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CAPITAL GAINS TAX
MULTIPLE DISCRETIONARY TRUSTS

TAX ADMINISTRATION
SETTLEMENTS AND SEIZURES

VALUE-ADDED TAX
IMPORTED SERVICES

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Editorial panel:

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MULTIPLE DISCRETIONARY TRUSTS

The question whether a capital gain can flow through multiple discretionary trusts has finally been settled by the Supreme Court of Appeal (SCA) late in 2022. The judgment clarified that a capital gain (not an asset) distributed from one trust to a second, which then distributes to a natural person beneficiary (all in the same year) must be taxed in the second trust, not in the hands of the natural person.

This is important because, in practice, the following situation could arise. Discretionary Trust 1 sells an asset, realises a capital gain of R100 and vests it in discretionary Trust 2 in the same tax year. Trust 2 vests the R100 in John, one of its beneficiaries, in the same tax year. John is on the maximum marginal rate of 45%. If the gain could flow to John, he would pay tax of R18 (R 100 × 40% inclusion rate × 45% marginal tax rate) (ignoring the annual exclusion of R40 000). But if the gain could travel only as far as Trust 2, it would be taxed at an effective rate of 36% ((80% inclusion rate) × 45% flat rate) and the tax would be R36.

In *C:SARS v The Thistle Trust,* [2022], 10 vesting trusts (collectively the "Zenprop Group") carried on business as property owners and developers. In the 2014 to 2016 years of assessment, these "tier 1" trusts disposed of capital assets, giving rise to capital gains which vested in The Thistle Trust in the same year of assessment. The Thistle Trust in turn vested the capital gains in its natural person beneficiaries in the same year of assessment, and they declared the capital gains.

SARS raised additional assessments for the years in question on The Thistle Trust as well as an understatement penalty of 50%, plus interest in terms of section 89*quat* of the Income Tax Act, 1962 (the Act). In the tax court (*ITC 1941* [2021] 83 SATC 387 (G)), Wright J found in favour of the taxpayer, ruling that the capital gains were correctly taxed in the hands of the natural person beneficiaries of The Thistle Trust under section 25B of the Act, paragraph 80(2) of the Eighth Schedule to the Act and the conduit principle.

On appeal by SARS to the SCA, the SCA held that section 25B did not apply because the Eighth Schedule had a self-contained rule for dealing with capital gains in the form of paragraph 80(2). Paragraph 80(2) required the capital gains to be disregarded by the tier 1 trusts and to be taken into account by The Thistle Trust. What was vested in the natural person beneficiaries of The Thistle Trust was simply a sum of money that did not give rise to a capital gain capable of attribution. The conduit-pipe principle formulated in *Armstrong v Commissioner for Inland Revenue,* [1938], and *Secretary for Inland Revenue v Rosen,* [1971], did not apply.

The lesson from this case is that multiple discretionary trust structures are inefficient for capital gains tax (CGT) purposes because they prevent gains from being taxed in the hands of natural person beneficiaries at the lower of 0% to 18% CGT effective rate. Instead, the capital gains are taxed in the tier 2 trust at 36%.

By implication, the case also puts paid to the argument that capital gains can be distributed to non-resident beneficiaries by resident trusts through the conduit principle.

It would be interesting to know whether the assessments of the natural person beneficiaries will be reduced or whether they have prescribed.

The taxpayer at least enjoyed success in one area. The court found that it was not liable for the understatement penalty of 50% because it had relied on a legal opinion. But the trust still had to pay the interest due on the underpayment of provisional tax.

(This article first appeared in the *Davey's Locker newsletter* (November 2022) and is reproduced with permission.)

"The lesson from this case is that multiple discretionary trust structures are inefficient for capital gains tax (CGT) purposes because they prevent gains from being taxed in the hands of natural person beneficiaries at the lower of 0% to 18% CGT effective rate."

Duncan McAllister

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 25B & 89*quat*; Eighth Schedule: Paragraph 80(2).

Cases

- *C:SARS v The Thistle Trust,* (516/2021) [2022] ZASCA 153;
- *ITC 1941* [2021] 83 SATC 387 (G);
- *Armstrong v Commissioner for Inland Revenue* [1938] AD 343, 10 SATC 1;
- *Secretary for Inland Revenue v Rosen* [1971] (1) SA 172 (A), 32 SATC 249.

Tags: natural person beneficiary; marginal tax rate; discretionary trust; non-resident beneficiaries.

INCOME TAX RATE REDUCTION

It came as a relief to corporate taxpayers that during the February 2022 Budget Speech presented by the Minister of Finance it was confirmed that the corporate income tax rate would be reduced from 28% to 27%.

Tax practitioners need to be on high alert as they navigate the logistics of this tax rate reduction. It will have a significant impact on how they calculate their clients' tax liabilities during the 2022 and 2023 years of assessment.

Companies with years of assessment ending before 31 March 2023 will continue to base their income tax liabilities on a rate of 28%. For companies with years of assessment ending on or after 31 March 2023, the rate will be the reduced rate of 27%.

The new rate will be applicable to the calculation of a company's first provisional income tax return if the company's year ends on or after 31 March 2023. These first provisional income tax submissions became due and payable from 30 September 2022 onwards.

To illustrate, companies with 28 February 2023 year-ends continue to pay their first, second and third top-up payments for 2023 based on a rate of 28%. The new rate will only be applicable to these companies for their first provisional tax payments for the 2024 year of assessment, which would be due and payable on 31 August 2023.

However, companies with 31 March 2023 year-ends will calculate their first, second and third top-up payments for the 2023 year of assessment using a rate of 27%.

This can get slightly confusing, as a 28 February 2022 year-end company and a 31 March 2023 year-end company may both have had to make a provisional tax payment on 30 September 2022. However, the February 2022 year-end company could have made a voluntary top-up payment based on a rate of 28%, being a voluntary top-up payment in relation to its 2022 year of assessment, and the March 2023 year-end company would have had to make a first provisional tax payment based on a rate of 27%, relating to the first period of its 2023 year of assessment.

December is known to be a busy month from a corporate tax perspective and is another example of when tax practitioners must be on high alert. Companies with 30 June 2023 year-ends had to make their first provisional tax payments in December 2022 and had to base these payments on the reduced rate of 27%. However, companies with 31 December 2022 year-ends had to make their second provisional tax payments in December 2022 and these payments had to be based on a rate of 28%.

As is evident from the above examples, tax practitioners need to pay close attention to the year-ends of their corporate clients and keep their wits about them to correctly apply the rates applicable to the various payments. [*Editorial comment*: These rate changes also impact on deferred tax computations.]

"The new rate will be applicable to the calculation of a company's first provisional income tax return if the company's year ends on or after 31 March 2023."

Jodie Allman & Johann Benadé

BDO

Tags: corporate income tax rate; voluntary top-up payment.

ASSISTANCE TO EXECUTORS

On 22 March 2022 the Western Cape High Court delivered a judgment on the duties of executors of deceased estates and the care with which professional assistance to them should be dealt with.

A decisive element in deciding the dispute between the *dramatis personae* in the matter *Paulus Bernhardus Koch v Michele Weiland NO & The Master of the High Court, Cape Town,* [2020], was Regulation 2 of the regulations promulgated in terms of the Attorneys, Notaries and Conveyancers Admission Act, 1934. This regulation states, as the court summarised, that "no person other than an attorney, notary or conveyancer, or an agent in terms of section 22 of the Magistrates' Courts Act, 1944 (a so-called law agent) may liquidate or distribute a deceased estate". This includes "the performance of any act relating to the liquidation or distribution of the estate other than the realisation, transfer or valuation of estate assets or of any right in or to such assets".

There are four exemptions under Regulation 3: boards of executors; trust companies; public accountants; and persons duly licensed under the Licences Act, 1962, and carrying on business predominantly consisting in the liquidation or distribution of deceased estates. Under Regulation 4, there are another seven: banking institutions under certain conditions; persons in the full-time service of a person lawfully liquidating a deceased estate, assisting or acting on that person's behalf; persons in the full-time service of any trade union, under certain conditions; persons acting on the instructions of an attorney, notary or conveyancer; persons acting under the direction of the Master; the surviving spouse of or any person related by consanguinity up to and including the second degree to the deceased person, in so far as he or she is liquidating or distributing the estate: and, most relevant, to the present matter,

any natural person nominated by a deceased person in a will and accepted by the Master, **in so far as the person is personally liquidating or distributing the estate** [Emphasis added].

The court decided that, although the two Acts had long since been repealed, the regulations had continued in existence in their successors, currently the Legal Practice Act, 2014. They therefore applied in the present matter.

The court referred to *Meyerowitz* where, at paragraph 12.23 the learned author stated that an executor cannot substitute another person to act in their place, but may appoint an agent under power of attorney to administer the estate. The power of attorney may not be irrevocable.

The first defendant was the deceased's daughter, who was nominated as executor in the deceased's will and duly appointed. She and the plaintiff entered into an agreement, the salient provisions of which were that she nominated and appointed the plaintiff (in translation):

> *"…as my authorised Agent to administer, distribute and finalise the Estate in accordance with prevailing legislation and against payment of the prescribed executors' fee or such other fee as we agree upon between us. Without limiting in any way my Agent's general powers, I authorise him in particular to:*
>
> (1) *Complete and sign any documents, returns Liquidation and Distribution accounts, tax returns and so forth*
>
> (2) *Open bank accounts in the name of the Estate, operate thereon and close them*
>
> (3) *(Represent the Estate in any actions and/or suits instituted by or against the estate*
>
> (4) *[To] complete and sign all documents regarding the transfer, cession and/or alienation of any estate assets to heirs, purchasers and/or claimants*
>
> *My Agent's lawful actions in respect of the estate and related matters are ratified herewith as if I personally acted herein and this power of attorney will remain in force until the Estate has been finalised and all monies owing to my Agent have been paid in full."*

As an aside, Judge van Zyl stated that it appeared to him that this was an irrevocable power of attorney, which rendered it unenforceable on the authority referred to earlier. However, the parties had not taken the point and he said no more about it.

Before the liquidation and distribution process had been concluded, the defendant repudiated the agreement before the plaintiff was able to fulfil his mandate. The plaintiff claimed payment of about R1.3 million, based on 90% of the commission the plaintiff had expected, based on the statutory executor's rate of 3,5% of the gross value of the assets in the estate. The defendant's case was to take exception to the plaintiff's claim in that he had failed to disclose a cause of action, because in terms of the regulations he was prohibited from administering and liquidating deceased estates.

