

Werksmans Tax Brief

25 November 2021 28 min read

Tax Amendments 2021

Introduction

On 11 November 2021, 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, 2021, the Tax Administration Laws Amendment Bill, 2021 and the Taxation Laws Amendment Bill, 2021. 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 of the amendments are of a highly technical or esoteric nature, many of which are more of interest to tax professionals than to businesspeople in general. Additionally, Treasury was under greater drafting pressure this year as there was also the additional tax legislation that had to be prepared relating to the further 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. This will involve comment on the Income Tax Act, 1962 (the ITA) and on the Value-Added Tax Act, 1991 (the VAT Act).

We record at this point that the most controversial of the draft amendments, whereby an exit charge was proposed to be inserted in the ITA on the value of an emigrant's retirement funds when residence ceased, has been withdrawn. Treasury states that it will continue to consider the matter, and we shall have to see whether this proposal (or something like it) is ever revisited, especially given the effect it might have on the obligations that South Africa has under its various double tax agreements.

Corporate Taxpayers

Interest limitation rules

In line with measures adopted by many countries, and as part of the OECD's BEPS (Base Erosion and Profit-Shifting) initiative to prevent profits being shifted from high tax jurisdictions to low tax jurisdictions, legislation has been introduced that, shortly stated, will limit the deductibility of certain cross border interest payments to an amount equal to 30% of, what is colloquially termed, Tax EBITDA.

This was first announced in the 2019 Budget to take effect in 2021 but was postponed to 2022 because of COVID. The legislation itself is a lot less broad than was initially suggested in the draft discussion document circulated for comment, which means that there will be a lesser compliance and tax burden on South African companies. It will also only take effect on the date on which the company tax rate is first reduced after an announcement by the Minister of Finance in his Budget Speech, and will apply in respect of tax years commencing on or after that date. In this regard, it is noted that in this year's Budget Speech the Minister announced that the corporate rate might reduce to 27% from next year, so that the new limitation rules could first apply in respect of tax years commencing on or after 1 April 2022.

No new section has been inserted into the ITA and rather section 23M has been fairly extensively amended. This section was originally inserted into the ITA in 2013 and was intended to limit the deductibility of interest paid to a controlling shareholder (essentially defined as a shareholder holding at least 50% of the South African company) where the interest received was neither subject to income tax nor the withholding tax on interest of 15% (and the section would not apply even if the foreign recipient was subject to a lower rate of withholding tax under a double tax agreement (DTA)). Although the section was primarily aimed at interest received by a non-resident controlling shareholder, it also nevertheless

applied, and will continue to apply, where there is a resident shareholder that is tax-exempt, such as a public benefit organisation, a retirement fund, and so on.

Previously there was a fairly complex formula linked to the Reserve Bank's repo rate, and, depending upon the rate and other elements of the formula, the limitation could be as high as approximately 40% of Tax EBITDA. This has now been changed to a flat 30% of Tax EBITDA.

The section uses the expression "adjustable taxable income" for what is colloquially referred to as Tax EBITDA and in summary is defined to mean the taxable income before applying section 23M, which is then:

- reduced by interest earned, imputed income of a controlled foreign company, and any recovery or recoupment of depreciation or similar allowance; and
- increased by interest expense, allowable depreciation, any assessed loss brought forward before applying the section, and any deductible dividend paid by a REIT or its subsidiary.

Other important elements of the amendments are as follows:

- The concept of interest has been broadened from meaning only interest as defined in section 24J of the ITA. It now includes: an amount incurred or accrued under an interest rate swap contemplated in section 24K; the finance cost element recognised under IFRS in respect of a finance lease as defined in IFRS 16 (such finance element is actually part of a rental payment for the purposes of the ITA); certain foreign exchange gains or losses that have been taken into account under section 24I(3) and (10A) of the ITA; and any amount deemed to be interest under section 24JA (which relates to Sharia compliant financing arrangements), but does not include any interest that is treated as a dividend for the purposes of the rules relating to hybrid debt instruments and hybrid interest (sections 8F and 8FA respectively of the ITA).
- Previously there was a gap in section 23M in that if the loan was made to a South African treasury or holding company that on-lent the funds to the operating company, effectively the section would not apply. Provisions have been made to close this gap.
- As stated above, the section did not apply even if the foreign recipient was subject to a lower rate of withholding tax than the rate of 15% as contained in the ITA. An amendment is made so as to include such interest as being subject to section 23M, but reduced proportionately to the extent that withholding tax has been paid. So, if the full 15% has been withheld no portion of that interest paid will be subject to the limitation. If the withholding rate has been reduced under a DTA to, say, 10%, only one-third of the interest will be taken into account for the limitation rules.

