GMG ARTICLE:

By: Ruaan van Eeden Director - Head of Tax
T +27 11 268 1560 **M** +27 72 373 2250 **E** ruaan@gmgfinancial.com
Date: 08 March 2017

SOUTH AFRICA:
FUNDAMENTAL CHANGES PROPOSED IN 2017 BUDGET SPEECH

It has been a sobering few weeks since the Minister of Finance delivered his 2017 Budget Speech, sending shockwaves through various sectors of the economy, affecting individuals and corporates alike. My view is that the real hard-hitting changes were expected, perhaps delayed by a year or two, but expected. Given the fact that the tax base has not expanded sufficiently and that the elephant in the room, being Value-Added Tax (**VAT**), was left unchanged yet again, the easy targets were wealthy individuals, resulting in an even higher burden compared to previous years.

The purpose of this article is not to provide a detailed analysis of the budget, but rather to set out our views on selected and relevant proposals that could potentially affect the wider client base of the Geneva Management Group, as well as selected ancillary changes and recent interpretations by the South African Revenue Service (**SARS**) and the Financial Surveillance Department of the South African Reserve Bank (**FSD**). As any prudent tax advisor would caution, it is advisable to wait for the draft legislation to be published (expected June/July 2017) to get an idea of National Treasury's and SARS' thinking. The legislative cycle is open to a public consultation process and it seems debate from the private sector might be vigorous this year.

The big talking point of the 2017 Budget Speech related to the 'super-tax' on higher-earning individuals, which serves as a good starting point for this article. In most quarters, as expected, the individual was once again targeted to make up the estimated R28 billion in additional tax revenue required to ensure a balanced and sustainable recovery of the economy, according to National Treasury. The consensus in the market is that the introduction of a super-tax bracket of 45% for income above R1,5 million is simply not sustainable in the medium to longer term and one feels that tax rate increases for higher-earning individuals may have reached its limit in one fell swoop, instead of being gradually introduced.

To put it into perspective, the 45% tax rate only affects an estimated 1.4%, or roughly 100,000 registered individual taxpayers for the 2018 year of assessment. The self-same 100,000 registered taxpayers have a greater ability and means to externalise capital and potentially emigrate from South Africa – the consequential change in the effective capital gains tax rate for individuals (18%) could be more than enough incentive to pay the exit charge and take their tax base with them.

Now the question is, where to next if the additional tax revenue generated makes little to no impact on economic growth? Taxing the consumer into submission through consumption taxes, such as VAT, fuel levies, and sin taxes is not sustainable. My view is that the proposed sugar tax (and let's not forget the carbon tax), is nothing more than a tax revenue generator, disguised in a cloak of behavioural changes relating to health and the environment. The proposed sugar tax is already sparking enormous public debate, as well as receiving resistance from industry lobby groups – expect a delay in its implementation, much like the carbon tax.

With the aforementioned in mind, let's turn to selected proposals made in the Budget Speech.

THE FOREIGN TRUST STRUCTURES AND THE CONTROLLED FOREIGN COMPANY (CFC) DEBATE

This proposal is of fundamental importance for offshore wealth planning as it could affect various offshore trusts and holding company structures put in place by South African tax residents. It seems the target is not so much the offshore trust itself, but rather the underlying holding company in which the offshore trust, in most cases, owns at least 10% of the equity shares and voting rights. Potential changes were already mentioned in 2015, but not acted upon.

The main thrust of the latest proposals is seemingly targeted at amending the CFC provisions to impute income into the South African tax net, subject to the various exclusions under section 9D of the Income Tax Act 58 of 1962 (the **Act**). National Treasury is setting itself a difficult challenge to draft legislation that essentially looks through an offshore discretionary trust structure into the underlying companies, deeming them to be CFCs. In my view, restructuring the underlying holding companies in an offshore trust structure at this early stage would be premature. Once the draft legislation has been published by National Treasury, one would be able to see the mechanism to be applied to pull the underlying holding companies into the CFC net.

