Tax & Exchange Control

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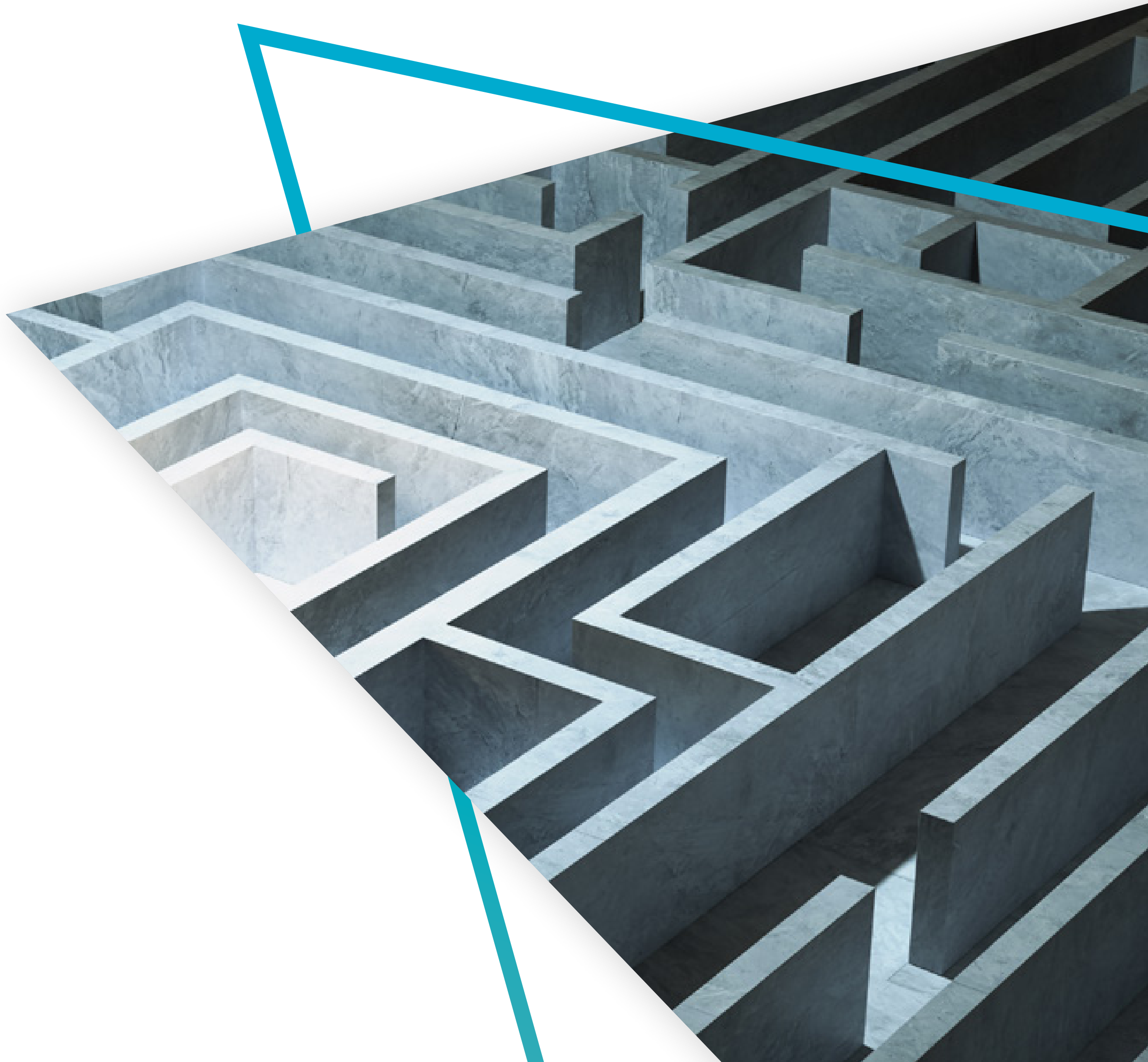

In this issue

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Relief for tax-exempt projects: Court of Appeal finds section 13(2) of the Income Tax Act constitutional

Imagine preparing a bid for a project and, while coming up with the costs, you are informed that you need not worry about certain costs because they are already catered for. You submit the bid, get the work, and start. However, as the project continues, or after completion, you are informed that you need to bear the costs that you were told not to worry about. This was the predicament faced by Japanese contractors and employees who were involved in tax-exempt projects, including the Mombasa Special Economic Zone Development Project, Olkaria V Power Development Project, and Mombasa Port Development Project, among others.

