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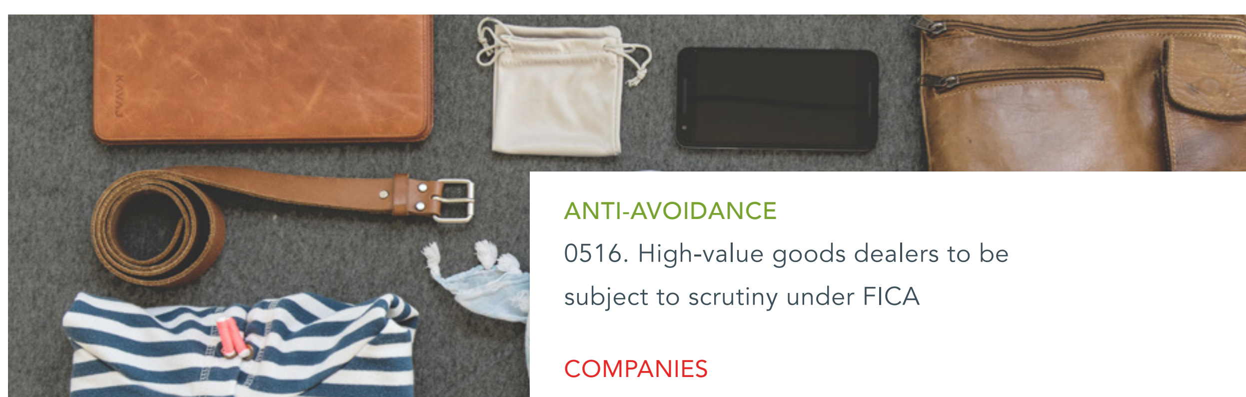
SHARE BUY-BACKS USING CTC

VALUE-ADDED TAX
EXEMPTION FOR NON-RESIDENT AIRLINE LESSORS

ANTI-AVOIDANCE
HIGH-VALUE GOODS DEALERS
TO BE SUBJECT TO SCRUTINY UNDER FICA



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HIGH-VALUE GOODS DEALERS TO BE SUBJECT TO SCRUTINY UNDER FICA

South Africa has until the end of February 2023 to meet a tight deadline to amend the Financial Intelligence Centre Act, 2001 (FICA), or face the consequences of its financial institutions being added to a grey list by the Financial Action Task Force (FATF) alongside countries such as Yemen, South Sudan, and Haiti.

The FATF's mutual evaluation of the country identified significant weaknesses in the country's anti-money-laundering and counter-financing of terrorism systems. National Treasury has noted that the Prudential Authority, Financial Sector Conduct Authority, and Financial Intelligence Centre (FIC) are working closely with the South African Revenue Service (SARS) to prevent illegal financial transactions and flows, including regulating transactions in sectors prone to illegal activities, such as the scrap steel market.

It is therefore not surprising that on 21 July 2022, the Standing Committee on Finance (SCOF) released draft amendments to the Schedules 1, 2, and 3 to FICA (the FICA Schedules). On 29 November 2022, the amendments were published by the Minister of Finance in the *Government Gazette* in terms of sections 73, 75 and 76 of FICA – the amendments are scheduled to come into effect from 19 December 2022.

A number of entities will now become accountable institutions in terms of Schedule 1 and have to comply with stringent obligations, including –

- registration with the Financial Intelligence Centre (FIC);
- customer due diligence;
- recordkeeping;
- reporting; and
- documenting their compliance measures in a risk management and compliance programme (RMCP).

Included in the list of entities are persons who carry on the business of dealing in high-value goods in respect of any transaction where such a business receives payment in any form to the value of ZAR100 000 or more. This is regardless of whether the payment is made in a single operation or in more than one operation that appear to be linked.

When interpreting these provisions it is relevant to turn to the *"FATF Recommendations, the international anti-money laundering and combatting the financing of terrorism and proliferation (AML/CFT) standards, and the FATF Methodology to assess the effectiveness of AML/CFT system"*. Recommendation 12 mandates that the requirements for customer due diligence, record-keeping, and paying attention to all complex, unusually large transactions apply to dealers in precious metals and dealers in precious stones.

The Consultation Paper on the Amendments to the FICA Schedules issued by the FIC refers to the FATF standards and notes that criminals can potentially use any high-value goods to launder illicit funds. However, some high-value goods dealers are more vulnerable to being misused for money laundering or the financing of terrorism than others, such as dealers in –

- precious metals and stones (eg, jewellers):
- antiques and collectibles;
- fine art; and
- aircraft, boats, and luxury motor vehicles.

The Consultation Paper goes on to provide:

> "[a] proposed category of high value goods dealers will be focussed on the retail sector as the risk of money laundering and terrorist financing lies in this area. Consultation with, amongst others, the Diamond Council and the Jewellery Council has confirmed the view that the risk lies in the retail sector as compared to the manufacturing or wholesale sector in so far as trade in precious metals and stones is concerned."

The new high-value goods category will also include the categories of business that are currently referred to in Schedule 2 to the FICA, namely, Krugerrand dealers and motor vehicle dealers.

The inclusion of a category aimed at high-value goods is in line with the approach followed by foreign jurisdictions. The 4th Anti-Money Laundering Directive (AMLD4), adopted by the European Union on 20 May 2015, applies to persons who trade in goods to the extent that payments are made or received in cash in an amount of EUR10 000. Likewise, in the United Kingdom, high-value dealers (classed as persons who accept cash payments of EUR15 000 or more in exchange for goods) are subject to the UK Money Laundering Regulations 2007. However, unlike the focus by foreign jurisdictions on cash payments, the amendments to the FICA Schedules will apply to payment *in any form* in excess of the ZAR100 000 threshold, with additional reporting requirements applicable to cash payments.

The publication of the draft amendments to the FICA Schedules came shortly after the promulgation on 8 June 2022 of the Regulations on Domestic Reverse Charge relating to Valuable Metal (relating to gold-containing material) (the DRC regulations). The DRC regulations is a mechanism aimed at curbing value-added tax (VAT) refund fraud involving illicit gold trading in the second-hand gold market but also apply to certain historic mine dumps.

"The Consultation Paper on the Amendments to the FICA Schedules issued by the FIC refers to the FATF standards and notes that criminals can potentially use any high-value goods to launder illicit funds."

The fraudulent scheme is similar to "missing trader" or "carousel" VAT fraud found in the European Union and elsewhere globally involving the theft of VAT from a government by fraudsters who exploit VAT rules. Missing trader fraud generally involves a trader charging VAT on the sale of high-value goods and absconding with the VAT instead of paying the VAT to the revenue authority. A stand-off usually ensues between purchasing vendors claiming VAT refunds and the revenue authority disallowing the refund claims over whose responsibility it was to scrutinise whether the supplier was a *bona fide* business.

In South Africa purchasers are also facing the brunt of SARS' enforcement action by having to fend off allegations of wilful blindness and flouting robust supplier due diligence, notwithstanding that such due diligence is not currently required by legislation. It is therefore significant that the amendments to FICA include high-value goods dealers transacting above the specified threshold of ZAR100 000 per transaction as this is seen as a clear signal to precious metals suppliers to toe the line.

The amendments will provide a much-needed regulatory framework to guide transacting parties in adequately vetting who they do business with. Unfortunately, the legislation is entirely misdirected when taking into account where the due diligence risk lies when dealing with missing trader fraud. FICA predominantly requires suppliers to validate their customers (ie, downstream due diligence), whereas an inherent feature of VAT refund fraud is unscrupulous suppliers requiring upstream due diligence by a customer.

FICA does not apply both ways. The efforts to be expended by high-value goods suppliers complying with FICA will therefore serve little purpose in curbing illicit activities in high-value goods supply chains aimed at defrauding the fiscus. More work is needed in this area.

In terms of the amendments, dealers in scrap metal, precious metals and precious stones (eg, jewellers), antiques and collectibles, fine art, aircraft, boats, luxury motor vehicles and Krugerrands will certainly become accountable institutions. Without further amendments to the Schedules or guidance from the FIC it also seems fair to conclude that all other dealers in any goods that are valued in excess of ZAR100 000 would become accountable institutions too.

"Missing trader fraud generally involves a trader charging VAT on the sale of high-value goods and absconding with the VAT instead of paying the VAT to the revenue authority."

Era Gunning & Annelie Giles

ENSafrica

Acts and Bills

- Financial Intelligence Centre Act 38 of 2001: Schedules 1 (List of accountable institutions), 2 (List of supervisory bodies) and 3 (List of reporting institutions).

Other documents

- *FATF Recommendations, the international anti-money laundering and combatting the financing of terrorism and proliferation (AML/CFT) standards, and the FATF Methodology to assess the effectiveness of AML/CFT system*: Recommendation 12;
- Consultation Paper on the Amendments to the Financial Intelligence Centre Act Schedules issued by the FIC;
- 4th Anti-Money Laundering Directive (AMLD4), adopted by the European Union on 20 May 2015;
- Money Laundering Regulations 2007 (UK);
- Regulations on Domestic Reverse Charge relating to Valuable Metal (issued in terms of section 74(2) of the VAT Act; GN 2140 in *GG* 46512 of 8 June 2022 (wef 1 July 2022);
- *Government Gazette* 47596 of 29 November 2022 (Notice 2800 – amendment of Schedules 1, 2 and 3 to the Financial Intelligence Centre Act 38 of 2001).

Tags: high-value goods; missing trader fraud; accountable institutions.

SHARE BUY-BACKS USING CTC

The Draft Taxation Laws Amendment Bill, 2022 (the draft TLAB), released on 29 July 2022, proposed important amendments to the definition of contributed tax capital (CTC) in section 1(1) of the Income Tax Act, 1962.

As widely expected, those amendments did not stand the test of time. A newly worded proposal can be found in clause 41(1) of the Taxation Laws Amendment Bill, 2022, introduced in the National Assembly on 26 October 2022. The new proposals, which are likely to be passed into law, strike a better balance between the flexibility sought by taxpayers and the anti-avoidance concerns of National Treasury.

To recap, CTC is a tax concept akin to the old company law concept of share capital and share premium. If an amount is received by or accrues to a company in exchange for shares issued by the company, such amount is added to the CTC attributable to the class of shares that was issued. If the company makes a distribution to shareholders, its directors may resolve that the distribution, or a part of the distribution, constitutes a return of CTC. In such a case there is a subtraction of the return of CTC from the balance of CTC attributable to the relevant class of shares. To the extent that the distribution is not resolved to be a return of CTC, it will constitute a dividend.

