

INTERPRETATION NOTE: NO. 67 (Issue 2)

DATE: 14 February 2014

ACT : INCOME TAX ACT NO. 58 OF 1962
SECTION : SECTION 1(1), DEFINITION OF A “CONNECTED PERSON”
SUBJECT : CONNECTED PERSONS

CONTENTS

| | PAGE |
|---|-------------|
| Preamble | 2 |
| 1. Purpose..... | 2 |
| 2. Background | 3 |
| 3. The law and its application | 3 |
| 3.1 Connected person in relation to a natural person | 3 |
| 3.1.1 Paragraph (a) | 3 |
| 3.1.2 A relative [paragraph (a)(i)]..... | 4 |
| 3.1.3 A trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property) of which the natural person or relative is a beneficiary [paragraph (a)(ii)]..... | 7 |
| 3.2 Connected person in relation to a trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property) | 8 |
| 3.2.1 Paragraph (b) | 8 |
| 3.2.2 A beneficiary of the trust [paragraph (b)(i)] | 8 |
| 3.2.3 A connected person in relation to the beneficiary of the trust [paragraph (b)(ii)]..... | 8 |
| 3.3 Connected person in relation to a connected person in relation to a trust..... | 9 |
| 3.3.1 Paragraph (bA)..... | 9 |
| 3.3.2 A person who is a connected person in relation to the trust [paragraph (bA)] | 9 |
| 3.4 Connected person in relation to a member of any partnership..... | 10 |
| 3.4.1 Paragraph (c) | 10 |
| 3.4.2 Any other member of the partnership [paragraph (c)(i)] | 11 |
| 3.4.3 A connected person in relation to any member of the partnership or foreign partnership [paragraph (c)(ii)] | 12 |
| 3.5 Connected person in relation to a company..... | 12 |
| 3.5.1 Paragraph (d) | 12 |

| | | |
|-------|--|----|
| 3.5.2 | A company that would form part of the same group of companies [paragraph (d)(i)] | 14 |
| 3.5.3 | A person that holds at least 20% of the equity shares or voting rights in the company [paragraph (d)(iv)] | 17 |
| 3.5.4 | Any other company that holds at least 20% of the equity shares or voting rights in the company and no holder of shares holds the majority voting rights [paragraph (d)(v)] | 21 |
| 3.5.5 | Any other company which is managed or controlled by a connected person [paragraph (d)(vA)] | 23 |
| 3.5.6 | Connected person in relation to a company that is a close corporation [paragraph (d)(vi)]..... | 25 |
| 3.6 | The reverse “connected person” relationship..... | 27 |
| 3.6.1 | Paragraph (e) | 27 |
| 3.6.2 | The other person [paragraph (e)]..... | 27 |
| 3.7 | A portfolio of a collective investment scheme in securities..... | 27 |
| 3.7.1 | Proviso to the definition of a “connected person” | 27 |
| 3.7.2 | A portfolio of a collective investment scheme in securities [proviso to the definition of a “connected person”]..... | 27 |
| 3.8 | A portfolio of a collective investment scheme in property..... | 28 |
| 3.9 | Timing of the “connected person” test | 29 |
| 3.10 | Expanded or restricted definition of a “connected person” | 30 |
| 3.11 | Application of the definition of a “connected person”..... | 31 |
| 4. | Conclusion | 33 |
| | Annexure – Diagram illustrating the rule for determining persons who are related within the third degree of consanguinity | 34 |

Preamble

In this Note unless the context indicates otherwise –

- **“paragraph”** means a paragraph of the definition of a “connected person” in section 1(1);
- **“Schedule”** means a Schedule to the Act;
- **“section”** means a section of the Act;
- **“the Act”** means the Income Tax Act No. 58 of 1962;
- **“the TA Act”** means the Tax Administration Act No. 28 of 2011; and
- any word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance on the interpretation and application of the definition of a “connected person” in section 1(1).

The Value-Added Tax Act contains a definition of the term “connected persons” in section 1(1) of that Act. Apart from the fact that the term is defined in the plural, there

are a number of other significant differences between the value-added tax definition and the income tax definition. For example, the value-added tax definition includes the estates of deceased and insolvent persons, a partnership and in specified circumstances a branch or division of a person, while the income tax definition does not. Although the two definitions share some common features, this Note focuses only on the income tax definition and should not be relied on for purposes of interpreting the value-added tax definition.

Section 1 of the TA Act contains a definition of a “connected person” which is cross-referenced to the income tax definition.

2. Background

The Income Tax Act No. 113 of 1993 introduced the definition of a “connected person” into section 1.¹ This definition is central to specific anti-avoidance provisions which regulate the tax consequences of transactions entered into between related taxpayers. Such related-party transactions are more likely to be open to manipulation in order to secure a fiscal advantage than transactions entered into between unconnected parties, hence the need for specific rules to deal with connected persons.

The definition became effective as from 21 June 1993. It replaced the previous definition of a “connected person” in section 12C(6) which was relevant only in the context of that section.

3. The law and its application

This Note reflects the law as amended by the Taxation Laws Amendment Act No. 31 of 2013 which was promulgated on 12 December 2013.

Some of the provisions in the Act that apply the “connected person” concept apply an expanded or restricted definition of a “connected person” as contained in section 1(1) depending on their respective purposes (see **3.10**).

The definition of a “connected person” identifies connected persons in relation to different types of taxpayers, namely, natural persons, trusts, members of partnerships, companies and close corporations. It does not, however, deal with deceased and insolvent estates and holders of shares in a company.²

3.1 Connected person in relation to a natural person

3.1.1 Paragraph (a)

“Connected person” means –

- (a) in relation to a natural person—
 - (i) any relative; and

¹ It has been amended since it was originally introduced.

² The holders of shares in a company are not connected persons in relation to each other by virtue of their holding of shares but may be connected persons in relation to each other under, for example, paragraph (a), (b) or (bA) read with paragraph (e).

- (ii) any trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property)³ of which such natural person or such relative is a beneficiary;

3.1.2 A relative [paragraph (a)(i)]

A relative of a natural person is a connected person in relation to that person. A “relative” is defined in section 1(1) as follows:

“**[R]elative**” in relation to any person, means the spouse of such person or anybody related to him or his spouse within the third degree of consanguinity, or any spouse of anybody so related, and for the purpose of determining the relationship between any child referred to in the definition of “child” in this section and any other person, such child shall be deemed to be related to its adoptive parent within the first degree of consanguinity;

A “spouse” is defined in section 1(1) as follows:

“**[S]pouse**”, in relation to any person, means a person who is the partner of such person—

- (a) in a marriage or customary union recognised in terms of the laws of the Republic;
- (b) in a union recognised as a marriage in accordance with the tenets of any religion; or
- (c) in a same-sex or heterosexual union which the Commissioner is satisfied is intended to be permanent,

and “**married**”, “**husband**” or “**wife**” shall be construed accordingly: Provided that a marriage or union contemplated in paragraph (b) or (c) shall, in the absence of proof to the contrary, be deemed to be a marriage or union out of community of property;

A “spouse” includes a person who is the partner of such person in a same-sex or heterosexual union which the Commissioner is satisfied is intended to be permanent. The assessment of whether a relationship is intended to last for an indefinite period, and is thus considered permanent, will be based on a review of all the facts and circumstances applicable to the particular case.

The word “consanguinity” is defined in the *Chambers 20th Century Dictionary*⁴ as “relationship by blood as opposed to affinity or relationship by marriage” and in the *Concise Oxford English Dictionary*⁵ as “of the same blood”. There are different degrees of relative consanguinity – the first, second and third degrees of consanguinity are relevant for purposes of the definition of a “relative” (see the diagram in the **Annexure**).

A “child” is defined in section 1(1) as follows:

“**[C]hild**”, in relation to any person, includes any person adopted by him or her—

- (a) under the law of the Republic; or

³ The definition of a “connected person” was amended with effect from the commencement of years of assessment commencing on or after 1 January 2010, to exclude a portfolio of a collective investment scheme in securities and a portfolio of a collective investment scheme in property from a trust.

⁴ New Edition 1983, W & R Chambers Ltd.

⁵ Eleventh Edition (revised) 2006, Oxford University Press Inc. New York.

- (b) under the law of any country other than the Republic, provided the adopted person is under such law accorded the status of a legitimate child of the adoptive parent and the adoption was made at a time when the adoptive parent was ordinarily resident in such country;

A relative of a natural person therefore includes –

- that person's spouse;
- anybody related to that person within the third degree of consanguinity;
- anybody related to that person's spouse within the third degree of consanguinity; and
- the spouse of anybody related within the third degree of consanguinity to that person or his or her spouse.