The contractors in these projects had an assurance that the tax cost would be catered for by the Government of Kenya and they proceeded with the projects in line with this until there was a challenge to the tax exemption in court.

On 17 February 2023, the High Court declared Legal Notice 15 of 2021 (Legal Notice) unconstitutional. The notice sought to exempt Japanese companies, consultants, and employees involved in specified projects from payment of income tax.

The National Assembly, National Treasury, and the Attorney General were aggrieved by the High Court's decision. They appealed against it in the Court of Appeal. In this alert, we highlight the determination by the Court of Appeal on 30 December 2024 and the implications.

Background

Section 13(2) of the Income Tax Act empowers the Cabinet Secretary for National Treasury and Planning (CS Treasury) to, by notice in the gazette, exempt from tax any income or class of income that accrued in or was derived from Kenya to the extent specified in the notice. Exercising this power, the CS Treasury issued Legal Notice 15 of 2021 to exempt Japanese companies, Japanese consultants, and Japanese employees involved in projects under specified financing agreements from payment of income tax.

National Treasury signed 16 financing agreements with the Government of Japan between 20 December 2007 and 18 September 2020. Among the projects covered in the tax exemption were the Mombasa Special Economic Zone Development Project, Olkaria V Power Development Project, Mombasa Port Development, and power distribution systems in Nakuru and Mombasa.

Eliud Karanja Matindi challenged the constitutionality of the Legal Notice for being discriminatory as Kenyans working for Japanese companies did not receive the same exemption. He also contended that the CS Treasury had no power to issue the tax exemption and that the Legal Notice was invalid for want of public participation.

The High Court agreed, and by extension declared section 13(2) of the Income Tax Act unconstitutional for being contrary to Article 210 of the Constitution of Kenya, 2010 (Constitution), which provides that no tax or licensing fee may be waived or varied except as provided by legislation.

Relief for tax-exempt projects: Court of Appeal finds section 13(2) of the Income Tax Act constitutional

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Additionally, it found that the mandate to issue an exemption or waiver of income tax lies with the National Assembly through the legislation process after it passes as a money bill, as provided for under Article 114(3) of the Constitution.

Dissatisfied with the High Court's decision, the Attorney General, CS for National Treasury, and National Assembly filed separate appeals at the Court of Appeal faulting the judgment for, among other reasons, declaring the Legal Notice to be unconstitutional.

Issues before the Court of Appeal

The Court of Appeal identified three issues for determination:

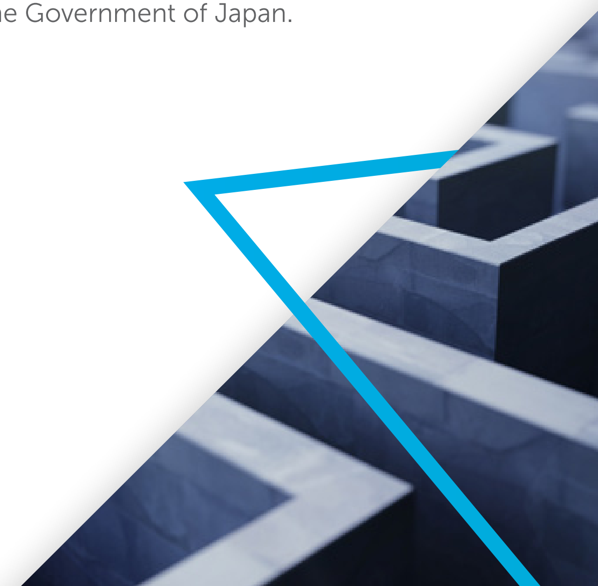
1. Whether Legal Notice 15 of 2021 was unconstitutional for entrenching discrimination on the grounds that it was never subjected to public participation.
2. Whether section 13(2) of the Income Tax Act was unconstitutional to the extent that it authorised an income tax waiver through a gazette notice instead of legislation.
3. Whether the exemption of income tax can only be granted by the National Assembly through legislation after it has passed as a money bill as provided under Article 114(3) of the Constitution.

