Personal Perspectives

KPMG Private Client Magazine

2016

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1 Introduction

Welcome to Personal Perspectives, the first edition of our Private Client tax publication, We launch at a time when tax is on the Government's agenda and once again in the news. There is a significant momentum behind greater global transparency, and increased focus on the obligations of both corporates and individuals to pay their fair share of tax and contribute to the costs of running public services.

With the start of the Special Voluntary Disclosure Program a little over two months away (October 1st) the window for regularisation of tax and exchange control rules on overseas assets is closing at the same time as a new era on exchange of information and country by country reporting is about to kick off. It is clear that the net is tightening on South African's who illicitly moved funds out of the country and failed to declare them for tax and exchange controls.

Finance Minister Pravin Gordhan believes that Africa's loses $50bn per annum from illicit financial flows, tax evasion and transfer pricing and are the major sources of Africa's and South Africa's tax gap.

We also report a renewed focus by SARS on the use of Trust structures which they believe are widely abused to avoid tax. New legislation will impose deemed interest from 1 March 2017, where assets have been loaned interest free or at a low rate of interest. The deemed interest will be the difference between the official interest rate and any interest actually charged. The trust does not get a deduction for this interest but the person who loaned the assets will be taxed on the deemed interest. Furthermore individuals will no longer be able to use the R100,000 per annum Donations Tax Exemption to donate part of the loan to the trust.

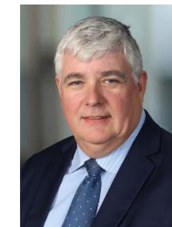
All of this highlights the need to ensure that an individual's tax affairs are correct and could withstand scrutiny if SARS were to investigate.

Another issue that merits careful attention is around "Employee owned" shares that lock in employees (including senior management) for specific time periods, and will typically defer the liability for employees' tax to the time when these restrictions are lifted.

Dividends earned by employees on these shares will usually be subject to vanilla tax consequences namely, exemption from income tax and Dividend Withholding Tax at 15 % for individuals. If the assumption is that dividends are paid from employers' after tax profits, the current rules essentially result in an effective tax rate of 38,8 % on the said dividend.

Proposed changes to the draft 2016 Taxation Laws Amendment Bill seek to include dividends in respect of so-called "Restriction Equity Instruments" within the definition of "remuneration" for employees' tax purposes. At the marginal rate of 41% the effective tax rate for employees holding these shares and generating dividend income will increase to 57.5 %.
Without any tax relief for the employer company, employee share participation with lock in features may become too costly.

We hope you enjoy this edition of Personal Perspectives. As always, if you have any comments, feedback or suggestions of what you would like us to cover in future issues, please do get in touch.



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2 Content

2.1 Tax issues in Franchising can seriously impact cash flows

2.2 Challenges for international expansion

2.3 Overseas assets soon to be visible on SARS's radar

2.4 Divorce: There are tax consequences

2.5 Who do you trust?

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2.1 To be or not to be...a franchisor or a franchisee?

The concept of franchising is not new to South Africa, but it is growing. The tax issues for both franchisors and franchisees are complex and both parties need to understand the tax impact on the other as it can dramatically impact cash flows, especially in the early years.

Franchising is a relatively straightforward concept – someone comes up with a business idea and wants to expand rapidly, but may not have access to the capital required to do so. In order to overcome that hurdle they will develop the concept, design the business model and protect their intellectual property so that they can then licence it to others. The franchisee can then acquire a proven business model, with detailed instructions on its operation and a developed brand with market recognition. The franchisor will commit to supporting the franchisees and the development of the brand.

Types of "income/ expenses"

There are a number of different types of income/ expenses associated with franchising, and the method of payment can vary between upfront payments; annual payments; or a combination of both; and payments arising from day to day operations. The tax treatment of these payments may at first appear to be straightforward but they need to be looked at closely to ensure all parties understand the tax consequences of the different amounts.