For a shareholder receiving a distribution from a company, there are important differences between whether what is received is a return of CTC or a dividend. If it is a dividend, the dividend will not give rise to capital gains tax, but dividends tax may be payable. There are various types of shareholders who are not subject to dividends tax – most notably, South African resident companies. On the other hand, if the distribution is a return of CTC, the amount received usually has capital gains tax consequences for the shareholder but not dividends tax consequences. However, there are various situations in which shareholders are not subject to capital gains tax in relation to shares in South African resident companies, including where the shareholder is a non-resident (with some exceptions) or an entity that is entirely exempt from income tax. Depending on the nature of a company's shareholders and the availability of CTC for distribution, the definition of CTC currently does not prohibit a company from resolving, based on the tax consequences of the decision for its shareholders, whether a distribution will constitute a return of CTC or a dividend.

National Treasury's anti-avoidance concerns arise because, under the current wording of the definition, CTC contributed by a shareholder of a company may be "returned" to another shareholder and the company is able to elect whether a distribution constitutes a return of CTC or a dividend.

The wording that appeared in the draft TLAB would have had the effect that companies would, as before, still be able to allocate unequal amounts of CTC between shareholders in a distribution, provided that in all other distributions of CTC made within 91 days prior to or after the date of the non-pro rata CTC distribution, CTC was allocated on a pro-rata basis to all shareholders within the relevant class of shares. Failure to comply with this requirement would have resulted in distributions made during this running period having to be accounted for entirely as dividends, which could have resulted in problems such as the retrospective reclassifications of distributions as dividends together with associated dividends tax implications. Effectively, the 91-day periods against which the distribution would have been tested would have allowed companies to make both a half-yearly and final distribution each year, allocating CTC unequally between shareholders, provided that any other distributions of CTC during the year were made on a pro-rata basis.

So, for example, if there are three issued shares in a given class with a total CTC of R120, the company may buy back one of the shares and distribute up to R40 of CTC to the shareholder. In this case, there is only one share participating in the buy-back and the company may allocate CTC to the share up to its pro-rata maximum. If, instead of one share, two shares were bought back at the same time, each of the shares being bought back would have to be allocated an equal amount of CTC, up to the pro-rata maximum of R40 per share. Failure to comply with the requirements of the definition would result in the entire amount of the buy-back, for both shares being bought back, being regarded as a dividend and not a return of CTC. In the case of a regular "going concern" distribution to all shareholders in a class, all shares in the class would have to be allocated an equal amount of CTC that may not exceed the pro-rata share of CTC, for the distribution to constitute a return of CTC in relation to any of the shares.

Provided that the buy-backs are truly commercially distinct, the wording allows for more than one share buy-back to occur within any given period. It may then be the case that in the respective buy-backs, different amounts of CTC are allocated to the shares that are bought back, provided that the shares that are bought back in each buy-back are allocated an equal amount of CTC.

The proposal is certainly more taxpayer-friendly than the amendments contained in section 4(1)*(c)* of the Taxation Laws Amendment Act, 2021, which would have had the effect that all proceeds arising in a targeted share buy-back scenario would have had to constitute a dividend and that no portion thereof could have constituted a return of CTC. As such, the change is welcomed.

Assuming the Bill passes into law, the above proposal will become effective from 1 January 2023.

The proposal contained in the version of the Bill tabled in October 2022 does away with the requirement to test distributions against any period. Instead, it requires that for a distribution, share buy-back, cancellation or redemption to constitute a return of CTC for any shareholder participating in the distribution, etc, all of the shares participating in that distribution, etc, must each receive an equal allocation of CTC. Additionally, as is the case under the current definition, the allocation of CTC per share may not exceed the total available CTC for the class of shares divided by the total number of issued shares within that class of shares.

"The new proposals, which are likely to be passed into law, strike a better balance between the flexibility sought by taxpayers and the anti-avoidance concerns of National Treasury."

Adjunct Associate Professor David Warneke

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 1(1) (definition of "contributed tax capital");
- Taxation Laws Amendment Act 20 of 2021: Section 4(1)*(c)*;
- Draft Taxation Laws Amendment Bill, 2022: Clause 41(1) (definition of "contributed tax capital");
- Taxation Laws Amendment Bill 26 of 2022: Clause 41(1) (definition of "contributed tax capital").

Tags: contributed tax capital (CTC); capital gains tax consequences; reclassifications of distributions as dividends; going concern.

TAXATION OF CRYPTO ASSET TRANSACTIONS

A gain on the disposal of crypto assets may be taxed as either revenue or capital, in line with the same income tax rules that apply to the disposal of shares or unit trusts.

The gyrations of crypto asset markets have delivered a first wake-up call to crypto traders and investors who thought it was an easy way to make money. The second alarm is about to go off as SARS is looking at how to tax all possible crypto activities.

Work on tax and financial regulatory laws that will apply to crypto assets has already begun, and the South African Reserve Bank (SARB) is taking the lead.

In a presentation in July 2022, the deputy governor said that the SARB was busy with various workstreams, including a regulatory framework for crypto exchange platforms that will ensure compliance with anti-money laundering measures, countering the financing of terrorism measures, exchange control regulations and tax laws. This would take from a year to 18 months to finalise.

In South Africa, the term crypto asset, not cryptocurrency, is used as the South African regulatory framework moves towards uniformity. According to the South African Revenue Service (SARS) website, a crypto asset is –

> "a digital representation of value that is not issued by a central bank, but is traded, transferred and stored electronically by natural and legal persons for the purpose of payment, investment and other forms of utility, and applies cryptography techniques in the underlying technology".

The Income Tax Act, 1962 (the Act), in section 1(1) defines a "financial instrument" to include any crypto asset. The ordinary meaning of crypto asset includes cryptocurrencies, and non-currency assets such as non-fungible tokens, security tokens and utility tokens – all items that are stored on a distributed ledger on decentralised networks.

FUNDAMENTALS OF TAXING CRYPTO ASSETS

The Act does not contain special rules for crypto assets. This means that the tax treatment of crypto assets would be determined in terms of the usual income tax rules for financial instruments such as equity shares or unit trusts.

The disposal of crypto assets is a taxable event. The purchase of goods or services using crypto assets results in the disposal of crypto assets with proceeds equal to the market value of the goods or services acquired. The disposal of the crypto assets thus triggers tax payable and a cash outflow. It should be noted that a disposal also occurs when one crypto asset is exchanged for another.

In considering whether the gains or losses from the disposal of crypto assets are capital or revenue in nature, the question, based on case law, will be whether the taxpayer was engaged in a scheme of profit making. Did the disposal of an asset for capital gain take place, or was there a disposal of an existing asset for the purpose of generating revenue?

SECTION 9C – GAINS DEEMED CAPITAL IF HELD FOR THREE YEARS

If a taxpayer has held an equity share for at least three years, section 9C of the Act deems the gains from the disposal of the share to be capital in nature, regardless of the intention. An "equity share" is defined in section 9C(1) to include shares in companies or a participatory interest in a portfolio of a collective investment scheme. It does not include crypto assets.

Section 9C arguably does not apply to the holding of crypto assets, which makes it more difficult for taxpayers to prove that their crypto gains are capital, rather than revenue in nature, and therefore subject to capital gains tax (CGT) rather than income tax.

INTENTION IN THE DISPOSAL OF CRYPTO

Below, we present three scenarios to illustrate how the intention behind crypto gains could be determined.

Scenario 1

AB, who is completing articles at a medium-sized audit firm, used personal savings to purchase crypto assets as an investment, intending to hold it for at least a year. However, AB sold the crypto assets two months later, for one of two possible reasons:

(1a) AB sold the crypto assets because he needed the funds to repair his car when he had an accident. AB had a small loss but was glad to recover most of the capital put down.

(1b) AB sold the crypto assets and made a small gain on the sale, as his risk appetite diminished at the first signs of a crash. He had also done more research and concluded that he was not as comfortable with the risks as he thought he would be.

We submit that these losses (1a) or gains (1b) are capital in nature. However, AB may find it difficult to satisfy the burden of proving a capital intention, especially if the coins were held in an exchange wallet, and not in a personal wallet. In an exchange wallet, crypto assets are stored on a platform which lends itself to easy liquidation and trading. A third party, namely the exchange, is given the right to dispose of the coins. In contrast, coins stored in a personal wallet cannot easily be traded.

If AB is on the highest marginal bracket (R1 731 601 for the 2023 tax year), crypto asset assessed losses could also be ring-fenced under section 20A only to be set off against future crypto asset gains.

> "The disposal of the crypto assets thus triggers tax payable and a cash outflow."

Scenario 2

In this second scenario, CD works full time at a bank. She spends every spare moment researching and watching the crypto asset markets with a view to purchasing and selling crypto assets as a long-term investment for her retirement. She discovers that one has to be quick and nimble to make a profit while investing in crypto assets.

CD had 200 disposals in the first year of 10 different crypto assets (testing the waters), and 1 000 disposals in the second year of 30 different crypto assets.

In our view, all gains/losses in both years are likely to be considered as revenue in nature.

Scenario 3

In this third scenario, EF works full time as a content creator for YouTube, a dog trainer and social influencer. EF also keeps a few machines in a spare bedroom which he uses to mine crypto assets.

In our view, the gains on disposal of the crypto assets mined would be capital in nature. EF's situation is similar to a homeowner who has a home and builds another house on the plot which is then sold after subdividing the land.

However, the gains would be more akin to be revenue from a scheme of profit making if the value of coins minted became a few million rands and the number of coins minted numbered in the hundreds, and not fractions. When EF requires an infrastructure upgrade or has to rent more space for the machines and installs a cooling system, then in our view EF would have crossed the Rubicon and is carrying on a scheme of profit making.

INTENTION MAY BE DIFFICULT TO PROVE

The intention of the taxpayer is key in determining whether gains or losses from the disposal of crypto assets are capital or revenue in nature. However, taxpayers face an uphill battle to prove that their gains or losses are capital in nature due to the high risk and volatile nature of this asset class.

Joon Chong

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "financial instrument"), 9C (more specifically also the definition of "equity share" in subsection (1)) & 20A.

Tags: disposal of shares; disposal of crypto assets; participatory interest; exchange wallet; scheme of profit making.

THIRD-PARTY DATA FROM TRUSTS AND SECTION 18A INSTITUTIONS

In line with its Vision 2024 *to streamline tax collection, the South African Revenue Service (SARS) will implement new systems for reporting trust distributions and donations to approved institutions.*

In terms of the *SARS Vision 2024*, SARS is to become a modern revenue authority informed by data-driven insights, self-learning computers, artificial intelligence (AI) and interconnectivity between people and devices.

Vision 2024 anticipates a data analytics environment in which third-party data will be provided to SARS on a real-time monthly basis. Although there is still work to be done, *Vision 2024* will improve efficiency in tax compliance, since assessments can be pre-populated with as much third-party information as possible. Income tax deductions through PAYE will also be more accurate through effective tax rates generated by SARS for each taxpayer, based on this third-party information.

Currently, banks, financial institutions (such as long-term insurers, retirement funds and collective investment schemes), medical schemes, attorneys, estate agents, and issuers of bonds, debentures and financial products are required to file third-party returns to SARS. These third-party returns are filed with SARS once a year after the end of the year of assessment and contain information on, for example, interest, dividends or capital gains on disposals in the year of assessment which accrued to a taxpayer in that year.