As now amended, the amount to be allowed as a deduction comprises:

- Tax EBITDA multiplied by 30%; plus
- interest earned; less
- interest paid on debts other than those owing to a controlling shareholder (or connected person thereto).

Moreover, as before, any amount disallowed may be carried forward to a following year and is deemed to be interest in that year (and there is no limitation of the number of years that this amount can be carried forward).

When the draft discussion document was issued in 2019 it indicated that some rationalisation would be legislated for the interaction between this section and section 31 of the ITA, the latter containing the transfer pricing rules, because both sections overlap and have a similar purpose. It was also suggested that a safe harbour rule might be inserted to cover both the debt:equity rule and the rate of interest in section 31. Unfortunately neither of these positive suggestions has found its way into the legislation.

Limitation on utilisation of assessed loss

As with the interest limitation above, the proposed amendment to section 20 of the ITA was also announced in 2019 and postponed to 2021 because of COVID. And as with the interest limitation rule, the limitation of utilisation of an assessed loss will only commence applying when a reduction in the company tax rate is announced and becomes applicable.

At present, any taxable income derived from any trade by any person can be reduced by:

- a current year's loss from another trade; and
- an assessed loss brought forward from a previous year.

The change applies only to companies and not to other taxpayers (individuals, trusts, etc) and the new rules state that an assessed loss brought forward (current year's losses are not affected) will be limited to an amount of 80% of taxable income determined before applying section 20. So,

for example, if there is an assessed loss brought forward of R15 million and a current year's taxable income of R10 million, previously there would have been no taxable income and R5 million of the loss would be carried forward. Now only R8 million of the loss (80% of taxable income) can be offset against the current year's taxable income of R10 million, so that tax on R2 million will have to be paid, and R7 million, instead of R5 million, can be carried forward.

To assist smaller businesses the rule states that the set-off is the greater of 80% and R1 million. So if there was an assessed loss brought forward of R5 million and a current year's profit of R800 000, the full set-off will be allowed and not only 80% of R800 000. Likewise if the current year's taxable income is R1.1 million, the set-off will not be limited to R880 000, but will be allowed to the extent of R1 million.

Contributed tax capital

Contributed tax capital, or CTC as it is known, is, what might loosely be referred to as, the tax equivalent of share capital. To be a return of CTC in a distribution by a company (including a distribution by way of a share repurchase) the directors must specifically determine this to be a reduction of CTC. Failing any such determination, any distribution (even out of share capital) is a dividend under the ITA.

It can be more tax efficient in certain circumstances to have a reduction of CTC rather than a dividend. The reason is that in the shareholder's hands a reduction of CTC goes to reduce the base cost of the shares held, and provided the CTC reduction does not exceed the base cost (which would trigger CGT on the excess) there is no tax on the shareholder in respect of the distribution. On the other hand, a dividend could be taxable at a rate as high as 20%.

There has for several years existed a proviso to the definition of CTC that states that, in respect of any class of shares, the reduction of CTC cannot exceed the amount of, in effect, the CTC per share. So, for example, if there is one class of shares and the CTC amounts to R100, and 20% of the shares are being repurchased, the company cannot treat the full R100 of CTC as being applicable to that 20%, but it will be limited to R20.