- Licence Fees – these can be either upfront initial fees or annual fees.
- Initial Fees
- Royalties
- Cancellation fees
- Marketing & advertising fees
- Renewal fees
- Training fees
- Consent fees
- Restraint of trade payments
- Merchandise & stock in trade costs

Different tax treatments

There are a number of separate types of income typically associated with franchising, some of which are capital in nature and others which are revenue. An individual who is resident in South Africa is liable to income tax on their gross income, less allowable expenses & deductions, but excluding receipts of a capital nature. For a non-resident gross income is defined as amounts received from a South African source, excluding anything of a capital nature.

There is a significant body of case law around when something is capital or revenue, and the determining factors can be more complex than one might have imagined.

Income for the franchisor is generally an expense for the franchisee but the tax treatment for the one is not always mirrored for the other and it is important to understand the different tax impact as it can affect the cash flows of the parties, especially in the early years when cash flows can be critical to the success of the venture.

By way of example, the initial fees payable by a franchisee for the business model and branding of the franchisor will normally be included in the gross income of the franchisor. However, the payment may not give rise to a deductible expense for the franchisee in the same year as the franchisee is generally seen as having incurred a capital expense. . However in certain circumstances the franchisee may be entitled to a specific allowance under Section 11 of the Income Tax Act. These allowances generally spread the tax deduction over the life of the asset (in this case the term of the franchise agreement) or a prescribed period as set out in the Act.

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So the franchisor may have an upfront tax liability in the year they grant the franchise , but the franchisor may only get a deduction over 25 or 30 years, and give rise to an asymmetrical tax position for franchisors and franchisees in any given tax year.

Capital Gains Tax

CGT is part of the income tax system and taxes the disposal of assets where a gain arises from the proceeds of sale. South African residents are liable to CGT on the disposal of assets world-wide, whereas non-residents are only liable on the disposal of immoveable property situated in South Africa and on any asset that is attributable to a permanent establishment of the non-resident in South Africa. The definition of immoveable property includes shares in an entity (including trusts) that derives 80% or more of their market value from immoveable property and where the individual or connected persons directly or indirectly holds 20% of the equity shares. For non-residents it is important to note that the terms of any Double Tax Treaty between South Africa and their country of residence may over ride these provisions.

Value Added Tax

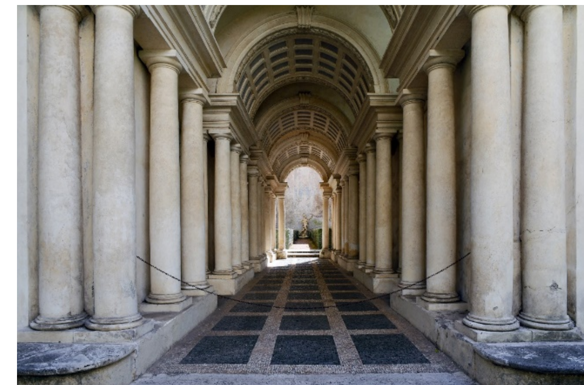
VAT is generally payable on all types of payments, regardless of whether or not they are revenue or capital in nature. One exception is where a business is sold as a going concern, which may be zero rated for VAT, subject to certain conditions.

VAT charged by the franchisor on upfront licence fees and initial payments can significantly impact the cash flows for the franchisee as it has to be funded until a refund is obtained from SARS. The franchisee has first to get registered for VAT and then lodge a refund claim – the whole process can take several months to complete.

Conclusion

Given that both the franchisor and franchisee want the business to succeed and be profitable for both parties over the long term, it is important that both understand the tax position and cash flow consequences of the other, and work together to ensure the business is not crippled by tax costs before it gets the chance to be profitable.

Given the complexity, we recommend that tax advice is taken at the earliest opportunity to ensure that everyone is clear on what taxes will be payable, by whom and when.