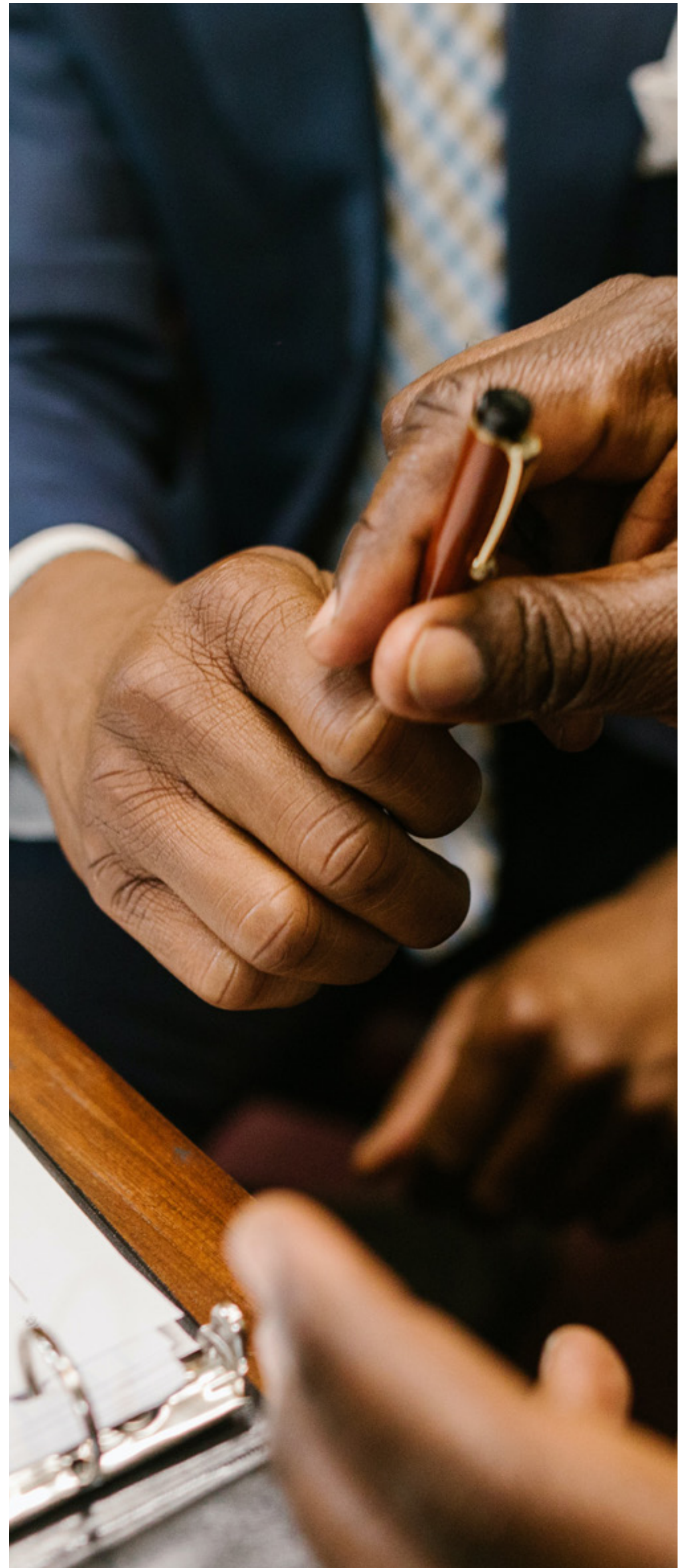
It was clear that the plaintiff was well aware of the prohibition against substitution, as it was expressly alleged in the particulars of claim that "the purpose of the agreement was not to substitute or surrogate the First Defendant with the Plaintiff to act as executor in her place, is [sic] was to render services to the First Defendant against the fee similar to and/or equivalent to the fee which the First Defendant will receive upon the successful liquidation and distribution of the estate. The Defendant [sic] therefor [sic] did not abdicate from her responsibilities and duties regarding the administration of the estate but delegated these to the Plaintiff".

The agreement was clearly, on its plain language, a power of attorney granted by a principal to an agent. The plaintiff's case was that, even with his assistance, it was the defendant who was regarded as having acted. It followed, according to the plaintiff, that he had no need to make any allegation as to his capacity under the regulations. His claim was purely for contractual damages for loss of income.

The court found that the plaintiff could not evade the implications of the regulations in this way. On a proper interpretation of the regulations, having regard to the approach set out in *Natal Joint Municipal Pension Fund v Endumeni Municipality,* [2012], one of the reasons for their promulgation must have been to protect the public and to ensure the orderly and lawful administration of deceased estates. "Notably, the regulations do not say that no person, save as provided for in the regulations, shall be appointed as executor." [The Administration of Estates Act, 1965, deals with this in section 13(2): "No letters of executorship shall be granted or signed and sealed and no endorsement under section fifteen shall be made to or at the instance or in favour of any person who is by any law prohibited from liquidating or distributing the estate of any deceased person."] "The regulations specifically state that no such person 'shall liquidate or distribute' a deceased estate. This (sensibly so, given the purpose of the regulations) refers to the acts involved in liquidating and distributing an estate, rather than to where the responsibility lies for those actions." And further: "The first defendant patently did not administer the estate 'personally', as is required by regulation 4(1). To interpret the requirement of 'personally' in the regulations as to include liquidation and distribution via an agent would undermine the essence of the regulations."

The grant of a power of attorney without regard to the regulations would allow them to be side-stepped and enable an unqualified person to administer an estate. If the plaintiff were allowed to sue on the power of attorney for an executor's fee, it would mean that the plaintiff was effectively allowed to step into the shoes of the executor.

The court upheld the defendant's exception and gave the plaintiff leave, within 10 days, to amend his particulars of claim so as to remove the excepted cause of complaint (and, presumably, replace it with a more anodyne one such as "for services rendered and advice provided in the course of your liquidation and distribution of the estate of the late xxx").



It commonly occurs that the person appointed as executor of a deceased estate is not equipped to carry out the liquidation and distribution unaided. This frequently applies where the surviving spouse is appointed, for example. Invariably, the surviving spouse obtains professional help. If the person so engaged falls within one of the categories of persons listed in Regulations 3 and 4, the sort of situation that arose in the present matter would not arise. Should the executor elect as advisor a person who falls outside the Regulations, the executor and the advisor should conduct the process in a way that makes clear that the executor was involved in the entire process and took all the important decisions, even though they were based on the advisor's guidance. And it would be most unwise to link the advisor's fee to the statutory executor's remuneration rate.

Professor Peter Surtees

Acts and Bills

- Attorneys, Notaries and Conveyancers Admission Act 23 of 1934 (repealed in 1979);
- Magistrates' Courts Act 32 of 1944: Section 22;
- Licences Act 44 of 1962;
- Legal Practice Act 28 of 2014;
- Administration of Estates Act 66 of 1965: Section 13(2).

Other documents

- Regulations promulgated in terms of the Attorneys, Notaries and Conveyancers Admission Act, 1934: Regulations 2, 3 & 4;
- *Meyerowitz on Administration of Estates and their Taxation* (Juta 2010).

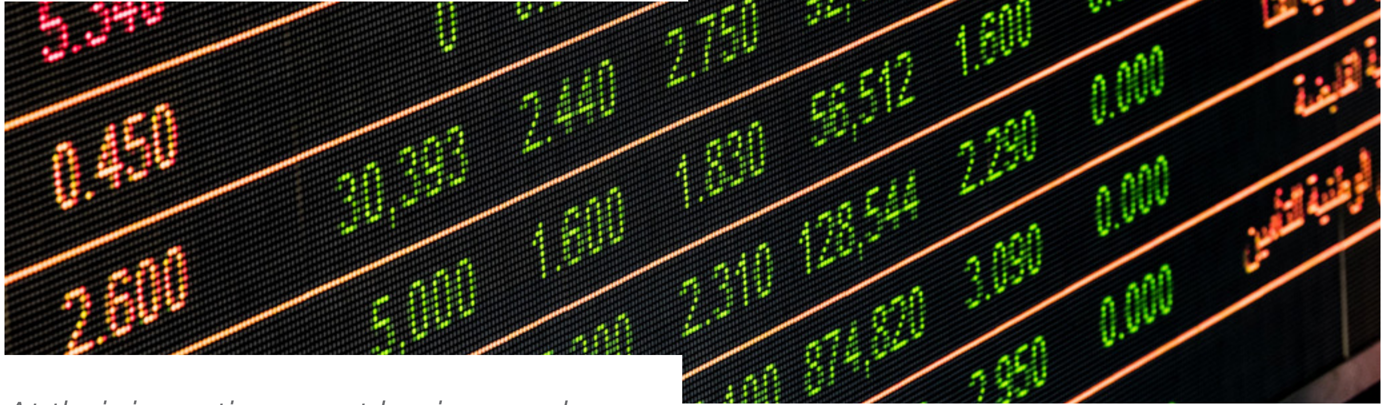
Cases

- *Paulus Bernhardus Koch v Michele Weiland NO & The Master of the High Court, Cape Town* [2020] Case no 16526/2020;
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA) (paragraph [18]).

Tags: deceased estate; power of attorney; executor's fee.

"The grant of a power of attorney without regard to the regulations would allow them to be side-stepped and enable an unqualified person to administer an estate."

RESTRAINT OF TRADE PAYMENTS



At their inception, most businesses have nothing but their names on their back and a bit of property to kickstart their operations. As employees join the business and begin contributing their time and innovative ideas, these eventually drive up the business' unique selling point and, ultimately, its value in the market.

When these employees look to leave the business, it may cause a decrease in its value in relation to what those employees do with the confidential information they had access to in the course of their employment. In an attempt to protect this value, employers may enter into restraint of trade agreements with exiting employees where the employees will receive financial compensation in exchange for refraining from engaging in a particular activity in a particular area for a period of time. The importance of the categorisation of these payments in one's tax returns was highlighted in the case of *Mr Taxpayer v the Commissioner of the South African Revenue Service,* [2022], in which the tax court was tasked with determining whether a sum of money received in consideration of a restraint of trade agreement amounted to capital or gross income, in terms of paragraph *(c*B*)* of the "gross income" definition in section 1(1) of the Income Tax Act, 1962 (the Act). The answer to this question, as this article will demonstrate, hinged on the determination of a link between the restraint of trade and the employment of the appellant at the company in question.

