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Corporate Tax
2022

South Africa: Law & Practice
Mike Benetello and Mogola Makola
Bowmans

South Africa: Trends & Developments
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SOUTH AFRICA

Law and Practice

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1. TYPES OF BUSINESS ENTITIES, THEIR RESIDENCE AND BASIC TAX TREATMENT

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form (a company). An alternative structure which is sometimes adopted is that of a partnership. The key difference between a company and a partnership is that a company has legal personality and is therefore treated as a person for corporate and tax purposes. A partnership, conversely, does not have legal standing in South Africa and is not treated as a distinct taxable entity. Accordingly, a partnership is not liable to tax in terms of the Income Tax Act No 58 of 1962 (ITA). As a result, income earned by a partnership is not taxed in the partnership. Rather, the partners are taxed on their proportionate share of the partnership income and are able to claim deductions in respect of expenses incurred by the partnership in the course of carrying on its business or trade. There is an exception in the Value Added Tax Act (VAT Act), which allows a partnership to apply to be registered as a vendor, notwithstanding the fact that it has no distinct legal existence. It is also common for non-residents to operate branch operations in South Africa. The tax rate of a branch is aligned to that of a corporate; however, South Africa does not have branch profit-repatriation tax.

1.2 Transparent Entities

The partnership structure is commonly used in the private equity sector, with most private equity funds being set up as *en commandite* partnerships. A small number of private equity funds have been set up as trusts (specifically, *bewind* or ownership trusts). South Africa has legislation that favours these structures, from a permanent establishment perspective, to encourage the use of South African general partners.

1.3 Determining Residence of Incorporated Businesses

In terms of the ITA, a person (other than a natural person) qualifies as a South African tax resident if it is incorporated, established or formed in South Africa or has its place of effective management in South Africa. This excludes any person who is deemed to be exclusively a resident of another country for purposes of the application of any double-taxation agreement (DTA) entered into between the governments of South Africa and that other country. Transparent vehicles do not have a residence test; rather, one looks through the transparent vehicle to the tax residence of the beneficial owners.

1.4 Tax Rates

Companies currently pay corporate income tax at 28%. This rate is set to reduce to 27% with effect from the year of assessment (tax year) ending on or after 31 March 2023. Trusts pay income tax at a flat rate of 45% and individuals pay income tax at marginal rates, ranging from 18% to 45%. Branches of foreign companies are taxed at 28% and South Africa does not levy branch repatriation taxes.

2. KEY GENERAL FEATURES OF THE TAX REGIME APPLICABLE TO INCORPORATED BUSINESSES

2.1 Calculation for Taxable Profits

Income tax is levied on taxable income. “Taxable income” is defined as the aggregate of:

- the amount remaining after deducting from the income of any person all the amounts allowed to be deducted from or set off against that income; and
- all amounts to be included or deemed to be included in the taxable income of any person

in terms of the ITA; the formula set out below illustrates the calculation of taxable income in accordance with the definition:

(a) gross income (as defined in **1.4 Tax Rates**) is Rxxx, less exempt income (xxx) = income xxx
(b) less deductions and allowances (xxx), less assessed loss brought forward (xxx) = xxx
(c) plus taxable capital gains xxx total = xxx plus inclusions in taxable income (xxx) = xxx (xxx)
(d) taxable income (or assessed loss) = Rxxx.

The calculation of taxable income does not necessarily coincide with the calculation of accounting profits, and adjustments are necessary when completing tax returns.

2.2 Special Incentives for Technology Investments

There is provision in the tax legislation which grants a special allowance in respect of scientific or technological research and development.

2.3 Other Special Incentives

There are special incentives for companies that are in the mining industry, the oil and gas industry, owners/charterers of aircraft and ships, farming or the production of renewable energy, manufacturing and hotel-keeping. Attention is drawn to the announcement by the Minister of Finance in 2020, during which he stated that, in order to promote economic growth, the government intended to restructure the corporate tax rate over the medium term by broadening the base and reducing the rate. Broadening the base would involve minimising tax incentives, among others.

2.4 Basic Rules on Loss Relief

Taxpayers are entitled to carry forward assessed losses (tax losses) and set them off against their income in future years. At this stage, the only requirement is that the taxpayer must be trading in order to be able to utilise its assessed losses. There is currently no limit on the use of assessed losses. Therefore, provided that a taxpayer is still trading, it can utilise its assessed losses in perpetuity. However, there are plans to introduce rules that will limit the use of assessed losses by taxpayers. These rules will come into effect with effect from the tax year ending on or after 31 March 2023. In terms of the amended rules:

- a company will be able to set off any balance of assessed loss incurred in any previous tax year carried forward from the preceding tax year subject to a limit of ZAR1 million or 80% of the amount of taxable income, whichever is higher; and
- a taxpayer other than a company will be able to set off its balance of assessed loss in full.