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2.2 Challenges for international expansion

In mid-January this year the South Africa rand hit a low of R16.88 to the dollar. Against this low mark we have seen the rand weakening steadily since trading at R6.63 to the dollar back in January 2011.
The further the currency depreciated, more-and-more investors rushed to get money offshore.

But what are some of the tax and regulatory consequences that should be considered by individuals upon investing offshore.

Nature of investment vehicle

Important for any individual investing offshore is to understand the nature of the vehicle being used or instrument that's being invested in. From a South Africa tax perspective, these vehicles could either be considered foreign companies, foreign partnerships, foreign trusts or foreign collective investment schemes that are similar to South African collective investment schemes in participation bonds and securities.
In turn, the nature of the vehicle will depict the form of instrument through which the investor will receive its returns. These instruments could take many forms, but ultimately, the return on investment is likely to be in the form of foreign dividends, rental, interest or capital gains.

In the context of rental and interest income, these amounts will be taxed in the hands of the South African investor, at his marginal tax rate, after the deduction of allowable expenditure. Similarly, with capital gains, the individual can deduct from any capital gain, the base cost incurred in "creating" that investment after which the capital gain will be taxed at an effective rate of 16.4%.

More often than not an individual investor will not qualify for the participation exemption applicable on the taxation of foreign dividends on the basis that the investment is unlikely to reach the required 10% equity holding in the investment vehicle. In such an instance, the foreign dividend received by or that accrues to the individual investor will be taxed at an effective rate of 15%, unless the investment vehicle is inwardly listed on the Johannesburg Stock Exchange, in which case the foreign dividend will be exempt from South African tax. Careful consideration should be given to any inward listed investment vehicle, as any returns in the form of foreign dividends could be subject to South African dividends tax, against which a foreign tax credit could be claimed in respect of foreign withholding taxes suffered.

Foreign jurisdiction in which investment vehicle is located

More often than not the investment vehicle is located in a different jurisdiction than the one in which the asset is located. Accordingly, a proper understanding is required on whether there are agreements for the avoidance of double taxation between the different jurisdictions that will protect your return on investment from being subject to double tax. Such relief could either be in the form of restricting a jurisdiction's right to tax or to provide in-country relief through the claiming of foreign tax credits.

South African Exchange Control provisions

From a regulatory perspective, South African individuals investing outside of South Africa should be conscious of the various exchange control requirements as determined by the Financial Surveillance Department of the South African Reserve Bank. Currently South African exchange control residents are allowed a foreign investment allowance of up to R10million per year, which should be attested by a tax clearance certificate issued by the South African Revenue Service.

Conclusion

The examples above are not exhaustive but are merely a sample set to illustrate some of the tax and regulatory aspects to consider by an individual upon investing offshore.

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2.3 Overseas assets soon to be visible on SARS radar

Key developments are just about to raise the stakes for anyone holding assets outside South Africa.

Many people turn off when they hear messages from the Government about tax evasion and tax cheats, as they think that it is not relevant to them. Tax and penalties are expected for evasion, but tax liabilities and penalties can also arise from inadvertent non-compliance, often as a result of complex technical matters not being declared properly. Also individuals may not be aware of overseas assets held by a spouse or parent, which only comes to light after they have passed away.

Such new developments could impact *many* South African residents with overseas assets.

The key developments are:

- unprecedented levels of information will be provided to the South African Revenue Service (SARS) in respect of assets held overseas from the authorities of overseas jurisdictions;
- Individuals have until the end of March 2017 to regularise their affairs in relation to off shore assets under the Special Voluntary Disclosure Programme.

Transparency

South Africa's disclosure guidelines are aligned to the Common Reporting Standard (CRS), and 96 countries have committed to exchanging information from 2017 or 2018 and more are likely to follow.
The impact of these agreements is to oblige jurisdictions to obtain client information from their financial institutions (such as banks) and copy it automatically to the tax authorities (e.g. SARS) in other jurisdictions each year.

