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TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

ANTI-AVOIDANCE
SECTION 8EA – QUALIFYING PURPOSE

SECURITIES TRANSFER TAX
COLLATERAL ARRANGEMENTS AND REPOS

VALUE-ADDED TAX
VAT AGENCY AND PRINCIPALS

CONTENTS

ANTI-AVOIDANCE

0677. Section 8EA – qualifying purpose 03

0678. Tax evasion vs tax avoidance 05

COMPANIES

0679. CIPC's system upgrade 07

SECURITIES TRANSFER TAX

0680. Collateral arrangements and repos 09

TAX ADMINISTRATION

0681. Process for tax disputes 11

TRANSFER PRICING

0682. Pillar One and Amount B 13

VALUE-ADDED TAX

0683. VAT agency and principals 16

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SECTION 8EA – QUALIFYING PURPOSE

When raising finance by way of preference shares, taxpayers are well aware of the risks posed by the anti-avoidance provisions of sections 8E and 8EA of the Income Tax Act, 1962 (the Act), and that care should be taken to ensure that preference shares, which are typically issued to fund the purchase of share investments, do not fall foul of these provisions.

Section 8E is aimed at preference shares that are "hybrid equity instruments", while section 8EA targets shares that are "third-party backed shares". If the preference shares meet the requirements of either of these provisions, any dividends declared and paid to their holders are deemed to be income for the full year of assessment in which they are so characterised (even if that status only applies for a portion of that year).

In relation to section 8EA, a "third-party backed share" is in essence a preference share in respect of which, *inter alia*, an enforcement right is exercisable by the holder of the preference share as a result of any dividends or foreign dividends attributable to the shares not being received by or accruing to the person entitled thereto. An enforcement right includes any fixed or contingent right to require any person other than the issuer of the preference share to acquire the shares from the holder or to make any payment in respect of the share in terms of a guarantee, indemnity or similar arrangement or to procure, facilitate or assist with the aforegoing.

A "qualifying purpose" is defined in section 8EA(1) in relation to the application of the funds derived from the issue of a preference share, as one or more of the following purposes:

"(a) The direct or indirect acquisition of an equity share by any person in a company that is an operating company at the time of the receipt or accrual of any dividend or foreign dividend in respect of that preference share . . .;

(b) the partial or full settlement by any person of any—

(i) debt incurred for one or more of the following purposes:

(aa) The direct or indirect acquisition of an equity share by any person in a company that is an operating company at the time of the receipt or accrual of any dividend or foreign dividend in respect of that preference share...;

There is an important carve-out in section 8EA(3), which provides that where funds derived from the issue of a preference share were applied for a "qualifying purpose", in determining whether an enforcement right is exercisable in respect of that share, no regard must be had to any arrangement in terms of which the enforcement right is exercisable against certain specified persons.

(bb) a direct or indirect acquisition or a redemption contemplated in paragraph *(c)*;

(cc) ...

(ii) . . .;

> *(c)* the direct or indirect acquisition by any person or a redemption by any person of any other preference share if –
>
> (i) that other preference share was issued for any purpose contemplated in this definition; and
>
> ...
>
> *(d)* . . . ;".

The Taxation Laws Amendment Act, 2023 (the TLAA), which was promulgated on 22 December 2023, in section 5(1) amended section 8EA by the addition to subsection (3) of the following proviso:

> "Provided that **where an equity share in an operating company is acquired by any person as contemplated in paragraph *(a)* or *(b)*** of the definition of 'qualifying purpose' and the share so acquired is **no longer held directly or indirectly by that person** at the time of the receipt or accrual of that dividend or foreign dividend in respect of the preference share, this subsection must not apply, unless ..." **[own emphasis]**

Therefore, in essence, it is now a requirement that the equity shares in the operating company which underpin the qualifying purpose requirement, must be held by the person that acquired those shares at the time that each dividend is received or accrues in respect of the relevant preference share.

It is important to note that this amendment came into operation on 1 January 2024 and applies in respect of any dividend or foreign dividend received or accrued during years of assessment commencing on or after the date. Specifically, the amendment does not only apply to "new" preference shares issued after such date, but also applies to existing preference shares in issue.

"Section 8E is aimed at preference shares that are 'hybrid equity instruments', while section 8EA targets shares that are 'third-party backed shares'. If the preference shares meet the requirements of either of these provisions, any dividends declared and paid to their holders are deemed to be income for the full year of assessment in which they are so characterised (even if that status only applies for a portion of that year)."

One submission made in the Draft Response Document (published on 25 October 2023) in respect of the Draft Taxation Laws Amendment Bill, 2023 (released on 31 July 2023), was that "this new ownership requirement will affect many commercially driven transactions which [are] not intended to undermine the fiscus.... as there are various legitimate commercial reasons why a disposal or substitution of the equity shares held in an operating company should be allowed". This comment was only partially accepted and the final draft of the legislation now excludes from the new proviso two scenarios with limited application.

In particular, the application of this amendment to "equity shares held in an operating company" which have been or are transferred between companies within the same group (for example in terms of a group rationalisation) will need to be carefully considered with reference to the wording of the proviso which requires that the operating company shares must be **directly or indirectly held by the original purchaser of such shares**.

Given the above, it is recommended that corporates that have existing preference share funding in place and which have in the past restructured or intend to restructure the group's shareholding in the "operating company", should consider how this amendment may impact such existing preference shares before implementing any such restructuring. Preference share arrangements with financial institutions generally require the preference share issuer to gross up dividend payments where such dividends are recharacterised as income in terms of section 8EA, resulting in a potential increase in the funding costs for the issuer.

Carmen Gers & Nicolette Smit

ENSafrica

Acts and Bills

- Income Tax Act 58 of 1962: Sections 8E(1) (definition of "hybrid equity instrument") & 8EA(1) (definitions of "qualifying purpose" & "third-party backed share") & (3) (proviso);
- Taxation Laws Amendment Act 17 of 2023: Section 5(1);
- Draft Taxation Laws Amendment Bill, 2023 (released on 31 July 2023).

Other documents

- Draft Response Document in respect of Draft Taxation Laws Amendment Bill, 2023 (published on 25 October 2023).

Tags: hybrid equity instruments; third-party backed shares; enforcement right; qualifying purpose; operating company.

TAX EVASION VS TAX AVOIDANCE

Every day South Africans pay tax, whether it is VAT charged on basic goods, fuel levies or the dreaded estate duty on passing. With taxes around every corner, it is reasonable that a person would look into how to validly limit one's tax exposure. This brings to the fore the question of what is construed as tax evasion *or* tax avoidance.

