year between 29 February 2020 and 28 February 2021, the requirement is to spend 117 full days in aggregate during any period of twelve months. This reduction of 66 days supposedly correlates to the period of lockdown when not even flights for business purposes were available.

Emigration

For some years now, when a member of a pension or pension preservation fund, provident or provident preservation fund or retirement annuity fund (a retirement fund) emigrates, including emigrating for exchange control purposes, that individual is entitled to receive 100% of the value of the retirement fund, even though this might be contrary to the general rules in the case of a resident.

Given the proposed exchange control relaxations, one of which will be that there will no longer be a distinction between a resident and an emigrant, and thus no longer any formal emigration procedure, the reference point in granting this dispensation can no longer be exchange control emigration. Accordingly, with effect from 1 March 2021, the requirement, in order to access the money in the retirement fund, is that the person must not be a South African resident for an uninterrupted period of three years or longer from that date.

As a phasing-out provision, a concession has been made such that the old rules will continue to apply to any person who has submitted an application for emigration to the Reserve Bank. The application must have been received by the Reserve Bank on or before 28 February 2021, and approved by it or an authorised dealer on or before 28 February 2022.

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1. Allowance limited to rolling stock brought into use during tax year ending on or before the date.
2. Limited to an asset brought into use during a tax year ended on or before the date.
3. The section ceases to apply from a tax year commencing on or after the date.
4. Section ceases to apply to expenditure incurred during a tax year starting on or after the date.
5. Building or improvements must be brought into use by this date.
6. Deduction only allowed in a tax year ending on or before this date.



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