Tax & Exchange Control

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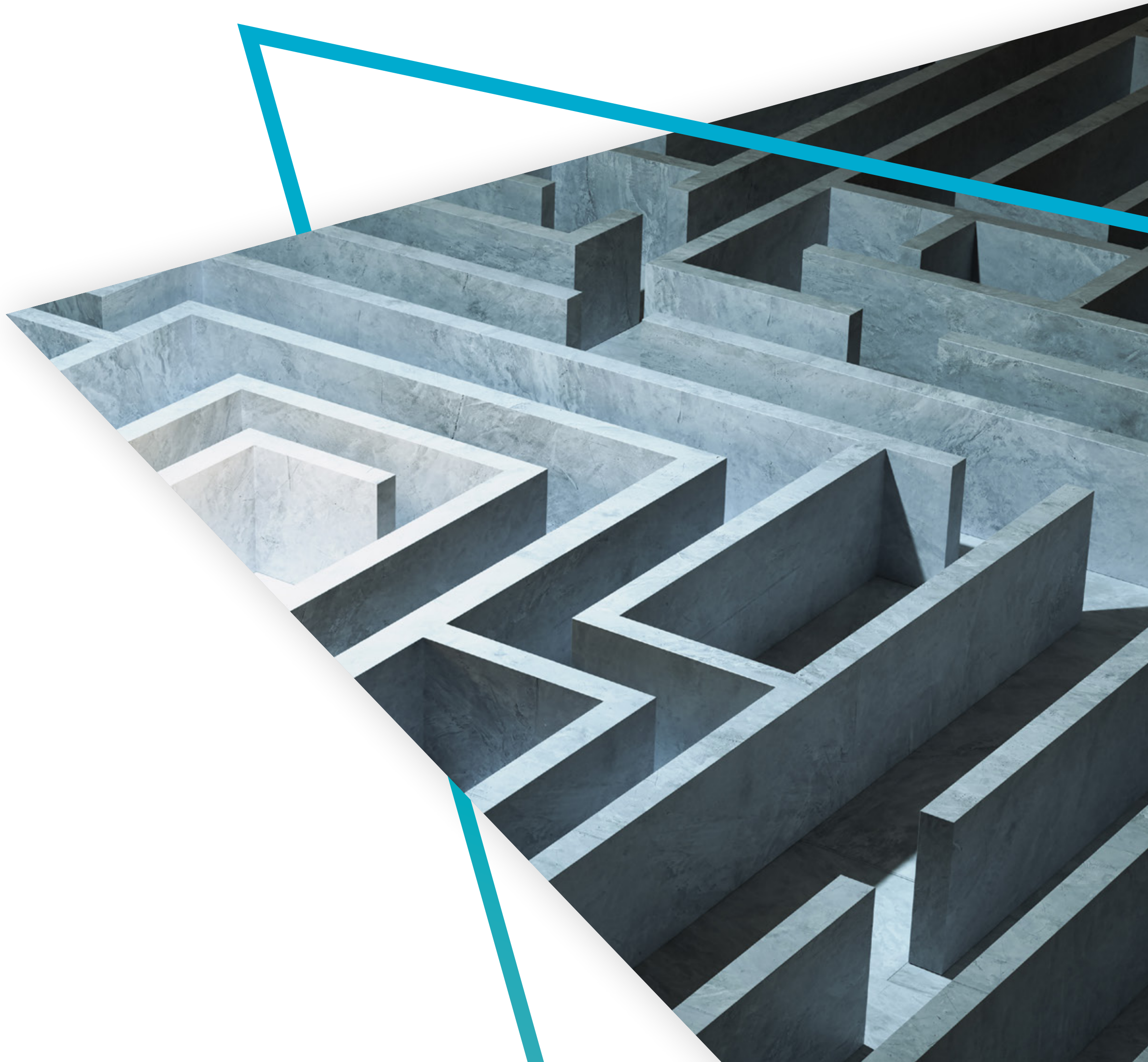

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Avoiding pitfalls: The impact of deemed donations on section 42 transactions

In the dynamic world of corporate taxation, section 42 of the Income Tax Act 58 of 1962 (ITA) stands as a beacon for persons looking to restructure without immediate tax consequences. This provision provides a mechanism for tax-neutral "*asset-for-share*" transactions in terms of which a person can transfer an asset to a resident company in exchange for shares in that company without immediate tax consequences, provided certain conditions are met.

One such condition is that the market value of the asset being transferred (on the date of disposal) must be equal to or exceed the tax (base) cost. In other words, the "*asset-for-share*" provisions are not available where the disposal would give rise to a loss.