The court's analysis and determination

Constitutionality of Legal Notice 15 of 2021

Eliud challenged the constitutionality of the legal notice for failure to comply with the requirements of Article 210 of the Constitution and for being discriminatory in nature, as no similar exemption was accorded to Kenyans working for Japanese companies. He also contended that the notice was never subjected to public participation.

The Court of Appeal relied on Article 94(5) of the Constitution to rule that although legislative authority is a preserve of Parliament, there are instances when it may be delegated to any person, but only with the express authority of either the Constitution or legislation. The Court of Appeal found that the CS Treasury exercised their powers in accordance with Article 94(5) of the Constitution and section 13(2) of the Income Tax Act. Further, the Court of Appeal found that the Legal Notice was issued after negotiations between the Governments of Kenya and Japan and that the same was not restricted to Kenya only as it also applied to other countries that had financing agreements with the Government of Japan.



Relief for tax-exempt projects: Court of Appeal finds section 13(2) of the Income Tax Act constitutional

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The court further clarified that since the Legal Notice was issued after government-to-government negotiations, it was executive in character and did not require mandatory public participation as it was not a statutory instrument.

Constitutionality of section 13(2) of the Income Tax Act

The High Court had declared section 13(2) of the Income Tax Act unconstitutional as it authorises an income tax waiver through a gazette notice instead of legislation. The Court of Appeal ruled that the alleged unconstitutionality of section 13(2) of the Income Tax Act was neither pleaded nor was it one of the requests sought in the petition before the High Court and the High Court in essence erred in making such a determination when it had not been so moved by any of the parties.

Whether income tax exemption can only be granted by the National Assembly through legislation

Eliud contended that an income tax exemption or waiver can only be granted by the National Assembly through legislation after it has passed as a money bill as provided under Article 114(3) of the Constitution. The Court of Appeal reiterated that although legislative authority is a preserve of Parliament, Article 94(5) provides that there are instances where such authority may be conferred on any person or body, but only with the express authority of either the Constitution or Parliament.

The court affirmed that the authority to grant an income tax exemption is bestowed on the CS Treasury under the Income Tax Act (section 13(2)). This section empowers the CS Treasury to grant income tax exemption by way of a notice, which must be transmitted to the National Assembly for consideration, as was done in the case of Legal Notice 15 of 2021.

Comment

Following the Court of Appeal's decision declaring section 13(2) of the Income Tax Act and Legal Notice 15 of 2021 constitutional, all legal notices pegged on section 13(2) of the Income Tax Act – including Legal Notice 91 of 2015, which granted waivers on withholding tax on foreign-sourced loans meant for investment in energy, water and related sectors, and Legal Notice 165 of 2015, which exempts withholding tax on payments for services rendered by a non-resident person under a power purchase agreement – will now remain effective.

All income tax accrued by Japanese companies, Japanese consultants, and Japanese employees who were engaged in the projects listed in the schedule accompanying the Legal Notice remains tax-exempt.

The exemption is likely to boost confidence for countries that provide concessional loans or grants to Kenya in exchange for certain negotiated tax exemptions. We may see more robust development in renewable energy and roads if Kenya continues to attract funding from such countries. Tax exemptions do not automatically translate to completed projects; therefore the Government has to continue monitoring tax-exempt projects to ensure they are completed, and add value to Kenyans.

The parties in this case have a right to appeal to the Supreme Court. The Supreme Court can vary the decision of the Court of Appeal.

Alex Kanyi, Denis Maina and Nicholas Owino

Your interest-free loan to a foreign trust can now be subject to both donations tax and transfer pricing adjustments: The interplay between section 7C and transfer pricing rules

Many South Africans use foreign trust structures for tax-efficient asset protection and estate planning. Consequently, the recent amendment to section 7C of the Income Tax Act 58 of 1962 (ITA), in the context of low or interest-free loans to a foreign trust by a connected person, is critical to ensuring that such trusts achieve their intended objectives without contravening the trust anti-avoidance provisions.