SARS is in the process of engaging with stakeholders by requesting comments on draft Business Requirement Specifications (BRS) for –

- resident trusts to declare distributions and vesting amounts to beneficiaries using the new IT3(t) returns; and
- institutions approved in terms of section 30 to be public benefit organisations and authorised to issue section 18A receipts to declare details of donations through the new IT3(d) returns.

REPRESENTATIVE TAXPAYERS OF TRUSTS TO DECLARE AMOUNTS VESTED OR DISTRIBUTED TO BENEFICIARIES

Currently, trust distributions are not reported by third parties to SARS. There is usually a delay (sometimes years) between the time when taxpayers file their ITR12/14 to SARS and the receipt by SARS of trust data filed through the standard ITR12T process. This means that SARS does not usually have independent data for verifying the beneficiaries of trust income, capital or assets.

Under these circumstances, it is also impossible to pre-populate those taxpayers' ITR12s for auto assessments with their distributions or amounts vested from trusts.

In a recent meeting with tax practitioners and stakeholders, SARS outlined how it, over time, intends to pre-populate the entire beneficiary section of the ITR12T with data from third parties. This cannot be done immediately because of the need to make legal and systems changes.

Over time, this information will be collected by third parties, who will provide data to SARS on amounts distributed or vested to trust beneficiaries monthly, using the standard IT 3 data flow. SARS proposes to use the ITR12T and IT3(t) processes simultaneously, and eventually merge them into a single linked beneficiary system.

The representative taxpayers of resident trusts, who would be responsible for providing this information, would be the reporting persons (in many cases, it will be tax practitioners). Non-resident trusts, collective investment schemes, employee share incentive schemes and real estate investment trusts are excluded, for various reasons.

The proposals anticipate monthly reporting of any amounts vested or distributed, when there is activity, with a final report due at the end of February. It appears nil reporting is also possible if there is no monthly or annual activity.

APPROVED SECTION 18A INSTITUTIONS TO REPORT DONATIONS

In a recent stakeholder engagement meeting, SARS emphasised the need to have approved section 18A institutions file the new IT3(d) returns with information on donors and donation amounts. This is because there have been various abuses of the system, including misuse of PBO registration numbers and situations where section 18A receipts were used for donations which had not actually been made, or where the PBOs did not exist, or the entities were not approved as PBOs.

The new reporting system ensures greater transparency and integrity in the section 18A donor deduction process. Donors can claim tax-deductible donations to an approved section 18A institution up to, generally, 10% of their taxable income.

Approved section 18A institutions include government entities, public institutions (eg, public schools and universities), PBOs engaged in welfare, health care or education (Part II of Ninth Schedule public benefit activities), specialised agencies such as United Nations agencies (eg, the UN Children's Fund and the UN Development Programme) and funding / conduit entities of the above institutions.

These institutions will be required to submit the new IT3(d) returns to SARS using different submission channels, depending on their size and governance complexities. As with the new trust return, SARS will prescribe the additional information requested in the new IT3(d) by public notice.

PROPOSED SUBMISSION CHANNELS BY TRUSTS AND SECTION 18A INSTITUTIONS

The proposals anticipate that Phase 1 will enable submission of XML data through SARS eFiling (up to 20 records per submission), uploaded via HTTPS (21 to 50 000 more records), or via IBM Connect Direct (50 001 records and above).

Phase 2 will see data reporting to SARS integrated with the third-party's financial IT systems in real time. Phase 2 is in line with the *Vision 2024* data analytics environment with real-time data processing.

SARS' efforts to obtain input from stakeholders on these new third-party submissions are most welcome. It is anticipated that the public notice requiring third-party reporting from trusts and approved section 18A institutions will be published in 2023.

"In a recent stakeholder engagement meeting, SARS emphasised the need to have approved section 18A institutions file the new IT3(d) returns with information on donors and donation amounts."

Joon Chong

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Section 18A; Ninth Schedule: Part II.

Other documents

- *SARS Vision 2024* (to streamline tax collection);
- draft Business Requirement Specifications (BRS) (issued by SARS);
- IT3(t) (trust income distributions) tax certificate;
- IT3(d) (section 18A donations) tax certificate;
- ITR12/14 tax return;
- ITR12T tax return.

Tags: trust distributions; representative taxpayers; employee share incentive schemes; tax-deductible donations; approved section 18A institution.

TIMING MATTERS WHEN TAX LEGISLATION CHANGES

In the tax court judgment of Taxpayer A v Commissioner for the South African Revenue Service, *on 14 July 2022, the court was tasked with determining whether the finance charges incurred by the taxpayer stood to be deducted in terms of section 24J of the Income Tax Act, 1962 (the Act).*

FACTS

The taxpayer in this case was a company that conducted the business of property investment and property management, including the letting out of property for purposes of earning rental income and property management income. During the 2016 year of assessment (tax year), the taxpayer entered into various loan agreements in terms of which it borrowed funds for the purposes of facilitating property development and investment. It was in respect of these loans that the taxpayer contended that it had incurred finance charges.

In its tax return for the 2016 tax year, the taxpayer claimed a deduction in respect of the aforementioned finance charges that it had incurred. These finance charges comprised raising fees, debt origination fees and structuring fees.

Subsequent to a request from the South African Revenue Service (SARS) for further information pertaining to (amongst other things) the finance charges, the taxpayer provided SARS with a breakdown of the expenses that had been incurred, including the dates on which they had been incurred, the amounts involved and the nature of the expenses.

In May 2018, SARS raised an additional assessment in respect of the taxpayer's 2016 tax year wherein it disallowed the finance charges expense in the amount of R19 500 000. The reason provided by SARS for the adjustment it made was that the taxpayer had provided no or insufficient information. SARS also imposed an understatement penalty of 50%, attributed to an incorrect statement made by the taxpayer in its return.

In disputing the additional assessment that was raised by SARS, the taxpayer contended that the finance charges (or upfront fees, as referred to by the court) together with the loan amounts constituted one and the same lending package such that the finance charges were directly connected to the loan and formed part of the total cost of borrowing. On the other hand, SARS argued that the fees were not the same or related to interest, since the fees (i) were payable upfront; (ii) constituted a "once-off payment"; and (iii) were not linked to the duration of the loan terms.

JUDGMENT

At issue before the court was whether the finance charges in question constituted interest for purposes of section 24J of the Act.

At the outset, the court noted that the definition of "interest" as provided in section 24J(1) was amended to include "similar finance charges" with effect from 19 January 2017. In respect of the 2016 tax year, the word "interest" in section 24J was defined as including the "gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement".

In summary, in the 2016 tax year, the definition referred to "related finance charges" whereas the subsequent amendment referred to "similar finance charges".

On the basis that the present case pertained to the 2016 tax year, which is the period prior to that in which the amendment came into effect, the court could not have regard to the amended definition in making its determination regarding the deductibility of the finance charges in the present matter.

It was therefore necessary for the court to determine whether the upfront fees/finance charges in question constituted "related finance charges" as contemplated in the 2016 tax year definition of "interest".

The court further noted:

> "In deciding how the expenditure should properly be regarded, the court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects."

It was held that the taxpayer had presented sufficient evidence to establish that the upfront fees, together with the interest, made up the cost of borrowing on the basis that, had the fees not been paid, the taxpayer would not have been able to acquire the loan. There was thus no reason to justify a difference between the interest on the loans and the upfront fees.

To this end, the court reiterated that the fact that (i) the upfront fees were not linked to the duration of the loans; and (ii) the taxpayer was liable to pay value-added tax on the upfront fees but not on the interest, did not constitute a basis to find that the upfront fees were not "related [to] finance charges". The court therefore agreed that the upfront fees constituted "interest" as defined in the legislation applicable to the 2016 tax year.

"In May 2018, SARS raised an additional assessment in respect of the taxpayer's 2016 tax year wherein it disallowed the finance charges expense in the amount of R19 500 000."

SARS then contended that the upfront fees were not deductible because they were capital in nature.

Section 24J permits a taxpayer to claim an interest expense deduction to the extent that the interest is incurred in the production of income from the carrying on of a trade. There is no requirement in section 24J that the interest (or related charges) claimed must not be of a capital nature and the court held that a deduction in terms of section 24J must not be conflated with a claim for deduction under section 11*(a)* (which imposes the requirement that the expense being claimed must not be of a capital nature).

In the present matter, the taxpayer claimed the deduction in terms of section 24J and not in terms of section 11*(a)* and the court agreed with the taxpayer's contention that "section 24J constitutes a stand-alone deduction provision in relation to interest as defined". As the deductibility test in terms of section 24J does not include an element regarding the capital nature of the expense, SARS' contentions in this regard were held to be unfounded.

Having regard to the specific requirements of section 24J, the court held that the upfront fees (which constituted "interest" as defined) were incurred in the production of income in the course of a trade that was carried on by the taxpayer. As such, the upfront fees stood to be deducted by the taxpayer in terms of section 24J and the taxpayer succeeded with its appeal.

On the basis that the taxpayer had succeeded with its deduction claim in terms of section 24J, the issue surrounding the understatement penalty imposed by SARS fell away.

COMMENT

A fundamental legal principle is that the law is not intended to be retrospective unless a clear contrary intention appears in the legislation. In South Africa, the tax statutes are amended regularly, and it is imperative that taxpayers and practitioners keep up to date with the legislative amendments that affect them.

This judgment serves as reminder that it is necessary to take cognisance of the dates on which the amendments come into effect and to ensure that tax returns are submitted having regard to the correct legal provisions applicable to the relevant tax year.

This judgment is also noteworthy because it reiterates the importance of (i) understanding and applying the specific requirements prescribed in each section of the Act; and (ii) not conflating provisions that overlap but are in fact stand-alone provisions.