There are anti-avoidance provisions that apply to prevent the abuse of assessed losses to the detriment of the fiscus. These are contained in section 103(2) of the ITA.

2.5 Imposed Limits on Deduction of Interest

The rules on limits imposed generally on the deduction of interest by local corporations are contained in section 23M and 23N of the ITA. Section 23M limits the deduction of interest incurred in respect of debts owed to persons that are not subject to tax in South Africa. In terms of the section, the amount of interest allowed to be deducted cannot be more than an amount calculated in terms of a prescribed formula. The excess of the interest over the amount calculated may be carried forward to the immediately succeeding tax year and will be deemed to be interest incurred in that succeeding tax year.

Section 23N limits the deduction of interest incurred in respect of debt incurred to fund an acquisition in terms of a reorganisation and acquisition transactions. In terms of the section, the amount of interest allowed to be deducted cannot be more than an amount calculated in terms of a prescribed formula. The interest deduction is subject to a limit of six tax years, ie, the tax year in which the acquisition takes place and the five tax years subsequent to the acquisition.

2.6 Basic Rules on Consolidated Tax Grouping

South Africa does not have a system of group taxation. Every company in a group of companies is taxed separately on its own income and assessed/tax losses attach to each company. Only the company that has accumulated tax losses can utilise or set off those losses.

2.7 Capital Gains Taxation

South African-resident companies are subject to tax on worldwide capital gains at an effective rate of 22.4%. With effect from the tax year ending on or after 1 March 2023 the effective rate is 21.6%. Non-resident companies only pay tax on capital gains realised on the disposal of:

- immovable property situated in South Africa;
- interests in or rights to immovable property situated in South Africa, including rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; and
- assets that are effectively connected with a permanent establishment (PE) of the non-resident in South Africa.

The ITA defines an interest in immovable property to include equity shares held in a company or ownership or the right to ownership in any other entity or a vested interest in any assets of any trust, if:

- at least 80% of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property situated in South Africa or any interest or right, including rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources in South Africa; and
- in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the equity shares in the company or ownership or right to ownership of that other entity.

Where a DTA has been concluded between South Africa and the non-resident's country of residence, its provisions will be taken into account in determining whether the non-resident is subject to South African tax on its capital gains.

2.8 Other Taxes Payable by an Incorporated Business

Value-added Tax and Securities Transfer Tax (in the event that the transaction involves the acquisition of shares).

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are not subject to any other notable taxes.

3. DIVISION OF TAX BASE BETWEEN CORPORATIONS AND NON-CORPORATE BUSINESSES

3.1 Closely Held Local Businesses

Closely held local businesses are generally in corporate form (specifically, companies).

3.2 Individual Rates and Corporate Rates

There are anti-avoidance provisions relating to personal service-providers (PSPs). A "personal service-provider" is any company or trust where any service rendered on behalf of that company or trust to a client of the company or trust is rendered personally by any person who is a connected person in relation to the company or trust, and:

- the person would be regarded as an employee of the client if the service were rendered by him or her directly to the client, other than on behalf of the company or trust; or
- where those duties must be performed mainly at the premises of the client, the person or company or trust is subject to the control or supervision of the client as to the manner in which the duties are performed, or are to be performed in rendering the service; or
- where more than 80% of the income of the company or trust during the tax year, from services rendered, consists of or is likely to consist of amounts received directly or indirectly from any one client of the company or trust, or any associated institution in relation to the client.

Excluded from the ambit of the definition are companies or trusts which, throughout a tax year, employ at least three full-time employees who are engaged on a full-time basis in the business of the company or trust of rendering any such service, other than any employee who is a shareholder in the company or settlor or beneficiary of the trust or is a connected person in relation to such a person. In terms of the ITA, a PSP qualifies as an employee for tax purposes, with the consequence that fees earned by the PSP are subjected to tax employees' tax (Pay-As-You-Earn) as if the PSP were a natural person.