FACTUAL BACKGROUND

Mr Taxpayer (the appellant) was previously employed by Holdings as a director. When he terminated his employment with Holdings, and after a period of four and a half years had passed, the appellant and Holdings entered into a restraint of trade agreement (restraint agreement) to safeguard against the potential exposure of confidential information to which the appellant had access during his tenure as a director. Upon the conclusion of the agreement, a sum of R60 million was paid over to the appellant.

Following receipt of this sum, the appellant declared it as a capital gain in his annual return and paid over R8 million to the South African Revenue Service (SARS) as capital gains tax. Once SARS assessed the appellant's return, it disagreed with the categorisation of the payment as a capital gain, rather finding the sum to be gross income and taxed him accordingly. The appellant objected to this adjustment but his objection was disallowed and ultimately led to his filing of an appeal in court.

The key issues for determination were:

- was the payment received in consideration of a restraint of trade agreement gross income as defined in section 1(1) of the Act; and
- was the understatement penalty imposed in terms of sections 221 and 223 of the Tax Administration Act, 2011, warranted and reasonable?

LEGAL ANALYSIS

The court first considered the definition of gross income in the Act – it is defined as "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident" in any year of assessment. To determine whether the payment fell under this definition, the court further dissected the definition of gross income into smaller parts. Firstly, it had to determine whether the payment was received by a natural person. The restraint agreement was between Holdings and the appellant, with the appellant being the recipient of this payment. Suffice to say, the amount was paid to a natural person. Secondly, the court had to determine if the money was received in respect of or by virtue of his employment or holding office. To determine this, the court needed to consider whether a causal link existed between the restraint agreement and the employment contract between Holdings and the appellant.

SARS argued that because the appellant was a former employee and director of Holdings, this created a link between the restraint agreement and the appellant's employment. However, the appellant argued that there was no causal link as he terminated his employment with Holdings four and a half years earlier.

The court sided with SARS on this point and found that there was indeed a causal link between the employment and position of the appellant as a director of Holdings on the one hand, and the restraint agreement on the other. The logic was that the restraint agreement existed because during the appellant's tenure as director of Holdings, he had acquired confidential information which, if divulged to persons outside of Holdings, would decrease the value of the company's shares. The amount received by the appellant arising from the restraint agreement was in connection with his past employment with Holdings. The court found this to be a sufficient qualifier to regard the amount received as gross income.

ASSESSING THE PENALTY

As the amount was viewed to be income, the court had to then determine if the penalty imposed on the appellant by SARS was reasonable, which it found to be so. The appellant claimed that the reason he categorised the amount as capital in his return was due to a tax directive issued to him by SARS on 11 June 2015 informing him to do so and to pay R8 million in capital gains tax. The circumstances surrounding this directive were, however, questionable. A witness for SARS in this matter claimed that the document he had sent to the appellant was not a directive and was issued based on the information the appellant had given to SARS. The appellant informed SARS in a letter that the restraint only lasted for a year following the termination of his employment. The witness also confirmed that he did not sign this directive and was not in a position to do so as capital gains was not his area of expertise.

"A witness for SARS in this matter claimed that the document he had sent to the appellant was not a directive and was issued based on the information the appellant had given to SARS."

Further, an experienced tax consultant of 27 years who testified for the appellant stated that he had advised the appellant to pay over the capital gains tax despite not being able to make the distinction himself on whether the amount was capital or income in nature. He also confirmed that there was no mention of the restraint agreement in the document. With this logic, the court found that the appellant misrepresented the true state of affairs in his letter to SARS in relation to the amount received, which led to SARS' misunderstanding of the amount in question being of a capital nature. As such, the court found that the appellant did not make a *bona fide* error in his return and was liable for the understatement penalty at the rate of 10% as a substantial understatement.

This case serves as a guide to recipients of amounts in connection with restraint agreements in the completion of their returns. It reminds us of the importance of making a clear and full disclosure of the circumstances surrounding the payment of a restraint of trade consideration as intricate details could be the tipping point in categorising the amount.

Esther Ooko & Howmera Parak

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 1(1) (definition of "gross income": paragraph (*c*B));
- Tax Administration Act 28 of 2011: Sections 221 & 223.

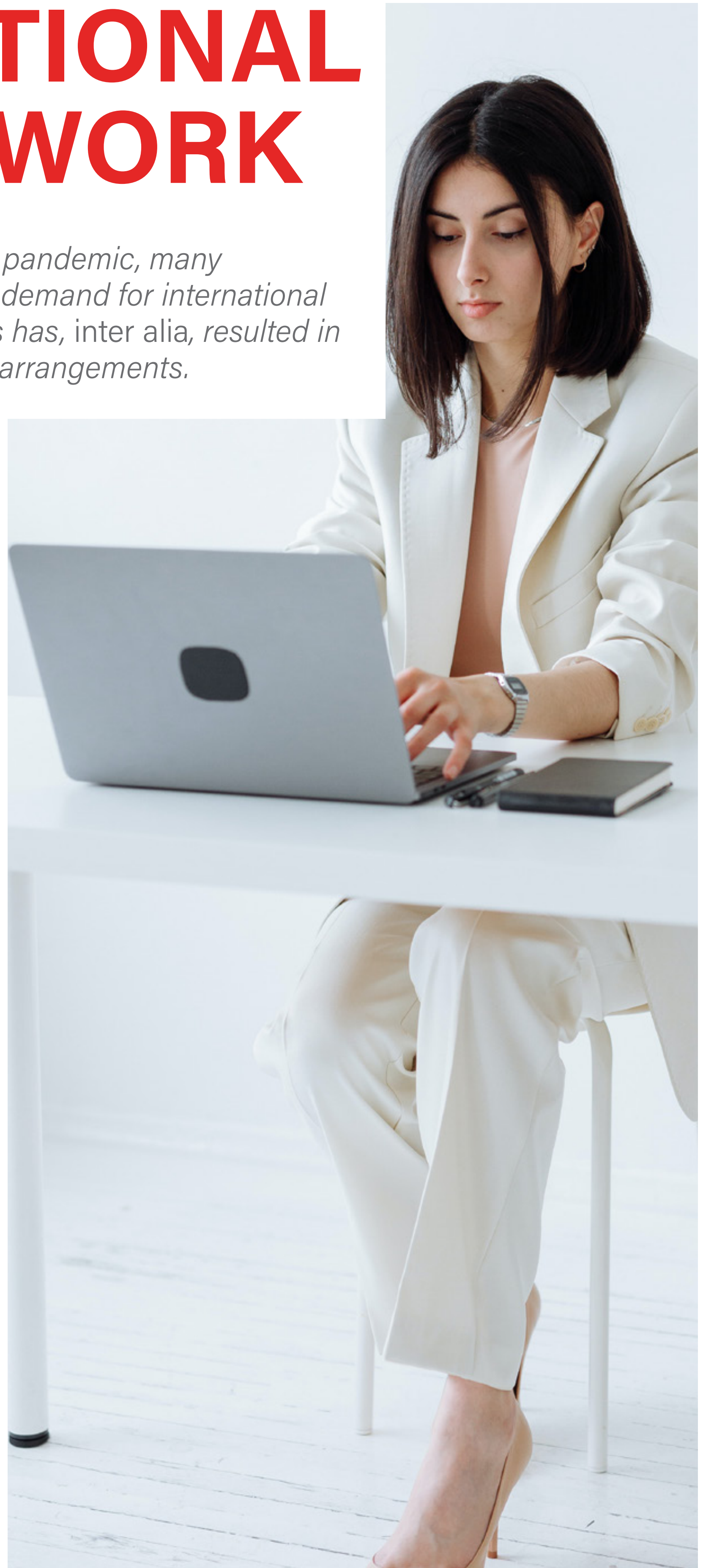
Cases

- *Mr Taxpayer v the Commissioner of the South African Revenue Service* (IT45628) [2022] ZATC 8 (17 August 2022).

Tags: restraint of trade agreements; understatement penalty.

INTERNATIONAL REMOTE WORK

Due to the impact of the COVID-19 pandemic, many employers have seen an increased demand for international remote working arrangements. This has, inter alia, *resulted in OECD guidelines relevant to these arrangements.*



Different tax consequences of international remote working may arise for both employers and employees, depending on the facts, such as employees working in South Africa for a foreign employer and employees working abroad for a South African employer. However, there are certain key tax issues that are common to these scenarios. We deal with some of these below.

1. CORPORATE INCOME TAX CONSIDERATIONS FOR THE EMPLOYER COMPANY

Where an employee works abroad, a key consideration from a corporate income tax perspective is whether the activities of that employee in the foreign country could create a taxable presence for the employer.

This would most likely be the case if –

- the employer is regarded as carrying on a trade or business in the foreign country through a permanent establishment situated in that country (in which case, the profits of the employer which are attributable to that permanent establishment may be taxed there); or
- the employer may be regarded as a tax resident in that country, usually due to its place of effective management shifting to that jurisdiction (in which case it may be fully taxable there).

Determining whether such a taxable presence may arise for the employer would typically depend on the role and activities of the employee, the domestic law of the country concerned as well as the provisions of any double tax treaty concluded between the relevant countries, if applicable. An additional consideration is the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which entered into force in South Africa on 1 January 2023.

2. EMPLOYEES' WITHHOLDING TAX AND TAX COMPLIANCE

An important practical issue for both the employer and the employee is whether, and in which jurisdiction/s, employees' tax-withholding and tax-compliance obligations may arise.

This often depends on the location and the duration for which services are rendered by the employee, as well as the provisions of any double tax treaty concluded between South Africa and the foreign country, if applicable. In addition, a change in the employee's tax residence status as a consequence of the remote working arrangement may impact on the employer's tax-withholding obligations.

Where more than one jurisdiction requires withholding of employees' tax (usually accompanied by a local filing obligation for both the employer and employee), this would result in a dual withholding obligation for the employer and a cash-flow issue for the employee (which may be temporary, depending on the relevant local legislation and potential refunds, exemptions and/or foreign tax credits).