This article takes a look at what is meant by the terms "tax evasion" and "tax avoidance", the differences between the two, how one determines which is which, and factors to look out for that should immediately ring alarm bells.

THE WESTMINSTER DOCTRINE

The Westminster Doctrine is a widely renowned principle that stems from *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1, and provides us with the following quote:

> "Every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable."

The Westminster Doctrine, in short, allows taxpayers to arrange their affairs to minimise their tax liability, as long as such structuring of affairs is within the provisions of the law.

TAX AVOIDANCE THROUGH LEGISLATION

Tax avoidance stems from efficient tax planning and structuring one's affairs in the most tax-friendly manner to reduce one's tax burden by avoiding or paying less tax. There are correlations between the Westminster Doctrine and what is understood to be tax avoidance.

By making use of the advantages provided for in legislation, specifically the Income Tax Act, 1962 (the Act), taxpayers can legally minimise their tax liability using efficient tax planning by following the Act and the applicable provisions of the law.

Tax avoidance is, however, governed by strict provisions in South Africa. The General Anti-Avoidance Rules (GAAR) are general provisions under the Act that address instances of general tax avoidance that are deemed impermissible by the South African Revenue Service (SARS).

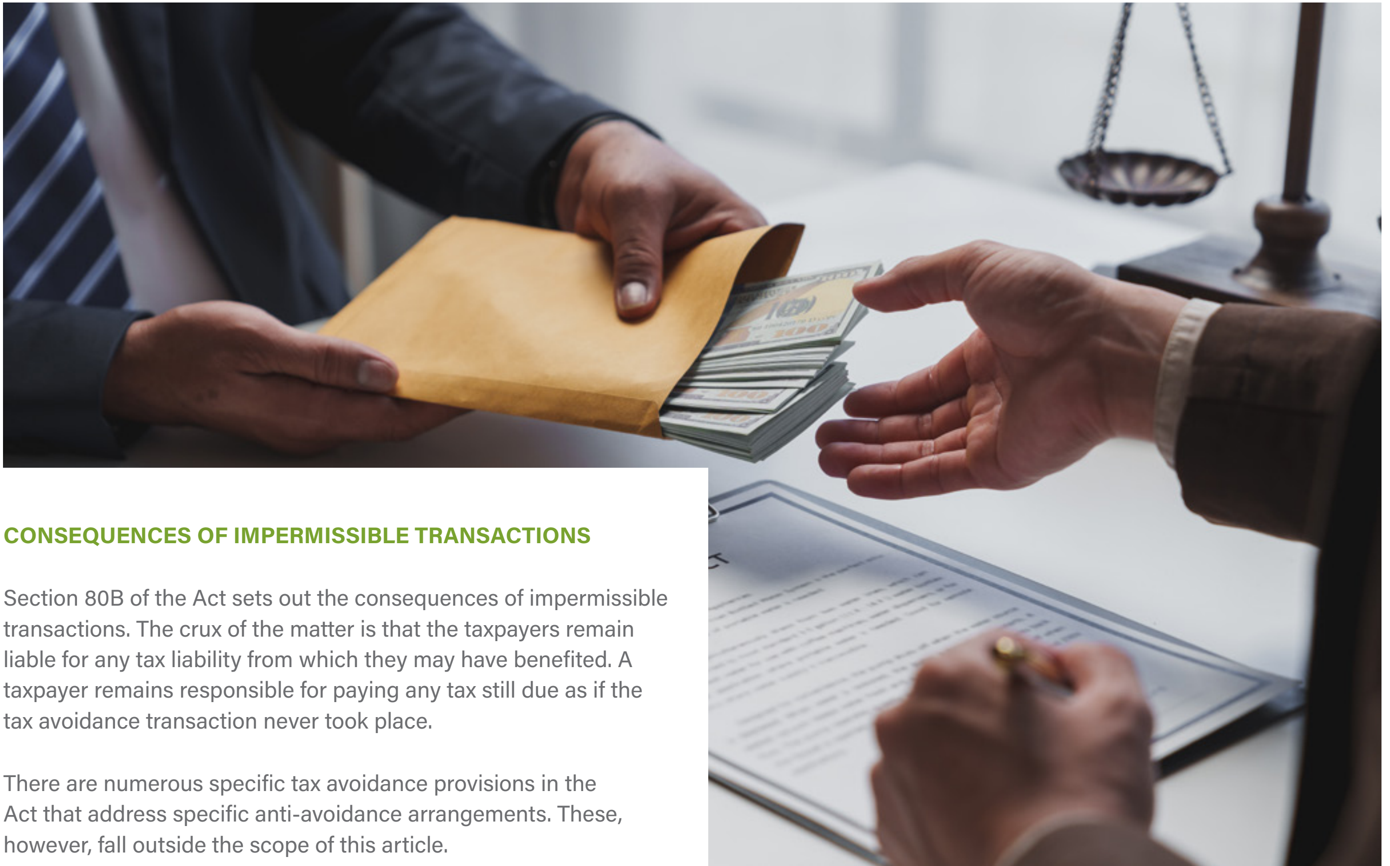
Currently, the provisions of GAAR are found in sections 80A to 80L of the Act. In section 80A a test is provided to determine whether there is any impermissible tax avoidance arrangement by considering the following elements, in short:

(i) Entering into an "arrangement" (which is defined in section 80L as "any transaction, operation, scheme . . .").

(ii) The "arrangement" is entered into solely or mainly to obtain a tax benefit.

(iii) The "arrangement" did not take place for commercial purposes.

For an "arrangement" to be deemed an "impermissible avoidance arrangement", it must satisfy each of the elements set out above. However, the onus of proof lies with the taxpayer. Section 80G creates a presumption that any "arrangement" concluded by a taxpayer is considered to have been specifically concluded as an "arrangement" to obtain tax benefits and it remains the taxpayer's responsibility to prove otherwise.



CONSEQUENCES OF IMPERMISSIBLE TRANSACTIONS

Section 80B of the Act sets out the consequences of impermissible transactions. The crux of the matter is that the taxpayers remain liable for any tax liability from which they may have benefited. A taxpayer remains responsible for paying any tax still due as if the tax avoidance transaction never took place.

There are numerous specific tax avoidance provisions in the Act that address specific anti-avoidance arrangements. These, however, fall outside the scope of this article.

TAX EVASION

Tax evasion, on the other hand, refers to illegally minimising or removing certain tax liabilities in their entirety. Tax evasion typically involves a person engaging in fraudulent activities, and such activities include providing information that is false and incorrect in an attempt to mislead SARS. Tax evasion is a criminal offence and is punishable by way of a fine or imprisonment.