Louise Kotzé

Cliffe Dekker Hofmeyr

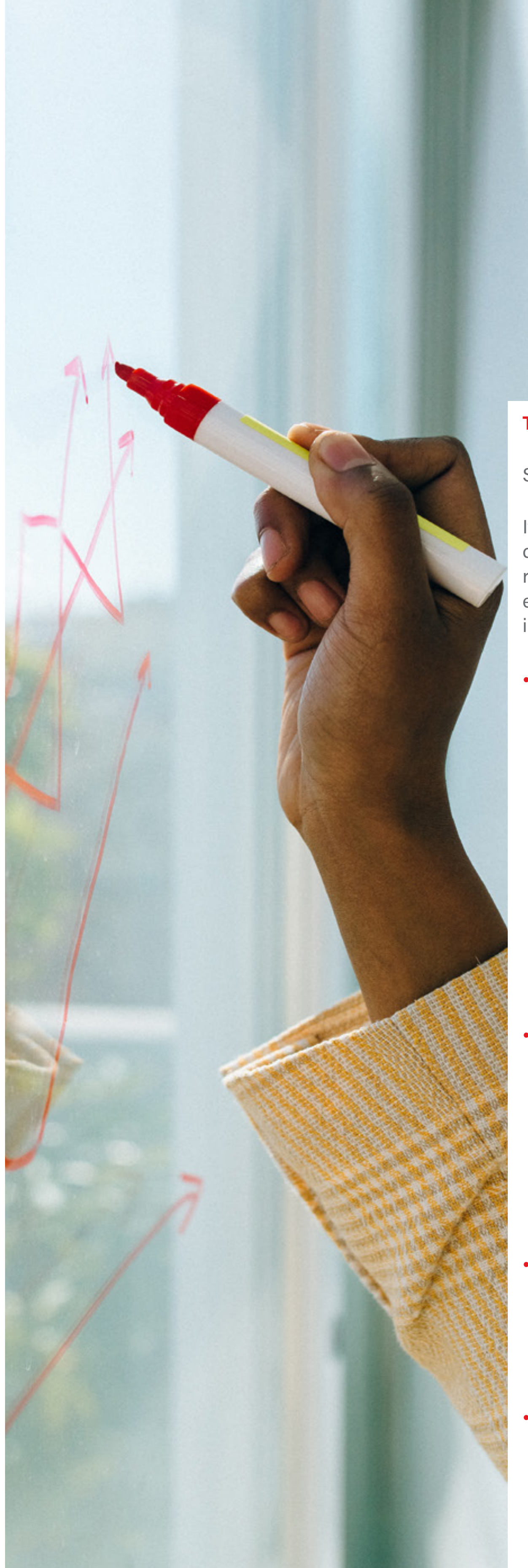
Acts and Bills

- Income Tax Act 58 of 1962: Sections 11*(a)* & 24J (more specifically subsection (1) (definition of "interest")).

Cases

- *Taxpayer A v Commissioner for the South African Revenue Service* [2022] (IT 25042) (14 July 2022).

Tags: rental income; property management income; finance charges; upfront fees.



SARS INTEREST RATES INCREASES

TAX AND VAT – INTEREST RATE INCREASES

SARS has again increased rates as detailed below.

It is important to remember that interest and penalties paid to SARS are not deductible expenses for income tax purposes. On the other hand, interest received from SARS is fully taxable (after deducting the current initial exemption of R23 800 per annum (R34 500 if you are 65 or older) for all local interest income earned by natural persons).

- ***Income tax, provisional tax, dividends tax, etc***

  Payable to SARS on short payments of all such taxes (other than VAT): 9.75% per annum from 1 January 2023 (was 9% per annum with effect from 1 November 2022).

  Payable by SARS on refunds of tax (where interest is applicable): 5.75% per annum from 1 January 2023 (was 5% per annum with effect from 1 November 2022).

  If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 9.75% per annum from 1 January 2023 (was 9% per annum with effect from 1 November 2022).

- ***VAT***

  Payable to SARS on late payments: 9.75% per annum from 1 January 2023 (was 9% per annum with effect from 1 November 2022).

  Payable by SARS on VAT refunds after prescribed period: 9.75% per annum from 1 January 2023 (was 9% per annum with effect from 1 November 2022).

- ***Fringe benefits***

  Official interest rate for loans to employees below which a deemed fringe benefit arises: 8% per annum with effect from 1 December 2022. See below for details of historical changes.

- ***Dividends tax***

  Official interest rate for loans (designated in rands) to shareholders below which the interest on such loans can be deemed to be dividends on which dividends tax is payable: 8% per annum with effect from 1 December 2022. See below for details of historical changes.

"It is not the amount of the loan but the interest reduction which is deemed to be a dividend."

- ***Donations tax***

  Loans to trusts by natural connected persons with interest charged at rates below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

- ***Penalties***

  The amount of penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX – INTEREST RATES

- If inadequate interest is charged to an employee (including working directors) on loans (other than for the purpose of furthering their own studies) in excess of R3 000 from their employer (or associated institution), tax on the fringe benefit may be payable.

  Unless interest is charged at the "official" rate or greater, the employee is deemed to have received a taxable fringe benefit calculated as being the difference between the interest actually charged and interest calculated at the "official" rate.

  For employees' tax purposes, the tax deduction must be made whenever interest is payable; if not regularly, then on a monthly basis for monthly paid employees, weekly for weekly paid employees, etc.

- Subject to a number of exceptions, distributions of income and capital gains from a company / close corporation are normally subject to dividends tax at the flat rate of 20%. Loans or advances to or for the benefit of a shareholder / member will be deemed to be dividends but only to the extent that interest at less than the "official" rate (or market-related rate in the case of foreign currency loans) is payable on the loan, or fringe benefits tax is payable on an interest-free (or subsidised-interest) loan to an employee.

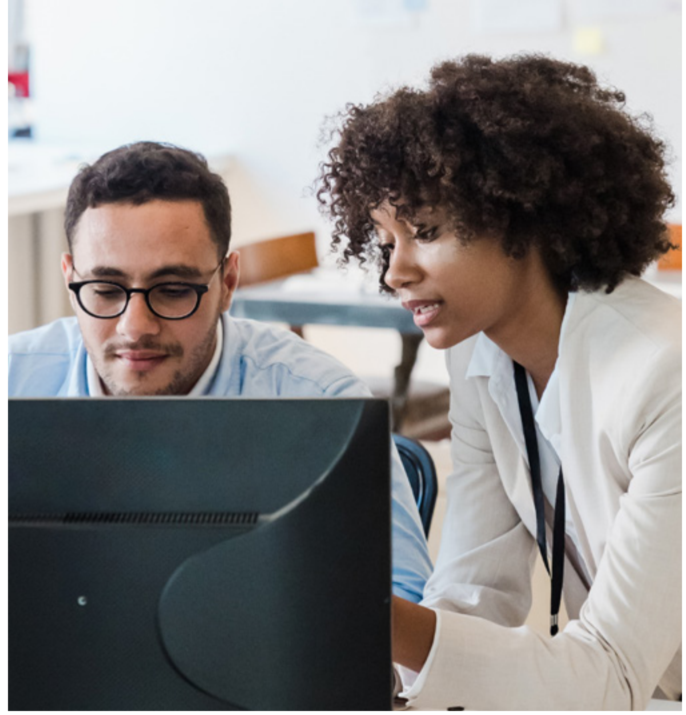
  It is not the amount of the loan but the interest reduction which is deemed to be a dividend. Low-interest loans are accordingly subject to dividends tax payable by the company and only in respect of the interest benefit.

- Loans to trusts by natural connected persons with interest charged below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

- With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African "repo rate" plus 1%. For foreign-currency loans, the rate is the equivalent of the foreign "repo rate" plus 1%. The South African repo rate currently stands at 7% per annum (with effect from 1 December 2022).

THE "OFFICIAL" RATE OF INTEREST OVER THE PAST FIVE YEARS

With effect from		*Rate per annum*
1 April 2018	–	7.50%
1 December 2018	–	7.75%
1 August 2019	–	7.50%
1 February 2020	–	7.25%
1 April 2020	–	6.25%
1 May 2020	–	5.25%
1 June 2020	–	4.75%
1 August 2020	–	4.50%
1 December 2021	–	4.75%
1 February 2022	–	5.00%
1 April 2022	–	5.25%
1 June 2022	–	5.75%
1 August 2022	–	6.50%
1 October 2022	–	7.25%
1 December 2022	–	8.00%



Kent Karro

Tags: deductible expenses; natural connected persons; donations tax; taxable fringe benefit; low-interest loans; repo rate.

UAE CORPORATE TAX

RECENT DEVELOPMENTS IN UAE CORPORATE TAX LAW

Post release of a public consultation document by the Ministry of Finance (MoF) in the UAE in April 2022, a press article was published stating that it was expected that the final UAE corporate tax law could be unveiled in September 2022. Following the expectation of final law soon and the introduction of UAE corporate tax from 1 June 2023, it is imperative that African companies having transactions in the UAE either through group companies or through third parties, identify and analyse the applicability of UAE corporate tax to their business operations and start thinking in terms of implications and restructuring operations.

APPLICABILITY TO MULTINATIONAL/ FOREIGN COMPANIES

Prima facie, UAE corporate tax will apply to companies and legal persons incorporated in the UAE. In addition to this, UAE corporate tax will also apply to multinational and foreign companies which have a –

- permanent establishment (PE) in the UAE; or
- place of effective management (POEM) in the UAE.

A summary of the impact on multinationals/foreign companies follows below:

(A) PERMANENT ESTABLISHMENT (PE) IN THE UAE

The UAE corporate tax proposes to introduce the concept of PE based on the OECD Model Tax Convention. Furthermore, it also provides an inclusive definition of PE under two general tests, ie, a fixed place PE and an agency PE.

Fixed place permanent establishment (PE)

A fixed place PE is triggered in situations where a foreign company has a "fixed place" in the UAE through which the business is wholly or partly carried on and includes a branch, office, factory, workshop, real property and building site, installations and structures used in exploration of natural resources, etc. In a typical fixed place PE scenario, all the following conditions need to be satisfied:

- Existence of place of business in the UAE;
- There must be a fixed place of business in the UAE, ie, established in a distinct place with a certain degree of permanence (the fixed place can be owned, rented, leased, etc);
- The business must be carried out wholly or partially through such fixed place.

Agency permanent establishment (PE)

An agency PE will be created if a person acting on behalf of the foreign company in the UAE has and habitually exercises the authority to conclude contracts or negotiates/concludes contracts without any material intervention by the foreign company. However, this is a very fact-sensitive exercise.

Any conduct of certain activities of a preparatory and auxiliary nature, will not result in the creation of any PE in the UAE including, but not limited to –

"An agency PE will be created if a person acting on behalf of the foreign company in the UAE has and habitually exercises the authority to conclude contracts or negotiates/concludes contracts without any material intervention by the foreign company."

- an independent agent acting in the ordinary course of its own business;
- an agent who does not work exclusively for the foreign company and is truly legally and economically independent from the foreign company. It is worthwhile to note that the above PE rules also apply to Free Zone persons in the UAE.

Certain instances such as frequent overseas travel or employees working from their home, local office or even a temporary field office could lead to potential PE exposure. Accordingly, it will be important to observe the approach of the UAE tax authorities while scrutinising the applicability of UAE corporate tax to foreign entities in the UAE. The arrangements of foreign companies would require thorough review in the light of PE rules and tax treaty provisions in the UAE.

Attribution of profits where a permanent establishment is established

Attribution of profits to a PE is probably one of the most complex subjects of the international tax space. Typically, the profits attributed to the PE will be those profits that the PE would have expected to generate, if it was a separate and independent enterprise carrying out the same or similar activities in the same or similar conditions, taking into account functions performed, and assets used, and risks assumed.