The type of assets impacted includes not only overseas bank accounts but also interests in entities such as trusts, companies and foundations.
The type of information reported includes the name and address of the South African person, income, proceeds of investments sold and account balances.

Extensive SARS investigation activity is anticipated using the information provided from overseas jurisdictions. SARS are expected to both crackdown on undeclared tax evasion and check the position of offshore entities they have not been aware of before, identifying any associated South African tax implications.

SARS & SARB disclosure facilities

There are in fact two mechanisms for making a disclosure to SARS. The Voluntary Disclosure Programme (VDP) and the Special Voluntary Disclosure Programme (SVDP). The VDP is a permanent feature of South African Tax legislation and allows SA residents to disclose to SARS non-compliance in relation to any undeclared income or gains that may have been omitted from a South African tax return, and includes income tax; capitals gains tax, VAT, PAYE etc. The program allows for a mitigation of penalties on payment of the undeclared tax and interest.

The Special Voluntary Disclosure Programme which was announced in this year's budget is specifically for overseas assets (wherever in the world they are). The programme will run for a limited period from October 1st this year to June 30th 2017. It will provide both tax relief and relief for exchange control violations.
At present the calculations required to avail of the SVDP are quite complex, requiring the taxpayer to identify the "high-water" value of offshore assets during the period 2010 – 2015, 40% of which will be taxed at the taxpayers marginal rate.

Depending on the source of funds taken offshore (pre-tax or after tax funds) it may well be necessary to complete complex calculations to determine which of the disclosure programs should be availed of, and it is advisable to start the process as early as possible.

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Criminal charge

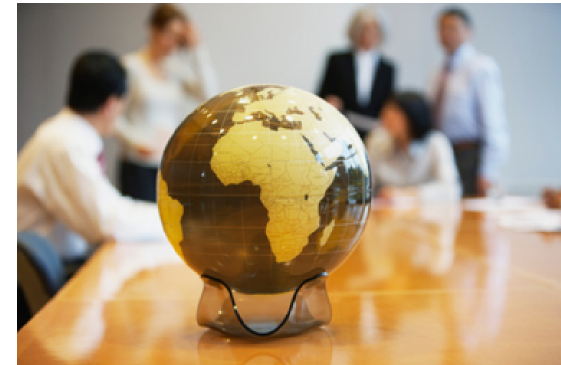
It is important to remember that under declarations in a tax return continue to expose the taxpayer to potential criminal charges, and whilst SARS doesn't instigate criminal proceedings very often, it is likely that there may well be an increase in prosecutions after the SVDP closes. Both the VDP and SVDP provide specific immunity from criminal prosecution but where illicit offshore assets are detected outside of the VDP and SVDP the Minister of Finance has made it clear in his budget speech that this is the "last chance" to regularise those assets and the undeclared income from them.

Given the vast increase in the information that will be shared with SARS from overseas, the risks associated with continued non-disclosure are simply too great, and there has to be an expectation that SARS will instigate criminal proceedings on a more regular basis. The SVDP provides an excellent opportunity to regularise any undisclosed off shore assets at a reasonable cost.

What next?

South African taxpayers need a proactive approach to these changes and in particular to:

- ensure their tax affairs are correct and would withstand scrutiny if SARS were to investigate;
- be aware of what information is being disclosed to SARS from overseas jurisdictions and that this will be cross checked to future tax return filings; and
- If a disclosure is required, take professional advice as soon as possible and make use of the SVDP whilst it still exists.



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2.4 Divorce: There are tax consequences

Divorce, or the dissolution of a civil or customary union, usually involves a division of assets, with the resultant (often costly) tax consequences.

It's important to recognise that a "spouse" in the South African context is broad and includes:

- Partners in a marriage or customary union as recognised by South African law;
- Partners in a union recognised as a marriage in accordance with the tenets of any religion; or
- Any person in a same-sex or heterosexual union which is intended to be permanent.