3.3 Accumulating Earnings for Investment Purposes

There are no rules preventing closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

South African tax-resident individuals are subject to a withholding tax at a rate of 20% on dividends paid by South African-resident companies or non-resident companies that are listed in South Africa. Non-resident individuals are also subject to the withholding tax at the same rate. However, the rate of tax may be reduced by the provisions of a DTA. South African tax-resident individuals are also subject to capital gains tax on capital gains realised on the disposal of their assets (in the case of capital assets or assets held as long-term investments) or income tax (in the case of assets held for a profit-making purpose). The gains are taxed at effective tax rates ranging between 7.2% and 18%. The income tax is levied at rates ranging between 18% and 45%. In addition, they pay income tax on foreign dividends (dividends paid by non-resident companies or headquarter companies). Certain foreign dividends are fully exempt from tax and some foreign dividends are partially exempt. With regard to non-resident individuals, see **2.7 Capital Gains Taxation**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. KEY FEATURES OF TAXATION OF INBOUND INVESTMENTS

4.1 Withholding Taxes

South Africa levies withholding taxes on dividends, interest, royalties and payments to foreign entertainers and sportspersons. The withholding tax on dividends is levied at a rate of 20%. The withholding taxes on interest, royalties and foreign entertainers/sportspersons are levied at a rate of 15%. The rates at which the withholding taxes are levied can be reduced by the provisions of a DTA. The withholding tax on foreign entertainers and sportspersons does not apply where the non-resident is:

- an employee of an employer who is a South African resident; and
- physically present in South Africa for a period or periods exceeding 183 full days in aggregate during any 12-month period commencing or ending during the tax year in which the specified activity is exercised.

In addition to the withholding taxes mentioned previously, South Africa also imposes an obligation on persons who are obliged to make payments to non-residents or for the benefit of non-residents in respect of the disposal of immovable property in South Africa to withhold a certain percentage of the amount payable. The amount withheld is an advance payment in respect of the non-resident's liability for tax (capital gains tax) in South Africa. The amount withheld must be paid to the South African tax authorities within 14 days after it was withheld, where the person making payment is a South African resident, or 28 days after it was withheld where the person making payment is a non-resident of South Africa.

4.2 Primary Tax Treaty Countries

The primary tax-treaty countries used by foreign investors to make investments in local corporate stock or debt are Mauritius, Luxembourg and the Netherlands.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

This is not common practice in South Africa.

4.4 Transfer Pricing Issues

The absence of an Advance Pricing Agreement (APA) regime and the lack of transfer-pricing skills within the tax authority are the biggest transfer-pricing issues presented for inbound investors operating through a local corporation. The South African tax authority is currently considering the feasibility of introducing an APA regime in South Africa.

4.5 Related-Party Limited Risk Distribution Arrangements

The local tax authorities have considered and will continue to consider these types of arrangements in the context of transfer-pricing audits, in order to ensure a fair return for the South African related party.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

No significant aspects of local transfer-pricing rules and/or enforcement vary from OECD standards.

4.7 International Transfer Pricing Disputes

This mode of settlement is not often used in practice, although it has gained some momentum. The local authorities are amenable to utilisation of the Mutual Agreement Procedure (MAP) process, provided all other avenues of resolution have been exhausted.

5. KEY FEATURES OF TAXATION OF NON-LOCAL CORPORATIONS

5.1 Compensating Adjustments when Transfer Pricing Claims Are Settled

Compensating adjustments are allowed/made, typically factored in as part of the settlement package, and especially where a DTA is applicable.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Non-local corporations are only taxed on South African-sourced income. If the head office has access to a DTA, the existence of a PE as a result of the branch becomes relevant. If the branch constitutes a PE, only South African-sourced income attributable to that branch may be taxed in South Africa, typically. There is no profit-repatriation tax in South Africa.

5.3 Capital Gains of Non-residents

See **2.7 Capital Gains Taxation**.

5.4 Change of Control Provisions

There is an anti-avoidance provision in the restructuring provision dealing with intra-group transactions (section 45 of the ITA), which applies where a transferee company that acquired an asset in terms of an intra-group transaction, or in terms of one or more intra-group transactions which were tax-neutral, ceases to form part of any group of companies as the transferor company or any controlling group company in relation to the transferor company, prior to disposing of the asset in question and within six years after the acquisition of the asset. The anti-avoidance provisions are unlikely to apply to the disposal of an indirect holding much higher up because the transferee and transferor companies are likely to remain part of the same group of companies after that disposal.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

See **2.1 Calculation for Taxable Profits**.

5.6 Deductions for Payments by Local Affiliates

In terms of the ITA, a taxpayer can only deduct expenses which they incur for the purpose of their business and in the production of their income. Based on this principle, a local affiliate would not be entitled to deduct expenses incurred by a non-local affiliate. There is scope for South African taxpayers to be charged management or administrative fees, but the exchange control authority regulates the payment of these and requires third-party expert assurance that the arrangements are priced correctly (ie, at market value) and that the South African party does in fact receive the full benefit for what they pay for.

5.7 Constraints on Related-Party Borrowing

Exchange control approval must be obtained from the South African Reserve Bank. The transfer-pricing rules (contained in section 31 of the ITA) will apply to the borrowing. Sections 23M and 23N may also apply to the borrowing. Section 31 applies prior to considering the impact, if any, of section 23M and section 23N.