DISTINGUISHING TAX EVASION AND TAX AVOIDANCE

The crucial difference between tax evasion and tax avoidance is the legality of the transaction and the manner in which the transaction takes place. Tax evasion is a criminal offence, whereas tax avoidance is deemed to be either a permissible or an impermissible method of avoiding tax. It is only where tax avoidance arrangements are considered to be impermissible that the taxpayer will be subject to the applicable tax in respect of that arrangement.

Although it may appear a fine line for the uninformed, there is a distinct difference between *tax evasion* and *tax avoidance*, with tax avoidance a legal method to avoid paying tax, and tax evasion involving illegal transactions aimed at avoiding tax. In both instances, the reduction of the tax burden is sought, but the manner in achieving this differs. As much as tax planning is appropriate and important, the complexity and dangers of incorrect planning should be clear from the above. Any tax planning must be within the legislative rules and must preferably be reviewed by a tax advisor who will ensure that tax planning is legitimate and permissible and remains in compliance with our tax laws.

"The Westminster Doctrine, in short, allows taxpayers to arrange their affairs to minimise their tax liability, as long as such structuring of affairs is within the provisions of the law."

Dr Candice Reynders & Mark le Riche

PH Attorneys

Acts and Bills

- Income Tax Act 58 of 1962: Sections 80A to 80L (GAAR provisions) – more specifically sections 80A, 80B, 80G & 80L (definition of "arrangement").

Other documents

- General Anti-Avoidance Rules (GAAR).

Cases

- *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1.

Tags: Westminster Doctrine; tax avoidance; tax evasion.

CIPC'S SYSTEM UPGRADE

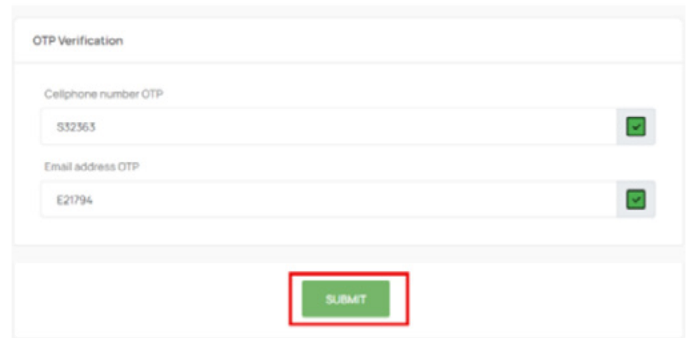
As 2023 drew to a close, the Companies and Intellectual Property Commission (CIPC) gave taxpayers something new to learn over the festive break.

Throughout 2023 the CIPC, together with SARS, implemented a number of changes, including Beneficial Ownership Registers, and Foreign Director Verification; December, however, saw the launch of CIPC's new and improved system updates to its eServices and BizPortal platforms. Now in 2024, companies and their representatives find themselves faced with unexpected and unchartered compliance requirements, which they often have little idea how to fulfil.

CIPC RAISES THE COMPLIANCE BAR

The CIPC migration to enhanced eServices and BizPortal platforms was aimed at automating numerous CIPC functions, including company registrations, annual return filings and other company changes. In doing so, the new paperless system catered for users no longer requiring hard copy documentation and lengthy manual submissions, whilst being more cost-effective for start-ups.

The CIPC upgraded its system at the beginning of December 2023 by introducing some additional and more stringent verification steps, one of which is a multifactor authentication. The multifactor authentication system is specifically required for director amendments and makes use of an OTP in order to improve data security, whilst simultaneously enhancing data-driven compliance insights. The CIPC reasoned that these additional security checks are an attempt to combat corruption, money laundering and other corporate crimes which have contributed to South Africa's greylisted status.



Example of OTP submission form on CIPC

"The CIPC upgraded its system at the beginning of December 2023 by introducing some additional and more stringent verification steps, one of which is a multifactor authentication."

THE PROS AND CONS OF MULTI-FACTOR AUTHENTICATION

The new enhanced system provides directors with twin-factor authentication in the form of both SMS and email OTPs for authorisation of all amendments to a company's directorship, including new appointments, removals and resignations:

Whilst the CIPC's objective of introducing this authentication process was to improve data security, thus far, and with bugs to still be worked out, all it has served to do is frustrate the directorship amendment process. Aside from the obvious submission of 2 OTPs, it does not create user-friendly information updating opportunities; this means that, if a director has, since appointment, changed their contact details, this must first be updated. The CIPC has itself reported a noticeable backlog in processing amendments much to the disdain of corporate secretaries and administrative staff who are often the ones tasked with navigating these eServices and BizPortal platforms.

The backlog was initially caused on account of users bypassing the new CIPC system by submitting old system applications, forcing the CIPC to complete those applications first to avoid situations of data corruption and other system errors.

The real challenge begins when companies have foreign directors that need to authorise these director changes. The CIPC implemented a Foreigner Assurance service, which is an additional step for foreign directors. This step requires that all foreign directors must be verified by submitting a certified copy of their passport. The problem is that this does not seem to be a once-off verification and a foreign director may even be required to recertify and verify their passport on a quarterly basis. The process creates further confusion when foreign directors do not receive their OTPs or do not respond to requests timeously.

BENEFICIAL OWNERSHIP – SARS AND CIPC JOIN FORCES

If one holds "Beneficial Ownership" in relation to a company, one should already be aware of the "Beneficial Ownership Register" functionality on the CIPC eServices platform; especially considering that the updating of this register needed to have been done in October 2023 for existing companies!

Natural Person Owner Information

Are you a South African citizen? Yes

Date of Birth: Click calendar icon to select date

Issue Date: Click calendar icon to select date

ID/Passport No:

Name:

Surname:

Email:

Personal Income Tax Number:

Ownership percentage (between 5 to 100):

Interest Type: Shareholding

Demographic: African

Gender: Female

CIPC Beneficial Ownership Form

Entities incorporated after the promulgation of the amended Companies Regulations, are required to file beneficial ownership information within 10 business days after the date of incorporation. Entities incorporated before this promulgation will also have to file beneficial ownership information before effecting any changes.

With the support of SARS, the "Beneficial Ownership Register" must tie in to the ITR14 declaration on shareholding – remember that, in light of automatic exchanges of information in place with a number of foreign jurisdictions, it is likely that SARS is already privy to all interests held by taxpayers, both locally, and offshore.