For this purpose, guidance may also be drawn from internationally accepted policies and OECD guidelines. Needless to say, transfer pricing would also play an important role here.

(B) PLACE OF EFFECTIVE MANAGEMENT (POEM) IN THE UAE

A UAE-headquartered company operating overseas through subsidiaries or an intermediate holding company, will need to consider place of effective management risks for their foreign group entities in the UAE as a result of the introduction of the place of effective management concept. Furthermore, since "residence" is to be determined for each year, POEM will also be required to be determined on a year-by-year basis.

Attribution of profits where place of effective management is established

A foreign company that is effectively managed and controlled in the UAE will be subject to UAE corporate tax on their worldwide income, whereas a non-resident entity will be taxed only on UAE-sourced income and / or income attributable to a PE in the UAE.

TRANSFER PRICING

Taxpayers having intra-group transactions will need to comply with transfer pricing regulations which follow the OECD Transfer Pricing Guidelines, ie, Master File and Local File.

Transfer pricing regulations require that transactions between related / connected persons are to be at "arm's length". In simple terms, the arm's length principle means that a contractual relationship between related / connected persons should be the same as, or similar to, one with a third party or between third parties, under comparable circumstances.

WAY FORWARD

With Africa being one of the fast emerging and important markets for the UAE and the increasing trade of African countries in the UAE, it is important for multinationals having operations in the UAE to proactively assess the impact of corporate tax and transfer pricing laws, and to mitigate the PE risk.

This will help companies to reduce the risk of unexpected tax payments, to identify opportunities for tax efficiencies and/or improvements to the internal control framework and to facilitate appropriate disclosures to tax authorities in order to reduce the risk of challenge and penalties.

Binit Shah

Crowe UAE

Other documents

- OECD Model Tax Convention;
- OECD Transfer Pricing Guidelines.

Tags: permanent establishment (PE); place of effective management (POEM); Agency permanent establishment (PE); transfer pricing regulations.

BONA FIDE INADVERTENT ERROR

*Section 222(1) of the Tax Administration Act, 2011 (the TAA), provides that, in the event of an "understatement" by a taxpayer, the taxpayer must pay, in addition to the "tax" payable for the relevant tax period, the understatement penalty, as determined under section 222(2), unless the "understatement" results from a "*bona fide *inadvertent error".*

In terms of section 222(2), an understatement penalty is determined with reference to the table contained in section 223, which takes into account, among other things, the "behaviour" of the taxpayer. The first listed "behaviour", item (i), which attracts the lowest penalty percentage, is "substantial understatement", which is defined in section 221 as "a case where the prejudice to SARS or the fiscus exceeds the greater of five per cent of the amount of 'tax' properly chargeable or refundable under a tax Act for the relevant tax period, or R1 000 000". Thereafter, a further five behaviours are listed, ranging from (ii) "reasonable care not taken in completing return" to (vi) "intentional tax evasion", which attracts the highest penalty percentage. The South African Revenue Service (SARS') *Guide to Understatement Penalties* (the SARS Guide) indicates that:

> "If the act or omission of the taxpayer is not encapsulated in any of the listed behaviours, there is no basis for the determination of a penalty and consequently there can be no penalty."

On the basis that categories (ii) to (vi) seem to require a level of blameworthiness, it seems that the "*bona fide* inadvertent error" exclusion would be most (if not only) relevant in relation to a "substantial understatement". It is noted that SARS seems to answer the question of whether a "*bona fide* inadvertent error" has been made by asking whether reasonable care had been taken in completing a return. The distinction between these phrases is important in the context of a prospective voluntary disclosure programme (VDP) application since it is one of the requirements that the disclosure must "involve a behaviour referred to in column 2 of the understatement penalty percentage table in section 223".

In *ABC Holdings (Pty) Ltd v The Commissioner for the South African Revenue Service* [2016] (ITI 13772), the tax court held that

> "... the *bona fide* inadvertent error has to be an innocent misstatement by a taxpayer on his or her return, resulting in an understatement, while acting in good faith and without the intention to deceive."

The SARS Guide prefers a very narrow interpretation and states as follows:

> "An inadvertent error is one that does not result from deliberate planning, and a *bona fide* inadvertent error is one that genuinely does not result from deliberate planning. Importantly, the lack of deliberate planning must relate to the error, that is, the default, omission, incorrect statement, failure to pay the correct tax, or impermissible avoidance arrangement must be genuinely involuntary.
>
> . . .
>
> In a similar vein, for example, the payment of an amount of tax when a return is not required, or deductions of capital expenses in returns, presupposes the application of forethought. Even when this forethought is based on *bona fide* incorrect reasoning, or an opinion incorrectly interpreted without the intention to deceive, the payment, non-payment, or incorrect statement itself cannot be said to be validly unmeant. Only if the amount captured or its location on the return does not coincide with the actual intent of the taxpayer, could such an error possibly be regarded as an authentically unthinking mistake.

> From the foregoing, it seems likely that the only errors that may fall within the *bona fide* inadvertent class are typographical mistakes – but only properly involuntary ones. This does not mean that a lack of reasonable care will be excused. An error cannot be said to be legitimately unplanned when for instance, a clerk makes a capturing error that results in an understatement, and as it should be, the return is reviewed by their supervising public officer or tax practitioner, and this person misses the error because they are anxious to attend the golf day organised by a supplier. In such an instance, the choice not to take the reasonable care appropriate to their station cannot be said to be truly unpremeditated".

SARS gives an example of a taxpayer who filed a tax return that included a deduction in respect of a donation of R2 500 to a charity. It then turns out the charity's system issued an erroneous certificate, and that the donation was only R1 000. SARS, however, is of the view that the omission does not constitute a "*bona fide* inadvertent error" as "the amount was deliberately captured in the return" but that since none of the behaviours per the table are applicable, no penalty can be imposed. How would one make sense of this if there was a "substantial understatement", eg, the donation was R2.5 million and not R2 500?

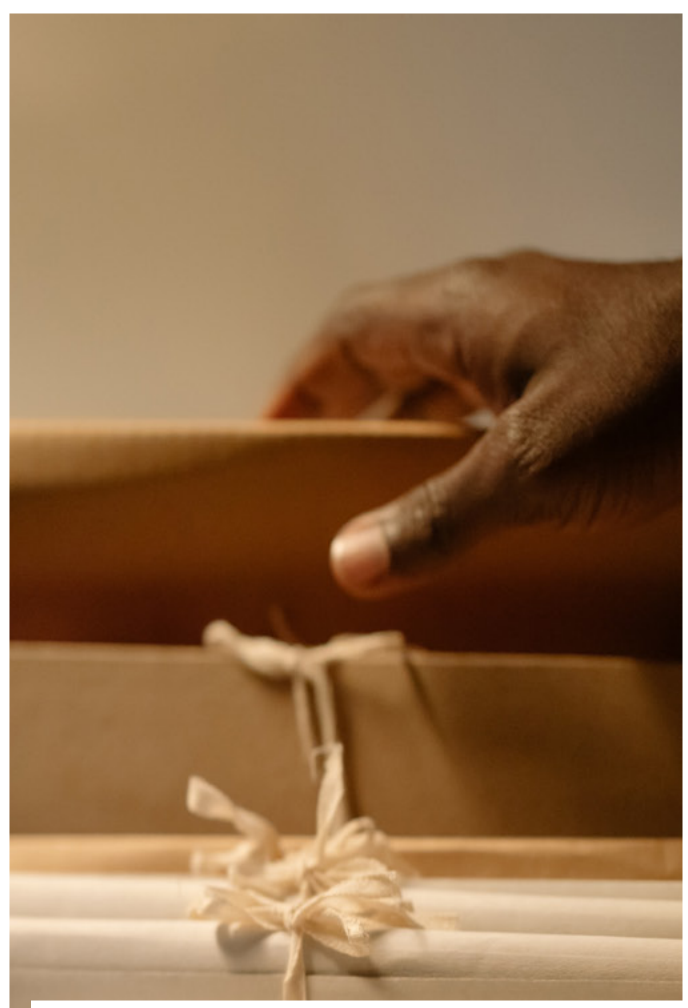
In December 2019, the distinction between a "*bona fide* inadvertent error" and "reasonable care not taken in completing return" was considered by the tax court in Port Elizabeth in *ITC 1948* 84 SATC 110 [2019]. The taxpayer (Appellant), a close corporation, appointed professional accountants to prepare and complete its 2016 income tax return.

Based on input from the accountant, the Appellant changed certain accounting depreciation policies to bring it in line with the wear-and-tear rates of SARS. The accountants prepared a tax computation in preparation of the Appellant's income tax return, but forgot to add back the adjustment in respect of the change in accounting policy. The same omission was made in the tax return completed by the accountant and submitted to SARS, which resulted in an overstatement of the Appellant's assessed loss.

The discrepancy was subsequently identified and SARS issued a revised assessment and imposed an understatement penalty on the basis that the taxpayer had not taken reasonable care in completing the return. The Appellant objected to the imposition of the penalty, *inter alia*, on the basis that the omission constituted a *bona fide* inadvertent error. The objection was disallowed, and the Appellant then lodged an appeal.

The court had to consider, among other things, whether the Appellant should be excused from paying the penalty on the basis that the understatement was as a result of the *bona fide* inadvertent error. In dismissing the appeal, the court held as follows:

- The dictionary meaning of the word "inadvertent" was linguistically not that straightforward;
- The context of what will constitute an honest mistake must be provided by the provisions which follow section 222(1). An "inadvertent" error cannot include any error that is the result of neglect as it would be inconsistent with the nature of the wrongdoing for which the taxpayer is responsible in terms of the table contained in section 223. The determination of what an inadvertent error is, must therefore be done with reference



"The SCA held that the Thistle Trust had erred, but did so in good faith and acted unintentionally and that SARS was therefore not entitled to levy any understatement penalty."

to what it was not, ie, an error is not inadvertent, and therefore inexcusable, where the taxpayer's action or omission can be classified as a failure to take reasonable care in the completion of his or her tax return, or as being intentional or grossly negligent.

- Taking reasonable care in the context of submitting a tax return requires giving "appropriately serious attention to complying with the obligations imposed under the tax legislation". While it could be accepted that the incorrect statement in the return was an honest mistake, it also had to be an inadvertent mistake.

- "Reasonable care requires the taxpayer to take the degree of care that would be expected of a reasonable and prudent taxpayer in the position of the taxpayer concerned to fulfil his or her tax obligations... The question was whether on an objective analysis there had been a failure by the taxpayer to take reasonable care and it was a factual question that must be decided on the facts of each case."

- The accountant had failed to act with the expected diligence when he advised the Appellant to effect a change to its accounting policy but then failed to ensure that the change was reflected in the tax computation and in the tax return. The mistake was then carried over into the tax return which indicates that the return was prepared without being checked to the financial statements. Such "failures speak of an absence of reasonable measures and/or the implementation of measures to avoid the obvious mistake in question".