Other relevant considerations include the situation where remuneration is paid to an employee by different employers in different jurisdictions, and remuneration (such as a bonus or share incentive payment) payable to the employee relates to services rendered in different jurisdictions.

3. TAX RESIDENCE FOR EMPLOYEES

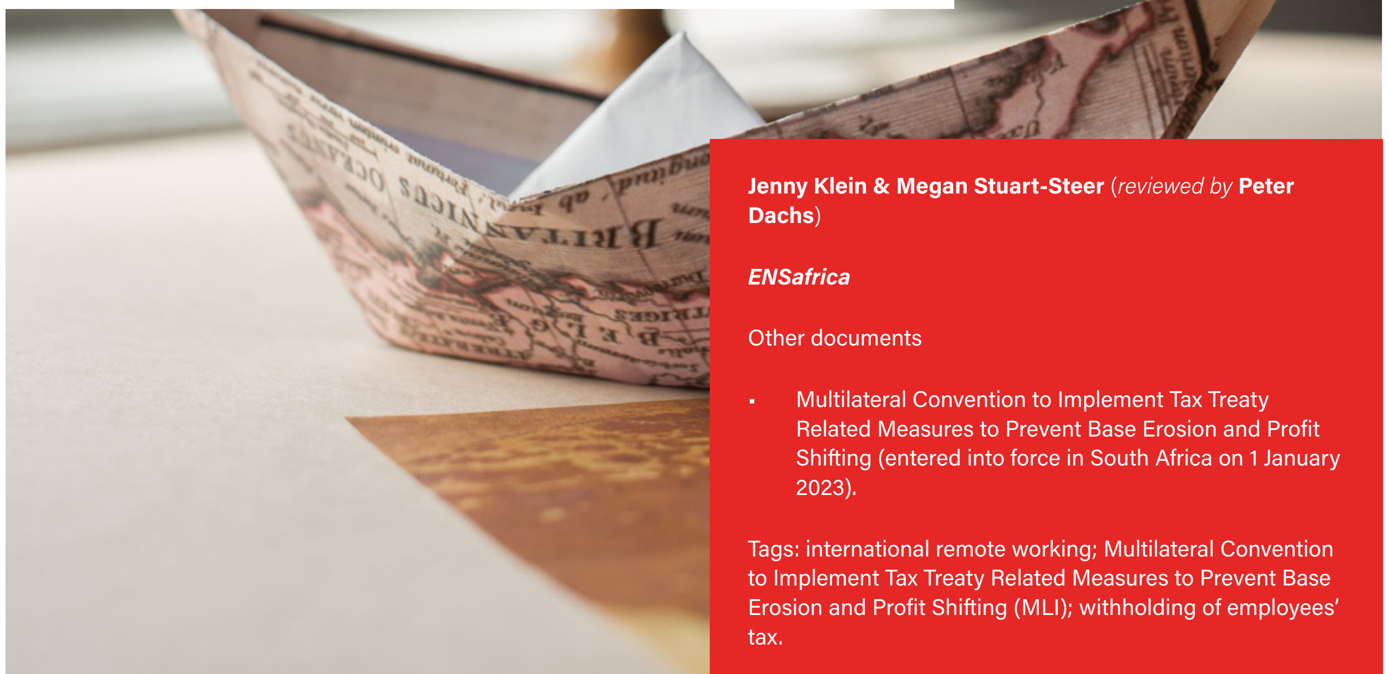
In respect of employees relocating, it will be necessary to determine whether they will cease to be tax residents of a particular jurisdiction as a result of their relocation and, if so, when this will occur. This is usually a factual enquiry based on various factors and will depend on the individual's personal circumstances.

If it is determined that the employee will cease to be tax resident, there are often various deemed disposal and timing rules which apply and which will need to be considered.

The above are some of the key tax issues which must be carefully thought through when considering remote working arrangements. In addition to these and other tax considerations, there are various immigration, employment law, exchange control, and regulatory issues which may arise, both locally and in the relevant offshore jurisdictions. Most of these issues are case-specific and require bespoke legal analysis.

As the frequency of international remote working increases, employers will need to bear these complexities in mind when assessing and implementing these arrangements.

"In respect of employees relocating, it will be necessary to determine whether they will cease to be tax residents of a particular jurisdiction as a result of their relocation and, if so, when this will occur."



Jenny Klein & Megan Stuart-Steer (*reviewed by* **Peter Dachs**)

ENSafrica

Other documents

- Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (entered into force in South Africa on 1 January 2023).

Tags: international remote working; Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI); withholding of employees' tax.

OECD PILLAR ONE PROGRESS

On 6 October 2022, as part of the ongoing work of the OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS) to implement the Two-Pillar solution to address the tax challenges arising from the digitalisation of the economy, the OECD released its progress report for comment.

BACKGROUND

The report was prepared for the purposes of obtaining further input from stakeholders on the administration and tax certainty aspects of Amount A. [*Author's note*: Amount A of Pillar One has been developed as part of the Two-Pillar Solution for addressing the tax challenges arising from the digitalisation of the economy. Pillar One provides jurisdictions in which consumers and users are located (hereafter "market jurisdictions") a new taxing right over a portion of the residual profits of the largest and most profitable multinational enterprises (MNEs) in the world.] Comments were requested with respect to the processes and rules contained in this document. The comments were required by no later than 11 November 2022.

Significant progress has been made in developing the comprehensive technical rules for the new taxing right (Amount A) for market jurisdictions established under Pillar One. It is recognised that the substance of these rules must be stabilised before the development and completion of a Multilateral Convention (MLC) which will be signed and ratified by IF members.

The MLC will establish the legal obligations of the parties to implement Amount A in a coordinated and consistent manner. This will include binding rules on all aspects of implementing Amount A, including –

- the allocation of Amount A to market jurisdictions;
- the elimination of double taxation;
- a marketing and distribution profits safe harbour;
- the simplified administration process;
- exchange of information; and
- tax certainty process.

Work has already commenced on the overall design and framing of the individual provisions of the MLC pending finalisation of the substantive rules.

In addition to the operative provisions of Amount A, the MLC will also contain provisions requiring the withdrawal of all existing digital service taxes and relevant similar measures with respect to all companies. A commitment not to enter into such measures in the future will also be required.

"The rules envisaged by the OECD progress report Amount A will go a long way in ensuring the tax challenges that have come about as a result of the increased digitalisation of the global economy are effectively addressed."

The MLC will enter into force if it is ratified by a critical mass of countries which will include the residence jurisdictions of the ultimate parent entities of a substantial majority of the in-scope companies whose profits will be subject to the Amount A taxing right as well as the key additional jurisdictions that will be allocated the obligation to eliminate double taxation otherwise arising as a result of the Amount A tax. Work in relation to Amount B was scheduled to be delivered by the end of 2022.

The progress report contains the different building blocks relating to the new taxing right under Amount A.

AMOUNT A

It is a new taxing right which applies to a portion of the residual profit of large and highly profitable enterprises for the benefit of jurisdictions in which goods or services are supplied or consumers are located. These are known as "market jurisdictions".

It operates as an overlay to the existing profit allocation rules and therefore includes a mechanism to reconcile the respective different profit allocation systems and prevent double taxation.

It includes improved tax certainty processes that bring increased certainty for enterprises, on Amount A and related matters.

RULES FOR AMOUNT A

There are five different types of rules relating to Amount A. These are:

- Scope rules, which contain thresholds that are designed to ensure that Amount A only applies to large and highly profitable groups and have been drafted to apply in a quantitative and objective manner in order to be easy to administer and provide certainty as to whether a taxpayer is within scope.

"Work has already commenced on the overall design and framing of the individual provisions of the MLC pending finalisation of the substantive rules."

- A special purpose nexus rule, which identifies market jurisdictions that are eligible to receive Amount A. The nexus rule contains quantitative thresholds based on the amount of revenue a group generates in the market jurisdiction. A lower nexus threshold will apply for smaller market jurisdictions to ensure that these are able to benefit from Amount A as well. The nexus rule is supported by detailed revenue-sourcing rules, which provide a methodology for determining where the revenues of the group are generated, based on reliable indicators or allocation keys.
- The tax base rules provide the steps to calculate the profit (or loss) of a group that will be used for calculating Amount A. It is the profit of the group that forms the basis for the partial reallocation. The consolidated financial statements of a group which are prepared under acceptable financial accounting standards form the starting point for the tax base determination. The rules include a limited number of book-to-tax adjustments and a framework allowing groups to carry forward losses.
- The profit allocation rules are based on a formula which allocates 25% of a group's profits in excess of 10% of the group's revenues to eligible market jurisdictions. These profits will be allocated to market jurisdictions in proportion to the amount of revenues that the group generates in that jurisdiction and subject to any adjustment arising from the Marketing and Distribution Profits Safe Harbour.
- The elimination of double taxation rules will apply to eliminate any double taxation that arises from applying Amount A as an overlay to the existing profit allocation system. The rules will apply on a quantitative and jurisdictional basis to identify relieving jurisdictions that will be responsible for the elimination of double taxation.

The rules envisaged by the OECD progress report Amount A will go a long way in ensuring the tax challenges that have come about as a result of the increased digitalisation of the global economy are effectively addressed.

Mark Badenhorst

ENSafrica

Other documents

- OECD progress report (on the ongoing work of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) to implement the Two-Pillar solution to address the tax challenges arising from the digitalisation of the economy).

Tags: Base Erosion and Profit Shifting (BEPS); Multilateral Convention (MLC); profit allocation rules; Marketing and Distribution Profits Safe Harbour.

NOTICES OF OBJECTION

A taxpayer who is aggrieved by an assessment may object to the assessment in terms of section 104 of the Tax Administration Act, 2011 (the TAA). The objection must be instituted within 30 business days from the date of assessment, where the taxpayer has not requested reasons for the assessment.

This period may be extended by a further 30 days if a senior SARS official is satisfied that reasonable grounds exist for the delay in lodging the objection and may be extended up to a period of three years if exceptional circumstances exist.