In casting their net as wide as possible, the concept and required disclosures of Beneficial Ownership extend to an assortment of legal entities, including profit companies, non-profit companies, external companies, non-exempt state-owned companies, listed companies and close corporations.

Over and above the requirement that the register itself must be created, and maintained on a regular basis, where any person holds more than 5% Beneficial Ownership in a legal entity, full disclosure on one's Beneficial Ownership is required by both the CIPC and SARS.

KEEPING COMPLIANCE UP TO DATE

To ensure that a company does not fall foul of these new enhanced compliance processes, and keep one's focus on a business's continued success, it is recommended these administrative functions be outsourced to CIPC experts. Time is money and it only makes sense to use a seasoned CIPC specialist who understands how to navigate the new system seamlessly.

However, where one has already violated these new requirements, or is wholly uncertain of one's compliance status or of that of one's company, it is prudent to approach an astute corporate and tax attorney, to run a diagnostic test on both one's CIPC and SARS affairs. Not only does this ensure legal professional privilege on all disclosures, but it also guarantees that the correct remedial measures are executed post-haste.

Jashwin Baijoo & Taryn Govender

Tax Consulting SA

Tags: multifactor authentication system; Beneficial Ownership Register; ITR14 declaration on shareholding.

COLLATERAL ARRANGEMENTS AND REPOS

Although the overall economics of repurchase arrangements (repos) and collateral arrangements may be comparable in certain instances, the legal nature of these transactions and the South African tax implications arising in respect of these transactions, are quite different.

The legal form of a repo entails a sale of the underlying shares or bonds by a party who agrees to repurchase identical shares or bonds from the counterparty at the end of a specified time period. In comparison, a collateral arrangement is a funding arrangement in terms of which funding is advanced by a lender to a borrower, with the borrower providing security in respect of the amount owed by transferring shares or bonds to the lender on an out-and-out basis. At the end of the term of the arrangement, the borrower will repay the funding and the lender will return identical shares or bonds.

From a South African tax perspective, a specific dispensation is granted for transactions entered into over South African listed shares or certain bonds which meet the requirement of a "collateral arrangement" as defined in section 1 of the Securities Transfer Tax Act, 2007. Broadly speaking, in respect of qualifying collateral arrangements, the collateral provider will, from an income tax and capital gains tax perspective, disregard the disposal of the shares or bonds to the collateral receiver upon inception of the collateral arrangement and disregard the acquisition of the shares or bonds from the collateral receiver at the end of the term. The collateral receiver will similarly disregard the initial acquisition of the shares or bonds from the collateral provider as well as the subsequent disposal of the shares or bonds to the collateral provider at the end of the term.

"The tax treatment of a repo, on the other hand, will depend on, for example, whether the arrangement is treated as an interest-bearing instrument in terms of section 24J of the Income Tax Act, 1962, for South African tax purposes."

The tax treatment of a repo, on the other hand, will depend on, for example, whether the arrangement is treated as an interest-bearing instrument in terms of section 24J of the Income Tax Act, 1962, for South African tax purposes. In such cases, the seller of the shares or bonds may be required to account for interest income in respect of the arrangement, whilst the purchaser of the shares or bonds would need to meet various requirements in order to claim a deduction of "interest" in respect of the recharacterised loan. Repos are not afforded the income and capital gains tax dispensation that is provided to collateral arrangements as discussed above – the parties will therefore need to consider the income tax and capital gains tax implications arising upon the various disposal and acquisition legs of the repo.

From a securities transfer tax (STT) perspective, an exemption from STT applies to the transfer of shares between the parties in the event that the transaction qualifies as a collateral arrangement. No such exemption applies to a repo over shares and the parties would need to consider if any other STT exemption may apply in the circumstances. STT is not imposed in respect of the transfer of bonds and, as such, no STT implications should arise in respect of a repo or collateral arrangement entered into in respect of bonds.

The South African dividend withholding tax regime addresses collateral arrangements and repos involving South African listed shares. Manufactured payments made by a recipient of collateral to the collateral provider over the term of the collateral arrangement may be subject to dividends tax at the rate of 20% in the event that collateral arrangement spans a dividend date in respect of the underlying shares and certain other requirements are met. In respect of repos, the seller of shares may be deemed to be the beneficial owner of the dividend for dividends tax purposes in instances where the shares are acquired and held by the purchaser of shares over a dividend date, and where such purchaser receives the dividend.

Dividends received by both the recipient of collateral and the purchaser of shares under a repo are subject to provisions which may render such dividends or portions thereof as taxable in the hands of the recipient.

Understanding the South African tax treatment of repos and collateral arrangements which are commonly used in financial markets requires careful consideration despite such transactions having comparable economic outcomes in some instances.

"Understanding the South African tax treatment of repos and collateral arrangements which are commonly used in financial markets requires careful consideration despite such transactions having comparable economic outcomes in some instances."

Michael Reifarth

ENSafrica

Acts and Bills

- Income Tax Act 58 of 1972: Section 24J;
- Securities Transfer Tax Act 25 of 2007: Section 1 (definition of "collateral arrangement").

Tags: repurchase arrangements (repos); collateral arrangement; recharacterised loan; securities transfer tax (STT); dividend withholding tax.

PROCESS FOR TAX DISPUTES

"Surely, the question cannot be whether a taxpayer accepts non-compliance with the law but rather whether, objectively considered, there was a breach of the law."

Taxpayers are often aggrieved by SARS' assessments and decisions. The Tax Administration Act, 2011 (the TAA), provides a mechanism for taxpayers to raise these grievances through a process referred to as objection and appeal. The objection and appeal process is to a large extent an internal process, meaning that SARS itself has to listen to these grievances and decide whether to change their assessment or decision. Failing a decision by SARS to change the assessment or decision, the taxpayer has recourse to the tax court. The objection and appeal process can be perceived as time-consuming and perhaps even costly. This is especially the case where SARS' assessment or decision is believed to have been unlawfully issued for whatever reason.

Several taxpayers have tried to bypass this internal objection and appeal process where SARS' assessment is believed to have been unlawfully issued, by approaching the High Court directly. Logically, this approach seems sensible – after all, why should the taxpayer have to engage with SARS through this internal process if the assessment is unlawful? Stated differently, why should the taxpayer engage with SARS on the correctness or otherwise of the assessment in terms of the underlying tax Act, through the objection and appeal process, when the assessment or decision is unlawful for want of compliance with other statutory obligations?