Many commentators have stated that it would require the legislation to create a type of 'legal fiction', which I agree with, as the ability to tax the offshore trust itself is inherently difficult if it is effectively managed offshore, coupled with the fact that the beneficiaries only obtain a vested right to income or capital if the trustees exercise discretion in their favour – there is no South African tax event *per se* before the exercise of that discretion. In any event, the cornerstone of the CFC provisions that require the holding of equity shares or voting rights in excess of 50%, simply do not exist in the hands of a discretionary beneficiary in an offshore trust. Potentially affected structures would need to be reviewed once the draft legislation is published.

FURTHER AMENDMENTS PROPOSED THAT AFFECT LOANS TO TRUSTS

With the ink barely dry on the promulgation of section 7C into the Act, dealing with low or interest-free loans to trusts, National Treasury has already proposed amendments to address avoidance schemes being peddled in the market. One gets the feeling that the advance tax ruling process is turning out to be a more predictable indicator of tax planning structures than the reportable arrangement regime.

The main target, amongst others, is where planning has been undertaken by individuals to circumvent the application of section 7C of the Act by making interest-free or low-interest loans to a company owned by a trust and not to the trust directly. It was, therefore, proposed that the scope of section 7C of the Act be broadened so that loans made to companies owned by trusts are subject to the same rules as those for loans made directly to trusts. The aforementioned anti-avoidance measure will, however, not extend to trusts that are not used for estate-planning purposes, for example, certain trading trusts or employee share scheme trusts.

In an offshore context, loans to non-resident trusts would fall within the ambit of the transfer pricing provisions under section 31 of the Act. Affected loans of this nature must be kept at arm's length, which will result in a taxable event for the individual lender in South Africa on the interest earned.

DIVIDEND WITHHOLDING TAX INCREASED

Effective from 22 February 2017 and catching a number of companies off-guard, the dividend withholding tax rate for any dividend paid on or after that date has increased from 15% to 20%. This increase further limits the tax arbitrage ability for an individual in receipt of a dividend from a business that was taxed at 28%, versus receiving a salary subject to employees' tax at the highest marginal rate.

2nd Floor
1 Bompas Road
Dunkeld West, 2196, Johannesburg
South Africa

+27 11 268 1560
gmgfinancial.com

Co Reg.: 2008/012681/07

AMENDING THE FOREIGN EMPLOYMENT INCOME TAX EXEMPTION

The proposed amendment to the foreign employment exemption, essentially targeting the elimination of 'double non-taxation' is as controversial as the introduction of the super-tax bracket.

The proposed amendment will have far-reaching consequences for South African tax residents earning tax-free income in jurisdictions, such as the United Arab Emirates. The foreign employment exemption has been successfully utilised over the years and has proven to be beneficial to individuals physically rendering services in foreign jurisdictions and earning income in respect of those foreign services rendered, provided they complied with the 183-day (in aggregate during any 12-month period) and 60-day continuous absence criteria. However, the application of section 10(1)(o)(ii) of the Act could potentially result in double non-taxation, which is being exempt from income tax in the country of tax residence (under its domestic laws) and enjoying tax exemption in the source country (under its own domestic laws).

In light of the above, the Minister of Finance stated that "*... the exemption on foreign employment income appears excessively generous*". Accordingly, it has been proposed that the exemption be adjusted so that foreign employment income will only be exempt from normal tax if such income is subject to tax in the foreign country from which such income is sourced. As stated above, it would be premature to restructure an employee's affairs, given the lack of draft legislation.

Notwithstanding the lack of draft legislation, the initial option being considered by potentially affected individuals is to cease tax residency in South Africa (but not necessarily emigrate), take the exit charge hit at a rate of 18%, and only be taxed in South Africa going forward on source income or from the disposal of immovable property situated in South Africa. One can expect stern resistance to the proposed amendment, as National Treasury does not seem to have taken the allocation of taxing rights under relevant tax treaties into account.

INTELLECTUAL PROPERTY PROPOSALS

The Act currently contains certain anti-avoidance measures, which do not allow deductions for payments made to non-residents in respect of the use or the right to use 'tainted' intellectual property. The anti-avoidance legislation is specifically aimed at countering the erosion of the tax base resulting from assigning South African intellectual property to non-resident entities situated in low tax jurisdictions, followed by the licensing of that intellectual property back to South African taxpayers.