6. KEY FEATURES OF TAXATION OF FOREIGN INCOME OF LOCAL CORPORATIONS

6.1 Foreign Income of Local Corporations

Local corporations are subject to tax on their worldwide income. If the foreign income of a local corporation has been taxed in another jurisdiction, the corporation may obtain relief from double taxation in terms of the ITA or a double-taxation agreement. There are limited items that may be exempt, eg, certain foreign dividends.

6.2 Non-deductible Local Expenses

See **6.1 Foreign Income of Local Corporations**.

6.3 Taxation on Dividends from Foreign Subsidiaries

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**. Local corporations are likely to rely on the participation exemption in order to claim full exemption from income tax in respect of the dividends.

6.4 Use of Intangibles by Non-local Subsidiaries

The South African Exchange Control Authority regulates the use of South African intangibles outside of SA. It is often very difficult to dispose of these intangibles to related parties. It is, however, fairly simple to dispose of these to unrelated parties. It is more common in the case of related-party arrangements for intangibles to be licensed to foreign related parties. This triggers the transfer-pricing rules and typically results in a market-related royalty being paid to the South African owner of the intangible. Where permission is granted for the sale of intangibles, this may have income tax consequences, as well as capital gains tax consequences, depending on how the asset has been treated for income tax purposes by the seller.

6.5 Taxation of Income of Non-local Subsidiaries under Controlled Foreign Corporation-Type Rules

Local corporations are taxed on the income of their CFCs. Local corporations that have non-local branches are taxed on their worldwide income, but this is not in terms of CFC rules.

6.6 Rules Related to the Substance of Non-local Affiliates

South Africa does not have specific substance rules for taxation purposes.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Local corporations are subject to tax (capital or revenue) on their worldwide income. In the case of foreign affiliates, any capital gain derived on the sale of shares will be subject to tax in South Africa unless the capital gains tax-participation exemption applies. The latter typically applies where the South African resident holds at least 10% of the equity shares in the foreign affiliate, the requisite shareholding has been held for at least 18 months and the shares are disposed of to a non-resident purchaser that is neither a connected person in relation to the South African seller nor a CFC for South African tax purposes.

7. ANTI-AVOIDANCE

7.1 Overarching Anti-avoidance Provisions

There is a General Anti-Avoidance Rule in the ITA. This is contained in sections 80A to 80L of the ITA.

8. AUDIT CYCLES

8.1 Regular Routine Audit Cycle

The South Africa tax authority selects taxpayers for audit on the basis of its risk assessment.

9. BEPS

9.1 Recommended Changes

South Africa has adopted specific rules to limit the amount of interest that can be deducted in South Africa where a foreign related-party creditor is involved. These are contained in specific anti-avoidance rules (section 23M) over and above the transfer-pricing provisions. South Africa also introduced a VAT on electronic services in 2014 and was one of the first countries to do so.

9.2 Government Attitudes

The South African government is in favour of the BEPS initiative with South Africa being a signatory to the OECD Multi-Lateral Instrument (yet to be ratified). The government seeks to assist in the prevention of global tax avoidance through profit-shifting, as well as to protect the South African tax base. It is still being considered whether Pillar One and Pillar Two will be given effect to in South Africa. Concerns have been raised that these initiatives favour developed countries and may therefore not be suitable for South Africa.

9.3 Profile of International Tax

International tax has a high public profile in South Africa. The government are fully in support of the BEPS recommendations.

9.4 Competitive Tax Policy Objective

This is not applicable, as South Africa is a high-tax jurisdiction. It is anticipated that substance requirements may be introduced for South African headquarter companies.

9.5 Features of the Competitive Tax System

South Africa has a "headquarter" tax regime, which is often used for investment into the rest of Africa, given the extensive South African DTA network and the benefits attributable to the respective regime.

9.6 Proposals for Dealing with Hybrid Instruments

South Africa has introduced specific provisions to deal with hybrid debt and hybrid equity instruments. In each instance, the respective instruments are recharacterised, in order to give effect to their economic substance as opposed to their legal form. For example, treating debt items (legal) as equity items (substance), and vice versa. These rules existed prior to the BEPS initiative, but the South African government has been seen to focus more on them to assess whether they need to be expanded.

9.7 Territorial Tax Regime

South Africa taxes its residents on a "worldwide" basis whilst it taxes non-residents on a "source" basis. In general terms, interest must be incurred in the production of amounts that are "subject to" tax in South Africa. If the amounts are deductible, they are subject to specific limitations imposed by certain anti-avoidance provisions, as well as transfer-pricing provisions, which deal with the rate of interest as well as the quantum of debt (both based on the arm's-length principle). Interest payments made to non-residents are also subject to a domestic withholding tax of 15%, unless reduced by an applicable DTA.