Historically, before certain amendments were made to the TAA, the courts held that if the taxpayer's grievance turns only on a point of law, then the taxpayer is not obligated to engage SARS through the internal objection and appeal process and can, in fact, approach the High Court directly. [In this regard, see *Metcash Trading Ltd v Commissioner, South African Revenue Service, and Another*, [2001].] In fact, in at least two notable judgments [*Absa Bank Ltd and Another v Commissioner, South African Revenue Service,* [2021], and *A Way to Explore v Commissioner for the South African Revenue Service,* [2017]] the court seemed to have maintained this approach, despite the post-2015 amendments to the TAA.

However, the Supreme Court of Appeal, in *Commissioner, South African Revenue Service v Rappa Resources (Pty) Ltd,* [2023], changed this position having regard to, amongst others, certain amendments made to the TAA in 2015. These statutory amendments effectively interfered with the inherent jurisdiction of the High Court and limited its jurisdiction to hear and decide tax disputes in exceptional circumstances only. The SCA held that taxpayers whose grievance with an assessment turns only on a point of law cannot, without more, bypass the internal objection and appeal process and approach the High Court directly. It appears that the reasoning of the SCA's judgment in that matter is that the tax court can in any event hear and decide a taxpayer's grievances with an assessment or decision where that grievance relates to the lawfulness of the assessments. There is then nothing exceptional about a dispute turning only on a point of law and therefore taxpayers cannot approach the High Court directly on such matters.

Interestingly, the tax court [*ITC 1956* (84 SATC 321)] earlier held that the taxpayer in that case (taxpayer A) could not launch a legality review in the tax court and directed taxpayer A to the High Court for the High Court to hear and decide its complaints about the legality of SARS' assessments. This was, however, after the judgment in *ABSA* and before the judgment in *Rappa*. Then, in the High Court, the High Court held that it could not entertain taxpayer A's dispute because of the legislative interference with its inherent jurisdiction in 2015.

So what now? Does this mean that there is no court that can hear and decide complaints about the lawfulness of SARS' assessments? Is SARS then free to disregard its obligations to comply with the law because there is no court that can hold SARS to account for certain legal breaches? Absolutely not!

The reason for this conclusion is nuanced and requires some explanation. The position, it seems, is indeed that taxpayers cannot approach the High Court directly purely on a point of law (see *Rappa* and also *Erasmus v Commissioner for the South African Revenue Service,* [2023]), as the tax court can indeed hear and decide these matters. In the *ITC 1956* judgment, the facts before the tax court were that the taxpayer launched a legality review directly in the tax court. It did not first object and appeal and then approach the tax court on the issue of the legality of SARS' assessment. The tax court is a creature of statute and the types of applications it can hear do not allow the tax court to entertain such applications.

That does not mean the tax court cannot decide issues turning on the legality of SARS' assessments. It can [see *South Atlantic Jazz Festival (Pty) Ltd v Commissioner, South African Revenue Service,* [2015], and *Wingate-Pearse v Commissioner, South African Revenue Service and Others,* [2019]], but seemingly only if the taxpayer reaches the tax court after following the internal process of objection and appeal.

It appears then that taxpayers who take issue with the legality of SARS' assessment ought, for the moment at least, to raise exactly that as a basis for their grievance with SARS' assessment in the objection and appeal process. Then, where such a case eventually reaches the tax court, the tax court should be able to decide such an issue, as was exactly the case in the *ITC 1921* [81 SATC 373]. One might ask: does the very fact of submitting an objection not, by necessary implication, somehow condone any alleged unlawfulness of the assessment? After all, if the assessment is unlawful then there can lie no objection to it because it does not exist? It is submitted that this is not the case. Section 104 of the TAA allows taxpayers to challenge any assessment, on a grievance of any kind [see *Rappa* , at paragraph 12]. If the submission of an objection based on the lawfulness of the assessment were to mean that taxpayers are effectively condoning breaches by SARS of the law, then the legislature would not have drafted section 104 in such wide terms. Further still, it is doubtful whether a taxpayer can condone a breach of the law. Surely, the question cannot be whether a taxpayer accepts non-compliance with the law but rather whether, objectively considered, there was a breach of the law.

The position then as it stands, appears to be that taxpayers wishing to challenge an assessment or decision on a point of law must do so through the objection and appeal process and eventually then in the tax court. Is that fair and just? Perhaps. Perhaps not. Should the Tax Court Rules and TAA be updated to allow for direct access to the tax court (without having to go through the internal process of objection and appeal first) on points of law? Maybe. It is submitted that, until the current position changes, questions like "fairness" of the current position and whether amendments are required to the TAA and the Tax Court Rules serve largely to elicit academic debate. In the meantime, those of us who deal with tax disputes will have to "play it as it lies".

Nico Theron

Unicus Tax Specialists SA

Acts and Bills

- Tax Administration Act 28 of 2011: Section 104.

Other documents

- Tax Court Rules.

Cases

- *Metcash Trading Ltd v Commissioner, South African Revenue Service, and Another* [2001] (1) SA 1109 (CC); CSARS, 63 SATC 13;
- *Absa Bank Ltd and Another v Commissioner, South African Revenue Service* (2019/21825) [2021] ZAGPPHC 127; [2021] (3) SA 513 (GP) (11 March 2021);
- *A Way to Explore v Commissioner for the South African Revenue Service* (23896/17) [2017] ZAGPPHC 541 (23 August 2017); [2017] JDR 1480 (GP);
- *Commissioner, South African Revenue Service v Rappa Resources (Pty) Ltd* (1205/2021) [2023] ZASCA 28; [2023] (4) SA 488 (SCA); 85 SATC 517 (24 March 2023);
- *ITC 1956* (84 SATC 321);
- *Erasmus v Commissioner for the South African Revenue Service* (9706/21) [2023] ZAWCHC 127 (18 August 2023); 2023 JDR 3097 (WCC);
- *South Atlantic Jazz Festival (Pty) Ltd v Commissioner, South African Revenue Service* [2015] (6) SA 78 (WCC);
- *Wingate-Pearse v Commissioner, South African Revenue Service and Others* (29208/15) [2019] ZAGPJHC; [2019] (6) SA 196 (GJ);
- *ITC 1921* [81 SATC 373].

Tags: objection and appeal process; legality of SARS' assessment.

PILLAR ONE AND AMOUNT B

The Organisation for Economic Co-operation and Development (OECD) is an organisation which was formed to promote sustainable economic growth and improve economic policies. The OECD has been focused on base erosion and profit shifting (BEPS), ensuring that multinational enterprises (MNEs) pay their fair share of taxes and do not exploit loopholes to divert profits to low- or no-tax jurisdictions.