The Minister of Finance has, however, noted concerns that the anti-avoidance measures are too restrictive and may affect legitimate commercial transactions. This, in turn, could discourage the use of South African-based group infrastructure to further develop offshore intellectual property.

Accordingly, it was proposed that the existing income tax rules be relaxed. Consequential amendments have already been made by the FSD, by way of Exchange Control (**EC**) Circulars 7/2017 and 7/2018. EC Circular 7/2017 is of particular interest, which permits Authorised Dealers to authorise the sale, transfer, and assignment by a South African resident to an unrelated non-resident abroad, without referral to the FSD. A similar relaxation has been permitted for the licensing of intellectual property to any non-resident (not necessarily an unrelated party). Authorised Dealers are, however, required to view the license agreement and the auditor's letter confirming the basis for calculating the royalty or license fee.

TAX TREATMENT OF FEES RECEIVED BY NON-EXECUTIVE DIRECTORS

Although not part of the 2017 Budget Speech, the recent Binding General Rulings (**BGR**) issued by SARS on 10 January 2017, relating to the VAT (BGR41) and employees' tax (BGR40) consequences of non-executive directors, are of high importance as it will affect the tax and compliance status of various individuals serving as board members. BGR40 and BGR41 apply from 1 June 2017. Notwithstanding the aforementioned, SARS

2nd Floor
1 Bompas Road
Dunkeld West, 2196, Johannesburg
South Africa
+27 11 268 1560
gmgfinancial.com
Co Reg.: 2008/012681/07

has remained silent on the tax treatment of directors' fees received by non-executive directors for tax periods prior to 1 June 2017.

There has been a longstanding disagreement over the South African tax consequences of services rendered by non-executive directors. The question was essentially about whether the non-executive director acted in a sufficiently independent nature, so as to fall outside i) the employees' tax net and ii) the VAT net. Over the last few years, the debate has sparked numerous investigations by SARS. BGR40 and BGR41 now provide the necessary clarity on the South African tax treatment of fees paid to non-executive directors.

South African tax resident non-executive directors

In terms of BGR40, SARS has ruled that services rendered by a non-executive director are sufficiently independent and will not fall within the South African employees' tax net and will not be classified as remuneration from an employment perspective. This means the company paying the fee to the non-executive director would not be required to withhold employees' tax. The non-executive director would, however, in his/her personal capacity be required to pay tax on a provisional basis twice a year and declare the income on his/her annual tax return.

From a VAT perspective (BGR41), based on the fact that the fees earned fall outside the concept of employment remuneration means the non-executive director is, in fact, conducting an 'enterprise' for VAT purposes and will be obliged to register for VAT in South Africa, if the fees exceed R1 million in a 12-month period. The fees would be subject to VAT at the rate of 14%, which places an additional SARS compliance burden on the non-executive director.

Non-resident, non-executive directors rendering services in South Africa

BGR40 does not apply to non-resident, non-executive directors. It follows that where a non-resident, non-executive director physically renders the services in South Africa (and therefore, triggers the South African source taxation principles), the fees will be subject to the deduction of employees' tax (irrespective of his/her independent status), unless any relevant tax treaty limits South Africa's taxing rights.

The VAT principles as described above remain the same, meaning the non-resident, non-executive director runs the risk of triggering a VAT registration obligation if the fees exceed R1 million in a 12-month period.

CONCLUDING REMARKS

The 2017 Budget Speech has sparked debate in virtually every sector of the economy and affected individuals and corporate taxpayers, however, we would caution you not to restructure prematurely. An initial review of existing structures would be prudent in anticipation of the draft legislation to be published midway through 2017.

Please feel free to contact us directly should you wish to discuss any aspect of the 2017 Budget Speech proposals.

2nd Floor
1 Bompas Road
Dunkeld West, 2196, Johannesburg
South Africa
+27 11 268 1560
gmgfinancial.com
Co Reg.: 2008/012681/07