9.8 Controlled Foreign Corporation Proposals

CFC legislation in South Africa is complex and requires specific consideration when investing from South Africa into foreign jurisdictions. The provisions are focused on taxing items of income that arise from related-party transactions, transactions involving income streams that can be easily moved from the South African tax net (eg, interest and royalty income) and income that is not attributable to fully fledged business operations in foreign countries, especially where the substance requirements as set out in the CFC provisions are found to be wanting. They only apply to residents of South Africa and therefore do not impact non-residents.

9.9 Anti-avoidance Rules

Once South Africa ratifies the Multi-Lateral Instrument (MLI), the Principal Purpose Test and the application thereof to South African DTC counterparties is likely to become a significant consideration for both inbound and outbound investors. Further, the changes arising from the Multi-Lateral Instrument to the preparatory and auxiliary provisions across South Africa's DTA network must be carefully considered.

9.10 Transfer Pricing Changes

The transfer-pricing changes introduced by BEPS have not been seen as changing things radically in South Africa.

9.11 Transparency and Country-by-Country Reporting

South Africa is currently in favour of provisions for transparency and country-by-country reporting.

9.12 Taxation of Digital Economy Businesses

Proposals are currently being considered by the South African government (National Treasury). South Africa was one of the first countries to introduce VAT on electronic services in 2014.

9.13 Digital Taxation

South Africa was one of the first countries to introduce VAT on electronic services.

9.14 Taxation of Offshore IP

South Africa has taken specific steps in relation to intellectual property developed in South Africa, which is then exported out of South Africa and licensed back into South Africa. If the criterion is met and the intellectual property is regarded as "tainted", tax deductions in respect of the tainted intellectual property arrangement are denied in South Africa. There is also a withholding tax on royalties.

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Bowmans employs over 400 lawyers and delivers integrated legal services to clients throughout Africa from eight offices in six countries: South Africa, Kenya, Mauritius, Tanzania, Uganda and Zambia. The firm's tax lawyers have knowledge based on years of experience and a depth and breadth of tax law skills that few are able to match. Its services range from the tax aspects of corporate transactions to financial structuring and project finance matters to the tax implications of employment decisions. The firm also handles tax litigation and dispute resolution on behalf of its clients. The firm's aim is to assist its clients (including leading corporates, retail and investment banks, financial institutions, high net-worth individuals and international law firms) to achieve their objectives as efficiently as possible, while minimising the legal and regulatory risks. Bowmans works closely with its alliance firms in Ethiopia and Nigeria. It has special relationships with leading law firms in Malawi and Mozambique, a non-exclusive co-operation agreement with Gide Loyrette Nouel, strong relationships with other reputable law firms in Africa, and is a representative of Lex Mundi, a global association of more than 160 independent law firms across the globe.

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Mike Benetello is a tax executive with over 25 years' experience. His wide-ranging experience includes matters in the fields of mining taxation, corporate restructurings, debt and capital restructures, private equity transactions, mergers and acquisitions, dispute resolution in tax-related matters, procurement of tax rulings, international tax planning and taxation aspects related to business rescue. Mike is a registered charted accountant (South Africa). He holds an honours degree in accounting as well as a higher diploma in tax law. Mike is also a past chairperson of the South African Institute of Chartered Accountants (SAICA) National Tax Committee. Mike is actively involved in matters relating to tax policy in South Africa. He interacts regularly with the legislator and regulators in this regard and also provides commentary to proposed legislative amendments impacting the tax landscape in South Africa.

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Trends and Developments

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'"Most Favoured Nation" Dividends Tax Treatment: for Dutch and Swedish Shareholders in South African Companies, a Tough Call?

Introduction

Qualifying Dutch and Swedish corporates, holding 10% or more of the shares in a South African company (Qualifying Shareholders), may currently receive dividends without any dividends tax being withheld. In other words, the rate of dividends tax is reduced to 0%.

This is because there are Double Taxation Agreements (DTAs) between South Africa and The Netherlands, and South Africa and Sweden (Dutch DTA and Swedish DTA respectively), and each contains a "most favoured nation" (MFN) clause in respect of dividends tax.

It is well known that the primary purpose of DTAs is to prevent double taxation between partner countries, by providing certainty on how and when tax is imposed in the partner country. DTAs also serve as a useful tool against tax evasion and assist tax authorities in collecting and sharing relevant tax information. South Africa levies dividends tax in certain circumstances, and most DTAs reduce the rate of dividends tax that is payable on dividends paid to shareholders in partner countries.