The OECD introduced the Inclusive Framework (IF) on BEPS to enable over 140 IF members, including many developing economies, to participate equally in setting standards for BEPS-related issues and oversee the implementation of the BEPS project.

Digitalisation and globalisation have had a profound impact on economies, challenging the existing rules for taxing international business income. These rules, often over a century old, are no longer deemed as sufficient in today's interconnected world. This has led to the perception that certain MNEs are not paying their fair share of taxes, despite significant profit generation. The OECD, via the IF, has adopted a two-pillar approach to address the tax challenges and avoidance, with a view to ensuring that MNEs comply with international fair taxation principles. These pillars focus on addressing tax challenges arising from the digital economy. This article specifically delves into Amount B of Pillar One.

EXPANDING THE SCOPE OF AMOUNT B UNDER PILLAR ONE: SIMPLIFYING TRANSFER PRICING FOR BASELINE MARKETING AND DISTRIBUTION ACTIVITIES

Amount B has recently been revised, extending its applicability to all enterprises, specifically those engaged in baseline marketing and distribution activities such as buy-sell distributors, sales agents, or commissionaires.

The purpose of Amount B is to implement measures that simplify and streamline the application of the arm's length principle for baseline marketing and distribution activities within the designated scope and to bring about tax certainty, which includes the establishment of pricing matrices for industry groupings and factor intensities.

THE SIGNIFICANCE OF AMOUNT B IN SIMPLIFYING TRANSFER PRICING

Amount B is concerned with simplifying existing transfer pricing requirements for taxpayers which fall within the envisaged baseline marketing and distribution activities without a revenue or profitability requirement. Amount B's focus is on streamlining transfer pricing rules for baseline marketing and distribution activities only. Notably, baseline marketing and distribution activities are the subject of many transfer pricing controversy cases, including with low-capacity jurisdictions. Some tax experts argue that a dispute between tax certainty and the arm's length principle lies at the core of Amount B, whereas others may argue that this approach is similar to current analyses which determine an arm's length outcome. According to the OECD, Amount B is intended to promote tax clarity, minimise compliance and administrative expenses, aid low-capacity jurisdictions, and assist with the issue concerning a lack of local market comparables.

SCOPE OF AMOUNT B

The final OECD report on Amount B (Amount B Report) determines whether a transaction (referred to as qualifying transaction) falls within the scope of Amount B through considering the following:

- The qualifying transaction must exhibit economically relevant characteristics and can be reliably priced using a one-sided transfer pricing method, with the distributor, sales agent, or commissionaire being the tested party.
- The tested party in the qualifying transaction must not incur annual operating expenses lower than 3% or greater than an upper bound of between 20% and 30% of the tested party's annual net revenues.

The definition of distributor includes wholesale distributors, meaning it only includes the distribution to any type of customer except end consumers. Additionally, a distributor that carries out both wholesale and retail distribution is deemed to carry out solely wholesale distribution if its net retail revenues do not exceed 20% of total net revenues, calculated based on a weighted average for the past three years.

Qualifying transactions will nevertheless be out of scope if:

- The qualifying transaction involves the distribution of non-tangible goods, services or the marketing, trading, or distribution of commodities.
- The tested party carries out non-distribution activities in addition to the qualifying transaction, unless the qualifying transaction can be adequately evaluated on a separate basis and can be reliably priced separately from the non-distribution activities.

AMOUNT B'S APPROACH TO IMPLEMENTING AN ARM'S LENGTH RETURN

The Amount B Report provides step-by-step guidance on how to price an in-scope transaction. In summary, the following steps need to be followed:

- Use the pricing matrix to determine the return, taking into account the industry groupings and the factor intensity in relation to operating expenses and assets.
- Apply the operating expense cross-check as a guardrail to mitigate abnormal results.
- Apply an adjustment using the data availability mechanism for qualifying jurisdictions.

In essence, the Amount B Report is applying the transactional net margin method, with a return on sales (ROS), (also known as operating margin) as the profit level indicator. The arm's length range derived from the pricing matrix within the Amount B Report is based on three industry groups and five categories of factor intensities resulting in 15 different potential ROS percentage. The percentages considered to be acceptable, prior to potential risk adjustments for tested parties in qualifying jurisdictions, vary from 1.50% to 5.50%. There is an acceptable variance of 0.5% compared to the percentages provided. Only results over or under the identified data point for the particular fact pattern (including the variance) would need to be adjusted accordingly.

"The Amount B Report provides step-by-step guidance on how to price an in-scope transaction."

Then, a guard rail is applied to prevent particularly low-operating expense-intense entities from being over-remunerated under the simplified and streamlined approach and, conversely, high-operating expense entities from being under-remunerated under the approach.

The data availability mechanism accounts for cases where there is no or insufficient data in the global dataset for a particular tested party jurisdiction. The ROS is adjusted, inclusive of 1) a net risk adjustment percentage of the qualifying jurisdiction with reference to the sovereign credit rating of such qualifying jurisdiction, and 2) the net operating asset intensity percentage (not to exceed 85%).

AMOUNT B'S TRANSFER PRICING SIMPLIFICATION AND ITS POTENTIAL IMPLICATIONS FOR SOUTH AFRICA

With the goal of simplification in mind, it is expected that the focus of transfer pricing discussions would move to assessing whether an entity falls in or out of scope of Amount B. Depending on what favours an MNE, or tax authority, it is not yet clear how such a debate would unfold in South Africa.

Even though the Amount B Report is now final, it is still uncertain whether the South African Revenue Service (SARS) will accept Amount B and how that would play out with MNEs, in jurisdictions with a policy mismatch (eg, if SARS accepts Amount B and the counterparty's revenue authority does not, or *vice versa*).

Some questions also remain about the prospective treatment of carry-forward losses, accumulated by entities that now fall within the ambit of Amount B. The Amount B Report suggests that this is likely going to be addressed by domestic law and is not within the scope of the guidance. However, it is not clear whether an entity performing baseline marketing and distribution activities can now operate at a loss, even though this is unlikely even in the absence of the Amount B guidance. Commercial operations do not operate in a policy vacuum; though, and it is worth emphasising that, in reality, comparable independent entities may have lower profit margins or could be loss-making for various reasons. For example, these entities may experience supply chain interruptions and challenges because of economic downturns, inflationary threats and currency fluctuations, which all put pressure on already thin profit margins.

Within this context, it is also essential to emphasise that, in contrast to several other BEPS 2.0 initiatives, Amount B does not incorporate specific financial thresholds. Consequently, it carries the capacity to impact a broad range of MNEs.