Section 7C of the ITA is a trust anti-avoidance provision aimed at limiting the tax-free transfer of wealth to trusts using low or interest-free loans, advances or credit arrangements, including cross-border loan arrangements. Since its inception, section 7C has been plagued by uncertainties that have led to multiple amendments aimed at clarifying and expanding the ambit of its application.

The most recent amendment to section 7C took effect on 1 January 2025 and was introduced by section 4(1)(b) of the Taxation Laws Amendment Act 42 of 2024, with the objective of limiting the exclusion of an 'affected transaction' as defined under section 31(1) of the ITA from the scope of section 7C.

Before we deal with what the amendment entails and the implications for taxpayers, it is useful to recap the anti-avoidance measures contained in section 7C and section 31 of the ITA.

Section 7C and its anti-avoidance objective

In terms of section 7C, when a South African resident who is a connected person in relation to a trust makes a loan (including a cross-border loan) to that trust and either does not charge interest or charges interest at a rate that is lower than the official rate of interest, the shortfall amount of interest that would have been applied as per the official rate of interest will be deemed to be an ongoing annual donation to the trust by the resident lender. This deemed donation is subject to South African donations tax as may be applicable from time to time.

The official rate of interest is defined in the ITA to mean:

- in the case of a debt denominated in the currency of the Republic, a rate of interest equal to the South African repurchase rate plus 1%; or
- in the case of a debt denominated in any other currency, a rate of interest that is the equivalent of the South African repurchase rate in that currency plus 1%.

For example, consider a situation where a loan of GBP 1 million is made by a South African resident to a connected person foreign trust (on an arm's length basis) against an interest rate of 4,75%. With the official interest rate currently at 5,75% (based on the Bank of England base rate of 4,75% plus 1%), the difference of GBP 10,000, representing the forgone interest, would be deemed to be a donation under section 7C. At an exchange rate of GBP 1 = ZAR 23, this amounts to ZAR 230,000, which would be subject to donations tax.

Your interest-free loan to a foreign trust can now be subject to both donations tax and transfer pricing adjustments: The interplay between section 7C and transfer pricing rules

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Section 31 transfer pricing adjustments

Section 31 of the ITA contains anti-avoidance measures (also known as the transfer pricing rules) that apply to certain 'affected transactions', which include but are not limited to cross-border loan arrangements between connected persons.

In terms of section 31, if an 'affected transaction' has terms and conditions that deviate from those that would exist in an 'arm's length' agreement between independent parties, certain transfer pricing adjustments must be made, which in turn may result in an increased tax liability in the hands of the South African residents.

For purposes of this article we focus only on cross-border loan arrangements that would qualify as 'affected transactions' under the transfer pricing rules. In such instances, the provisions of section 31 would require the following transfer pricing adjustments to be made:

- **primary adjustment (section 31(2))**: the lender must include the difference between the arm's length interest rate and the actual interest charged (if any) in its taxable income; and
- **secondary adjustment (section 31(3)):**
  - where the lender is a company, then the amount of the primary adjustment is deemed to be a dividend consisting of an asset *in specie* declared and paid by the resident lender to the non-resident borrower; or
  - where the lender is a natural person, the amount of the primary adjustment is deemed to be a donation made by the resident lender to the borrower, thereby potentially incurring a donations tax liability at the donations tax rate as may be applicable from time to time.

Historical interaction between sections 7C and 31 of the ITA

Previously, to avoid double taxation in instances where the application of sections 7C and 31 intersect, section 7C(5)(e) excluded cross-border loans classified as 'affected transactions' under section 31 from the ambit of section 7C.

The 2024 budget announcement highlighted the concern that the 7C(5)(e) exclusion (as worded at that point in time) inadvertently created a loophole allowing for the avoidance of donations tax where the arm's length interest rate determined in terms of section 31 was lower than the official rate of interest under section 7C.

For instance, imagine Y, a South African resident, advanced an interest-free loan of R5 million to a connected non-resident trust. The arm's-length interest rate (market-related rate) was 6%, resulting in interest of R300,000, while the official interest rate applicable under section 7C was 8,75%, equating to R437,500.