It is interesting to note that this is the only express requirement (in section 42 at least) regarding the value of the asset being transferred. In other words, for purposes of section 42 itself, any contractual consideration for the asset is not determinative of whether the section applies, provided the market value of the asset being transferred equals or exceeds its base cost.

However, it's a mistake to think that if section 42 applies, no further analysis is required as there could (for example) be latent tax consequences that arise where the value of the shares received as consideration pursuant to the "*asset-for-share*" transaction is not commensurate with the value of the asset. This article considers those consequences.

Deemed donation

At common law, a disposition qualifies as a donation if it is motivated by pure liberality or disinterested benevolence. In other words, without the donor receiving any consideration in return. Therefore, where the recipient gives some consideration, the disposition cannot arguably be regarded as a donation.

For purposes of donations tax, section 55(1) of the ITA defines a donation as "*any gratuitous disposal of property including any gratuitous waiver or renunciation of a right*".

On the other hand, where property is disposed of for a consideration that, in the opinion of the Commissioner of the South African Revenue Service (SARS) (Commissioner), is not "*adequate consideration*", it will be deemed to have been disposed of under a donation as contemplated in section 58(1). The court in *Welch's Estate v Commissioner, South African Revenue Service* [2005] (4) SA 173 (SCA) confirmed that the definition of "*donation*" in section 55(1) plays no role in interpreting or giving effect to the provision in section 58.

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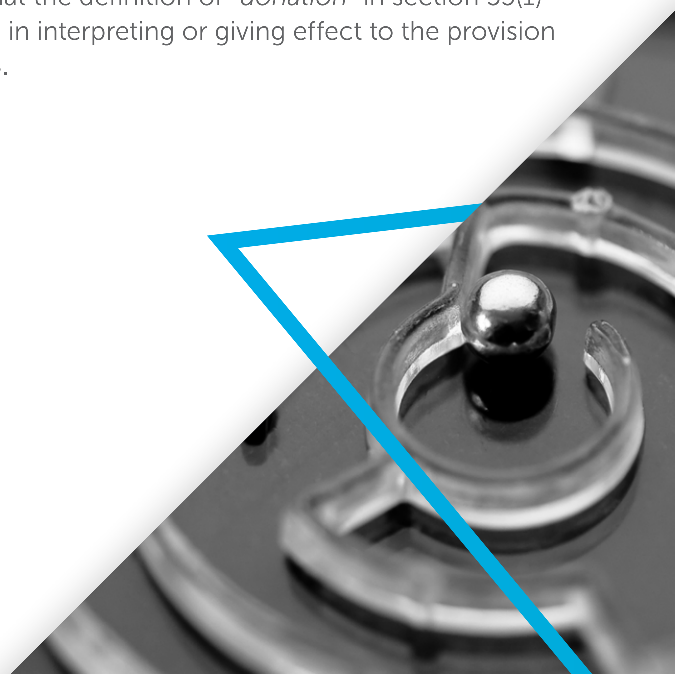

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Section 58(1) provides that:

> *"where property has been disposed of for a consideration which, in the opinion of the Commissioner, is not an adequate consideration, that property shall … be* ***deemed*** *to have been disposed of under a donation; provided that, in determining the value of such property, a reduction shall be made of an amount equal to the value of that consideration."*

Therefore, and notwithstanding what constitutes a donation at common law, section 58 deems a disposition in return for a *quid pro quo* but for inadequate consideration as a donation that is (potentially) subject to donations tax as contemplated in section 54. This means that even if something has been done for non-gratuitous reasons (e.g. has a commercial purpose), it can still be a donation under section 58 if SARS is of the view that property was disposed of for inadequate consideration.

Potential impact on section 42 transactions

Given the wording of section 58(1), the Commissioner may invoke the section whenever the consideration for an asset is (in SARS' opinion) inadequate, irrespective of whether there is an intention to donate. The Commissioner may therefore be entitled to apply section 58(1) where transfers of assets at prices lower than their fair market value are made by a sole beneficial shareholder to its company, or between associated companies with similar shareholders pursuant to section 42, even though the transferor is no better or worse off financially.

In practice, the Commissioner considers that the term *"adequate consideration"* does not necessarily mean 'fair market value'; the Commissioner will have regard to all the circumstances surrounding a particular transaction in determining whether the consideration is adequate. As such, the consideration can qualify as *"adequate"* depending on the circumstances and the requirements of the particular transaction (see SARS Interpretation Note 91).