- The question was therefore not whether the accountant's conduct should be imputed to the Appellant, but rather whether the Appellant had exercised the standard of care and diligence expected of a reasonable taxpayer in respect of the completion and submission of its tax return.

The court held that a reasonable taxpayer would at a minimum have taken steps to satisfy itself that the accountant did not make an obvious error in preparing the return. In the previous tax year, the Appellant had made a profit and in the 2016 tax year it suffered a loss of more than R37-million per its tax return. A diligent taxpayer would have picked this up, and this indicates, in the absence of any evidence to the contrary by the Appellant, that the Appellant had not carefully reviewed the tax return before submission. Accordingly, the incorrect statement did not constitute a *bona fide* inadvertent error; instead, the Appellant had failed to take reasonable care in completing its tax return.

In terms of *ITC 1948*, it therefore seemed that an escape from understatement penalties based on the "*bona fide* inadvertent error" defence would only be accepted by SARS in very limited circumstances.

However, in this context SARS recently suffered a blow in the Supreme Court of Appeal (the SCA) case, *CSARS v The Thistle Trust* (516/2021) (2022) ZASCA 153. In this case, despite the taxpayer (the Thistle Trust) having obtained a legal opinion (sought by one of the underlying companies) regarding the tax treatment of capital gains vested in and by the Thistle Trust, SARS had imposed a 50% understatement penalty on basis that the taxpayer had "no reasonable grounds for the tax position taken". SARS initially argued that the Thistle Trust had consciously and deliberately adopted a tax position and that the error therefore did not constitute a "*bona fide* and inadvertent error". However, during argument before the SCA, SARS conceded that the Thistle Trust had made "a *bona fide* and inadvertent error" in believing that section 25B of the Income Tax Act, 1962, applied in respect of the capital gains. The SCA held that the Thistle Trust had erred, but did so in good faith and acted unintentionally and that SARS was therefore not entitled to levy any understatement penalty.

Whilst the case unfortunately does not provide any detail around the reasoning behind SARS' "concession", the Thistle Trust case is significant for taxpayers in that it challenges SARS' narrow interpretation of what constitutes a "*bona fide* and inadvertent error".

"In terms of *ITC 1948*, it therefore seemed that an escape from understatement penalties based on the '*bona fide* inadvertent error' defence would only be accepted by SARS in very limited circumstances."

Annalie Pinch (Reviewed by **Peter Dachs**)

ENSafrica

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 221 (definition of "substantial understatement"), 222(1) & (2) & 223;
- Income Tax Act 58 of 1962: Section 25B.

Other documents

- Guide to Understatement Penalties (SARS) (Issue 2).

Cases

- *ABC Holdings (Pty) Ltd v The Commissioner for the South African Revenue Service* [2016] (ITI 13772);
- *ITC 1948* 84 SATC 110 [2019];
- *CSARS v The Thistle Trust* (516/2021) (2022) ZASCA 153.

Tags: *bona fide* inadvertent error; innocent misstatement; understatement penalty.

PROTRACTED LEGAL DISPUTES

In the judgment of SACS (Louis Trichardt) (Pty) Ltd v Commissioner for the South African Revenue Service *(Case No 40420/2020 and 17064/2021), which was handed down on 14 July 2022, the High Court was faced with two applications brought by the taxpayer after a litany of prior litigation spanning the course of over a decade.*

FACTS

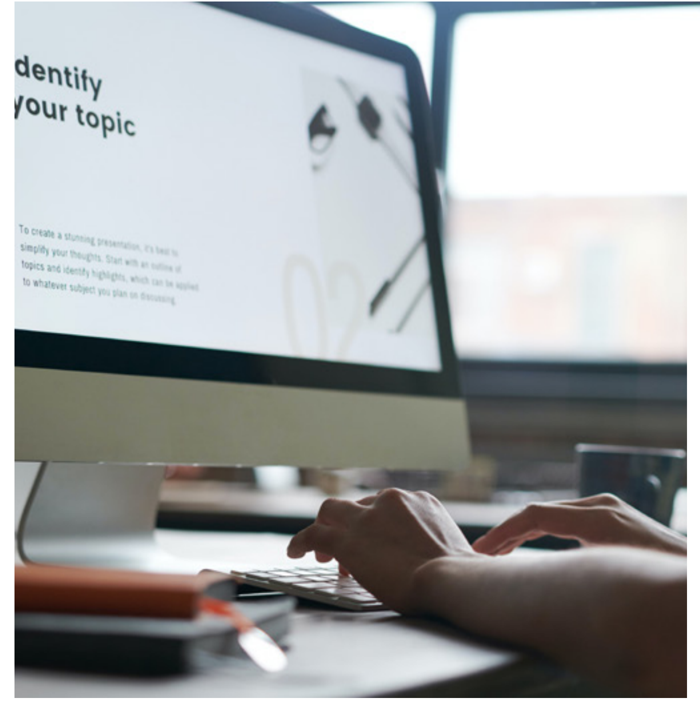
The litigious history between the taxpayer in this case and the Commissioner for the South African Revenue Service (SARS) is protracted and cumbersome to wade through. The first dispute between the parties arose in 2007, in relation to the taxpayer's 2002–2004 years of assessment (tax years), and subsequent disputes have arisen in respect of the taxpayer's 2005–2012 tax years and its 2013–2017 tax years.

The dispute related to the 2002–2004 tax years was brought to finality in the Supreme Court of Appeal (SCA) in 2014, after which the taxpayer requested that SARS compute its tax liabilities for the 2005–2012 tax years in accordance with the outcome. However, SARS declined to do so, on the basis that it had reconsidered the facts and relevant legal principles. As a consequence SARS included a substantial recoupment in the taxpayer's tax computation. Thus, the dispute in respect of the 2005–2012 tax years arose.

Before this dispute was finalised, the taxpayer had to submit its tax returns for the 2013 and 2014 tax years. This was done by adopting the same approach as was taken by the taxpayer in respect of the 2005–2012 tax years. SARS rejected this approach and the parties engaged in dispute resolution proceedings in respect of the taxpayer's 2013 and 2014 tax years.

In October 2016, the taxpayer and SARS entered into an agreement (the Agreement) to extend the prescription period for the assessment of all tax liabilities for the 2013 and 2014 tax years (in terms of section 99(2)*(c)* of the Tax Administration Act, 2011 (the TAA)), until the dispute relating to the 2005–2012 YOAs was finally determined. Importantly, the Agreement noted that –

- the outcome of the 2005–2012 tax years dispute (referenced in the Agreement as the "Final Decision") would have an impact on the tax liability determination of subsequent tax years: and
- in respect of the 2013–2014 tax years, both parties would give effect to the Final Decision.



The parties proceeded to litigate the 2005–2012 tax years dispute. However, on the basis that SARS continuously failed to adhere to the prescribed deadlines, the taxpayer applied for default judgment in the tax court in 2017. SARS again failed to timeously submit the necessary documents in respect of the application for default judgment and, as such, judgment was granted in favour of the taxpayer. This decision was not taken on appeal by SARS. Barring a few issues pertaining to the payment of interest by SARS to the taxpayer, the 2005–2012 dispute had been finalised.

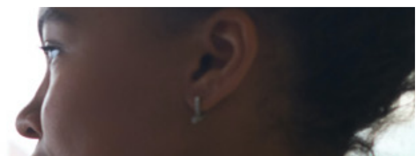
The taxpayer then relied on this judgment in an attempt to persuade SARS that the outcome of the 2005–2012 dispute (being the Final Decision, which favoured the taxpayer) was to be applied in respect of the 2013–2014 tax years. SARS declined, contending that the outcome of the 2005–2012 dispute did not constitute a "Final Decision" that would apply to the subsequent tax years, as the merits of the dispute had not been judicially determined.

A year later, SARS extended its latest audit to include the taxpayer's 2013–2017 tax years. The issues in dispute remained unchanged save for the additional tax years that came under review.

Substantial litigation took place between the parties, thereafter, including multiple applications by the taxpayer for default judgment on the basis that SARS failed to adhere to the prescribed tax court rules' deadlines.

In October 2020, another agreement (Agreement 2) to extend the prescription period in respect of the taxpayer's 2013–2016 tax years was orally agreed to between the parties. However, this agreement was only signed by SARS in November 2020, whereas it was specified in the agreement that it had to be signed by October 2020. The taxpayer thus contended that Agreement 2 was invalid and that the 2013–2016 tax years had prescribed, therefore precluding SARS from raising additional assessments in respect thereof.

Two applications were brought by the taxpayer in the present case.



"In the present matter, the court took the view that the argument advanced by the taxpayer would pass muster only to the extent that the default judgment referred to by it constituted a final pronouncement on the substantive issues comprising the dispute between the parties."

JUDGMENT

The first application

The first application brought by the taxpayer sought an order precluding SARS from assessing the taxpayer's tax liabilities for the 2013–2016 tax years on a basis different to the outcome pertaining to the 2005–2012 tax years.

As the 2005–2012 tax years' default judgment had not been taken on appeal by SARS, the taxpayer contended that the outcome thereof constituted a "Final Decision" in terms of the Agreement and that the parties were thus bound by that decision in respect of the subsequent tax years. To this end, the taxpayer referred to section 100(1)*(f)* of the TAA, which provides that a final decision in respect of an assessment exists when "the matter has been determined by the tax court and there is no right of further appeal".

SARS, however, maintained its argument that the default judgment only addressed the issue of SARS' application for condonation for its failure to adhere to the tax court rules' time periods and that the merits of the dispute between the parties were not considered or pronounced on by the court in that case.

In the present matter, the court took the view that the argument advanced by the taxpayer would pass muster only to the extent that the default judgment referred to by it constituted a final pronouncement on the substantive issues comprising the dispute between the parties. To this end, the court highlighted that the default judgment specifically stated that in that case, the court was "not determining the merits of the disputed assessments" because it had not been placed in a position to decide whether or not the prospects of success of SARS' case were good.

The court in the present case then reiterated that:

> "The key component of the context of the [Agreement] was a joint recognition by the parties that their respective understandings of the interpretations and applications of [the relevant sections] of the ITA were not the same, and that the only way to resolve their differences was for the court to make a determination on these issues."

The purpose and intention behind the Agreement was thus to allow the parties to seek a judgment from the tax court clarifying which of the understandings of the parties was correct. As such, even though the tax court's default judgment had not been appealed by SARS, the merits of the parties' respective cases remained alive and awaited judicial pronouncement.

Ultimately, the court concluded that only a pronouncement on the merits of the matter would constitute a "Final Decision" in terms of the Agreement that SARS would be bound to give effect to in respect of the taxpayer's subsequent tax years.