DOCUMENTATION

The documentation requirements as per the Amount B Report build on the existing local file documentation requirements included in Chapter V of the OECD Transfer Pricing Guidelines, which are mirrored by South African transfer pricing legislation. In summary, the local file should include an explanation on the delineation of the in-scope qualifying transaction, written contracts, calculations showing the determination of the relevant revenue, costs and assets allocated or attributed to the in-scope transaction.

Considering this is new, the Amount B Report also stipulates that where a taxpayer is seeking to apply Amount B for the first time, the taxpayer should include in its local file consent to apply Amount B for a minimum of three years, unless the transactions fall out of scope during that period or there is a significant change in the taxpayer's business. The taxpayer is also required to notify the tax authorities of the jurisdictions involved in the qualifying transaction of its intention to apply Amount B.

OTHER CONDITIONS AND EXCEPTIONS FOR AMOUNT B

There are numerous conditions and exceptions to be aware of. Key ones include:

- The tested entity should not engage in unrelated activities, with manufacturing, research and development, procurement and financing specifically mentioned.
- In the context of intangibles, the tested entity should refrain from performing "risk control functions" that would result in assuming economically significant risks associated with development, enhancement, maintenance, protection and exploitation (DEMPE) functions.
- The tested entity should avoid engaging in strategic activities that lead to the creation of unique intangibles.
- Amount B will not be applicable if the baseline marketing and distribution activities are already covered by a bilateral or multilateral advance pricing agreement (APA).
- The Amount B Report also specifies that the financial data and other data points will be reviewed annually and updated as necessary, providing a framework for maintaining the approach's accuracy over time.
- India has provided reservations on the incomplete nature of the report owing to the non-inclusion of the definitions of low-capacity jurisdictions and qualifying jurisdictions, and an appropriately designed optional qualitative scoping criterion. Further, India also provided reservations on various aspects of the Amount B design, including the operating expense cross-check mechanism and the overall design of the pricing methodology. A developing country which is also part of BRICS recording such reservations, questions whether South Africa will have similar concerns.
- The Amount B Report stated that the IF will agree on the list of low-capacity jurisdictions by 31 March 2024; however, this list has not yet been released (as this article went to press) – this creates doubt as to when the list will be released and how this may impact implementation.

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BDO

Other documents

- OECD (2024), *Pillar One – Amount B: Inclusive Framework on BEPs,* OECD/G20 Base Erosion and Profit Sharing Project;
- *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022.*

Tags: base erosion and profit shifting (BEPS); multinational enterprises (MNEs); Inclusive Framework (IF) on BEPS; Amount B of Pillar One.

VAT AGENCY AND PRINCIPALS

The terms "agent" and "agency" are not defined in the Value-Added Tax Act, 1991 (the VAT Act). The South African Revenue Service (SARS) has indicated in Interpretation Note 42 (Issue 2) (IN 42) that it accepts that the common law relationship between the principal and the agent prescribes the value-added tax (VAT) consequences of this legal relationship.

The general VAT rule is that where a person, acting as agent, supplies goods or services on behalf of a principal to a third party, the supply is deemed to be made by the principal and not the agent (section 54(1) of the VAT Act). Conversely, where a third-party supplier makes a supply to an agent acting on behalf of a principal, that supply is deemed to be made to the principal (section 54(2)). In these instances, the principal and not the agent must account for VAT on the supplies.

It is sometimes difficult to determine whether a person acts as an agent or a principal. Even more so when it comes to cross-border supplies, and particularly regarding services provided by tour operators and travel agents. Section 11(2)*(l)*, which provides for the zero rating of certain services supplied to non-residents, has been amended several times. Some of these amendments were specifically aimed at clarifying the VAT status of supplies by tour operators. Notwithstanding these amendments, our courts are still being called upon to rule on whether local travel agents' supplies to foreign tour operators qualify for the zero rate.

TAX COURT JUDGMENT

In a case heard by the Cape Town Tax Court in 2023, *KEN CC v The Commissioner for the South African Revenue Service,* [2023] (8 December 2023), Dickerson AJ ruled that the vendor was entitled to apply the zero rate in terms of section 11(2)*(l)* to the commission it charged to foreign tour operators for assembling tour packages.

> "The court granted an order for the costs of KEN's two counsel, which is uncommon in the tax court, as this means it concluded that SARS' grounds of assessment or its 'decision' was unreasonable, as contemplated in section 130 of the Tax Administration Act, 2011."

The taxpayer (KEN) led evidence that it is a destination management company whose function is to provide local tourist knowledge of South Africa to foreign tour operators, and to assist them with structuring tour packages for marketing and sale to their foreign clients. KEN assists the foreign tour operators to assemble tour packages by providing information regarding local conditions and supplies, acting as conduit between the foreign tour operator and local suppliers such as hotels, and implementing the foreign tour operators' specific requests.

The terms and conditions which govern the relationship between KEN and the foreign tour operator explicitly stipulate that KEN acts as the foreign tour operators' exclusive representative in South Africa to make bookings, reservations and payments in South Africa on behalf of the foreign tour operator. KEN adds a percentage to the prices it negotiates with the suppliers and includes this percentage in the quotations it provides to the foreign tour operators, as its commission. If a quotation is accepted, KEN issues an invoice to the foreign tour operator, which is required to pay the total amount before the tour commences. Upon receipt of payment, KEN sends emails confirming the bookings with the suppliers, which state that the confirmation is on behalf of the foreign tour operator.

KEN clarified with SARS in 2005 that it was acceptable to issue an invoice for amounts which included its commission, because it does not want to disclose the commission amount separately on the basis that the commission is confidential, and it is common industry practice not to disclose it. Furthermore, KEN only reflects the commission amounts in its financial records as income and does not deduct any VAT on the fees charged by the suppliers.

THE ARGUMENTS AND DECISION OF THE COURT

KEN applies VAT to its commission at the zero rate, which it adds to the fees it negotiates with the suppliers. It contended that it provides a single supply of a service comprising of the assembly of tour packages to foreign tour operators who are outside South Africa at the time the service is rendered. The services are therefore zero-rated under section 11(2)*(l)*.

SARS argued that KEN supplies the actual tourism services to the foreign tourists when they are in South Africa, and therefore subparagraph (iii) of section 11(2)*(l)* excludes these services from the zero rate. Accordingly, SARS assessed the total amount on the invoices, including the commission at the standard rate. SARS took the view that by not disclosing its commission separately on its invoices, KEN was not acting as an agent but as a principal, and KEN was required to establish a "trade usage" in this regard, which is the custom that has the force of law.