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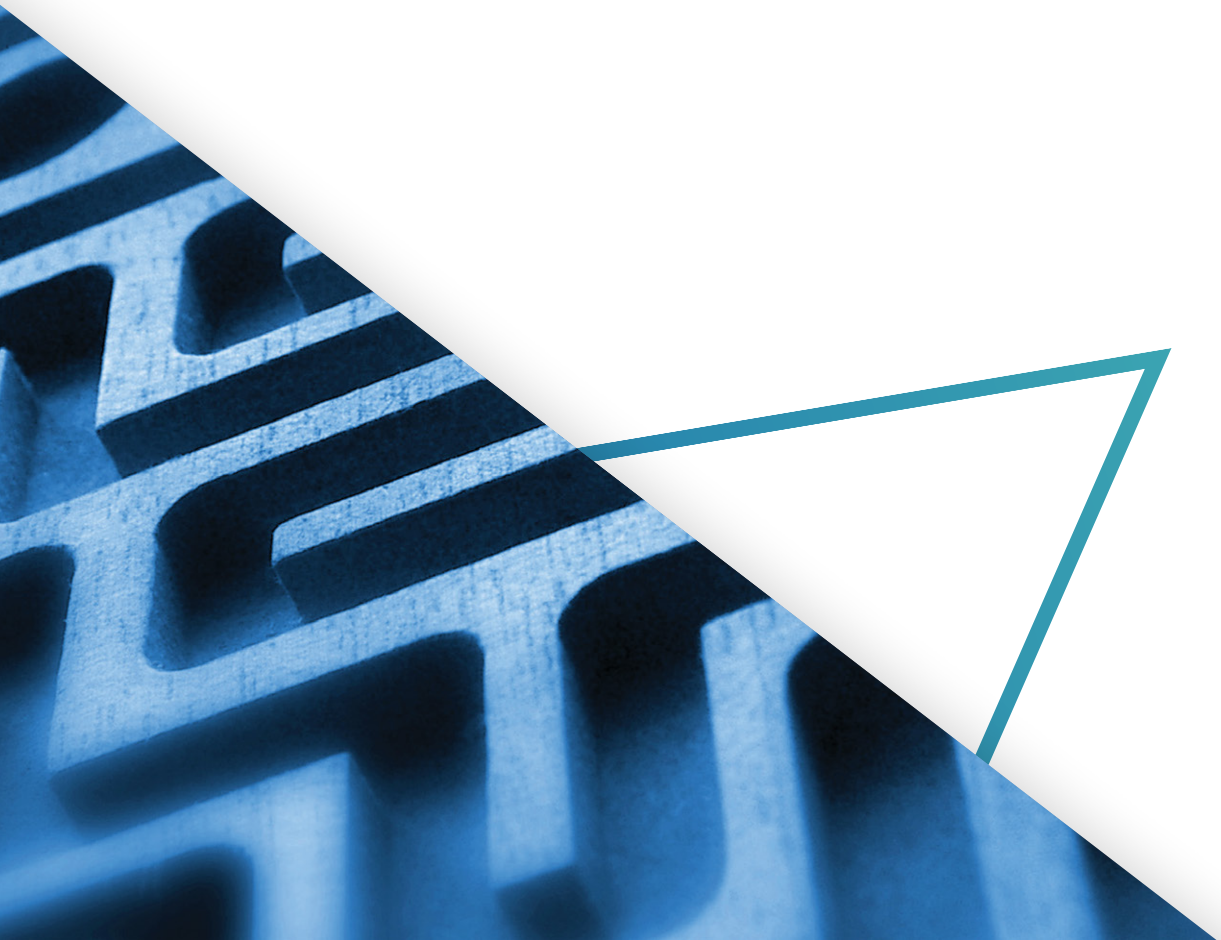
On this basis, there is a view that SARS does not usually challenge transfers of assets at less than market value between companies and their sole beneficial shareholders or between associated companies with the same shareholders, provided that there is no enrichment of any particular person under section 58(1) – or, conversely, impoverishment. Therefore, if, as a result of any transfer of assets at less than market value between a company and its shareholders, a shareholder is no better or worse off financially, SARS may be less likely to invoke section 58(1).



Conclusion

Section 42 provides a valuable tool for tax-neutral *"asset-for-share"* transactions. While it may be less likely that SARS will impose donations tax on the transferor where the value of the consideration shares is not commensurate with the value of the asset in circumstances where the transferor is no better or worse off financially and/or economically, the interplay between section 42 and the deemed donation provisions highlights the need for careful consideration of the tax implications of any transaction.