A further proviso is now introduced into the definition that takes effect on 1 January 2022. This proviso states that any distribution by a company will not comprise a reduction of CTC unless all the holders of the shares in that class participate in the same manner and are actually allocated an amount of CTC based on their proportional shareholding. Thus if a distribution is made to, say, the two equal shareholders in a company the resolution cannot say that the distribution to shareholder A includes a reduction of CTC amounting to Rx and the distribution to shareholder B includes a reduction of CTC of Ry. So, in the example of the share repurchase above not even the 20% of shares being repurchased can include R20 of reduced CTC, because the remaining 80% shareholders are not participating.

This is a rather unfortunate outcome, because it could mean that the shareholder of the 20% being repurchased is forced to receive it as a dividend subject to dividends tax, while the shareholder holding 80% can now benefit from the full R100 of CTC rather than R80.

Submissions were made to Treasury and SARS in this regard, and they made only one concession, namely, that this new proviso would not apply in the case of a listed company undertaking a general repurchase of shares.

We remain puzzled by this discrimination and we cannot understand why a listed company making a specific repurchase of shares, or an unlisted company, is being denied this alternative.

Corporate restructuring rules

Asset-for-share transaction

Section 42 of the ITA allows roll-over relief when a person exchanges an asset for shares in a company and ends up with a 'qualifying interest' in that company (usually at least 10%). The section is intended to apply only where the consideration given by the company comprises an issue of its own shares. Any other consideration (eg cash) will trigger CGT to the extent of the amount thereof. An exception to this rule is made where certain qualifying debt is assumed by the company when it acquires the asset.

Because this could result in loss to the fiscus, section 42(8) provides that the amount of debt assumed will be added to the proceeds when the shares are sold. So, for example, if an asset with a base cost of R100 and a related liability of R80 are transferred to a company in exchange for shares, commercially and for accounting purposes the shares will be issued for R20, which will be the shareholder's cost of those shares. Under section 42, however, the shares issued are deemed to have a base cost in the recipient's hands equal to the base cost of the asset, which is R100 in this case. Assume that at a later stage the shares are sold for R110. Commercially the shareholder makes a profit of $R110 - R20 = R90$, but for CGT purposes the capital gain is $R110 - R100 = R10$. For this reason the amount of the debt is added to the proceeds of R110, making it R190, and now the capital gain will be $R190 - R100 = R90$, which equals the commercial profit.

This anti-avoidance provision was, however, defeated where the shares were in turn disposed of under one of the other corporate restructuring rules. So, for example, if those shares were distributed by the shareholder to its holding company as a liquidation distribution under section 47 of the ITA, the holding company receiving the distribution would have 'inherited' the base cost of R100, but would not have been subject to the obligation to add the amount of the debt of R80 when it sells the shares.

To resolve this problem section 42(8) has been amended to state that where the shares are first disposed of, immediately prior thereto there is deemed to be a return of capital equal to the amount of debt assumed. Under the rules, a return of capital is deducted from the base cost by the shareholder, and only if the amount goes negative will a capital gain apply.

So in the example above, the person disposing of the shares with a base cost of R100 would be treated as having received a return of capital of R80 just prior to the disposal, which would reduce the base cost to R20. Now the capital gain, when the shares are sold for R110, equals the commercial profit. But if those shares are not sold but are immediately distributed to a holding company under a liquidation distribution, also as per the example above, the holding company will 'inherit' the base cost of R20, so that if it ever on-sells the shares it is the holding company that will make the capital gain based on the base cost of R20, so that the anti-avoidance provision will not have been defeated.

This amendment will apply to disposals of shares on or after 1 January 2022.

Intragroup transactions

Section 45 of the ITA allows companies within the same group for tax purposes to sell assets among them on a roll-over relief basis. The rules also state that if the transferee disposes of that asset to an acquirer outside of the group within six years, then the transferor would (generally) be subject to the capital gain based on market value at the date of the intragroup transaction as if the roll-over did not apply (but, clearly, after six years this so-called degrouping charge falls away).

Where intragroup debt is utilised for this purpose, eg the purchase price is left owing on loan account, that loan is deemed to have a nil base cost in the creditor's hands. The effect of this means that any repayment will trigger a capital gain in the hands of the creditor. However the rules prevent this happening by stating that the gain will be disregarded provided that, at the date of repayment, the debtor and creditor still form part of the same tax group. Moreover, unlike in the case of disposals of assets by the transferee company, there was no six-year limitation.