Your interest-free loan to a foreign trust can now be subject to both donations tax and transfer pricing adjustments: The interplay between section 7C and transfer pricing rules

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As this is a cross-border loan between connected persons, it falls within the scope of section 31's transfer pricing rules and accordingly would have been excluded from section 7C (under the previous wording of section 7C(5)(e)). Under the transfer pricing rules, Y would have been required to:

- make a primary adjustment by including the difference between the arm's length interest (R300,000) and the actual interest charged (R0) in their taxable income; and
- secondary adjustment: if Y was a company, the R300,000 would have been deemed to be a dividend *in specie* and subject to South African dividends tax, or, if Y was a natural person the R300,000 would have been deemed to be a donation and subject to donations tax.

Had section 31 not applied, the transaction would have been subject to section 7C. In that case, the deemed donation would have been based on the shortfall between the official interest rate (8,75%) and the actual interest charged (0%), resulting in a deemed donation in the amount of R437,500 (R5 million × 8,75%).

Therefore, the section 7C(5)(e) exclusion in its previous form would have reduced the deemed anti-avoidance tax amount declared by Y by R137,500.

In the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2024, National Treasury relied on a similar example and referred to the loophole as an *"unintended anomaly in the interaction between the trust anti-avoidance measures and transfer pricing rules"*, which inadvertently created structuring opportunities that had the potential to lead to the erosion of the tax base.

The amendment

The section 7C5(e) exemption was duly amended and now reads as follows:

> *"…(e) that loan, advance or credit constitutes an affected transaction as defined in section 31(1)* ***to the extent of an adjustment made in terms of section 31(2)****"*. (own emphasis added)

Practically, this amendment introduces a 'further section 7C adjustment' in as far as qualifying cross-border loan arrangements are concerned.

The exemption under section 7C(5)(e) now only applies to interest subject to a section 31(2) adjustment. Where the arm's length interest rate under section 31(2) is lower than the official rate, the difference is no longer be excluded from section 7C, leading to an additional donations tax liability.

Your interest-free loan to a foreign trust can now be subject to both donations tax and transfer pricing adjustments: The interplay between section 7C and transfer pricing rules

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Using the earlier example, the implications of the amendment are illustrated in terms of Y's tax liabilities as follows:

- **primary adjustment (section 31(2)):** Y is required to include the R300,000 of forgone interest in their taxable income;
- **secondary adjustment (section 31(3)):**
  - if Y is a company, the amount of the primary adjustment (R300,000) is deemed to be dividend *in specie*, or
  - if Y is a natural person, the amount of the primary adjustment (R300,000) is deemed to be a donation; and
  - **a further 7C adjustment:** the balance of the interest up to the official rate of interest (R137,000) is deemed to be a further donation under section 7C.

The report of the Standing Committee on Finance on the Taxation Laws Amendment Bill, 2024, dated 19 November 2024, indicates that numerous submissions called for exclusions for arm's length transactions with lower interest rates from the ambit of section 7C. National Treasury, however, dismissed these proposals, citing the anti-avoidance purpose of section 7C and asserting that the new amendment adequately addresses the gaps in the interaction between the trust anti-avoidance provisions and transfer pricing rules.

This amendment to section 7C(5)(e) therefore underscores the legislature's commitment to ensuring that anti-avoidance measures are robust and effective. Taxpayers engaging in cross-border trust structures must carefully evaluate their compliance with the amended provision, as they may now face anti-avoidance tax liabilities under both sections 31 and 7C. Consulting with tax professionals is essential to navigate the complexities of these rules and avoid unintended tax consequences.

Emil Brincker and Mariska Delport

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Emil Brincker ranked by Chambers Global 2003–2024 in **Band 1**: Tax.

Gerhard Badenhorst was awarded an individual spotlight table ranking in Chambers Global 2022–2024 for Tax: Indirect Tax.

Stephan Spamer ranked by Chambers Global 2019–2024 in **Band 3**: Tax.

Jerome Brink ranked by Chambers Global 2024 as an "**Up & Coming**" tax lawyer.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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