It should also be noted that the above does not consider the application of other provisions, such as section 24BA or Paragraph 38 of the Eighth Schedule to the ITA, which could potentially apply where there is a value mismatch between the asset transferred and the shares issued in consideration. Therefore, if a taxpayer or their professional adviser is not *au fait* with the technical tax aspects of the transaction they are contemplating, costly mistakes can occur.

Puleng Mothabeng

Is a cash tax refund application dead on arrival? Lessons for the Finance Bill, 2025

The Tax Appeals Tribunal (Tribunal) has recently issued a significant decision in *Nabo Africa Funds v Commissioner of Domestic Taxes (Tax Appeal E334 of 2024)* [2025] KETAT 141 (KLR) (21 February 2025) (judgment), concerning the treatment of approved tax refunds and the right of exempt taxpayers to receive such refunds in cash.

The Tribunal held that, even though the refund decision from the Kenya Revenue Authority's Commissioner (Commissioner) is appealable, the modalities and the mechanics of implementing the refund do not qualify as a refund decision and it is therefore not appealable.

Background

Nabo Africa Funds (the taxpayer), an umbrella investment scheme registered as a collective investment scheme, specifically as a unit trust, under the Capital Markets Act, lodged an income tax refund claim with the KRA for the financial year 2019–2020, amounting to KES 16,549,291. The claim was based on income tax that was erroneously deducted at source. The KRA approved the claim in its entirety but issued a refund adjustment voucher (advance credit) instead of disbursing the amount in cash, allowing the taxpayer to offset the approved amount against pending and future tax liabilities. Dissatisfied with this decision of not receiving a cash refund, the taxpayer appealed to the Tribunal.

The taxpayer's key arguments

The taxpayer argued that the KRA erred in both law and fact by allocating the income tax refund claim as an advance credit instead of disbursing it in cash. The taxpayer argued that being a registered unit trust, under the Capital Markets Act it was exempt from income tax pursuant to section 20(1)(a) of the Income Tax Act, meaning it did not have pending or future tax liabilities, effectively rendering the advance credit useless.

The taxpayer emphasised that, according to section 47(5) of the Tax Procedures Act (TPA), the KRA is supposed to first deal with a tax overpayment by offsetting a tax liability under a specific tax law, followed by offsetting a tax liability under any other tax law and, finally, refunding the reminder to the taxpayer in cash. Since the taxpayer is exempt from income tax, it argued that it was only right to get the refund in cash as it had no other tax liabilities.

The taxpayer further contended that the KRA's refusal to disburse the refund in cash violated its constitutional right to fair administrative action, and thus the refund decision was both legally flawed and procedurally unjust, warranting its annulment and a cash refund.

Is a cash tax refund application dead on arrival? Lessons for the Finance Bill, 2025

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The KRA's key arguments

The KRA did not dispute that a refund claim was due to the taxpayer, however, it stated that National Treasury's funding allocation for income tax refunds is limited to KES 150 million, paid on a quarterly basis. The KRA argued that cash payments are made on a first-in-first-out basis with a cap of KES 3 million per applicant and, due to these constraints, it issued a refund adjustment voucher instead of a cash refund.

To support its position, the KRA relied on the express provisions of the law, citing section 60(b)(ii) of the Finance Act, 2023, which amended section 47(2)(b) of the TPA. The amendment replaced the previous two-year timeline for processing tax refunds with a new requirement that refunds of overpaid taxes must be made within six months from the date the KRA confirms the claim's validity. If the refund is not processed within this period, the overpaid amount is to be applied against any existing or future tax liabilities of the taxpayer. The KRA submitted that this application is therefore mandatory and without exception, emphasising that the amended provision does not guarantee a cash refund but permits the offsetting of the overpaid amount. It argued that issuing an advance credit, rather than a cash refund, was consistent with the law and did not violate the taxpayer's right to fair administrative action. Moreover, it maintained that its approach, informed by budgetary constraints, was lawful and prudent.

The Tribunal's analysis and determination

In its judgment, the Tribunal first considered whether the taxpayer was validly before it, noting that, it could only intervene if the appeal was based on an appealable decision properly made by the KRA, specifically, a "*refund decision*". It then proceeded to examine whether the KRA unjustifiably allocated the taxpayer's approved income tax refund as an advance credit instead of issuing a cash refund.