However, Qualifying Shareholders will soon be unable to claim this 0% dividends tax rate. More importantly, it is possible that Qualifying Shareholders that have previously claimed this 0% dividends tax rate may find this historical treatment challenged by the South African Revenue Service (SARS).

The legal status of DTAs in South Africa

In order to explain why the 0% dividends tax rate for Qualifying Shareholders will disappear going forward, and why their historical reliance on that 0% dividends tax rate may be challenged, it is helpful to understand the process through which DTAs become a part of South African law.

Section 108(2) of the Income Tax Act 58 of 1962 (Income Tax Act) provides that the South African Government is empowered to enter into DTAs with the governments of other countries. Soon after the DTA is signed, it is then presented for approval by Parliament, as contemplated in section 231 of the Constitution of the Republic of South Africa, Act 108 of 1996 (Constitution).

If approved, the DTA is ratified through publication in a Government Gazette, and its provisions are then effective, as if they had been incorporated into the Income Tax Act.

Current status of the MFN dividends tax treatment

In terms of the Swedish DTA, Qualifying Shareholders are ordinarily not subject to dividends tax of more than 5%, subject to the application of the MFN clause. That MFN clause provides for the automatic application of a lower dividends tax rate in respect of Qualifying Shareholders if South Africa and a third-party country have concluded a DTA that provides for a lower dividends tax rate. The Dutch DTA contains a similar MFN clause, but that MFN clause is only triggered if South Africa's DTA with that third-party country was concluded after the Dutch DTA.

Because the DTA between South Africa and Kuwait (Kuwaiti DTA) currently provides for a lower dividends tax rate of 0%, the MFN clause in the Swedish DTA is triggered, thereby allowing Swedish Qualifying Shareholders to claim the same 0% dividends tax rate. Although the Kuwaiti DTA was concluded before the Dutch DTA, the Swedish DTA was concluded after the Dutch DTA, thereby triggering the Dutch MFN clause with the result that Dutch Qualifying Shareholders can also rely on the 0% dividends tax rate.

The ability of a Dutch Qualifying Shareholder to rely on the Dutch MFN clause and claim the 0% dividends tax rate was confirmed in 2019, when the Tax Court in Cape Town upheld its application in a dispute between the SARS and a Dutch tax resident.

Evidence was brought in the Tax Court that, before the change from "secondary tax on companies" (STC) to dividends tax (the former being the predecessor of the latter) from 1 April 2012, multiple DTAs were renegotiated by National Treasury to provide for a dividends tax rate of 5%, on dividends declared by a South African company to a wholly owned non-resident shareholder.

However, due to unforeseen circumstances, although the negotiations to amend the Kuwaiti DTA were finalised, Kuwait still had to take the final steps in terms of its domestic procedures to give effect to the relevant protocol. At the time of the Tax Court's judgment, Kuwait had still not taken these final steps. Although the Tax Court found in favour of the taxpayer, it was clear from the arguments made by the SARS in that case that South Africa would lose a significant amount of tax revenue on the application of the MFN clause, if the judgment was left to stand.

The SARS and the South African Government kept their promise to close the loophole and finally, on 1 April 2021, the South African Government entered into a protocol to the Kuwait DTA (Kuwaiti Protocol), which now provides for a 5% withholding tax for Kuwaiti Qualifying Shareholders and 10% in all other cases.

Normally, a protocol, like a DTA itself, becomes effective when it is published in the Government Gazette and as per the date stated in that Government Gazette. At present, the Kuwaiti Protocol is still in the process of being ratified by Parliament, with certain internal Cabinet processes pending. The Kuwaiti Protocol has therefore not yet been published in the Government Gazette. Article 7(1) of the Kuwaiti Protocol provides that each of the contracting states shall notify the other in writing of the completion of the procedures, required by their respective laws, for bringing the protocol into force. The Kuwaiti Protocol should then enter into force on the date of the latter of these notifications.

However, interestingly, Article 7(2) of the Kuwaiti Protocol continues to state that the provisions of the protocol will "have effect beginning on the date on which a system of taxation at shareholder level of dividends declared enters into force in South Africa". As previously mentioned, dividends tax came into effect in April 2012. Accordingly, although it seems that the intention is that the Kuwaiti Protocol will enter into force on the latter date of notification by one of the contracting states, the wording of Article 7(2) suggests that the SARS actually intends for the Kuwaiti Protocol to have retroactive effect.