The following persons therefore qualify as "relatives" in relation to any person:

- Children (first degree of consanguinity)
- Grandchildren (second degree of consanguinity)
- Great-grandchildren (third degree of consanguinity)
- Parents (first degree of consanguinity)
- Grandparents (second degree of consanguinity)
- Great-grandparents (third degree of consanguinity)
- Brothers and sisters (second degree of consanguinity)
- Nephews and nieces⁶ (third degree of consanguinity)
- Uncles and aunts (third degree of consanguinity)

In addition, all of the above relatives of that person's spouse would be relatives of the person as well as the spouses of any of those relatives.

The deceased or insolvent estate of a natural person is not a connected person in relation to –

- that natural person;
- any relative of that natural person;
- any trust of which that natural person was a beneficiary, or
- any trust of which that natural person's relative is a beneficiary.

Example 1 – Connected person in relation to a natural person

Facts:

E is married to F. B and A are the parents of E and C and D are the parents of F. Are B and A connected persons in relation to C and D?

⁶ Children of a brother or sister.

Result:

B and A are not connected persons in relation to C and D under paragraph (a)(i) as they are not relatives of C and D. Paragraph (a)(ii) is also inapplicable.

Example 2 – Connected person in relation to a natural person*Facts:*

B is the half-brother of A, as they have the same father but different mothers. Is B a connected person in relation to A?

Result:

B is related to A in the second degree of consanguinity, since B and A have a common parent. B is therefore a connected person in relation to A under paragraph (a)(i).

Example 3 – Connected person in relation to a natural person*Facts:*

C is the stepmother of A and the spouse of B, who is the father of A. Is C a connected person in relation to A?

Result:

B is related to A in the first degree of consanguinity. C is the spouse of B and therefore a relative of A. C is a connected person in relation to A under paragraph (a)(i).

Example 4 – Connected person in relation to a natural person*Facts:*

X and Y are stepbrothers. The parents of X are C and D and the parents of Y are E and F. Both sets of parents are divorced and D and E have married. Is Y a connected person in relation to X?

Result:

D is related to X in the first degree of consanguinity. E is the spouse of D and therefore related to X. Y is not related to X within the meaning of the definition of a "relative", since Y and X do not have a common parent. Y is therefore not a connected person in relation to X.

3.1.3 A trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property) of which the natural person or relative is a beneficiary [paragraph (a)(ii)]

A trust is a connected person in relation to a natural person if the natural person, or a relative of the natural person, is a beneficiary of the trust.

A “trust” is defined in section 1(1) as follows:

“**[T]rust**” means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person;

A “beneficiary” is defined in section 1(1) as follows:

“**[B]eneficiary**” in relation to a trust means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust;

The authors of *Income Tax in South Africa* comment as follows on this definition:⁷

“This definition is wide and includes capital and income beneficiaries with vested rights and discretionary beneficiaries, provided that these have been designated as such, irrespective of whether or not they have ever been in receipt of any distributions or have formally accepted benefits. The same would apply to members (named or unnamed) of a designated class of persons and where the class is specified as being a collection of persons from whom beneficiaries may be chosen by the trustees, even where this choice has not been made in respect of a particular person.”

SARS is in agreement with the authors’ comments on the definition of a beneficiary.

Example 5 – Connected person in relation to a natural person

Facts:

B, who is the spouse of A, is a beneficiary of AB Family Trust. Is AB Family Trust a connected person in relation to A?

Result:

AB Family Trust is a connected person in relation to A under paragraph (a)(ii) because B is a beneficiary of AB Family Trust and a relative of A.

Example 6 – Connected person in relation to a natural person

Facts:

D is the founder of ABC Family Trust. D’s three grandchildren, A, B and C were named as beneficiaries of the trust. Is ABC Family Trust a connected person in relation to D?

⁷ D Clegg and R Stretch *Income Tax in South Africa* [electronic version – last updated April 2013] LexisNexis Butterworths in 24.1.1.

Result:

A, B and C are related to D in the second degree of consanguinity and they are beneficiaries of ABC Family Trust. ABC Family Trust is therefore a connected person in relation to D under paragraph (a)(ii).

3.2 Connected person in relation to a trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property)

3.2.1 Paragraph (b)

Connected person means –

- (b) in relation to a trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property)—⁸
- (i) any beneficiary of such trust; and
 - (ii) any connected person in relation to such beneficiary;

3.2.2 A beneficiary of the trust [paragraph (b)(i)]

A beneficiary of a trust is a connected person in relation to the trust (see 3.1.3 on the meaning of a “beneficiary”).

3.2.3 A connected person in relation to the beneficiary of the trust [paragraph (b)(ii)]

A person, who is a connected person in relation to a beneficiary of a trust, is also a connected person in relation to the trust.

Example 7 – Connected person in relation to a trust

Facts:

C is the founder of A Family Trust of which B Family Trust is the only beneficiary. The beneficiaries of B Family Trust are C, C’s son D and stepchild E. Are C, D and E connected persons in relation to A Family Trust?

Result:

B Family Trust is a connected person in relation to A Family Trust under paragraph (b)(i) because it is a beneficiary of A Family Trust. C, D and E are connected persons in relation to B Family Trust under paragraph (b)(i) because they are all beneficiaries of B Family Trust. C, D and E are therefore connected persons in relation to A Family Trust under paragraph (b)(ii).

⁸ The definition of a “connected person” was amended with effect from the commencement of years of assessment commencing on or after 1 January 2010, to exclude a portfolio of a collective investment scheme in securities and a portfolio of a collective investment scheme in property from a trust.

3.3 Connected person in relation to a connected person in relation to a trust

3.3.1 Paragraph (bA)

Connected person means –

(bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme in property or a portfolio of a collective investment scheme in securities),⁹ includes any other person who is a connected person in relation to such trust;

3.3.2 A person who is a connected person in relation to the trust [paragraph (bA)]

All connected persons in relation to a trust are connected persons in relation to each other. For this purpose a trust excludes –

- a portfolio of a collective investment scheme in property, and
- a portfolio of a collective investment scheme in securities.

A portfolio of a collective investment scheme in property is included in paragraph (e)(iii) of the definition of a “company” in section 1(1).¹⁰ For purposes of the definition of a “connected person”, a portfolio of a collective investment scheme in securities is treated as a company.¹¹

The beneficiary of a trust and a company in which the trust holds at least 20% of the equity shares or voting rights¹² would therefore be connected to each other. Beneficiaries of the same trust are likewise connected to one another.

Example 8 – Connected person in relation to a connected person in relation to a trust

Facts:

B Family Trust and AC CC are the beneficiaries of ABC Family Trust. Are AC CC and B Family Trust connected persons in relation to each other?

Result:

AC CC and B Family Trust are both beneficiaries of and connected persons in relation to ABC Family Trust under paragraph (b)(i). AC CC and B Family Trust are therefore connected persons in relation to each other under paragraph (bA).

⁹ The definition of a “connected person” was amended with effect from the commencement of years of assessment commencing on or after 1 January 2010, to exclude a portfolio of a collective investment scheme in securities and a portfolio of a collective investment scheme in property from a trust.

¹⁰ Paragraph (e)(iii) was inserted by section 2(1)(a) of the Taxation Laws Amendment Act No. 22 of 2012 and applies in respect of years of assessment commencing on or after 1 April 2013. Paragraph (e)(iii) was amended by section 4(1)(f) of the Taxation Laws Amendment Act No. 31 of 2013 with effect from years of assessment commencing on or after 1 January 2015 to restrict its ambit to a portfolio of a collective investment scheme in property that qualifies as a REIT.

¹¹ Proviso to the definition of a “connected person” in section 1(1).

¹² Under paragraph (d)(iv) the company would be a connected person in relation to the trust.

Example 9 – Connected person in relation to a connected person in relation to a trust

Facts:

ABC Trust holds all the shares in XYZ (Pty) Ltd. MNO CC is the beneficiary of ABC Trust. Are XYZ (Pty) Ltd and MNO CC connected persons in relation to each other?

Result:

XYZ (Pty) Ltd is a connected person in relation to ABC Trust under paragraph (d)(iv) and paragraph (e) because ABC Trust holds 100% of the equity shares in XYZ (Pty) Ltd (see 3.5.3 and 3.6.1). MNO CC is a connected person in relation to ABC Trust under paragraph (b)(i) because it is a beneficiary of ABC Trust. XYZ (Pty) Ltd and MNO CC are connected persons in relation to each other under paragraph (bA) as they are both connected persons in relation to ABC Trust.

Example 10 – Connected person in relation to a connected person in relation to a trust

Facts:

J and A, who are not relatives, are both beneficiaries of AJ Trust. K and B are respectively the spouses of J and A. Are K and B connected persons in relation to one another?

Result:

J and A are connected persons in relation to AJ Trust under paragraph (b)(i) as they are beneficiaries of AJ Trust. K and B are respectively relatives of J and A and connected persons in relation to them under paragraph (a)(i). K and B are connected persons in relation to AJ Trust under paragraph (b)(ii). K and B are connected persons in relation to each other under paragraph (bA) as they are both connected persons in relation to AJ Trust.