In its analysis, the Tribunal observed that the dispute centred on the interpretation and application of section 3(1) of the TPA, which defines a "*refund decision*" as the determination referred to in section 47(3) of the TPA. Under section 47(3) of the TPA, the KRA is required to issue a written decision on a refund application within 90 days of receiving the refund application.

According to the Tribunal, a "*refund decision*" is limited to the KRA's determination on whether to approve or reject a claim, and its communication of that outcome within the statutory 90-day period. It clarified that the subsequent implementation of an approved refund, including the method of disbursement, such as through offsetting mechanisms, falls outside the definition of a "*refund decision*". As such, the manner in which an approved refund is effected does not amount to an appealable decision under the TPA.

In conclusion, the Tribunal held that the taxpayer's case was not grounded on a valid, appealable decision as required by law. As a result, the appeal was deemed procedurally defective and could not be entertained. Having found the matter moot due to the absence of a justiciable decision, the Tribunal declined to address any remaining issues.

Is a cash tax refund application dead on arrival? Lessons for the Finance Bill, 2025

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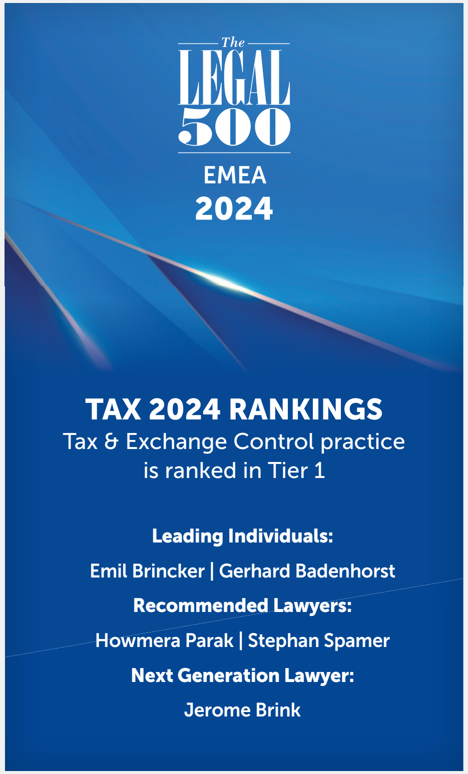


Comments

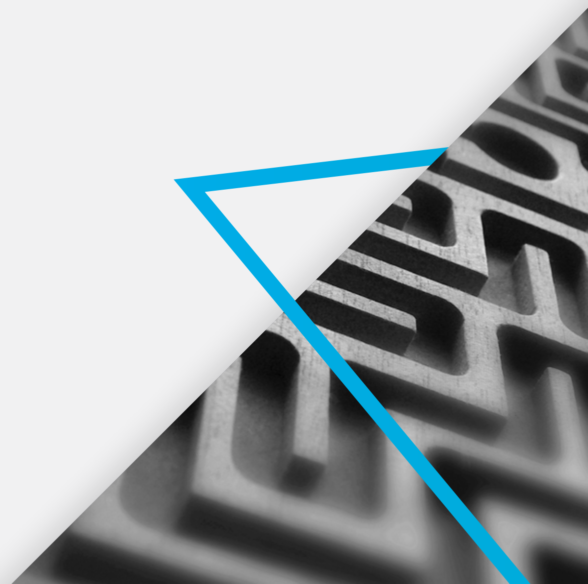
This case underscores how the KRA's approach, driven by budgetary constraints and administrative considerations, allows it to effectively avoid disbursing cash refunds. Taxpayers, especially those exempt from income tax, find themselves in a complex legal dilemma and at a disadvantage as they are compelled to accept a tax credit that offers little practical value compared to a cash refund. The KRA's fiscal policy stance, coupled with the statutory provisions, poses a serious risk of disenfranchising taxpayers who have no current or future tax obligations to offset tax credits of valid cash refunds.

While the TPA lays out clear procedures for processing and communicating refund claims, the judgment reveals that the actual implementation mechanism, specifically the issuance of advance credits, can effectively obstruct taxpayers' ability to reclaim their erroneously deducted funds, particularly when they have no pending or future tax liabilities.

As we gear up for the incoming finance bill, legislators should strive to address these concerns by ensuring that the refund process is not only transparent and procedurally fair, but also practically accessible to all taxpayers Moreover, it should consider provisions that guarantee cash refunds for eligible taxpayers who cannot use advance credits against tax liabilities.

The taxpayer still reserves the right to approach the High Court for recourse by way of an appeal or a judicial review application.

Alex Kanyi, Denis Maina, and Ian Ounoi



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