The court held that it was sufficient for KEN to show that it is common practice in the industry to keep commissions confidential. Furthermore, disclosing the commission amount is not one of the *essentialia* of agency, and it is perfectly permissible for an agent and a principal to agree that commission is payable, but that the amount may not have to be disclosed.

APPLICATION OF THE JUDGMENT IN *XO AFRICA SAFARIS V CSARS*

SARS also placed reliance on the Supreme Court of Appeal's judgment in *XO Africa Safaris v CSARS,* [2016], where the court held that the taxpayer supplied the tourism services to the foreign tourists, who consumed those services in South Africa, and that the tour packages supplied to the foreign tour operators were subject to VAT at the standard rate.

However, Dickerson AJ stated that the facts in the *KEN* case were completely distinguishable from the facts in *XO Africa Safaris* on at least five grounds:

1. XO Africa Safaris reflected the total amounts invoiced to the foreign tour operators as revenue in its financial records, and it reflected the fees charged by the local suppliers as its own expenses. KEN only reflects the commission as income in its financial records.

2. XO Africa Safaris led evidence that its contracts with the foreign tour operators required it to provide the local services which it sold to the foreign tour operators. KEN does not provide tourism services and it does not deal with customer complaints other than as a conduit to the foreign tour operators.

3. XO Africa Safaris was responsible for delivery of the local services; it employed consultants to supervise this, and it was required to rectify problems with local suppliers. KEN has no obligation to deliver any local services to the tourists or to resolve problems with local suppliers.

4. The terms and conditions of the contract between XO Africa Safaris and the foreign tour operator stated that XO Africa Safaris provided materials and services consisting of accommodation, meals, entertainment, transport, etc. KEN does not undertake to supply any tourism services. It merely books and arranges for payment on behalf of the foreign tour operator.

5. XO Africa Safaris sought to zero rate the fee charged for the tour package to the foreign tour operator, and to deduct the VAT charged by the local suppliers as input tax, which would cause the fiscus to forgo the VAT charged by the local suppliers. KEN does not seek this additional benefit in deducting the VAT charged by the local suppliers.

The court took a dim view of SARS' approach in raising the assessments, which it said was inconsistent with the approval of KEN's invoicing in 2005, the criteria it (SARS) set out in IN 42, the evidence of the case, and SARS' misplaced reliance on the *XO Africa Safaris* case, which the court stated "displays a careless disregard of the particular nature and *modus operandi* of KEN's business". The court granted an order for the costs of KEN's two counsel, which is uncommon in the tax court, as this means it concluded that SARS' grounds of assessment or its "decision" was unreasonable, as contemplated in section 130 of the Tax Administration Act, 2011.

CONCLUSION

The *KEN* and *XO Africa Safaris* cases confirm that our courts determine the VAT status of a supply by considering the legal rights and obligations concluded between a supplier and recipient, in view of the surrounding circumstances and the conduct of the parties. Moreover, the importance of properly documenting the relationship between the parties to substantiate that a person acts in the capacity as an agent, is emphasised in this case.

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Cliffe Dekker Hofmeyr

Acts and Bills

- Value-Added Tax Act 89 of 1991: Sections 11(2)*(l)* & 54(1) & (2);
- Tax Administration Act 28 of 2011: Section 130.

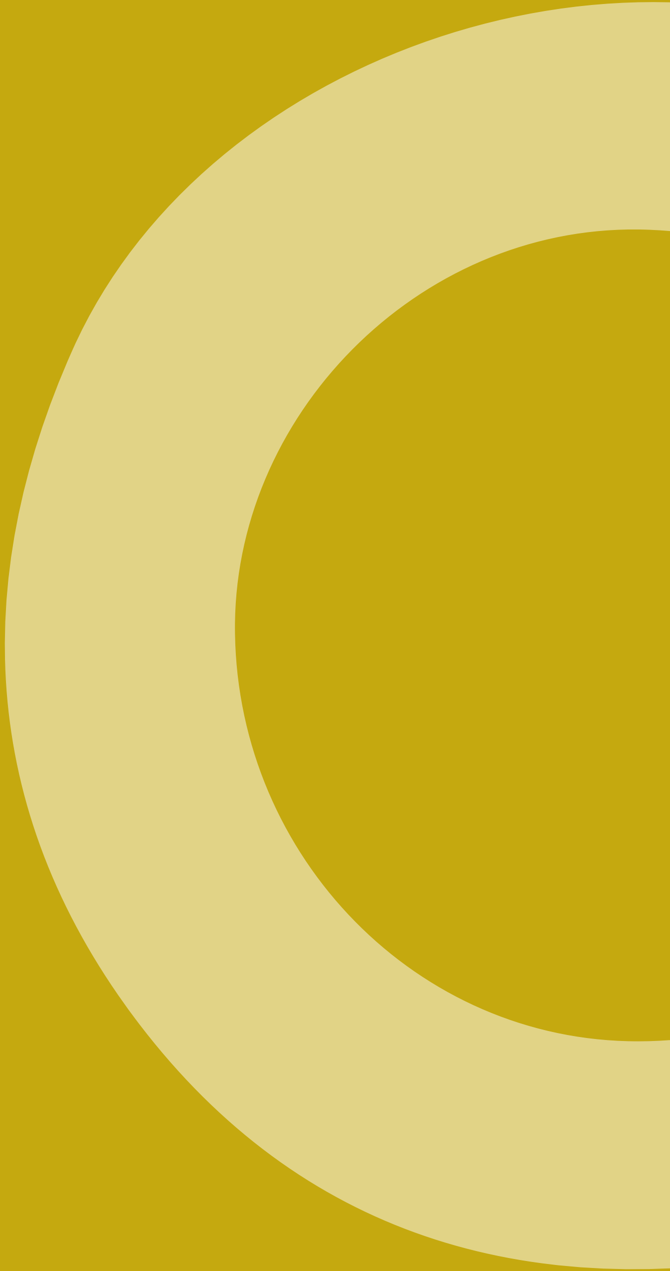
Other documents

- Interpretation Note 42 (Issue 2 – "The supply of goods or services by the travel and tourism industry").

Cases

- *KEN CC v The Commissioner for the South African Revenue Service* (Case No VAT 22184) [2023] ZATC 15 (8 December 2023);
- *XO Africa Safaris v CSARS* (395/15) [2016], ZASCA 160 (3 October 2016).

Tags: third-party supplier; cross-border supplies; local suppliers.



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