3.4 Connected person in relation to a member of any partnership

3.4.1 Paragraph (c)

Connected person means –

- (c) in relation to a member of any partnership or foreign partnership—¹³
- (i) any other member; and
 - (ii) any connected person in relation to any member of such partnership or foreign partnership;

¹³ The definition of a “connected person” was amended by section 4(1)(g) of the Taxation Laws Amendment Act No. 31 of 2013 to include a “foreign partnership” in paragraph (c). Since no effective date was specified the amendment takes effect on the date of promulgation of the amendment Act, namely, 12 December 2013.

3.4.2 Any other member of the partnership [paragraph (c)(i)]

All members of a partnership or foreign partnership are connected persons in relation to each other.

Partners include ordinary profit-sharing partners and partners in extraordinary partnerships [in other words, silent partners¹⁴ and partners *en commandite* (or commanditarian partners)].¹⁵ The existence and identity of silent and *en commandite* partners is typically not disclosed to the public however the existence and identity of all partners must, when required, be disclosed to SARS.

In *Bester v Van Niekerk*¹⁶ Holmes AJA confirmed that a joint venture, even one involving a single transaction, will be a partnership if it meets the following essentials:

- Each of the partners brings something into the partnership, or binds himself to bring something into it, whether it be money, or his labour or skill.
- The business must be carried on for the joint benefit of both parties.
- The object must be to make profit.
- In addition, the true intention of the parties must be to form a partnership.

A “foreign partnership” is defined in section 1(1) as follows:

“**[F]oreign partnership**”, in respect of any year of assessment, means any partnership, association, body of persons or entity formed or established under the laws of any country other than the Republic if—

(a) for the purposes of the laws relating to tax on income of the country in which that partnership, association, body of persons or entity is formed or established—

(i) each member of the partnership, association, body of persons or entity is required to take into account the member’s interest in any amount received by or accrued to that partnership, association, body of persons or entity when that amount is received by or accrued to the partnership, association, body of persons or entity; and

(ii) the partnership, association, body of persons or entity is not liable for or subject to any tax on income in that country; or

(b) where the country in which that partnership, association, body of persons or entity is formed or established does not have any applicable laws relating to tax on income—

(i) any amount—

(aa) that is received by or accrued to; or

(bb) of expenditure that is incurred by,

the partnership, association, body of persons or entity is allocated concurrently with the receipt, accrual or incurral to the members of that partnership, association, body of persons or entity in terms of an agreement between those members; and

¹⁴ Anonymous, sleeping or dormant partners.

¹⁵ On extraordinary partnerships, see J J Henning (assisted by E Snyman-Van Deventer) under “Partnership – Kinds of Partnership – Extraordinary Partnerships” in *The Law of South Africa* 19 (second edition) volume [electronic version] (30 August 2010) LexisNexis Butterworths in paragraph 258.

¹⁶ 1960 (2) SA 779 (A) at 783.

- (ii) no amount distributed to a member of a partnership, association, body of persons or entity may exceed the allocation contemplated in subparagraph (i) after taking into account any prior distributions made by the partnership, association, body of persons or entity;

3.4.3 A connected person in relation to any member of the partnership or foreign partnership [paragraph (c)(ii)]

A person, who is a connected person in relation to a member of a partnership or foreign partnership, is also a connected person in relation to the other members of the partnership or foreign partnership.

Example 11 – Connected person in relation to a member of a partnership or foreign partnership

Facts:

A and B are members of the AB Partnership. C, the spouse of B, is a beneficiary of ABC Trust. Is ABC Trust a connected person in relation to A?

Result:

Under paragraph (c)(ii) ABC Trust will be a connected person in relation to A if it is a connected person in relation to any member of the AB Partnership (that is, in relation to A or B). ABC Trust is a connected person in relation to B (and hence in relation to A) because –

- C is a relative of B, being B's spouse [definition of a "relative" in section 1(1)]. C, being a relative of B, is therefore a connected person in relation to B under paragraph (a)(i);
- C is a connected person in relation to ABC Trust, being a beneficiary of that trust [paragraph (b)(i)];
- B is a connected person in relation to ABC Trust, because B is a connected person in relation to a beneficiary of that trust (C) [paragraph (b)(ii)].

3.5 Connected person in relation to a company

In determining whether a person is a connected person in relation to a company, regard must be had to each of the tests in paragraph (d)(i), (iv), (v), (vA) and (vi).

3.5.1 Paragraph (d)

Connected person means –

- (d) in relation to a company—
- (i) any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent of the equity shares in" in paragraphs (a) and (b) of the definition of "group of companies" in this section were replaced by the expression "more than 50 per cent of the equity shares or voting rights in";
 - (ii)
 - (iii)

- (iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of—
 - (aa) the equity shares in the company; or
 - (bb) the voting rights in the company;
- (v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares¹⁷ holds the majority voting rights in the company;
- (vA) any other company if such other company is managed or controlled by—
 - (aa) any person who or which is a connected person in relation to such company; or
 - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and
- (vi) where such company is a close corporation—
 - (aa) any member;
 - (bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property)¹⁸ which is a connected person in relation to such member; and
 - (cc) any other close corporation or company which is a connected person in relation to—
 - (i) any member contemplated in item (aa); or
 - (ii) the relative or trust contemplated in item (bb); and

A “company” is defined in section 1(1) as follows:

“[C]ompany” includes—

- (a) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or
- (b) any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law; or
- (c) any co-operative; or
- (d) any association (not being an association referred to in paragraph (a) or (f)) formed in the Republic to serve a specified purpose, beneficial to the public or a section of the public; or
- (e) any—

¹⁷ Paragraph (d)(v) was amended by section 4(1)(k) of the Taxation Laws Amendment Act No. 31 of 2013 to substitute the word “shareholder” with the words “holder of shares”.

¹⁸ The definition of a “connected person” was amended with effect from the commencement of years of assessment commencing on or after 1 January 2010, to exclude a portfolio of a collective investment scheme in securities and a portfolio of a collective investment scheme in property from a trust.

- (i)¹⁹
 - (ii) portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest; or
 - (iii) portfolio of a collective investment scheme in property that qualifies as a REIT;²⁰ or
 - (f) a close corporation,
- but does not include a foreign partnership;

3.5.2 A company that would form part of the same group of companies [paragraph (d)(i)]

A company that forms part of the same “group of companies”²¹ as another company, is a connected person in relation to the other company.²²

The terms “group of companies”, “controlling group company” and “controlled group company” are defined in section 1(1) as follows:

- “[G]roup of companies”** means two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “controlled group company”), to the extent that—
- (a) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
 - (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;
- “controlling group company”** means a controlling group company contemplated in the definition of “group of companies”;
- “controlled group company”** means a controlled group company contemplated in the definition of “group of companies”;

¹⁹ A portfolio comprised in any collective investment scheme in securities was deleted from the definition with effect from the commencement of years of assessment commencing on or after 1 January 2010. However, for purposes of the definition of a “connected person”, a portfolio of a collective investment scheme in securities is deemed to be a company (see 3.7).

²⁰ A portfolio of a collective investment scheme in property was inserted in the definition with effect from the commencement of years of assessment commencing on or after 1 April 2013. Paragraph (e)(iii) was amended by section 4(1)(f) of the Taxation Laws Amendment Act No. 31 of 2013 with effect from years of assessment commencing on or after 1 January 2015 to restrict its ambit to a portfolio of a collective investment scheme in property that qualifies as a REIT.

²¹ For the purposes of the definition of a connected person paragraph (d)(i) refers to and modifies the definition of a “group of companies” in section 1(1), not the narrower definition of the same term in section 41.

²² Effective as from the commencement of years of assessment ending on or after 1 January 2007.

In applying the definition of a “group of companies” in section 1(1), paragraph (d)(i) provides that the expression “at least 70 per cent of the equity shares in” is replaced with “more than 50 percent of the equity shares or voting rights in”. A company will thus form part of the same group of companies if more than 50% of its equity shares or voting rights are directly owned by a controlling company, one or more other controlled group companies or any combination of such companies. The controlling group company should directly hold more than 50% of the equity shares or voting rights in at least one controlled group company.

In determining the “more than 50%” requirement a simple summation of direct holdings of controlling and controlled group company holdings in the company in question must be made. The calculation is not based on the determination of an effective percentage interest. For example, if A owns 60% of B and B owns 60% of C, A’s 60% interest in B and B’s 60% interest in C will determine whether A and B, B and C, or A and C are part of the same group of companies. Taking into account A and B’s 60% shareholdings, A, B and C are part of the same group of companies for purposes of the definition of a “connected person” in section 1(1). A’s effective interest in C of 36% (60% × 60%) is not relevant for this purpose.