In a recent Supreme Court of Appeal (SCA) judgment *The Commissioner for the South African Revenue Service v Airports Company for South Africa* (Case no 785/2021) [2022] ZASCA 132, the taxpayer brought an application to amend an objection after the time period to lodge an objection had lapsed. The facts briefly were that:

1. During December 2015 to February 2016, SARS conducted an income tax audit on the taxpayer.

2. SARS issued a Letter of Audit Findings on 8 February 2016 in respect of the 2011 year of assessment advising that it intended to –

   (1) disallow a deduction claimed in terms of section 11*(a)*, read with section 23*(g)*, of the Income Tax Act, 1962 (the Act);

   (2) disallow an allowance claimed in terms of section 13*quin* of the Act;

   (3) disallow an allowance claimed by the taxpayer in terms of section 12F of the Act; and

   (4) impose understatement penalties (USPs) in terms of the TAA.

3. After an exchange of correspondence between SARS and the taxpayer, on 30 March 2016 SARS issued a Finalisation of Audit Letter and issued additional assessments. It disallowed the section 11*(a)* deduction, the section 13*quin* allowance and the section 12F allowance, and it imposed USPs.

4. On 12 May 2016, the taxpayer lodged an objection to the additional assessments. However, it only objected to the disallowance of the section 11*(a)* deduction.

5. On 6 September 2019 through newly appointed attorneys, the taxpayer addressed a letter to SARS seeking an indulgence to amend the objection it had lodged in respect of the 2011 year of assessment. The taxpayer now wished to object against the disallowances in respect of section 13*quin* and section 12F and also the USPs imposed.

6. SARS refused to allow the objection on the basis that the taxpayer was seeking to introduce new grounds of objection, which was impermissible in terms of the TAA, read with the Tax Court Rules promulgated under section 103 of the TAA.

7. As neither the Act nor the Rules make provision for the amendment of an objection, the taxpayer applied to the tax court for leave to amend its objection in terms of Rule 28(1) of the Uniform Rules, read with Rule 42(1) of the Tax Court Rules.

8. Rule 42(1) provides that if the Tax Court Rules do not provide for a procedure in the tax court, then the most appropriate rule under the High Court Rules may be utilised.

9. The taxpayer asserted that Rule 28(1) of the Uniform Rules was the most appropriate rule, which states that any party desiring to amend a pleading or document filed in connection with any proceedings, shall notify all other parties of its intention to amend and shall furnish particulars of the amendment.

10. The tax court held that "rule 42 of the Tax Court Rules permits an applicant to approach a court for an amendment in terms of rule 28 of the Uniform Rules of Court".

On appeal by the Commissioner from the tax court, the Supreme Court of Appeal held:

1. An objection is part of the pre-litigation administrative process and is not a pleading.
2. It is also not a document filed in connection with judicial proceedings envisaged in terms of Uniform Rule 28(1).
3. Rule 42(1) only comes into play when the tax court rules do not make provision for a procedure *in the tax court*. Rule 42(1) does not apply to those procedures which constitute pre-litigation administrative procedures such as an objection to an assessment.
4. Therefore, the tax court erred in granting leave to the taxpayer to amend its notice of objection in terms of Uniform Rule 28.
5. The effect of the amendment sought by the taxpayer would be to extend the period for the filing of an objection (or the filing of new grounds of objection) long after the peremptory periods prescribed in section 104 of the TAA, read with Rule 7, have expired.
6. Accordingly, the Commissioner's appeal was upheld with costs.

"Taxpayers must be mindful that there is a difference between a new ground which amounts to a new objection and one which simply supplements what has already been objected to."

COMMENT

South African case law (*Reed and Others v Master of the High Court of SA and Others,* [2005] (EC) paragraphs 24–26; *Marais v Democratic Alliance,* [2002] (C) at 436–437) has held that an internal remedy has the following characteristics:

- It is an extra-curial remedy (it is out of court);
- The remedy takes the form of an administrative appeal to an official within the same administrative hierarchy as the initial decision-maker;
- The internal appellate body is created or given power to confirm, substitute or vary the decision of the initial decision-maker, in terms of an enactment of law.

A notice of objection has all the characteristics of an internal remedy as defined by case law, because it is an extra-curial (out of court) administrative appeal in terms of a statute (the Act) to an official (the Commissioner for SARS or a senior SARS official) within the same administrative hierarchy (SARS) and the official is empowered to confirm, substitute, or vary the decision of the initial decision-maker on the merits.

An objection is therefore not a pleading and is an internal remedy or pre-litigation administrative process. It does not fit into the provisions of Uniform Rule 28(1).

It is important to note that an assessment is not a piece of paper or single document but is defined in section 1(1) of the Act to mean the determination of the amount of a tax liability by way of self-assessment or assessment by SARS.

An assessment is therefore the Commissioner's administrative act and determination and when one objects to an assessment, the objections are to the individual determinations made by the Commissioner about which there have been complaints, and it is necessary in an objection to deal with each individual determination by which one is aggrieved.

What the taxpayer sought to do in this case was not merely to amend an objection but to introduce new grounds, which amounted to new objections after the lapsing of periods in which objections could be made, and this was rightly held by the court to be impermissible.

A taxpayer may of course supplement its grounds in appeal proceedings provided it does so in respect of something to which it has already objected. The new ground of appeal must be in respect of the same amounts and the same parts of the assessments originally objected to under Rule 7 (see Rule 32(3) and tax court decisions in *ITC 1912* 80 SATC 417).

The same reasoning applies to the Commissioner who, in terms of Rule 31(3), may not include a ground of assessment in appeal proceedings that constitutes a novation of the whole of the factual or legal basis of the disputed assessment or which requires the issue of a revised assessment. Had the SCA ruled in favour of the taxpayer, it may have had the unintended consequence of allowing SARS in other contexts to amend its basis of assessment through a similar request for amendment.

Taxpayers must be mindful that there is a difference between a new ground which amounts to a new objection and one which simply supplements what has already been objected to.

Second chances are often limited and our SCA has now authoritatively established that this is true in respect of objections.

Edlan Jacobs

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Sections 11*(a)*, 12F, 13*quin* & 23*(g)*;
- Tax Administration Act 28 of 2011: Sections 103 & 104.

Other documents

- Tax Court Rules (promulgated under section 103 of the TAA): Rules 7, 32(3) & 42(1);
- Uniform Rules of Court: Rule 28(1).

Cases

- *The Commissioner for the South African Revenue Service v Airports Company for South Africa* (785/2021) [2022] ZASCA 132 (7 October 2022);
- *Reed and Others v Master of the High Court of SA* [2005] 2 All SA 429 (E) (paragraphs 24–26);
- *Marais v Democratic Alliance* [2002] (2) BCLR 171 (C) (at 436–437);
- *ITC 1912* 80 SATC 417.

Tags: Letter of Audit Findings; understatement penalties (USPs); Finalisation of Audit Letter; additional assessments.

SETTLEMENTS AND SEIZURES

In the context of tax dispute resolution, most disputes are intended to be dealt with by the tax court, a creature of statute with its jurisdiction and powers defined by the Tax Administration Act, 2011 (the TAA), read with the dispute resolution rules published under section 103 of the TAA.

However, disputes involving the interpretation of settlement agreements and search and seizure provisions in the TAA do not fall within the tax court's jurisdiction and are heard by the High Court, such as in the matter of *Wingate-Pearse v The Commissioner for the South African Revenue Service* (54038/20) [2022] ZAGPPHC 732, decided on 30 September 2022.

In this matter, the High Court had to consider, amongst others, two things:

- the interpretation of a settlement agreement concluded between Mr Wingate-Pearse (taxpayer) and the respondent (the South African Revenue Service [SARS]) in 2009; and
- whether the taxpayer had made out a case for the return and delivery of material and goods seized during a 2005 search and seizure operation carried out by SARS.

FACTS

In 2009, the taxpayer brought an urgent application to interdict SARS from enforcing the pay-now-argue-later principle.

The urgent application was settled in terms of a settlement agreement (2009 Agreement), which stated that the taxpayer would do certain things, pending his tax appeal against assessments raised by SARS. This included payment of an amount of approximately R336 000 to SARS (the settlement amount), the cession *in securitatem debiti* of certain shareholdings, and tendering security in the form of immovable properties to SARS.

A further settlement agreement was concluded between SARS and the taxpayer in 2020 (2020 Agreement), which stated that the taxpayer had to pay an amount of R3 million in full and final settlement of the taxpayer's outstanding payment obligations. The 2020 Agreement also required SARS to release anything held as security, once the amount of R3 million had been paid.

The taxpayer argued that the settlement amount constituted security, which had to be released to him in terms of the 2020 Agreement.

In relation to the seized goods, the taxpayer argued that these had to be returned to him in terms of section 66 of the TAA.

JUDGMENT

The settlement amount

While the taxpayer raised various arguments as to why the settlement amount should be seen as security, SARS made arguments as to why it constituted payment of a tax debt. A key issue the court had to consider was how the 2009 Agreement and 2020 Agreement should be interpreted and, specifically, whether extrinsic evidence could be relied upon to interpret the agreements. SARS argued that the interpretation as to whether the settlement amount constituted security or payment of a tax debt should be determined by considering extrinsic evidence, namely the surrounding circumstances and documents which preceded both the 2009 and 2020 settlements. The specific extrinsic evidence SARS asked the court to consider was correspondence between the parties pursuant to the launching of the urgent application, as part of the settlement negotiations pertaining to the 2009 proceedings.

The High Court rejected the argument that extrinsic evidence is always impermissible, in terms of the well-known parol evidence rule. Its decision was based on the approach set out in *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA), which principles were also applied in more recent judgments handed down by the Supreme Court of Appeal and Constitutional Court. As the approach in *Endumeni* required that the text, context and purpose of a document must be considered holistically, the High Court held that it could be taken into account to the extent that it would contextualise the clause in the 2009 Agreement dealing with the settlement amount.

Ultimately, the court considered correspondence between the parties, pleadings filed by the taxpayer in the 2009 urgent application, pleadings filed by the taxpayer in a 2015 review application brought against SARS, portions of the judgment in the 2015 review application, and a 2019 judgment involving the taxpayer and SARS. As these documents referred to the 2009 settlement amount as a payment or interim payment, the High Court drew the inference that the settlement amount could not have been intended as security, considering the extrinsic evidence and both parties' arguments. Therefore, the High Court decided that the settlement amount was a payment towards outstanding tax debt.

Seizure of goods

In relation to the seizure of goods, the taxpayer sought an order in terms of section 66 of the TAA for the return of the goods. However, based on the parties' pleadings, the court noted that there were material disputes of fact and decided that the matter had to be referred to oral evidence.