Given increased global investment access and individual mobility, individuals' assets are often sourced and accumulated from all around the world. The division of assets located/sourced across the globe is quite complex given that, as with any cross-border matter, more than one jurisdiction may seek to tax the same tax event/transaction. There are various matters that should be considered when contemplating a divorce or dissolution of a union, not least of which are the potential tax consequences. We provide herein some pointers on matters to consider for a person contemplating a divorce or dissolution of a union. Wherever possible, discuss this with a financial advisor to ensure that the potential risk is mitigated and that, where possible, unnecessary or unintended consequences are avoided.

Tax-related questions and considerations:

- Who are the relevant parties? It is essential to determine the tax residency of the parties as well as the potential impact of any double taxation agreements.
- Where are the assets located/sourced? One must ascertain where the assets are located, as well as how the assets were sourced (i.e. how was the assets acquired, what activity generated the assets, from which funds were the assets acquired, etc.)
- Who owns the assets? It is necessary to determine whether the marriage or union is in or out of community of property or whether a similar principle applies as this would have an effect on the ownership of the assets. During this process determine whether any of the assets are encumbered, as well as whether there are other liabilities that should be taken into account.
- Will there be a transfer of assets required? It is important to determine whether any donations tax, income tax, transfer duty, securities transfer tax, value-added tax, capital gains tax, etc. may apply where assets are to be transferred from one party to another (whether through sale to liquidate assets or transfer between spouses). This may be especially complex if the tax residence and the location/source of the assets differ.
- Do the partners in the marriage/union co-own a business and will one of the parties exit the business? Under these circumstances, one must determine the exit strategy from the business, including capital gains tax, potential employees' tax, income tax, value added-tax, etc. It may be prudent to commission a due diligence to establish the true value of the business as well as to ensure that there are no unexpected surprises in terms of tax or legal liability going forward.
- Will maintenance or alimony payments be required (dependants, whether minor or for other reasons)? It is also necessary to consider the length of any potential obligation, the estimated cost, etc. as well as to determine where the payments will be sourced from (future income or retirement fund). Thereafter, one can determine the tax consequences for the various parties – both the person paying and the recipient of the funds.

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- Will the divorce settlement include a payout from a retirement fund? South African legislation allows for partial withdrawal from certain retirement funds on divorce. One must however first determine the nature of the retirement fund and the potential consequences for the member of the fund as well and the tax consequences for the parties. Take care where the payout may take place from a defined benefit fund type structure.
- Consider retirement fund interest and insurance policies and ensure that the future tax consequences in terms of future payouts are considered.
- Where there is a Will, consider any ongoing obligations in terms of maintenance or alimony and ensure that the obligations are sufficiently provided for, as well as the potential effect of estate duty.
- Where there is a trust, consider the structure of the trust and the possibility that trustees and/or beneficiaries should be changed. The trust may or may not be affected by a divorce, but all parties should consider and determine a solid exit strategy, if required, where possible.
- Consider whether any of the parties could have, at any time, contravened exchange control and/or committed a tax default. The consequences of a contravention and/or default may well have consequences for both parties, and the resultant costs may be substantial.

Conclusion

Given the complexity of tax issues that may be connected to a decision to end a marriage or similar relationship, we highly recommend that tax advice is sought at the earliest opportunity to ensure that the tax and financial impact of the divorce or dissolution of the union is managed in the most efficient manner and that any unintended consequences are pre-empted and avoided, wherever possible.

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2.5 Who do you trust?

It is not uncommon for members of high-net-worth families to establish family trusts as a matter of financial prudence and for estate-planning purposes.

However, in order to protect the assets of any trust, it is vital that the trust is validly established in terms of the Trust Property Control Act and that the trust, once established, is properly administered by the duly appointed trustees with due care, skill and diligence. In this regard, recent case law has re-affirmed that creditors and estranged spouses alike will have difficulty in laying claim to trust assets as long as these fundamentals are in place.