The reference to a controlling group company’s indirect holding of shares in the opening words of the definition of a “group of companies” confirms that a group of companies can include multiple tiers.

An “equity share” is defined in section 1(1) as follows:²³

“**[E]quity share**” means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution;

A distribution could take the form of a distribution of profits (dividends) or capital (return of contributed tax capital). As long as the right to participate in either of these types of distribution is unrestricted the share will be an equity share. If both these rights are restricted the share will not be an equity share.

Example 12 – Connected person in relation to a company

Facts:

XYZ (Pty) Ltd holds 51% of the equity shares in ABC (Pty) Ltd and 30% of the equity shares in MNO (Pty) Ltd. ABC (Pty) Ltd holds 51% of the equity shares in MNO (Pty) Ltd. Are XYZ (Pty) Ltd, ABC (Pty) Ltd and MNO (Pty) Ltd connected persons in relation to each other?

²³ Substituted in this form by section 7(1)(i) of the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 April 2012.

Result:

XYZ (Pty) Ltd is a controlling group company as it holds more than 50% of the equity shares in ABC (Pty) Ltd. ABC (Pty) Ltd is also a controlling group company as it holds more than 50% of the equity shares in MNO (Pty) Ltd. ABC (Pty) Ltd and MNO (Pty) Ltd are controlled group companies in the same group of companies. XYZ (Pty) Ltd together with ABC (Pty) Ltd hold more than 50% of the equity shares in MNO (Pty) Ltd. XYZ (Pty) Ltd, ABC (Pty) Ltd and MNO (Pty) Ltd are therefore connected persons in relation to each other under paragraph (d)(i).

Example 13 – Connected person in relation to a company*Facts:*

XYZ (Pty) Ltd and MNO (Pty) Ltd each hold 50% of the equity shares in ABC (Pty) Ltd. XYZ (Pty) Ltd holds 100 Class A shares which carry a voting right of one vote per share. MNO (Pty) Ltd holds 100 Class B shares which carry a voting right of two votes per share. Are XYZ (Pty) Ltd and MNO (Pty) Ltd connected persons in relation to ABC (Pty) Ltd?

Result:

Under paragraph (d)(i) XYZ (Pty) Ltd and MNO (Pty) Ltd will be connected persons in relation to ABC (Pty) Ltd if they form part of the same group of companies as ABC (Pty) Ltd. For the purposes of paragraph (d)(i) this requirement would be met if they hold more than 50% of –

- the equity shares in ABC (Pty) Ltd; or
- the voting rights in ABC (Pty) Ltd.

MNO (Pty) Ltd holds only 50% of the equity shares in ABC (Pty) Ltd and thus does not meet the minimum shareholding requirement to be part of the same group of companies as ABC (Pty) Ltd. However, since it holds 66,67% of the voting rights in ABC (Pty) Ltd it is deemed to form part of the same group of companies as ABC (Pty) Ltd and is thus a connected person in relation to ABC (Pty) Ltd.

XYZ (Pty) Ltd is not a connected person in relation to ABC (Pty) Ltd because it holds only 50% of the equity shares in ABC (Pty) Ltd and 33,33% of the voting rights in ABC (Pty) Ltd. It has thus failed both the “more than 50%” equity shareholding and voting rights requirements.

XYZ (Pty) Ltd is also not a connected person in relation to ABC (Pty) Ltd under paragraph (d)(v). Although XYZ (Pty) Ltd holds at least 20% of the equity shares in ABC (Pty) Ltd, another holder of shares (MNO (Pty) Ltd) holds the majority voting rights in ABC (Pty) Ltd thus disqualifying XYZ (Pty) Ltd as a connected person under paragraph (d)(v).

Example 14 – Connected person in relation to a company*Facts:*

XYZ (Pty) Ltd holds 40% of the equity shares in MNO (Pty) Ltd and 30% of the equity shares in ABC (Pty) Ltd. MNO (Pty) Ltd holds 40% of the equity shares in ABC (Pty) Ltd. Are XYZ (Pty) Ltd, MNO (Pty) Ltd and ABC (Pty) Ltd connected persons in relation to each other?

Result:

MNO (Pty) Ltd together with XYZ (Pty) Ltd hold more than 50% (40% + 30%) of the equity shares in ABC (Pty) Ltd. However, none of the companies directly holds more than 50% of the equity shares in any of the companies. XYZ (Pty) Ltd, MNO (Pty) Ltd and ABC (Pty) Ltd accordingly do not form part of the same “group of companies” and are not connected persons in relation to one another under paragraph (d)(i).

Example 15 – Connected person in relation to a company*Facts:*

XYZ (Pty) Ltd holds 51% of the equity shares in ABC (Pty) Ltd and 10% of the equity shares in MNO (Pty) Ltd. ABC (Pty) Ltd holds 41% of the equity shares in MNO (Pty) Ltd. Are XYZ (Pty) Ltd, ABC (Pty) Ltd and MNO (Pty) Ltd connected persons in relation to each other?

Result:

XYZ (Pty) Ltd is a controlling group company of ABC (Pty) Ltd because it holds 51% of the equity shares in ABC (Pty) Ltd. XYZ's 51% holding satisfies paragraph (b) of the definition of a “group of companies”.

Under paragraph (a) of the definition of a “group of companies” –

- ABC (Pty) Ltd is a controlled group company because 51% of its shares are held by a controlling group company (XYZ); and
- MNO (Pty) Ltd is also a controlled group company because $10\% + 41\% = 51\%$ of its equity shares are held directly by a controlling group company (XYZ – 10%) and a controlled group company (ABC – 41%).

All three companies are therefore part of the same group of companies and are accordingly connected persons in relation to one another under paragraph (d)(i).

3.5.3 A person that holds at least 20% of the equity shares or voting rights in the company [paragraph (d)(iv)]

A person (other than a “company” as defined in section 1 of the Companies Act), that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20% of the equity shares or voting rights in a company, is a connected person in relation to the company.

A “person” is defined in section 2 of the Interpretation Act No. 33 of 1957 as follows:

“**[P]erson**” includes—

- (a) any divisional council, municipal council, village management board, or like authority;
- (b) any company incorporated or registered as such under any law;
- (c) any body of persons corporate or unincorporate;

The above meaning of a “person” is further modified in the definition contained in section 1(1) as follows:

“**[P]erson**” includes—

- (a) an insolvent estate;
- (b) the estate of a deceased person;
- (c) any trust; and
- (d) any portfolio of a collective investment scheme,²⁴

but does not include a foreign partnership,

A “portfolio of a collective investment scheme” is defined in section 1(1) as follows:

“**[P]ortfolio of a collective investment scheme**” means any—

- (a) portfolio of a collective investment scheme in participation bonds;
- (b) portfolio of a collective investment scheme in property;
- (c) portfolio of a collective investment scheme in securities; or
- (d) portfolio of a declared collective investment scheme,²⁵

Paragraph (d)(iv) therefore applies to a natural person, an insolvent estate, a deceased estate, a trust, a portfolio of a collective investment scheme and a “company” not falling within the definition of that term in the Companies Act.

A “company” is defined in section 1 of the Companies Act as follows:

“**[C]ompany**” means a juristic person incorporated in terms of this Act, a domesticated company, or a juristic person that, immediately before the effective date—

- (a) was registered in terms of the—
 - (i) Companies Act, 1973 (Act No. 61 of 1973), other than as an external company as defined in that Act; or
 - (ii) Close Corporations Act, 1984 (Act No. 69 of 1984), if it has subsequently been converted in terms of Schedule 2;
- (b) was in existence and recognised as an “existing company” in terms of the Companies Act, 1973 (Act No. 61 of 1973); or

²⁴ Paragraph (d) of the definition was amended to include a portfolio of a collective investment scheme in property with effect from years of assessment commencing on or after 1 April 2013.

²⁵ A “portfolio of a declared collective investment scheme” as defined in section 1(1) includes a “portfolio of a hedge fund collective investment scheme” which term is also defined in section 1(1).

(c) was deregistered in terms of the Companies Act, 1973 (Act No. 61 of 1973), and has subsequently been re-registered in terms of this Act;

Categories of companies as defined in section 1(1) which fall outside the definition of a “company” in the Companies Act and which consequently fall within paragraph (d)(iv) include –

- portfolios of a collective investment scheme in property;
- companies registered outside South Africa;
- voluntary associations that derive their corporate status under the common law from their constitutions; and
- companies incorporated under other statutes.

Examples of companies incorporated under other statutes which fall within paragraph (d)(iv) include the following:

- Close corporations established under the Close Corporations Act No. 69 of 1984. A close corporation may not be formed on or after 1 May 2011 but a pre-existing close corporation may continue and is not obliged to convert to a company under the Companies Act.
- A body corporate established under section 36 of the Sectional Titles Act No. 95 of 1986 is not a company as defined in the Companies Act.