"In 2009, the taxpayer brought an urgent application to interdict SARS from enforcing the pay-now-argue-later principle."

COMMENT

The judgment illustrates that when it comes to interpretation of documents in a tax dispute context, the general principles of interpretation will also apply. It must be kept in mind that in the tax context, settlements can arise in different ways. In terms of Part F of Chapter 9 of the TAA, where there is an ongoing tax dispute arising from a taxpayer's objection against a SARS assessment or decision, there are certain factors that need to be considered to determine whether a dispute is appropriate for settlement. Only if it is appropriate, can the dispute be settled. For example, the TAA notes that settlement may be appropriate in cases where it is a cost-effective way to promote tax compliance with a tax Act by the taxpayer concerned or a group of taxpayers. The settlement provisions in Part F only apply where there is a factual or legal interpretation dispute arising from a SARS decision or assessment.

In other words, a dispute about the pay-now-argue-later rule (as it existed when the 2009 Agreement was concluded in the case under discussion) or about suspending the obligation to pay an amount in dispute under section 164 of the TAA cannot be settled in terms of Part F of Chapter 9 and a different framework would apply to the settlement. For example, the parties can conclude a settlement agreement and have it made an order of court

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Acts and Bills

- Tax Administration Act 28 of 2011: Sections 66, 103 & 164; Chapter 9: Part F (sections 142–150).

Other documents

- Dispute resolution rules published under section 103 of the TAA.

Cases

- *Wingate-Pearse v The Commissioner for the South African Revenue Service* (54038/20) [2022] ZAGPPHC 732 (30 September 2022);
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA).

Tags: dispute resolution rules; pay-now-argue-later principle; parol evidence rule.

STICKING TO ORIGINAL GROUNDS OF OBJECTION IN SCA TAX APPEAL PROCEEDINGS

It's a long road to the Supreme Court of Appeal (SCA) for a taxpayer disputing an assessment – first they must lodge an objection, then an appeal to the tax court, and only then can they appear before the SCA, if leave to appeal is granted by the tax court. If leave to appeal directly to the SCA is not granted, an appeal to the High Court, heard by a full bench, will precede the SCA appeal.

Although a taxpayer can obtain new insights on the road to the SCA through the benefit of hindsight, a taxpayer must, by and large, rely on the same grounds for disputing the assessment. The SCA made this clear in its decision in *Nesongozwi v Commissioner for SARS,* [2022], handed down on 24 October 2022.

FACTS

The taxpayer in *Nesongozwi* was the sole director of Umthombo Resources (Pty) Ltd (Umthombo), a company which held coal prospecting and mining rights. Umthombo had entered into a consultancy agreement with Sumo Coal (Pty) Ltd (Sumo) whereby Umthombo would prospect for coal and enter into a joint venture with Sumo to mine any coal deposits found.

Umthombo's sole shareholder was the Nesongozwi Mining Corporation (Pty) Ltd (NMC), and in turn the taxpayer was the sole shareholder of NMC.

In August 2008, NMC sold 50% of its shares in Umthombo to a third party for a price of R150 million. In October 2009, the taxpayer, in terms of a verbal agreement, sold his shares in NMC (which still held a 50% interest in Umthombo) to the Nesongozwi Family Trust (the Trust) for R547 275. This price was reasoned on the basis that NMC was a holding entity, its only income being dividends paid by Umthombo, and, to date, Umthombo had not declared any dividends or engaged in any mining operations.

The South African Revenue Service (SARS) disagreed with the value attributed to the NMC shares by the taxpayer and raised an additional assessment wherein it imposed capital gains tax and donations tax on the taxpayer, in the amount of approximately R48 million.

The taxpayer objected against this additional assessment on the basis that SARS had not reduced the value of the NMC shares due to the value of the underlying Umthombo shares being impaired by the potential joint venture between Umthombo and Sumo. When SARS disallowed the objection, the taxpayer appealed to the tax court. The tax court ordered that an altered assessment be issued in terms of section 129(2) of the Tax Administration Act, 2011 (the TAA), which still left the taxpayer with a substantial additional tax liability. The taxpayer then appealed the tax court decision to the full bench of the High Court.

However, a day before the appeal was to be heard by the full bench, the taxpayer gave notice of his intention to file an amended notice of appeal to include two further grounds, being (i) that the valuation method applied by SARS when valuing the NMC shares was incorrect and (ii) that SARS' characterisation of Umthombo's mineral resources was incorrect. The full court disallowed the amendment in respect of the first issue but allowed it in respect of the second issue.

After the full bench dismissed the taxpayer's appeal, the taxpayer appealed to the SCA, and again relied on these two additional grounds of appeal.

The SCA indicated that prior to considering the merits of the appeal, it had to decide whether these additional grounds were properly before the SCA as grounds of appeal. This was because of the SCA's judgment in prior cases, such as *Lion Match Company (Pty) Ltd v Commissioner for the South African Revenue Service* [2018] ZASCA 36, where it was held that because the tax court is a creature of statute, its jurisdiction, powers and the scope of any right to appeal its decisions are defined in the TAA.

THE RELEVANT LEGAL PRINCIPLES

In its judgment, the SCA summarised the provisions of the TAA and the dispute resolution rules promulgated in terms of section 103 of the TAA (the Rules), dealing with the process for objection and appeal. The SCA referred to section 129 of the TAA, dealing with the powers of the tax court, including its power to alter an assessment, as the tax court ordered. It also dealt with the provisions of the TAA dealing with appeals against a tax court judgment, namely section 133, which deals with the appeal to the High Court or SCA and section 134, which deals with the process to be followed in pursuing the appeal, including documents that need to be filed.

However, it appears that the main provision on which it relied in deciding the issue of the additional grounds raised in the High Court and SCA appeals, was Rule 10 of the Rules, which deals with the filing of a notice of appeal, including concomitant grounds of appeal, to the tax court.

Rule 10(2) states that:

> "A notice of appeal must:
>
> *(a)* be made in the prescribed form;
>
> *(b)* if a SARS electronic filing service is used, specify an address at which the appellant will accept delivery of documents when the SARS electronic filing service is no longer available for the further progress of the appeal;
>
> *(c)* specify in detail:
>
> (i) in respect of which grounds of the [taxpayer's] objection [referred to in Rule 7] the taxpayer is appealing;
>
> (ii) the grounds for disputing the basis of [SARS'] [the] decision to disallow the [taxpayer's] objection; and
>
> (iii) any new ground on which the taxpayer is appealing ..."

Rule 10(3) expressly prohibits a taxpayer from appealing "on a ground that constitutes a new objection against a part or amount of the disputed assessment not objected to under Rule 7 [in the taxpayer's objection]".

The principle in Rule 10(3) is repeated in Rule 32, which states that in its statement of ground of appeal (which would be filed after SARS' Rule 31 statement of grounds of assessment), the taxpayer is prohibited from relying on "a ground of appeal that constitutes a new ground of objection against a part or amount of the disputed assessment not objected to under Rule 7 [in the taxpayer's objection]".

SCA DECISION

Pursuant to the above, the SCA found that in his initial objection lodged with SARS, the taxpayer objected on the basis that "SARS used incorrect valuations for its assessments" as it had failed to reduce the value of the NMC shares due to the value of the underlying Umthombo shares being impaired by the potential joint venture between Umthombo and Sumo. The taxpayer again relied on this exact ground when lodging his notice of appeal under Rule 10 with the tax court.

"The tax court ordered that an altered assessment be issued in terms of section 129(2) of the Tax Administration Act, 2011 (the TAA), which still left the taxpayer with a substantial additional tax liability."

When the taxpayer appealed to the full bench of the High Court, the SCA found that he initially appealed on the same ground. In fact, in his notice of appeal, "the taxpayer made it clear that the valuation of Umthombo's shareholding was not in issue". However, once leave to appeal had been granted, the taxpayer sought to change this, at the last minute, challenging both the valuation methodology of the NMC shares and the characterisation of Umthombo's mineral resources. The SCA also made reference to the expert evidence

that was led during the tax court hearing, from which it was clear that the valuation methodology was not in dispute. The SCA also noted the High Court's finding that on the issue of the joint venture impairing the value of the Umthombo shares, the issue was that the joint venture had not yet been formed at the time that the taxpayer sold the NMC shares. Therefore, it could not be taken into account to determine the value of NMC's Umthombo shares and in turn, the taxpayer's NMC shares at the time they were sold.

In relation to the characterisation of the mineral resources issue raised by the taxpayer for the first time in the High Court appeal and again in the SCA appeal, the SCA found that the issue was appealable in terms of the principle in *Matla Coal Ltd v Commissioner for Inland Revenue* [1987] (1) SA 108 (A). In *Matla Coal,* it was held that a court should not be unduly technical or rigid in its approach to a taxpayer's objection and notice of appeal and should focus on the "substance of the objection" within the context of the particular facts of the case.

However, in respect of the additional ground of appeal regarding the valuation method, the SCA held that this could not be raised as –

- it was not an issue before the tax court or the High Court, as it was first raised in the heads of argument filed in the High Court appeal;
- it was common cause that the valuation method used was the correct one; and
- even if the issue was appealable, the taxpayer would have had to establish a misdirection on the part of the High Court in the exercise of its discretion to disallow the amendment of the notice of appeal. The taxpayer did not do this.

Pursuant to the above, the SCA dismissed the taxpayer's appeal. It concluded that the reasoning of the tax court and High Court was firmly grounded in the credible evidence of SARS' expert witnesses and could not be faulted.

OBSERVATIONS

The taxpayer's approach

After going through an objection and three appeals, the taxpayer in *Nesongozwi* ran out of the proverbial road and found himself on two last-minute rocky grounds of appeal. The judgment illustrates the importance of a taxpayer formulating comprehensive grounds of objection and appeal from the beginning of the dispute resolution process. Obtaining professional advice early on, ideally at an early stage of the dispute resolution process and at least before lodging the objection, can go a long way to ensuring that the best possible outcome is achieved, particularly if further appeals are contemplated.