Invalidly established trusts

The case of *Van Zyl and Another NNO v Kaye NO and Others 2014 (4) SA 452 (WCC)* distinguished between the declaration that the trust is a sham on the one hand and looking behind "the veneer of the trust" on the other. Although in this particular case, the trust survived the legal onslaught from third party creditors, the case highlighted certain fundamental principles of trust law. Essentially, determining whether a trust is a sham is a matter of fact. A trust will be a sham if it is found that the requirements for the establishment of the trust (in terms of the Trust Property Control Act) were not met, or that the appearance that these requirements were met is, in reality, a misrepresentation of the truth. Ultimately a sham trust is not recognised as a trust and will not provide the benefits of a validly established trust.
One of the practical consequences of having a trust declared as a sham is that any assets ostensibly acquired by the trustees for the 'trust' will not vest in the trustees in their capacity as such but may instead vest in the trustees, the founder and/or beneficiaries in their personal capacities (depending on the particular facts).

Accordingly, the assets of a sham trust may not be ring-fenced from the personal creditors of the trustees, founder and/or beneficiaries and may potentially be deemed to form part of an individual's estate during divorce or insolvency proceedings.

Maladministration of trusts

If a trustee administers the trust without proper regard to his/her fiduciary duties and treats the trust as his/her 'alter ego,' that will not in itself make the trust a sham. However, the legal consequences of this type of conduct can potentially be quite severe.
In these circumstances, even if a creditor accepts that the trust has been validly established and that the trust assets consequently vest in the trustees in their official capacity, the creditor may nevertheless request a court to "look behind the veneer of the trust" to:

- hold the trustees personally liable for an obligation ostensibly undertaken in their capacity as trustees; or
- bind the trust to transactions ostensibly undertaken by the trustees which were beyond their authority or legal capacity.

While our courts have shown a general reluctance to go behind the trust form, they are more likely to grant an equitable remedy where the trust form is used by trustees/other parties in a dishonest, fraudulent or unconscionable manner to evade a liability or avoid an obligation.

The SCA agrees

The distinction drawn in the Van Zyl-case between a court disregarding the existence of "sham trusts" and a court "going behind" the trust form was endorsed by the Supreme Court of Appeal in *WT & others v KT (933/2013) [2015] ZASCA 9 (13 March 2015)*. The trust in this case also survived a legal attack by a third party, this time an estranged spouse.

Conclusion

The establishment of a valid trust is an essential first step for high-net-worth families to protect their assets from the reach of third parties. Once a trust has been validly established, the proper administration of the trust assets by the trustees is essential in order to avoid the potential dire

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consequences flowing from an aggrieved third party taking legal steps against the trustees. Not only could this tie-up the trustees and beneficiaries in lengthy and costly litigation but it could also result in an order which holds the trustees personally liable or even a finding that a particular asset was not properly transferred to the trust.

When protecting the family fortune through the establishment of a trust, careful attention will be required not only for the proper formation of the trust but also for the prudent and diligent operation thereof. Although strict adherence to trust formalities may at times seem tedious or technical, it is a small price to pay compared to the risk of getting it wrong.

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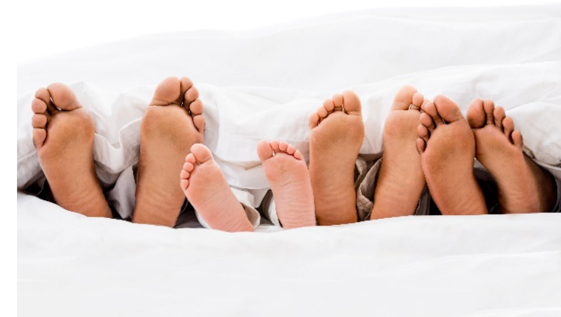

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