Companies falling within the definition of a “company” in the Companies Act and which are therefore excluded from paragraph (d)(iv) include the following:

- A state-owned company, a private company, a personal liability company, a public company and a non-profit company.
- A domesticated company, which is a company whose registration has been transferred to South Africa. Under section 13(5) of the Companies Act it is treated as if it had been originally incorporated under the Companies Act.
- A close corporation which converted to a company on or after 1 May 2011.
- A share block company, which is a company as defined in the Companies Act even though it must comply with the Share Blocks Control Act No. 59 of 1980.

A South African partnership is not an entity to which the law attributes legal personality.²⁶ The Act also excludes foreign partnerships from the definition of a “person”. Partners are usually co-owners of shares held by a partnership. In such a case the look-through principle is applied and the shareholding of the individuals is assessed in order to determine their individual shareholding. Under paragraph (c)(i) partners are connected persons in relation to each other and as a result the other partners’ shareholdings will need to be taken into account when determining the shareholding a partner jointly holds with a connected person.

Having regard to the purpose of paragraph (d)(iv), the word “jointly” is used in paragraph (d)(iv) in the sense of “together” or “in combination” and not in the restricted sense of an undivided share held in co-ownership. In other words the individual holdings of all connected persons must be aggregated to determine

²⁶ *Michalow, NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W) at 61.

whether a particular connected person meets the 20% threshold in relation to the company being examined.

The words “directly or indirectly” mean that indirect holdings must be taken into account in determining whether the 20% threshold has been attained. An indirect holding is determined by ascertaining the effective interest, namely, by multiplying the respective percentage holdings in the chain together. For example, if Individual X owns 20% of Company A and Company A owns 20% of Company B then Individual X has an indirect interest of $20\% \times 20\% = 4\%$ in Company B.

Example 16 – Connected person in relation to a company

Facts:

ABC CC and A, who is the member of ABC CC, each hold 10% of the equity shares in XYZ (Pty) Ltd. Are ABC CC and A connected persons in relation to XYZ (Pty) Ltd?

Result:

ABC CC and A are connected persons in relation to each other under paragraph (d)(vi)(aa) and paragraph (e) (see 3.5.6 and 3.6). ABC CC and A are connected persons in relation to XYZ (Pty) Ltd under paragraph (d)(iv)(aa) as they jointly hold 20% of the equity shares in XYZ (Pty) Ltd.

Example 17 – Connected person in relation to a company

Facts:

ABC Family Trust and A, who is the beneficiary of ABC Family Trust, each hold 10% of the equity shares in XYZ (Pty) Ltd. Are ABC Family Trust and A connected persons in relation to XYZ (Pty) Ltd?

Result:

ABC Family Trust and A are connected persons in relation to each other under paragraph (a)(ii) and paragraph (b)(i) (see 3.1.3 and 3.2.2) and they jointly hold 20% of the equity shares in XYZ (Pty) Ltd. ABC Family Trust and A are therefore connected persons in relation to XYZ (Pty) Ltd under paragraph (d)(iv)(aa).

Example 18 – Connected person in relation to a company

Facts:

D and E are members of DE Partnership. Under the partnership agreement D is entitled to 1% and E to 99% of the profits of the partnership. DE Partnership holds 100% of the equity shares in DEF (Pty) Ltd. Are D and E connected persons in relation to DEF (Pty) Ltd?

Result:

D and E are the members of DE Partnership and are therefore connected persons in relation to each other under paragraph (c)(i) (see 3.4.2). D and E jointly hold 100% of the equity shares in DEF (Pty) Ltd and are therefore connected persons in relation to DEF (Pty) Ltd under paragraph (d)(iv)(aa).

Example 19 – Connected person in relation to a company*Facts:*

X, an individual, holds 100% of the member's interest in XYZ CC and XYZ CC holds 20% of the equity shares in DEF (Pty) Ltd. Are X and XYZ CC connected persons in relation to DEF (Pty) Ltd?

Result:

X indirectly holds 20% (100% × 20%) of the equity shares in DEF (Pty) Ltd and is therefore a connected person in relation to DEF (Pty) Ltd under paragraph (d)(iv). XYZ CC directly holds 20% of the equity shares in DEF (Pty) Ltd and is also a connected person in relation to DEF (Pty) Ltd under paragraph (d)(iv).

Example 20 – Connected person in relation to a company*Facts:*

D, an individual, holds 20% of the equity shares in ABC (Pty) Ltd and ABC (Pty) Ltd holds 20% of the equity shares in DEF (Pty) Ltd. Both ABC (Pty) Ltd and DEF (Pty) Ltd are incorporated under the Companies Act. Are D and ABC (Pty) Ltd connected persons in relation to DEF (Pty) Ltd?

Result:

D indirectly holds 4% (20% × 20%) of the equity shares in DEF (Pty) Ltd and is not a connected person in relation to DEF (Pty) Ltd since D does not hold, directly or indirectly, at least 20% of the equity shares in DEF (Pty) Ltd. ABC (Pty) Ltd is not a connected person in relation to DEF (Pty) Ltd under paragraph (d)(iv) since a company incorporated under the Companies Act is specifically excluded from paragraph (d)(iv). However, ABC (Pty) Ltd may be a connected person in relation to DEF (Pty) Ltd under paragraph (d)(v) (see 3.5.4).

3.5.4 Any other company that holds at least 20% of the equity shares or voting rights in the company and no holder of shares holds the majority voting rights [paragraph (d)(v)]

A company that holds at least 20% of the equity shares or voting rights in another company is a connected person in relation to the other company if no holder of shares holds the majority (more than half) voting rights in that other company.

In determining the “at least 20%” requirement, only direct holdings of shares are considered since the words “directly or indirectly” are not used.

Paragraph (d)(v) has been amended by the substitution of the word “shareholder” with the words “holder of shares” to denote beneficial ownership of the shares. This amendment makes it clear that a person who is, for example, a registered shareholder and acts in a nominee capacity would not be a holder of shares for the purposes of paragraph (d)(v).²⁷

²⁷ See, for example, cases dealing with beneficial entitlement such as *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419; *SIR v Smant* 1973 (1) SA 754 (A), 35 SATC 1 and *Taxpayer v COT Botswana* (1980) 43 SATC 118.

Paragraph (d)(v) will not apply to a company holding at least 20% of the equity shares of or voting rights in another company if a holder of shares beneficially owns the majority voting rights in that other company.

Example 21 – Connected person in relation to a company

Facts:

ABC (Pty) Ltd and MNO (Pty) Ltd each hold 50% of the equity shares and voting rights in XYZ (Pty) Ltd. Are ABC (Pty) Ltd and MNO (Pty) Ltd connected persons in relation to XYZ (Pty) Ltd?

Result:

Both ABC (Pty) Ltd and MNO (Pty) Ltd are connected persons in relation to XYZ (Pty) Ltd under paragraph (d)(v) because each company holds at least 20% of the equity shares in the company and neither company holds the majority voting rights.

Example 22 – Connected person in relation to a company

Facts:

XYZ (Pty) Ltd holds 51% and MNO (Pty) Ltd holds 49% of the equity shares in ABC (Pty) Ltd. Are XYZ (Pty) Ltd and MNO (Pty) Ltd connected persons in relation to ABC (Pty) Ltd?

Result:

XYZ (Pty) Ltd is a connected person in relation to ABC (Pty) Ltd as it holds more than 50% of the equity shares in ABC (Pty) Ltd and is therefore treated as being part of the same group of companies under paragraph (d)(i). As XYZ (Pty) Ltd holds the majority voting rights in ABC (Pty) Ltd, MNO (Pty) Ltd is not a connected person in relation to ABC (Pty) Ltd under paragraph (d)(v) even though it holds at least 20% of the equity shares in ABC (Pty) Ltd.

Example 23 – Connected person in relation to a company

Facts:

DEF (Pty) Ltd and GHI (Pty) Ltd each hold 50% of the equity shares and voting rights in XYZ (Pty) Ltd. ABC (Pty) Ltd holds 100% of the equity shares in DEF (Pty) Ltd. Are ABC (Pty) Ltd, DEF (Pty) Ltd and GHI (Pty) Ltd connected persons in relation to XYZ (Pty) Ltd?

Result:

Both DEF (Pty) Ltd and GHI (Pty) Ltd are connected persons in relation to XYZ (Pty) Ltd under paragraph (d)(v) because each company holds at least 20% of the equity shares in the company and neither company holds the majority voting rights. ABC (Pty) Ltd is not a connected person in relation to XYZ (Pty) Ltd since it does not directly hold at least 20% of the shares or voting rights in XYZ (Pty) Ltd. In the latter regard the word "held" as used in paragraph (d)(v) refers to a direct holding of shares or voting rights and does not include indirect holdings.