Matla Coal *principle*

The SCA's reliance on the principle in *Matla Coal* as the basis for considering the additional ground of characterisation of mineral resources, should be welcomed. The principle promotes the focus on the substance of the objection as opposed to taking an overly technical approach that results in the disallowance of an appeal on purely technical grounds. While not explicitly stated by the court, it thus appears that if a taxpayer makes an argument or raises a ground of appeal that is different from its grounds of objection, at the initial appeal stage or later, the taxpayer could potentially argue that the ground of appeal must be considered, on the basis that it does not deviate from the substance of the initial objection. However, the most prudent approach is still to draft comprehensive grounds of objection and appeal, pursuant to obtaining professional advice early in the life of the dispute.

Donations tax and capital gains tax consequences

Considering that the SCA upheld the High Court and tax court decisions, the taxpayer remains liable to pay the additional tax, interest and penalties, as per the tax court finding.

While it is unfortunate that the SCA did not analyse this issue further, the judgment illustrates that on a set of facts, a transaction can give rise to both capital gains tax and donations tax consequences. While it is not stated in the judgment whether the taxpayer's initial valuation was based on expert advice, it would have likely been better for the taxpayer to conclude a written agreement between himself and the Trust for the NMC share sale. Furthermore, before entering into the agreement, it would have likely been best for the taxpayer to obtain a proper valuation and understand the tax risk, specifically the adverse capital gains tax and donations tax consequences that could ensue, as a result of SARS questioning the tax treatment and valuation, which ultimately happened in this case.

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Acts and Bills

- Tax Administration Act 28 of 2011: Sections 103, 129 (more specifically subsection (2)), 133, 134.

Other documents

- Dispute resolution rules promulgated in terms of section 103 of the TAA: Rules 7 & 10 (more specifically subrules (2) & (3)), 31 & 32.

Cases

- *Nesongozwi v Commissioner for SARS* (838/2021) [2022] ZASCA 138;
- *Lion Match Company (Pty) Ltd v Commissioner for the South African Revenue Service* [2018] ZASCA 36 (27 March 2018);
- *Matla Coal Ltd v Commissioner for Inland Revenue* [1987] (1) SA 108 (A).

Tags: amended notice of appeal; statement of ground of appeal; dispute resolution process.

UNDERSTATEMENT PENALTIES

The Tax Administration Act, 2011 (the TAA), imposes an obligation on SARS to impose a penalty called an "understatement penalty" in the event that a taxpayer makes an understatement (for example by making an incorrect statement in a tax return).

However, when, for example, an incorrect statement in a return is caused by a "*bona fide* inadvertent error", then the TAA provides that SARS may not impose the understatement penalty. The exact meaning of the term "*bona fide* inadvertent error" is not entirely clear but a judgment of the SCA, delivered on 7 November 2022, (*CSARS v The Thistle Trust* (516/2021) [2022] ZASCA 153) does seem to provide some guidance.

The facts of the case, insofar relevant here, is that the taxpayer, a trust, had obtained a legal opinion on the tax treatment of certain receipts and accruals it received as beneficiary of another trust. This opinion hinged on section 25B of the Income Tax Act, 1962. The views expressed in the tax opinion were ultimately not upheld by the SCA – this resulted in the taxpayer having made an understatement. The next issue that had to be determined by the court was whether the understatement penalty SARS imposed was correctly imposed.

Initially SARS defended its imposition of the penalty on the basis that the understatement made by the taxpayer in the return was made deliberately and that therefore the understatement could not have been caused by a *bona fide* inadvertent error. This approach to the meaning of the term *bona fide* inadvertent error seems to be in line with the view expressed by SARS in their *Guide to Understatement Penalties* (the USP guide). The crux of this view, as we understand it, is as follows:

"However, when, for example, an incorrect statement in a return is caused by a '*bona fide* inadvertent error', then the TAA provides that SARS may not impose the understatement penalty."

- An error in the true sense of the word cannot be made in good or bad faith. Therefore, the words *"bona fide"* must be interpreted with reference to the inadvertent nature of the error, and not with reference to the error itself.

The taxpayer in the SCA case deliberately made an incorrect statement in a return because the taxpayer took advice and planned or intended to make disclosures in line with the views as expressed in the legal opinion, or so the argument for SARS went initially. There was nothing inadvertent about the disclosure. Whilst indeed such deliberate understatement would have been made in good faith (in light of the legal opinion received), this should, on our understanding of SARS' interpretation of the term "*bona fide* inadvertent error", be irrelevant to establishing whether understatement indeed results from a *bona fide* inadvertent error.

Counsel for SARS in the SCA case though conceded (correctly, according to the SCA) that the penalty could not have been imposed because the understatement was in fact the result of a *bona fide* inadvertent error. The reason for this, according to the SCA is

> "… that the understatement by … [the taxpayer] was a *bona fide* and inadvertent error as it had believed that s 25B was applicable to its case. Though the … [the taxpayer] erred, it did so in good faith and acted unintentionally." [author's insertion].

This meaning of the term "*bona fide* inadvertent error" seems to align with what the tax court in *ITC 1890* [[2016] 79 SATC 62, at paragraph 45] held the meaning of these words to be, to wit:

> "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".

SARS, however, in their USP guide, at footnote 70, state the following with regards to the judgment in *ITC 1890*:

> "SARS disagrees with and will not follow the application of the law in this judgment which it is entitled to do as tax court judgments, although often instructive, have no binding effect."

Has SARS then, by conceding in the SCA, made a complete U-turn from what its previous position was, not only in this case but as also stated in the USP guide? Perhaps; maybe SARS will update its guide to make clear what their position actually is. Perhaps it has not made a complete U-turn. Perhaps its position remains the same, but, in this case, the legal opinion obtained (which is the result of the incorrect statement in the return) was inadvertently incorrect in the sense that the opinion did not intentionally incorrectly set out the law and that therefore the understatement was indeed the result of a *bona fide* inadvertent error. Perhaps SARS' concession was not actually that the understatement was caused by a *bona fide* inadvertent error but rather because the taxpayer, having obtained professional advice, was not guilty of any of the behaviours in the understatement penalty percentage table. In the event that it was a "substantial understatement", it would fall to be remitted in terms of section 223(3) of the TAA. That is not, however, how the judgment from the SCA reads.

Whatever the reason for the concession might have been and whether SARS has changed their mind or not remain to be seen. The good news for taxpayers though is that the SCA has at least provided some guidance which strongly suggests that a *bona fide* inadvertent error is in fact an error made in good faith and made unintentionally and that taxpayers can possibly avoid these penalties if professional advice is obtained.

Nico Theron

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Acts and Bills

- Income Tax Act 58 of 1962: Section 25B;
- Tax Administration Act 28 of 2011: Section 223(2).

Other documents

- *Guide to Understatement Penalties* (the USP guide – published by SARS).

Cases

- *CSARS v The Thistle Trust* (516/2021) [2022] ZASCA 153 (7 November 2022);
- *ITC 1890*, [2016] 79 SATC 62 (at paragraph 45).

Tags: *bona fide* inadvertent error; deliberate understatement; understatement penalty.

PREPARING FOR A TRANSFER PRICING AUDIT

Alleged base erosion and profit shifting activities of multinational enterprises (MNEs) have been a hot issue globally and therefore the chances of an MNE being confronted with a transfer pricing audit have increased substantially over the past few years.

Owing to the intense focus on transfer pricing by almost all tax authorities around the world, together with a growing focus on international exchange of information, it seems as though it will be only a matter of time before an MNE will be subject to transfer pricing audit scrutiny.

STEPS TAKEN IN PREPARATION OF A SOUTH AFRICAN TRANSFER PRICING AUDIT

Taxpayers need to proactively adopt strategies that will enable them to manage the risks associated with the transfer pricing audit.

- **Performing a self-assessment:** A regular assessment of your inter-company transactions, and the assessment of functions, assets and risks as well as the pricing structure are key. One must check that one's policy is up to date, ensure the validity and relevance of benchmarking studies and ensure that one's results fall within the interquartile range identified. If a possible risk is detected, a voluntary self-adjustment is always preferable to an adjustment being made by the South African Revenue Service (SARS).

- **Reporting requirements:** South Africa follows the three-tiered approach as implemented by the Organisation of Economic Cooperation and Development (OECD), ie, country-by-country reporting (CbCR), including the Master File and the Local File. South African parented multinationals that have an aggregate of potentially affected transactions of more than ZAR100 million annually need to prepare and submit a Master File and Local File. Such documentation should not be viewed as a simple compliance exercise as such documentation provides SARS (and other tax authorities with which it shares this information) with the basis for conducting thorough transfer pricing risk assessments. It is therefore imperative that such documentation is simultaneously prepared and filed.

"The increasing sophistication of transfer pricing audits incentivises taxpayers to take their transfer pricing seriously. Taxpayers should be proactive and cooperative and implement strategic measures – this will ensure a more favourable outcome in the long run."

- **Preparation of robust documentation:** Without substantiation of transfer prices, one opens the door to a thorough investigation, because tax authorities may then formulate their own views on the situation, which is extremely harmful and immediately puts the taxpayer on the back foot. In one transfer pricing case, a Danish court ruled in favour of the tax authority, entitling it to make a discretionary assessment of the taxable income. This permitted the tax authority to benchmark the manufacturer (taxpayer) as opposed to the related-party sales companies, arguing that the taxpayer had failed to furnish it with robust information concerning the sales companies and therefore it could not perform a reliable benchmarking study. In contrast, in another transfer pricing case the Danish court judged in favour of the taxpayer. The court ruled that the transfer pricing documentation provided adequate justification for the benchmarking applied, thus preventing the revenue authority from applying the Transactional Net Margin Method (TNMM) to assess the income of a company making losses.

  It is evident that well-prepared and robust documentation enables a taxpayer to defend its policies and provides context for how each party fulfils its obligations.

"Section 46 of the Tax Administration Act, 2011 (the TAA), gives wide powers to SARS to request information which it considers to be relevant."

- **Alignment of facts and evidence:** Check that the transfer pricing analysis aligns with the legal agreements and the actual conduct of the parties. It is critical to provide a consistent picture and allow the reader to fully understand the nature of the transactions. If there are inconsistencies, the chances are that SARS will disregard the analysis and draw its own conclusions. Therefore, always ensure that information is consistent and a cohesive story exists across CbCR, Master File, Local File, legal agreements and supporting evidence.