It is worth mentioning that Article 7 is similar to other protocols that the South African Government signed after the introduction of dividends tax, such as Article V(2)(b) of the Maltese Protocol, which provides that the amended withholding-tax provision will apply with effect from 1 April 2012, although the protocol was only promulgated in the Government Gazette on 24 January 2014.

While the publication of the Kuwaiti Protocol in the Government Gazette is pending, certain questions remain open. For example, South African companies wanting to declare dividends to their Qualifying Shareholders are asking whether dividends tax should be withheld on those dividends.

In addition, South African companies that in the past declared dividends to their Qualifying Shareholders and withheld dividends tax thereon, are questioning whether a claim for a refund of dividends tax can be submitted, on the basis of the above-mentioned Tax Court judgment.

Other South African companies want to know what will happen where dividends tax was actually withheld, but a claim for a refund of dividends tax was subsequently successfully submitted on the basis of the Tax Court judgment. The answers to these questions are unfortunately unclear.

Can the Kuwaiti Protocol apply "retrospectively" or "retroactively"?

South African law distinguishes between "retrospective" and "retroactive" legislation, and the effects thereof have raised ongoing constitutional debates. Essentially, "retrospective" legislation refers to legislation that only takes effect from its date of commencement but affects existing rights and obligations that came into being prior to the date that legislation takes effect (in other words, it only affects those existing rights and obligations, going forward).

However, "retroactive" legislation refers to legislation that takes effect before its date of commencement, affecting existing rights and obligations that came into being prior to the date that legislation takes effect: in other words, this legislation purports to change existing rights and obligations at a point in time before its date of commencement, and not merely going forward. The legislation in question is accordingly deemed to have been in operation at that earlier point in time.

Notwithstanding the foregoing, generally, and unless the contrary appears by express or necessary implication, legislation and amendments to legislation apply with prospective effect only.

The Pienaar Brothers case

Despite this, in 2017, the Gauteng High Court in Pienaar Bros (Pty) Ltd v CSARS 2017 (6) SA 435 (GP) (Pienaar Bros) was called upon to rule on the retroactivity of amendments to section 44 of the Income Tax Act (as it then was), that governs "amalgamation transactions". At the time that it was handed down, this judgment generated much controversy and debate regarding the extent to which South African tax legislation may operate retroactively.

The dispute in Pienaar Brothers arose in relation to a transaction that took place in 2007, in which Serurubele Trading 15 (Pty) Ltd (Serurubele Trading) acquired all of the assets in Pienaar Brothers (Pty) Ltd (Pienaar Brothers), in terms of such an "amalgamation transaction".

As partial settlement of the purchase price payable for those assets, Serurubele Trading issued shares to Pienaar Brothers, which resulted in a share premium being recognised by Serurubele Trading. Serurubele Trading subsequently, on 3 May 2007, distributed a portion of this share premium to its shareholders.

At the time of this distribution, companies generally had to declare and pay STC on dividends declared to their shareholders. However, this distribution did not attract STC as it was paid out of the above-mentioned share premium, which had been generated from the above-mentioned amalgamation transaction and not the capitalisation of profits. Importantly, although the applicable laws at the time did not impose STC on that distribution, the distribution took place in the middle of developments in those laws.

Specifically, on 21 February 2007, the Minister of Finance had announced (without giving any details) that legislation would be passed to address "anti-avoidance" schemes relating to STC. The next day, the Commissioner for the SARS (Commissioner) announced the immediate revocation of section 44(9) of the Income Tax Act, on the grounds that it permitted a permanent exemption from STC rather than a mere deferral of tax, which was the underlying purpose of that provision.

However, section 44 was only amended on 8 August 2007, the date of commencement of the Taxation Laws Amendment Act 8 of 2007 (Amendment Act), to provide for the removal of section 44(9), such that a dividend distributed out of a share premium, in these circumstances, would be subject to STC. The specific amendment was deemed to have come into operation on 21 February 2007 (ie, with retroactive effect), which is the date of the above-mentioned announcement by the Minister of Finance.

Serurubele Trading, which by then had changed its name to Pienaar Brothers (Pty) Ltd after "amalgamating" with the original Pienaar Brothers company in terms of the aforementioned transaction (Serurubele Trading is now referred to as Pienaar Brothers), now faced the prospect of paying STC on the dividend received on 3 May 2007, even though that dividend was exempt from STC at the time that it was actually declared and paid.

Pienaar Brothers accordingly applied to the High Court for an order declaring that the relevant amendment under the Amendment Act was inconsistent with the Constitution, and thus invalid because of its retroactive operation. Alternatively, Pienaar Brothers sought an order declaring that the Income Tax Act did not apply to the dividend in question, and that the imposition of STC on that dividend amounted to an impermissible deprivation of property.