The taxpayer raised a further argument in respect of a decision taken by SARS in 2007, whereby the tax treatment championed by the taxpayer in respect of the 2013–2014 tax years' dispute had been granted by SARS in respect of the taxpayers' 2001–2004 tax years. In response, the court held as follows:

> "It is correct that the exemption was granted in the 2001 to 2004 tax computations. But this does not mean that SARS has to grant the exemptions thereafter. It is clear from a comparison of what SARS said in its assessment for the 2001 to 2004 tax years – allowing the exemption – and what it said in its assessment for the 2005 to 2012 tax years – disallowing the exemption – that upon further analysis and reflection it had reassessed its understanding. There is nothing in law precluding it from doing so."

Ultimately, it was the court's finding that if SARS is of the view that its previous application or understanding of a tax provision was incorrect, it is not obliged to replicate that error in future assessments.

The court therefore dismissed the first application with costs.

The second application

In the second application, the taxpayer sought an order precluding SARS from raising additional assessments in respect of the 2013–2016 tax years on the basis that Agreement 2 had not been properly executed in accordance with the requisite formalities and, as such, these tax years had prescribed.

It was common cause that Agreement 2 was only formally executed by SARS in November 2020, whereas the agreement had to be concluded before or on 16 October 2020 in order to extend the period of prescription (on the basis that the previous extension would have lapsed on 16 October 2020).

In terms of section 99(1)*(c)* of the TAA, the only way to extend the limitations period in respect of any tax year is for the parties to agree to do so. It was the taxpayer's argument that since Agreement 2 was only signed by SARS in November 2020, the parties had not agreed to extend the prescription period. On the other hand, SARS contended that prior to 16 October 2020, the parties had orally agreed to extend the prescription period and that the execution of Agreement 2 in November 2020 was merely a confirmation of what had been agreed.

Section 99(1)*(c)* does not prescribe the method by which an extension should be agreed upon between SARS and a taxpayer. Of particular importance is that this section does not preclude an oral agreement extending the limitations period.

In light of the evidence presented by SARS that an oral agreement had been reached between the parties prior to 16 October 2020, the court held that the parties had in fact come to an agreement to extend the period of prescription in terms of the 2013–2016 tax years such that the provisions of section 99(1)*(c)* had been complied with.

The court therefore dismissed the second application with costs.

"Substantial litigation took place between the parties, thereafter, including multiple applications by the taxpayer for default judgment on the basis that SARS failed to adhere to the prescribed tax court rules' deadlines."

Louise Kotze

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 99(1)*(c)* & (2)*(c)* & 100(1)*(f).*

Cases

- *SACS (Louis Trichardt) (Pty) Ltd v Commissioner for the South African Revenue Service* (Case No 40420/2020 and 17064/2021) (handed down on 14 July 2022).

Tags: prescription period; disputed assessments.

RIGHT TO GROUNDS AND REASONS FOR ASSESSMENT

On appeal from a full bench of the High Court, the Supreme Court of Appeal (SCA) dispensed with a taxpayer's request for default judgment against the South African Revenue Service (SARS) in the case of Commissioner for the South African Revenue Service v Candice-Jean van der Merwe, *on 30 June 2022.*

Although the facts surrounding the SCA's decision were unique to that case, it does beg a broader question regarding a taxpayer's right to be provided with grounds for an assessment issued under section 95 of the Tax Administration Act, 2011 (the TAA).

FACTS

The taxpayer in this case received a large sum of money from an overseas benefactor which she declared as a donation when filing her tax return for the 2014 tax year. SARS disagreed with this and included the amount received in the taxpayer's gross income, thus subjecting her to normal tax. The dispute between SARS and the taxpayer was resolved by agreement, and SARS issued an assessment under section 95(3) of the TAA (an assessment by agreement). This assessment by agreement is not subject to objection or appeal by the taxpayer.

Nevertheless, the taxpayer subsequently lodged an objection against this assessment. SARS refused to entertain this objection on the basis that it was issued by agreement in terms of section 95(3), and thus not subject to objection. Undeterred, the taxpayer proceeded to lodge an appeal with the tax court.

Additionally, in the tax court the taxpayer delivered a further notice requesting that default judgment be granted against SARS. This was on the basis that SARS had failed to deliver its grounds for the assessment in dispute.

DECISION

The SCA upheld the tax court's decision against the taxpayer after the High Court had found in favour of the taxpayer. In short, the SCA agreed with SARS that it (SARS) is bound only to consider a valid objection, and that an appeal to the tax court can only follow a valid objection. Finding that the assessment raised by SARS by agreement with the taxpayer was not subject to objection, the SCA found the taxpayer did not have a basis to object or appeal.

The SCA's decision also dispensed with the taxpayer's request for default judgment. Although the case deals specifically with a process initiated by the taxpayer, which was seemingly flawed from the beginning, and does not centre on the taxpayer's request for default judgment, this request does raise questions regarding SARS' obligation to provide grounds for assessments it issues.

A TAXPAYER'S RIGHT TO REASONS

With reference to *ABSA Bank Ltd v Commissioner, South African Revenue Service*, [2021], SARS arguably takes administrative action, as defined in section 1 of the Promotion of Administrative Justice Act, 2000 (PAJA), when it issues an assessment. It follows, therefore, that taxpayers enjoy a right to reasons, as contemplated in section 5 of PAJA, for SARS' decisions.

The TAA reflects this in section 96(2), where SARS is obligated to provide a taxpayer with the grounds on which it has raised an estimation assessment in terms of section 95. Furthermore, rule 6 of the rules promulgated under section 103 of the TAA (Dispute Resolution Rules), allows a taxpayer who is aggrieved by an assessment to make a request to SARS for the reasons for the assessment.

"Therefore, where a taxpayer is aggrieved by an estimated assessment issued by SARS, and the grounds for this assessment have not been provided, the taxpayer should first consider whether it needs to submit any relevant material or an outstanding return."

While the request for reasons in the context of review proceedings in the High Court, as in *Absa Bank Limited*, must be distinguished from a rule 6 request, the reasons are necessary to enable an aggrieved taxpayer to formulate an objection against the assessment as provided for in section 104. Indeed, therefore, the TAA can be seen as an empowering provision envisaged in section 5(5) of PAJA, which provides a fair procedure for requesting reasons from SARS.

In practice, however, it has become more common for SARS to issue estimation assessments without providing the grounds for them, as required by section 96(2) of the TAA. In terms of recent amendments to the TAA, where an estimated assessment is issued, such assessment is only subject to objection or appeal if the taxpayer submits the relevant material (or outstanding return) required and SARS decides not to issue a reduced or additional assessment. The submission of the outstanding return or relevant material must occur within 40 business days from the date of the estimated assessment, unless SARS grants reasonable grounds for the extension. It is unclear whether a taxpayer is permitted to request reasons for such an estimated assessment or whether it should object to the assessment on the basis that it is invalid due to proper grounds of assessment not being provided.

In its *Dispute Resolution Guide (Issue 2)*, SARS draws a distinction between grounds for an assessment under section 96(2) and the reasons for an assessment which may be requested under rule 6 of the Dispute Resolution Rules:

> "The grounds for an adverse assessment by SARS should generally enable the taxpayer to understand the basis for the assessment and to object. However, if this is not the case, the taxpayer may request from SARS the reasons required to enable it to formulate its objection."

This seems to suggest that where a taxpayer is provided with the grounds for an assessment, but is still unable to formulate an objection, it may potentially request the reasons for the assessment from SARS under rule 6 of the Dispute Resolution Rules.

RECOMMENDED APPROACH

Both the grounds and reasons for an assessment are there to enable an aggrieved taxpayer to formulate an objection against SARS' assessment. However, the distinction between the two, and the possible procedural benefits of being provided with both, should not be ignored.

Therefore, where a taxpayer is aggrieved by an estimated assessment issued by SARS, and the grounds for this assessment have not been provided, the taxpayer should first consider whether it needs to submit any relevant material or an outstanding return. If this has been submitted and SARS refuses to issue a reduced or additional assessment, one can then object to the estimated assessment. The potential invalidity of an assessment, due to the absence of proper grounds of assessment, can be raised as a ground of objection. Such objection must be submitted in the prescribed form and manner set out in the TAA and Dispute Resolution Rules.

Lance Collop & Nicholas Carroll

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 95 (more specifically subsection (3)), 96 (more specifically subsection (2)), 103 (dispute resolution rules) & 104;
- Promotion of Administrative Justice Act 3 of 2000: Sections 1 & 5 (more specifically subsection (5)).

Other documents

- Dispute Resolution Rules (promulgated under section 103 of the TAA): Rule 6.

Cases

- *Commissioner for the South African Revenue Service v Candice-Jean van der Merwe* [2022] ZASCA 106 (30 June 2022);
- *ABSA Bank Ltd and Another v Commissioner, South African Revenue Service* [2021] (3) SA 513 (GP).

Tags: administrative action; estimated assessment; grounds for an assessment.

TAX DEBT COMPROMISE OR DEFERRAL

With inflation levels at their highest since 2009, coupled with rising interest rates in South Africa, cash-strapped consumers are scrambling to find means to curb their debt woes.

Tax appears to be the one debt that often surprises consumers each year. And with the annual individual tax filing season which closed on 24 October 2022 for non-provisional taxpayers, the clock is ticking to pay the taxman his dues.

THE OPTIONS

There are two specific mechanisms in the Tax Administration Act, 2011, that provide taxpayers with debt relief. The first is the *Compromise of Tax Debt* and the second the *Deferral of Payment.* These relief mechanisms may be the difference between financially constrained taxpayers experiencing financial continuity and prosperity, or facing sequestration (individuals) or liquidation (companies).

Although both mechanisms are favourable to the indebted taxpayer, each has its own pros and cons, to both the taxpayer and the South African Revenue Service (SARS).