Last year an attempt was made to ameliorate some of the harsh consequences of this debt rule, but the legislation, in the form of inserting a new subsection (3B), did not go far enough. The entire subsection has thus been replaced and takes effect in respect of tax years commencing on or after 1 January 2022.

Insofar as is relevant to this discussion, the new subsection (3B) applies in the circumstances where either:

- the transferor and transferee company cease to form part of the same group of companies; or
- the transferee and transferor company are still part of the same group on the sixth anniversary of the acquisition.

In such case, in effect, the creditor company will be deemed to have a base cost in respect of the balance of the loan still owing. In other words, the harsh treatment of nil base cost is reversed.

This makes sense because:

- in the case of the situation in (a) above, the transferor company will have been subject to the degrouping charge and therefore should not be double taxed, as it were, by being left with a debt owing that has no base cost; and
- in the case of (b), if the companies have remained as part of the group for the full six years, there seems to be no reason why the creditor should continue to suffer the burden of a nil base cost if the debt is still in existence.

That all said, we cannot see the justification for retaining this nil base cost rule at all. The fact is that it is being imposed, but whether the transferor and transferee companies do degroup within six years or do not, the base cost will always be restored. So the question immediately arises as to when the burden of the nil base cost will ever be felt.

International Tax

Controlled foreign company rules

Section 9D of the ITA contains the rules relating to a controlled foreign company (CFC). In short, an amount equal to the CFC's taxable income (determined under the rules in the ITA) is deemed to be earned by the South African-resident shareholders pro-rata to their shareholding and is

taxed in their hands at their normal tax rates.

There are certain exemptions to the CFC provisions, and one of them is where the CFC has a qualifying foreign business establishment (FBE), namely, adequate premises, equipment, management and staff outside South Africa, through which the CFC's business is carried on. Provided there is such an FBE, the taxable income attributed to that FBE (even if not taxed at all in the foreign country) will not be subject to the attribution rules in section 9D.

But it is not every and all types of income attributable to the FBE that fall within the exemption. Certain exclusions are contained in the rules that effectively render the income that falls under those exclusions still to be taxable in the shareholders' hands. Some of these rules are known as 'diversionary rules' in that they relate to transactions that have the effect of denuding the South African tax base.

These diversionary rules are contained in section 9D(9A) and one of them is to be found in paragraphs (a)(i)(aa) and (dd) where taxable income is derived from the sale of goods by the CFC directly or indirectly to any connected person in relation to the CFC that is a resident (eg a South African group company). This has the potential for shifting profit from South Africa to a lower tax jurisdiction where the CFC operates by the CFC charging the highest possible price for the goods. This rule, however, was made inapplicable if:

- the CFC purchased goods within its country of residence from a supplier who is not a connected person in relation to the CFC; or
- the CFC purchased the same or similar goods mainly within its country of residence from persons who are not connected persons to it.

These have now been amended so that the exclusion will no longer apply (and therefore the diversionary rules will not apply) where those goods are purchased within the CFC's country of residence, but with effect from tax years commencing on or after 1 January 2022, the exclusion will apply only if the CFC purchases those goods, or the same or similar goods mainly "for delivery" in the country of residence of the CFC.

So whereas it was possible for a CFC to purchase goods from a third party in its country of residence and on-sell these to a South African group company, without endangering the FBE exemption for the CFC, now the FBE exemption can only continue to apply if the CFC purchases those goods "for delivery in" its country or residence.

There is, of course, a difference between the concept of delivery from a commercial perspective and from a legal perspective. Commercially one would see delivery as meaning the actual passing of possession of the goods, eg the goods are delivered to the purchaser's warehouse and handed over. Legally, delivery occurs when ownership passes in the goods. It would therefore be possible to arrange that the CFC on-sells to the South African company where there is legal delivery taking place within the CFC's country of residence, which means that the FBE exemption will continue to apply.