The Court pointed to two types of retrospective legislation, namely: retrospectivity in the "weak" sense, in terms of which legislation changes the future tax consequences of pre-existing transactions; and retrospectivity in the "strong" sense, in terms of which legislation is deemed to have been in force from a date preceding its enactment, thereby changing the past tax consequences of pre-existing transactions (ie, a "retroactive" amendment, as previously described). This matter involved retrospectivity in the strong sense (ie, a retroactive amendment), as an amendment in the Amendment Act, which commenced on 8 August 2007, purported to change the tax consequences for affected transactions that took place from 21 February 2007.

The arguments and findings of the Court in the Pienaar Brothers case are too numerous to cover in this article. However, certain arguments and findings are worth highlighting, in the context of the Kuwaiti Protocol.

Firstly, regarding the constitutionality of the amendment, the Court considered the extent to which any warning of proposed retrospective amendments is required, in order to give effect to the rule of law. Pienaar Brothers argued that "unless there was adequate warning of the intention to implement the change retrospectively, such that the taxpayer cannot be said to have been entitled to rely on the law continuing to apply, a retroactive amendment could never pass constitutional muster", and also that such a warning must relate to the particular proposed amendment.

The Court could not find any authority for the position that a taxpayer necessarily had to be given any warning before the enactment of retroactive legislation. The Court found that a retroactive amendment to a tax law could indeed be rationally connected to a legitimate purpose. If this was the case, a warning regarding that retroactive amendment should not be necessary.

In the context of tax laws, the Court found that economic demands could be considered when evaluating the purpose and effect of an intended amendment. For example, a retroactive amendment may be preferred to a prospective amendment so that taxpayers are not encouraged to abuse a loophole before it is closed, thereby resulting in a greater economic loss for the fiscus.

The Court also held that, even if an adequate warning was required for the retroactive amendment of a tax law, in this circumstance adequate warning had been provided by virtue of the Minister's announcement and the solicitation of public comments on the relevant amendment.

Secondly, the Court dismissed the argument that the imposition of STC in this instance constituted an impermissible deprivation of property. It found that a person who simply incurs a liability imposed by law could not, on that basis alone, be said to suffer a "deprivation" of property – otherwise, every tax could constitute a potential "deprivation" of property under the Constitution.

The Court also concluded that, even if one were to argue that retroactive taxation could give rise to such a deprivation, no "unjust" deprivation had occurred in this instance: the Court reiterated its view that the State had used a well-accepted mechanism to close a loophole, that it had a rational purpose in doing so, that it had given sufficient warning of its intention, and that it did not solely target Pienaar Brothers.

The Pienaar Brothers case is not authority for the proposition that retroactive tax legislation will always be rational and consistent with the rule of law. The Court still found that the "proper approach" was to decide the legality of retrospective amendments on a case-by-case basis, having regard to the various considerations that it referred to.

However, this case does confirm that retroactive tax legislation may not automatically be regarded as unconstitutional. This is on the basis that the case is a High Court judgment and, based on the principle of stare decisis, the judgment would be law that is binding on lower courts and have persuasive value in respect of other High Courts. The judgment must be applied by taxpayers and the SARS in similar matters. Nevertheless, as the judgment was not appealed by Pienaar Brothers, it unknown whether the Supreme Court of Appeal or the Constitutional Court would have upheld the judgment.

The Pienaar Brothers case and the risks associated with claiming a 0% dividends tax rate, in relation to a qualifying shareholder

Although there have been delays, only a handful of steps remain until the Kuwaiti Protocol is brought into force under South African law.

In the meantime, although the SARS has acknowledged the correctness of the law as it stands, it has publicly expressed its unhappiness in this regard, and this issue has been covered extensively in tax and legal media. As previously noted, there is also publicly available evidence that the SARS intends the Kuwait Protocol to have retroactive effect.

In light of the foregoing, in the event that the Kuwait Protocol is made effective from some historical date (for example, 1 April 2012, when dividends tax was introduced), companies that have applied a 0% dividends tax rate to dividends paid to Qualifying Shareholders may find that the SARS challenges that approach, seeking payment of the 5% dividends tax, plus interest and penalties, on those dividends. (It is worth noting that the SARS may only assess taxpayers for dividends tax for five years from the date by which that dividends tax became due and payable, unless prescription does not apply for reasons under the law.)

For companies that wish to challenge the SARS in court, the Pienaar Brothers case serves as a warning that their arguments may fall on unsympathetic ears and that, on the basis of the principle of stare decisis, the taxpayer must be willing to argue the matter all the way to the Supreme Court of Appeal or the Constitutional Court.

Those potentially affected by these developments would be well-advised to seek guidance on the facts of their specific cases.

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