3.5.5 Any other company which is managed or controlled by a connected person [paragraph (d)(vA)]

Assuming that there are two companies, A and B, this provision makes company B a connected person in relation to company A when company B is managed or controlled by –

- a person who is a connected person in relation to company A [paragraph (d)(vA)(aa)]; or
- a person who is a connected person in relation to a person who is a connected person in relation to company A [paragraph (d)(vA)(bb)].

The second bullet point above can be put more simply as follows:

- X is a connected person in relation to Company A
- Y manages or controls Company B
- Y is a connected person in relation to X
- Company B is therefore a connected person in relation to Company A

The expression “managed or controlled” is integral to applying paragraph (vA). The use of the co-ordinating conjunction “or” between “managed” and “controlled” means that either term can apply. The expression is thus wider than “managed and controlled”.

Managed

The word “management” has been defined in the business dictionary as –²⁸

“the organization and coordination of the activities of a business in order to achieve defined objectives”.

The words “management” and, in context, “manage” are very broad and it is not possible to list activities which do (and in contrast, do not) constitute management. Instead when assessing whether or not a particular person is managing a company it is necessary to consider all the facts of the particular case taking into account the activities for which the person is responsible, the person’s level of seniority and the scope of the person’s responsibilities. For example, an employee who is responsible only for managing a company’s mailroom would not be considered to be managing the company but in contrast the managing director of the company who has overall responsibility for running all of the company’s business activities would be considered to be managing the company.

Controlled

Control refers to *de facto*²⁹ control and not shareholder control. *De facto* control is generally but not necessarily held and exercised by the board of directors. However, the facts and circumstances of each case are critical in determining who is controlling a company because the presence and influence of controlling individuals can have a significant impact.

²⁸ www.businessdictionary.com/definition/management.html [Accessed 14 February 2014].

²⁹ In fact, whether by right or not.

In ITC 1741³⁰ the court considered the meaning of “control”. In that case the appellant purchased certain machinery and plant from another company [J Shopfitters (Pty) Ltd] and claimed a deduction under section 12C(1) on the cost of acquisition of the machinery and plant. The Commissioner reduced the allowances under section 12C(4) and (6)³¹ to an amount based on the cost of the machinery and plant to the seller, contending that the buyer and the seller were connected persons in relation to each other. Under the then section 12C(6)(a)(i) a connected person in relation to a company included –

“any other company if both such companies are controlled or owned directly or indirectly by the same persons”.

Based on the facts of the case, the appellant company and J Shopfitters (Pty) Ltd were not commonly owned and the sole issue for decision was whether there was the requisite control by substantially the same persons.

Factually each company had its own board of directors. However, there was a substantial difference in terms of who made the decisions and practically ran the respective companies. The evidence showed that, in the appellant company’s case, control was exercised by the board of directors (excluding Mr C who although a director did not have any “real” say or power in relation to the appellant company). By contrast, in the case of J Shopfitters (Pty) Ltd the evidence clearly showed that even though the board of directors had the legal ability to control the company it was not practically in control of the company. Mr C was a domineering presence who effectively made all the decisions and informed everyone afterwards. He controlled the company and the input from fellow directors, if any, was limited to that of a consulting nature.

The court held that “controlled” in the absence of a statutory definition or any other contrary indicators meant *de facto* control. It did not mean the potential for the exercise of legal control by the board of directors or by the shareholders at a general meeting. Thus, if the directors of a company give a particular director *carte blanche* to run a company, the company will be *de facto* controlled by that individual. In the appellant company’s case control was exercised by the board of directors but in J Shopfitter’s case *de facto control* was exercised by Mr. C. Accordingly, the two companies were held not to be connected persons in relation to each other.

The case also highlighted that *de facto* control is not fixed and may change from time to time. It is therefore important to evaluate *de facto* control at the time required by the relevant provision of the Act.

The court further noted that interpreting control to be *de facto* control was consistent with the purpose of section 12C(4) and (6), namely, to prevent persons from manipulating assets under their control in order to increase tax allowances while in effect the assets remained under their control.³²

The purpose was still met when people who did not practically exercise control, although legally able to do so, were excluded from consideration because by virtue of their lack of involvement they could not be seeking to manipulate assets in order to

³⁰ (2002) 65 SATC 106 (EC).

³¹ As the sections read in 1992.

³² In the absence of section 12C(4) and (6) this would have been achieved by selling the asset to a connected person at a price which was above the seller’s cost, thus entitling the purchaser to an allowance calculated on an enhanced cost price.

increase tax allowances. The same principle applies to the definition of a “connected person” in section 1(1) which replaced the definition in section 12C(6).

Example 24 – Connected person in relation to a company

Facts:

K, an individual, holds 100% of the equity shares in XYZ (Pty) Ltd and manages MNO (Pty) Ltd. Is MNO (Pty) Ltd a connected person in relation to XYZ (Pty) Ltd?

Result:

MNO (Pty) Ltd is managed by K, who is a connected person in relation to XYZ (Pty) Ltd under paragraph (d)(iv)(aa) (see 3.5.3). MNO (Pty) Ltd is therefore a connected person in relation to XYZ (Pty) Ltd under paragraph (d)(vA)(aa).

Example 25 – Connected person in relation to a company

Facts:

XYZ (Pty) Ltd and MNO (Pty) Ltd both have five directors on their respective boards of directors. K is the only director who is common to both boards. K has a very dominant personality and practically “runs the show” at both companies. K owns 5% of the shares in XYZ (Pty) Ltd and 15% of the shares in MNO (Pty) Ltd. Is MNO (Pty) Ltd a connected person in relation to XYZ (Pty) Ltd?

Result:

K is not a connected person in relation to either XYZ (Pty) Ltd or MNO (Pty) Ltd. Thus, in spite of XYZ (Pty) Ltd and MNO (Pty) Ltd being controlled by the same person, they are not connected persons under paragraph (d)(vA)(aa).

Example 26 – Connected person in relation to a company

Facts:

XYZ (Pty) Ltd is controlled by X who holds all its shares. ABC (Pty) Ltd is controlled by B who holds all its shares. B is X’s spouse. Are XYZ (Pty) Ltd and ABC (Pty) Ltd connected persons in relation to each other?

Result:

X and B are connected persons in relation to each other under paragraph (a)(i) (see 3.1.2). X and B are respectively connected persons in relation to XYZ (Pty) Ltd and ABC (Pty) Ltd under paragraph (d)(iv)(aa) (see 3.5.3). XYZ (Pty) Ltd and ABC (Pty) Ltd are connected persons in relation to each other under paragraph (d)(vA)(bb) since they are controlled by X and B respectively, who are connected persons in relation to each other.

3.5.6 Connected person in relation to a company that is a close corporation [paragraph (d)(vi)]

The following persons are connected persons in relation to a close corporation:

- A member of the close corporation [(d)(vi)(aa)]
- A relative of a member of the close corporation [(d)(vi)(bb)]

- A trust (other than a portfolio of a collective investment scheme in securities or a portfolio of a collective investment scheme in property) which is a connected person in relation to a member of the close corporation [(d)(vi)(bb)]
- A close corporation or company which is a connected person in relation to – [(d)(vi)(cc)]
 - a member of the close corporation, [(d)(vi)(cc)(i)] or
 - any relative of a member of the close corporation, [(d)(vi)(cc)(ii)] or
 - any trust which is a connected person in relation to a member of the close corporation [(d)(vi)(cc)(ii)].

Example 27 – Connected person in relation to a close corporation

Facts:

X holds a 100% member's interest in XYZ CC. B, who is X's spouse, is a beneficiary of AB Trust. Is AB Trust a connected person in relation to XYZ CC?

Result:

AB Trust is a connected person in relation to X under paragraph (a)(ii) (see 3.1.3) and therefore a connected person in relation to XYZ CC under paragraph (d)(vi)(bb).

Example 28 – Connected person in relation to a close corporation

Facts:

X holds a 100% member's interest in ABC CC and a 20% members' interest in DEF CC. Is DEF CC a connected person in relation to ABC CC?

Result:

X is a connected person in relation to ABC CC and DEF CC under paragraph (d)(vi)(aa). ABC CC and DEF CC are connected persons in relation to X under paragraph (e). DEF CC is therefore a connected person in relation to ABC CC under paragraph (d)(vi)(cc)(i).

Example 29 – Connected person in relation to a close corporation

Facts:

X holds a 100% member's interest in ABC CC. B, who is X's daughter, holds all the shares in DEF (Pty) Ltd. Is DEF (Pty) Ltd a connected person in relation to ABC CC?