SARS takes the view that delivery here means physical delivery, ie in the commercial sense, though the legislation does not state this. It is possible that a court would agree with SARS having regard to the purpose of the provision, and the relative ease whereby legal delivery can be ensured.

Another point of concern is that this new rule could hit innocent transactions. For example if the CFC buys goods from a resident of the country and sells those goods to an unrelated buyer in another country (not being South Africa), the goods will not be delivered in the same country and now the FBE exemption does not apply. There is no abuse of the system here.

Withholding tax on interest

One of the amendments made to the ITA (not dealt with above) was to clarify the tax treatment in the case of hybrid debt instruments and hybrid interest, dealt with in sections 8F and 8FA respectively. Under these sections the interest paid is deemed to be a dividend in specie rather than interest so that the company gets no deduction. The amendment now clarifies that the amount will also be treated as a dividend in the recipient's hands, and thus will not be taxed.

As a consequential amendment, section 50A – which forms part of the rules relating to withholding tax on interest – is being amended to make it clear that 'interest' as defined does not include a deemed dividend received under sections 8F or 8FA.

There is a difficulty that arises in this regard that has not been addressed:

- First, it must be understood that, unlike in the case of a cash dividend where the dividends tax is imposed on the shareholder (even though withheld by the company and paid over to SARS), in the case of a dividend in specie it is the **company** that is liable for the tax, because the tax is imposed on the company itself and not on the shareholder. Technically this means that a non-resident shareholder which is entitled to a lower rate of dividends tax under a DTA will lose its entitlement thereto. This problem is addressed by the ITA itself providing that the company will be liable for the same amount of tax on a dividend in specie that would have been payable by the non-resident shareholder under the DTA.

- Even though the ITA will treat the amount paid as a dividend, it remains interest for the purposes of a DTA, where the withholding rate could be less than 15% – even zero. It can be argued that this is neutral to the recipient or even advantageous, because it will receive the deemed dividend free of tax, which is the same thing where the DTA provides for a zero withholding, or even be better off if the DTA provides for a rate of say, 10% withholding on the interest – now there will be nothing withheld.
- But this assumes that the company paying the interest is content to pay the interest *plus* the dividends tax that, at best under the DTA, might be reduced to 5%, or maybe only to 15%. If the hybrid interest paid is, say, R100 with zero withholding under the DTA but the company might have to pay dividends tax of, say, R15, depending upon the terms of the loan agreement the company might not be able to pay the recipient a net R85, which means that it becomes a larger burden to the local company, ie the cost of finance is R115 instead of R100. And there is no relief that the company can seek because it has already been held by our courts (in relation to STC before it was abolished) that a tax on dividends imposed on the company paying it cannot be reduced under a DTA as it is not a tax on the shareholder, but on the company itself.

Section 57B into the ITA

The major change has been the introduction of a new section 57B into the ITA. This is supposed to counter a scheme that has been identified by SARS in which the donations tax and trust attribution rules have been avoided.

Under existing law, it is possible to divest oneself of the right to an amount prior to accrual, by antecedently divesting it in favour of the new recipient. This could be the case, for example, where one cedes one's right to a dividend before it accrues. The law recognises that it is the person to whom it is ceded who is taxable on that dividend (leaving aside any other anti-avoidance provisions). When it comes to remuneration for services rendered, the law already states that if A renders services and B receives the compensation therefore, A will nevertheless be taxed on the amount received by B.

But where that remuneration is in the form of a right to receive an asset and, before it accrues, the employee cedes his or her right to receive the asset to, for example, a family trust, then the employee will still be taxable on the amount but will have been able to ensure that the asset is held by a trust and is therefore outside of the employee's estate for estate duty purposes. The employee will also not be subject to donations tax because the value of that right is argued to be nil. Moreover, any income of the trust derived from that asset will not be attributed to, and taxed in the hands of, the employee as donor, under the trust attribution rules.

To counter this, section 57B states that the disposal of the right is disregarded, and the employee is treated as having acquired the asset for an amount equal to the amount included in his or her gross income, and then he or she is treated as having disposed of the asset to (say) the trust by way of a donation for an amount equal to that deemed cost. And this applies for all purposes of the ITA, so that it will now apply both for donations tax and attribution purposes.