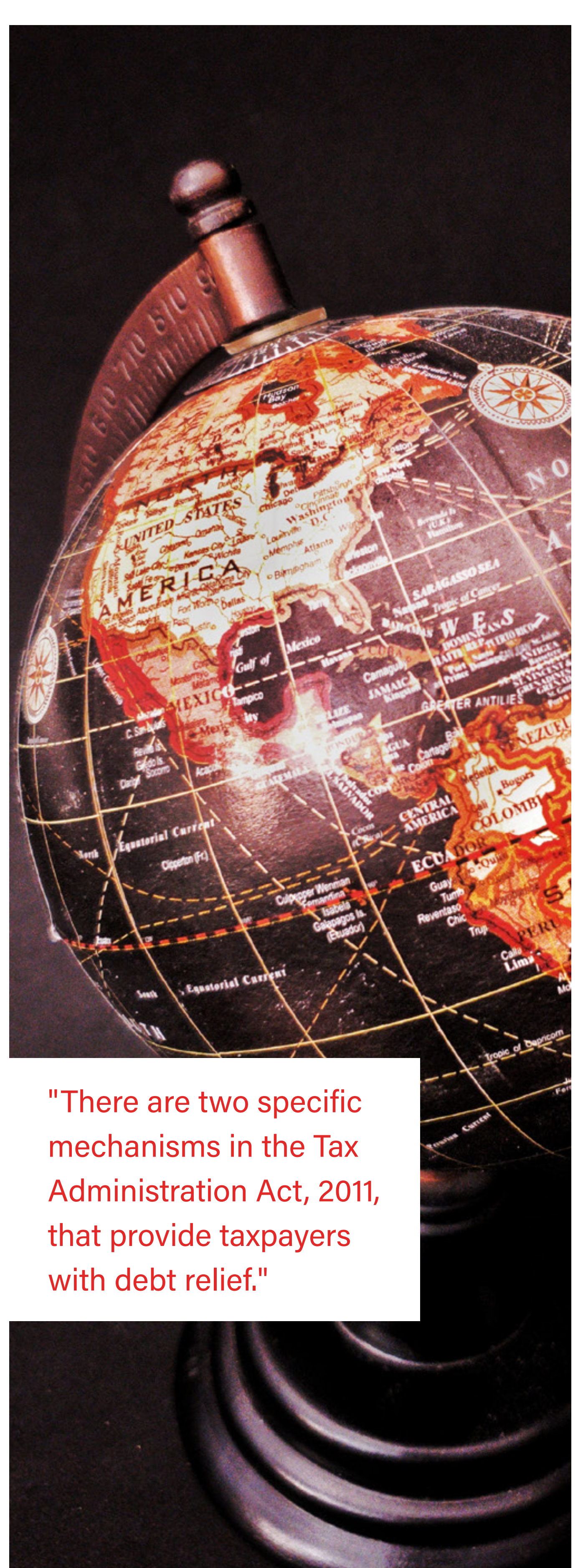
THE PROS AND CONS OF A TAX DEBT COMPROMISE

When a taxpayer applies for a tax debt compromise, SARS imposes upon the taxpayer a stringent evidentiary burden to meet the muster of securing a committee hearing. This process requires a number of disclosures as it pertains to the taxpayer's income and expenditure. It extends further to one's holdings, both local and offshore, including bank accounts, traditional investments and crypto assets.

In the case of a company, SARS will require both annual financial statements and management accounts. This is to evidence that there was no mismanagement of funds.

What makes the tax debt compromise appealing is that it permits a more favourable tax position to the taxpayer. Debt compromise settlement figures range from 10% to as high as 60% of the tax liability.

The only possible catch here is that SARS generally requires the entire settlement amount to be paid as a lump sum payment, which is not always feasible for a taxpayer experiencing cash flow constraints.



"There are two specific mechanisms in the Tax Administration Act, 2011, that provide taxpayers with debt relief."

THE PROS AND CONS OF A PAYMENT DEFERRAL

The payment deferral application works differently. The taxpayer does not actually reduce the tax liability due to SARS. Instead, one enters into an instalment arrangement with SARS to pay off the debt over a period of time. This means the taxpayer remains liable for the entire tax liability but is permitted to pay it off in tranches to ease up cash-flow constraints and allow continuity.

The fundamental difference between a tax debt compromise and a payment deferral is that, in the case of the latter, SARS requires proof of a future upturn in prospects for the taxpayer. This may not be the case for the typical taxpayer that pursues the tax debt compromise avenue.

WHAT TO CHOOSE?

On a level of solution-based thinking, the ideal outcome is to remain solvent, while ensuring tax compliance.

The tax debt compromise does present a more attractive option for taxpayers with a stable income that do not have the means to settle the entire tax liability, together with interest and penalties, in a single payment.

The process allows one to significantly reduce the tax liability and make full settlement. Thus, it allows one to use the remainder of one's resources to cover the cost of living / operating expenditure.

A WORD OF CAUTION

SARS has embarked on several aggressive revenue-collection drives and the Commissioner has categorically stated that non-compliance will be met with the full might of the law.

It is clear that SARS audit activity is increasing and that taxpayers are dealing with an intelligent, data-driven and focused revenue authority that has shaken its bad reputation of the past.

Taxpayers are therefore encouraged to seek professional assistance when using either a compromise or payment deferral, so that they do not fall foul of the law and its intent.

Fortunately, experience shows that where the correct process is followed, SARS remains amenable to engaging in negotiations surrounding the implementation of debt relief mechanisms.

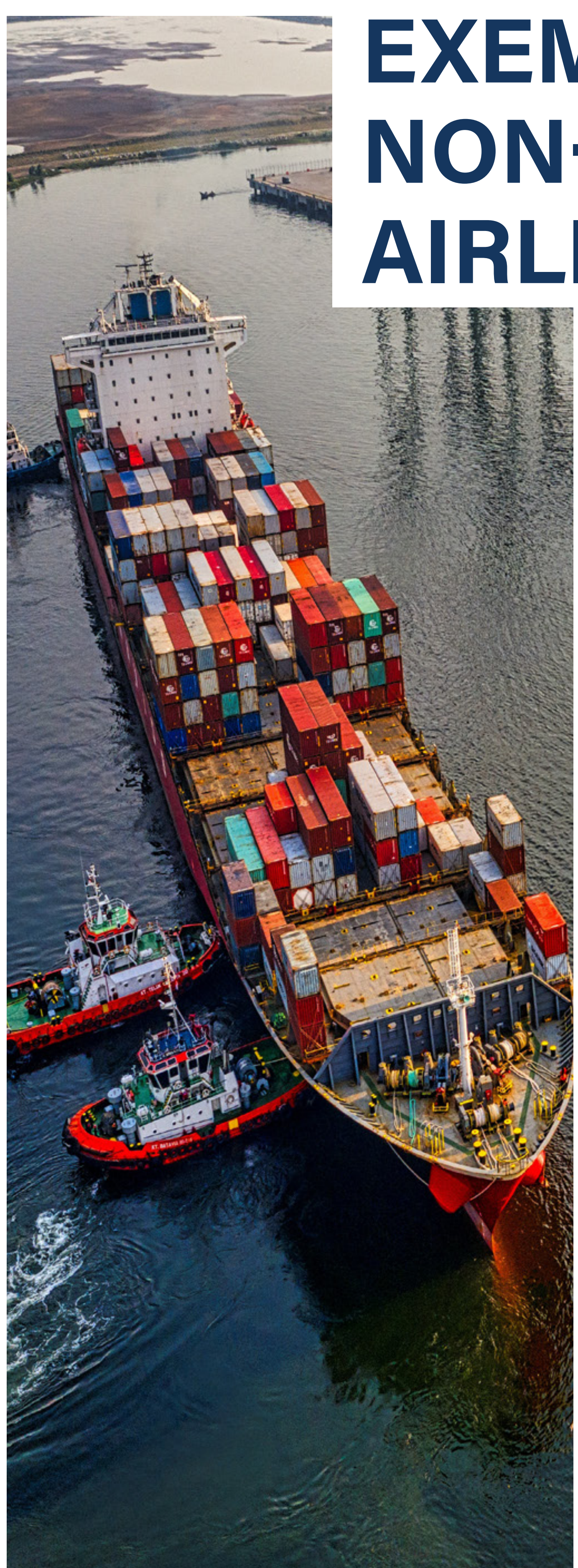
Jashwin Baijoo

Tax Consulting SA

Acts and Bills

- Tax Administration Act 28 of 2011.

Tags: sequestration; tax debt compromise; payment deferral; revenue-collection drives.



EXEMPTION FOR NON-RESIDENT AIRLINE LESSORS

The Taxation Laws Amendment Bill, 2022 (the TLAB), was introduced in the National Assembly on 26 October 2022.

Clause 27(1)*(a)* of the TLAB proposes a further amendment of proviso (xiii) to the definition of "enterprise" in section 1(1) of the Value-Added Tax Act, 1991 (the VAT Act). The amendment is effective from 1 January 2023 and has important tax consequences for lessors in the airline industry.

Previously and with an effective date of 1 April 2021, the Taxation Laws Amendment Act, 2020 (the Amendment Act), amended the definition of "enterprise" in section 1(1) of the VAT Act to include a statutory exemption (in the form of a new proviso (xiii)) for the supply of goods (aircraft, ships and rolling stock) by a non-resident lessor pursuant to a cross-border rental agreement (the Exemption).

In terms of the Amendment Act, the Exemption applies to, *inter alia*, a non-resident lessor leasing an aircraft for use in South Africa, provided that –

- the lessor is not a registered vendor in South Africa for VAT purposes;
- the supply is made to a recipient (a lessee) that is a resident of South Africa;
- the goods supplied are for use by the lessee wholly or partly in South Africa;
- the lessee declares the import VAT on the importation of the above-mentioned goods; and
- the lessee and lessor agree expressly and in writing that the lessee will enter the goods for home consumption and pay the VAT on importation and that the lessee will not be reimbursed by the lessor for any VAT so incurred.

Prior to the effective date of the Exemption, non-resident foreign aircraft lessors were required to either apply for VAT exemption in terms of section 72 of the VAT Act (the most common approach) or become a VAT-registered vendor in South Africa. Failure to do so and the failure to account for VAT in South Africa exposed lessors to the risk of payment of outstanding VAT, penalties (both late payment penalties and understatement penalties), and interest.

Although the Amendment Act and the Exemption marked a significant step forward for the South African aviation industry and in-bound aircraft leasing in particular, the Exemption raises several questions and issues, including the scope of the Exemption and, in particular, whether the reference to and interpretation of "aircraft" in the Exemption included the leasing of engines and other major components of aircraft.

Since the introduction of the Exemption, clarity has been sought from the South African tax authorities on these questions and issues, specifically in respect of engine operating leases. The authorities have confirmed that, contrary to the above position and notwithstanding the introduction of the Exemption, a non-resident lessor leasing an aircraft engine or any other major component of an aircraft (as distinct from the aircraft itself) for use in South Africa is deemed to be conducting an enterprise for VAT purposes and must register for VAT if the value of the lease payments exceeds R1 million in any 12-month period. In other words, the effect of the Exemption currently is to separate the leasing of engines from the aircraft itself in terms of the VAT treatment of these types of transactions.

Following extensive engagement with the tax authorities, the TLAB, *inter alia*, proposes that an operating lease by a non-resident foreign lessor/owner of aircraft parts/components (including aircraft engines) be expressly included in the Exemption. Therefore, in terms of the TLAB in its current form, engine leases would automatically qualify for VAT exemption, provided that the requirements of the Exemption applicable to aircraft leases are met. The proposed amendment is to come into effect from 1 January 2023.

Scott Edmundson & Chetan Vanmali

Webber Wentzel

Acts and Bills

- Value-Added Tax Act 89 of 1991: Sections 1(1) (definition of "enterprise") & 72.
- Taxation Laws Amendment Act 23 of 2020;
- Taxation Laws Amendment Bill 26 of 2022.

Tags: non-resident lessor; engine operating leases.

2023

HAPPY NEW YEAR