Result:

X is connected to ABC CC under paragraph (d)(vi)(aa). B is related to X in the first degree of consanguinity, that is, B is X's relative and is a connected person in relation to X under paragraph (a)(i) (see 3.1.2). DEF (Pty) Ltd is a connected person in relation to B under paragraph (d)(iv)(aa) (she holds 100% of the shares in DEF (Pty) Ltd) and paragraph (e) establishes the reverse relationship between her and DEF (Pty) Ltd). ABC CC is therefore a connected person in relation to DEF (Pty) Ltd under paragraph (d)(vi)(cc)(ii) and DEF (Pty) Ltd is a connected person in relation to ABC CC under paragraph (e) (see 3.6).

3.6 The reverse “connected person” relationship

3.6.1 Paragraph (e)

Connected person means –

- (e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person:

3.6.2 The other person [paragraph (e)]

A person is a connected person in relation to another person, if the other person is considered to be a connected person in relation to the first-mentioned person. Therefore, if a person is identified as a connected person in relation to a person under paragraphs (a) to (d), the other person is a connected person in relation to the person so identified.

Example 30 – Reverse “connected person” relationship

Facts:

B holds 100% of the equity shares in ABC (Pty) Ltd. Is ABC (Pty) Ltd a connected person in relation to B?

Result:

B is a connected person in relation to ABC (Pty) Ltd under paragraph (d)(iv) because B holds at least 20% of the equity shares in ABC (Pty) Ltd. Under paragraph (e) ABC (Pty) Ltd is therefore a connected person in relation to B.

3.7 A portfolio of a collective investment scheme in securities

3.7.1 Proviso to the definition of a “connected person”

The proviso to the definition of a “connected person” reads as follows:

Provided that for the purposes of this definition, a company includes a portfolio of a collective investment scheme in securities;

A “portfolio of a collective investment scheme in securities” is defined in section 1(1) as follows:

“[P]ortfolio of a collective investment scheme in securities” means any portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act managed or carried on by any company registered as a manager under section 42 of that Act for the purposes of that Part;

3.7.2 A portfolio of a collective investment scheme in securities [proviso to the definition of a “connected person”]

A portfolio of a local collective investment scheme in securities normally operates in the form of a vesting trust, and retains its status as a trust for income tax purposes. However, for the purposes of the definition of a “connected person”, a portfolio of a

collective investment scheme in securities is treated as a company.³³ Accordingly, in determining whether a particular person is a connected person in relation to such a portfolio the provisions of paragraph (d) discussed in 3.5 must be considered. This rule also ensures that the beneficiaries of a collective investment scheme in securities are not made connected persons in relation to each other, which would otherwise have been the case under paragraph (bA).

Example 31 – Portfolio of a collective investment scheme in securities

Facts:

A portfolio of a collective investment scheme in securities holds 20% of the equity shares in XYZ (Pty) Ltd. No other holder of shares owns more than 50% of the voting rights in the company.

Result:

The portfolio is a connected person in relation to XYZ (Pty) Ltd under paragraph (d)(v) because –

- the portfolio is deemed to be a company for the purposes of the definition of a “connected person”;
- it holds at least 20% of the equity shares in XYZ (Pty) Ltd; and
- no other holder of shares holds the majority voting rights in the company.

3.8 A portfolio of a collective investment scheme in property

A “portfolio of a collective investment scheme in property” is defined in section 1(1) as follows:

“[P]ortfolio of a collective investment scheme in property” means any portfolio comprised in any collective investment scheme in property contemplated in Part V of the Collective Investment Schemes Control Act managed or carried on by any company registered as a manager under section 51 of that Act for the purposes of that Part;

A portfolio of a collective investment scheme in property normally operates in the form of a vesting trust, but is included in the definition of a “company” as defined in section 1(1).³⁴ Accordingly, in determining whether a particular person is a connected person in relation to such a portfolio paragraph (d) discussed in 3.5 must be considered. This rule also ensures that the beneficiaries of a collective investment scheme in property are not made connected persons in relation to each other, which would otherwise have been the case under paragraph (bA).

³³ Proviso added with effect from the commencement of years of assessment commencing on or after 1 January 2010.

³⁴ A portfolio of a collective investment scheme in property is included in paragraph (e)(iii) of the definition of a “company” with effect from years of assessment commencing on or after 1 April 2013. Paragraph (e)(iii) was amended by section 4(1)(f) of the Taxation Laws Amendment Act No. 31 of 2013 with effect from years of assessment commencing on or after 1 January 2015 to restrict its ambit to a portfolio of a collective investment scheme in property that qualifies as a REIT.

Example 32 – Portfolio of a collective investment scheme in property*Facts:*

A portfolio of a collective investment scheme in property holds 30% of the equity shares in ABC (Pty) Ltd. No other holder of shares holds more than 50% of the voting rights in the company.

Result:

The portfolio is a connected person in relation to ABC (Pty) Ltd under paragraph (d)(v) because –

- the portfolio is a company as defined in section 1(1);
- it holds at least 20% of the equity shares in ABC (Pty) Ltd; and
- no other holder of shares holds the majority voting rights in the company.

3.9 Timing of the “connected person” test

The majority of the provisions in the Act which use the term “connected person” indicate that the criteria to determine whether persons are connected should be considered as at the time of a transaction, (that is, effectively before the transaction is concluded), for example, when the acquisition or disposal of an asset takes place or when certain expenditure is incurred. Some provisions, however, indicate that the relationship between persons should be determined at specified times.

For example, under section 24N special timing rules apply³⁵ when a person disposes of equity shares to another person during the year of assessment and a quantified or quantifiable amount which is payable by the purchaser to the seller is not due and payable in that year. The amount in question will be regarded as not having accrued to the seller and not to have been incurred by the purchaser during that year to the extent that it is not due and payable during that year. One of the requirements is that the purchaser and seller are not connected persons in relation to each other at any time after the disposal of the shares.

Paragraph 39(1) of the Eighth Schedule provides, amongst other things, that a person must, when determining the aggregate capital gain or aggregate capital loss of that person, disregard any capital loss determined in respect of the disposal of an asset to any person who was a connected person in relation to that person immediately before the disposal.

Section 23I is an anti-avoidance provision that stipulates, amongst other things, that no deduction will be allowed under certain circumstances for the amount of any expenditure incurred for the use or the right to use or permission to use any “tainted intellectual property”. The term “tainted intellectual property” is defined in section 23I(1) and in subparagraph (a) of the definition reference is made to intellectual property which was the property of the end-user or of a taxable person that is or was a “connected person” as defined in section 31(1A) in relation to the end-user. The relevant time for determining the “connected person” relationship is therefore when the expenditure is incurred.

³⁵ Provided detailed criteria, as specified in the section, are met.

These examples are not exhaustive and are merely presented for illustrative purposes. The timing of the “connected person” relationship will depend on the wording of the particular provision of the Act.

3.10 Expanded or restricted definition of a “connected person”

The table below sets out the provisions of the Act which expand or restrict the definition of a “connected person” in section 1(1).

Table 1 – Expanded or restricted definition of a “connected person”

| Section of the Act or paragraph of the Eighth Schedule | Expanded or restricted definition of a “connected person” |
|---|---|
| Section 9C(1) | As defined in section 1(1), provided that the expression “and no holder of shares holds the majority voting rights in the company” in paragraph (d)(v) of that definition must be disregarded. |
| Section 23I(1) definition “tainted intellectual property” | “Connected person” as defined in section 31(4). |
| Section 29A(10) | The individual policyholder fund, company policyholder fund, untaxed policyholder fund and corporate fund, shall be deemed to be separate companies which are connected persons in relation to each other for the purposes of section 29A(6), (7) and (8) and sections 9B, 20, 24I, 24J, 24K, 24L, 26A and 29B and the Eighth Schedule. |
| Section 31(4) | As defined in section 1(1), provided that the expression “and no holder of shares holds the majority voting rights in the company” in paragraph (d)(v) of that definition must be disregarded. |
| Paragraph 39(3) of the Eighth Schedule | <p>A connected person in relation to a natural person does not include a relative of that person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person.</p> <p>A connected person in relation to a fund of an insurer contemplated in section 29A does not include another such fund of that insurer in respect of the disposal of an asset by such fund to another such fund.</p> |
| Paragraph 42(3) of the Eighth Schedule | <p>A connected person in relation to a natural person does not include a relative of that person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person.</p> <p>A connected person in relation to a fund of an insurer contemplated in section 29A does not include another such</p> |

| | |
|--|--|
| | fund of that insurer in respect of the disposal of an asset by such fund to another such fund. |
|--|--|

3.11 Application of the definition of a “connected person”

The application of the definition of a “connected person” can be illustrated by the following examples:

Example 33 – Application of the definition of a “connected person”

Facts:

C, an individual, sold a fixed property that was acquired for R500 000 to XYZ (Pty) Ltd for R600 000. The market value of the property at the date of disposal was R2 million. C holds 20% of the equity shares in XYZ (Pty) Ltd. For the purposes of this example ignore any donations tax that may become payable.