This provision will apply in respect of any right disposed of on or after 1 March 2022.

Extension of Incentives

Two important incentives to certain taxpayers, both of which have so-called sunset clauses (ie they automatically cease to be available from a specific date), have had their termination dates extended.

Thus whereas:

- the learnership allowance under section 12H of the ITA only applied to a registered learnership agreement entered into between a learner and an employer before 1 April 2022, that date has been extended to 1 April 2024; and
- the UDZ, or Urban Development Zone incentive, whereby allowances are given to a taxpayer who redevelops urban areas in terms of section 13quat of the ITA, the date by which the building must be brought into use to qualify for the incentive has been extended from 31 March 2021 to 31 March 2023 (and this amendment is deemed to have come into operation on 1 April 2021 and to apply in respect of any building, part thereof or improvement that is brought into use on or after that date).

VAT

It is not uncommon that property developers, who build residential developments 'on spec' ie for the purpose of resale at a profit but before procuring purchasers, are compelled by market forces and the state of the economy to rent the properties temporarily as they are unable to achieve the prices that they require.

The sale of these residential units attracts VAT, and therefore the input tax on costs may be claimed by the developer. Rental of residential units are exempt from VAT under section 12 of the VAT Act, and therefore a person developing for rental purposes may not claim the VAT paid as input tax (the person may not even be registered as a vendor in relation to that development).

Section 18(1) of the VAT Act states that where one acquires an asset for use or disposal in the course of making taxable supplies, and then one uses or applies the asset wholly for a different purpose, there is a claw-back of input tax in order effectively to reimburse SARS for the VAT that was claimed.

In 2011 section 18B was inserted into the VAT Act to provide relief where residential units were temporarily let, and the rationale was that, but for this concession, the letting of the residential units would result in a change of use under section 18(1) – despite the fact that there was no permanent change in purpose. Section 18B ceased to apply on 1 January 2018.

Now a new section 18D is to be inserted in the VAT Act that will be a permanent provision relating to the temporary letting of residential property. As before, it applies to a "developer", which is defined to mean a vendor who continuously or regularly constructs, extends or substantially improves fixed property consisting of any dwelling, or continuously or regularly constructs, extends or substantially improves parts of that fixed property for the purpose of disposing of that fixed property after the construction, extension or improvement.

The provision applies where the fixed property is "temporarily applied" for rental as dwellings, i.e. rather than for sale, and the expression is defined to mean the application of fixed property or a portion thereof in supplying accommodation in a dwelling under an agreement for letting and hiring thereof, which agreement relates to a total period not exceeding twelve months. If it exceeds twelve months, then section 18(1) will apply, i.e. it will be treated as if there is a permanent change of purpose.

So where the dwellings are temporarily applied, the developer is deemed to make a taxable supply on the date that the rental agreement comes into effect, and the consideration for the supply (effectively the VAT-inclusive price) will be an amount equal to the adjusted cost of the dwelling. The "adjusted cost" in short means the cost before deduction of input tax, i.e. the VAT-inclusive cost. So in effect, the input tax claimed is being 'refunded' to SARS.

If, while the dwelling is being temporarily applied, i.e. within the twelve-month period, the dwelling is sold, the developer must charge VAT on the sale in the usual way. The developer will then be allowed an input tax deduction equal to the VAT on its costs. And if the letting period was for more than twelve months and VAT under section 18(1) was 'refunded' to SARS, but the dwelling was nevertheless sold within the twelve-month period, the developer will also be able to claim back the VAT. (If the dwelling is sold after the twelve-month period has expired, one assumes that transfer duty will have to be paid by the purchaser as no VAT will be leviable.)

Section 18D comes into operation on 1 April 2022.

New procedures when natural persons cease their SA tax residency – [read more here](#).

by Ernest Mazansky, Head of Tax Practice, Werksmans Attorneys



Ernest Mazansky

Director, Werksmans Tax (Proprietary) Limited

[View Profile](#)