Result:

C and XYZ (Pty) Ltd are connected persons in relation to each other under paragraph (d)(iv) and paragraph (e). Paragraph 38(1)(a) of the Eighth Schedule determines that if a person disposes of an asset to a connected person for a consideration that does not reflect an arm’s-length price, the person who disposed of the asset is treated as having disposed of it for an amount equal to its market value on the date of the disposal. The person who acquires the asset is treated as having acquired it at a cost equal to the same market value under paragraph 38(1)(b).

C is therefore deemed to have disposed of the property at market value of R2 million and must declare a taxable capital gain of R499 500 $[(R2\ 000\ 000 - R500\ 000) \times 33,3\%³⁶]$ instead of a taxable capital gain of R33 300 $[(R600\ 000 - R500\ 000) \times 33,3\%]$ which would have been the case if the parties had not been connected persons.

XYZ (Pty) Ltd is deemed to have acquired the property at a cost of R2 million.

Example 34 – Application of the definition of a “connected person”

Facts:

B and C are connected persons in relation to each other.

At the beginning of year 1, B acquired office equipment at a cost of R1 million. For years 1 and 2 B claimed a wear-and-tear or depreciation allowance under section 11(e) at the rate of 20% a year (R200 000) on the straight-line basis.³⁷

At the beginning of year 3 B sold the office equipment to C at its written-down tax value of R600 000 (R1 000 000 – R400 000). The market value of the office equipment at the time of disposal was R800 000.

Calculate the amount to be recouped by B on disposal of the equipment under section 8(4)(a).

³⁶ Capital gains inclusion rate for C.

³⁷ See Binding General Ruling (Income Tax): NO. 7 “Wear-and-tear or depreciation allowance” dated 2 November 2012.

Result:

Section 8(4)(k) applies because the office equipment was disposed of to a connected person for an amount which was less than its market value. Under that provision B is deemed for purposes of section 8(4)(a) to have disposed of the equipment for an amount equal to its market value of R800 000 at the time of disposal. The amount to be recouped by B under section 8(4)(a) is thus determined as follows:

| | R |
|--|------------------|
| Original cost of office equipment | 1 000 000 |
| Less: Wear-and-tear allowance (R200 000 × 2) [section 11(e)] | <u>(400 000)</u> |
| Tax value | 600 000 |
| Deemed consideration received by B | <u>(800 000)</u> |
| Amount recouped and included in B's income under section 8(4)(a) | <u>(200 000)</u> |

Capital gains tax

| | R | R |
|--|------------------|------------------|
| Amount deemed to be received or accrued (paragraph 38 of Eighth Schedule) | | 800 000 |
| Less: Amount included in income under section 8(4)(a) (paragraph 35(3)(a) of Eighth Schedule) | | <u>(200 000)</u> |
| Proceeds (paragraph 35 of Eighth Schedule) | | 600 000 |
| Less: Base cost | | <u>(600 000)</u> |
| Original cost | 1 000 000 | |
| (paragraph 20(1)(a) of Eighth Schedule) | | |
| Less: Allowances claimed | <u>(400 000)</u> | |
| (paragraph 20(3)(a) of Eighth Schedule) | | |
| Capital gain or loss | | <u>Nil</u> |

Under paragraph 38 of the Eighth Schedule, C is treated as having acquired the office equipment at a cost of R800 000.

Example 35 – Application of the definition of a “connected person”*Facts:*

The facts are the same as in Example 34, except that the equipment was disposed of 1 year after acquisition and its market value on date of disposal was R600 000. Calculate the amount of the loss incurred by B on disposal of the equipment.

Result:

The tax value of the equipment on date of disposal was R800 000 (R1 000 000 – R200 000). B therefore incurred a loss on disposal of R200 000 (R600 000 – R800 000). B is prohibited from claiming the loss under section 11(o) since the equipment was disposed of to a connected person [further proviso to section 11(o)]. The loss is also disregarded as a capital loss under paragraph 39(1) of the Eighth Schedule but may under paragraph 39(2) be deducted from future capital gains determined in respect of disposals of assets to C.

Under paragraph 38 of the Eighth Schedule, C is treated as having acquired the office equipment at a cost of R800 000.

4. Conclusion

The definition of a “connected person” in section 1(1) identifies those persons that are connected persons in relation to –

- an individual,
- a trust,
- a connected person in relation to a trust,
- a member of a partnership or foreign partnership,
- a company, and
- a close corporation.

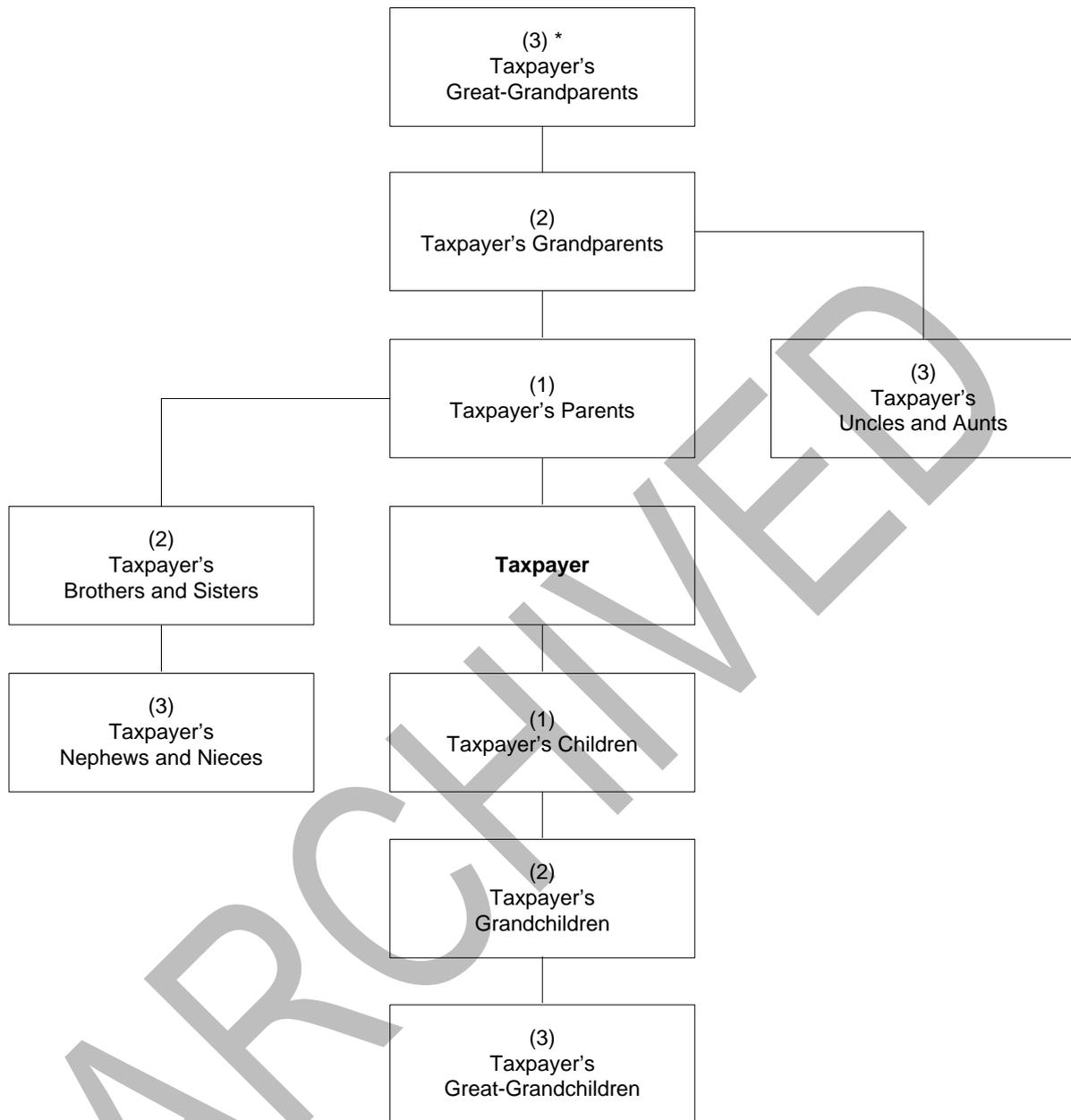
The definition also establishes the reverse relationship between the persons that are connected persons in relation to the above persons.³⁸

The wording of a particular provision of the Act will determine the time at which the existence of any “connected person” relationship must be determined. It will also determine whether an expanded or restricted meaning of the term as defined in section 1(1) must be applied.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE
Date of first issue: 1 November 2012

³⁸ That is, if A is connected to B then B is connected to A.

Annexure – Diagram illustrating the rule for determining persons who are related within the third degree of consanguinity



* Figures in brackets indicate the degree of consanguinity