- **Respond systematically to SARS' requests:** Section 46 of the Tax Administration Act, 2011 (the TAA), gives wide powers to SARS to request information which it considers to be relevant. It is advisable to provide comprehensive and timely responses to SARS' requests as this will create a cordial working relationship with SARS which will go a long way when it comes to granting extensions or penalty mitigation.

- **Interview readiness:** Ensure that the individuals (key strategic decision-makers) are fully briefed in advance. When it comes to the field audit interviews it is imperative to ensure that the individuals respond appropriately and understand the context of the questions raised by SARS. Interviewees should only respond when they know the answer and avoid speculating. A good idea is for the potential interviewees to refresh their memories by reviewing all relevant material in advance. It is also worth having someone present at the interview to moderate the discussion, if required, and to record the interview so that there is a clear record of what was said.

COMMON RISK AREAS FACED

One of the most common reasons for disagreements between taxpayers and SARS relates to the question whether the entity under investigation is doing what it claims to do. This is the limited risk versus full risk predicament. This would generally be caused by a disagreement over the functional profile of the parties, ie, marketing agent versus service provider. In such cases, the best line of defence is to ensure that as much factual evidence as possible is available to support the functional profile of the entity under audit.

The selection of comparables also plays a significant role as SARS will question the taxpayer's comparable data put forward and provide its own comparability analysis. SARS' analysis should not simply be accepted as correct. It is essential to thoroughly dissect SARS' analysis, request additional information where necessary and keep asking questions.

CONCLUSION

The increasing sophistication of transfer pricing audits incentivises taxpayers to take their transfer pricing seriously. Taxpayers should be proactive and cooperative and implement strategic measures – this will ensure a more favourable outcome in the long run.

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ENSafrica

Acts and Bills

- Tax Administration Act 28 of 2011: Section 46.

Tags: base erosion; profit shifting; multinational enterprises (MNEs); transfer pricing audit; transfer pricing analysis.

IMPORTED SERVICES

Value-added tax (VAT) is levied on the supply of goods or services by registered vendors, on the importation of goods and on the importation of services into South Africa.

The VAT on supplies of goods and services must be paid by the supplier, whereas the importer of goods is responsible for the payment of the import VAT. VAT on imported services must be paid by the recipient.

Persons who acquire services from foreign suppliers often omit to pay the VAT on these services. It is for this reason that the South African Revenue Service is focusing on imported services in its VAT audits. However, not all services rendered by foreign service suppliers comprise imported services.

WHAT ARE IMPORTED SERVICES?

"Imported services" is defined in section 1(1) of the Value-Added Tax Act, 1991 (the VAT Act), as services rendered by a supplier who is resident or carries on business outside the Republic, to a recipient who is resident of the Republic, to the extent that such services are utilised or consumed in the Republic, otherwise than for the purpose of making taxable supplies. The VAT thereon is payable in terms of section 7(1)*(c)* of the VAT Act.

There are in essence three requirements that must be complied with for a service to comprise an "imported service":

- the service must be supplied by a non-resident supplier to a South African resident;
- the service must be used or consumed in South Africa; and
- the service must be acquired otherwise than for the purpose of making taxable supplies.

The place of residence of the supplier and that of the recipient are generally easily determinable. However, in the absence of so-called "place-of-supply" rules in the VAT Act, it is not always clear where a service is utilised or consumed.

UTILISED OR CONSUMED IN SOUTH AFRICA

In the case of *CSARS v De Beers Consolidated Mines Ltd,* [2020] 74 SATC 330 the Supreme Court of Appeal (SCA) took a practical approach to determine where the services rendered by a foreign

supplier were used. The SCA considered that the company was incorporated in South Africa with its head office situated in Johannesburg, the directors appointed the foreign supplier following a meeting held in Johannesburg, and it is also here that the directors met to approve the recommendations made. In addition, a scheme of arrangement in relation to the transaction was approved and implemented in South Africa.

"In the case of *CSARS v De Beers Consolidated Mines Ltd,* [2020] 74 SATC 330 the Supreme Court of Appeal (SCA) took a practical approach to determine where the services rendered by a foreign supplier were used."

However, as correctly pointed out by SP van Zyl ((2013) 25 SA MERC LJ at p 538), it is not always possible to apply a practical test, and certain services can only be utilised or consumed where and when they are supplied. Such services include transport services, live performances or sporting events, seminars and medical procedures. These may also include foreign listing services or foreign legal services to comply with foreign statutes, or legal services to defend or institute legal action in a foreign country. It cannot be said that, if the benefit of a service is enjoyed in South Africa, the service comprises an "imported service". For example, if a person's vehicle breaks down in Botswana while they are on holiday and is repaired in that country, the repair service is utilised and consumed in Botswana, and the subsequent benefit upon return to South Africa does not bring the repair service within the definition of "imported services". In the absence of clear place-of-supply rules, one can expect on-going debates on where a service is utilised or consumed.

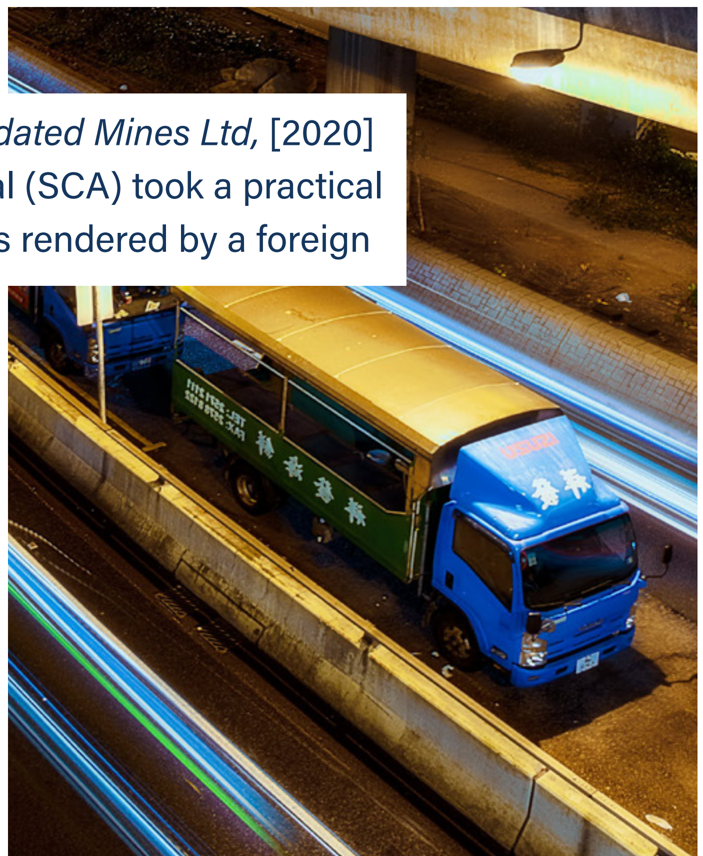
PURPOSE OTHER THAN FOR MAKING TAXABLE SUPPLIES

For a service rendered by a foreign supplier to comprise an "imported service", the service must also be acquired for a purpose other than for making taxable supplies. If the service is acquired for the purpose of making taxable supplies, the recipient is entitled to an input tax deduction if VAT was payable, and it is for this reason that services acquired for making taxable supplies are excluded.

The SCA in the *De Beers* case and in the case of *Consol Glass (Pty) Ltd v CSARS,* [2020], 83 SATC 186 also considered whether a foreign service was acquired for the purpose of making taxable supplies. In the case of *De Beers* the SCA stated that the foreign services were principally provided to enable the company to comply with its statutory obligations towards its unit holders, and that such services had no impact on its taxable enterprise, which comprised the mining, marketing and selling of diamonds. The SCA held that on this basis the foreign service was acquired for a purpose other than making taxable supplies.

In the *Consol Glass* case the SCA stated that the foreign services were acquired to redeem Eurobonds which were originally issued to effect a reorganisation of the Consol group of companies.

The court stated that the reorganisation did not bring about any material change to the enterprise comprising the making of glass containers, and as such there was no functional link between the issue of the Eurobonds and the making of taxable supplies. The court considered that the foreign services which were acquired to redeem the Eurobonds were acquired for the same purpose for which the Eurobonds had initially been issued. The foreign services were therefore not considered to be acquired for the purpose of making taxable supplies.



For a foreign service to fall outside the scope of "imported services" there must be a link between the services acquired and the making of taxable supplies. If the services are acquired partly for the purpose of making taxable supplies and partly for another purpose, then the services will only comprise "imported services" to the extent that they are acquired for a purpose other than making taxable supplies. Unlike the deduction of input tax, there is no prescribed method of apportionment to be applied to determine the extent to which an imported service is subject to VAT. It is also not a requirement that the recipient must obtain a ruling to approve an apportionment formula to be applied. The recipient must, however, be able to substantiate that the apportionment basis applied is reasonable.

EXEMPTIONS

The exemptions to imported services as contained in section 14(5) of the VAT Act should also be considered. Supplies that are subject to VAT at the standard rate under section 7(1)*(a)* are not also subject to VAT under section 7(1)*(c)* as imported services. A typical example is the supply of electronic services, where the foreign supplier is required to register and levy VAT on such supplies in South Africa in terms of section 7(1)*(a)*.

Services which would be exempt from VAT or zero-rated if supplied in South Africa are also exempt from VAT on imported services. Accordingly, the supply of a loan by a foreign credit provider to a South African resident does not comprise an imported service. However, any fees charged by the foreign supplier will comprise consideration for imported services because such fees are not exempt from VAT if supplied in South Africa.

In the case of *Metropolitan Life Ltd v CSARS,* [2008] 70 SATC 162 the taxpayer acquired business advice and computer services from foreign suppliers. The taxpayer argued that these services were physically rendered outside the Republic, and they qualified for the zero rate in terms of section 11(2)*(k)* of the VAT Act and VAT is therefore not payable thereon in terms of section 14(5). The High Court held that the purpose of sections 7(1)*(c)* and 14(5) must be considered in the context of the VAT Act, and that the zero-rating under section 11(2)*(k)* is not applicable to this kind of service. The services were held to be imported services because they were utilised or consumed in South Africa.

The supply of educational services by a foreign educational institution which is regulated by an educational authority in that country, is also exempt from the VAT payable under section 7(1)*(c)*, and so is the rendering of services by foreign employees or office holders to a South Africa employer. Finally, no VAT is payable on any supply of a service by a foreign supplier with a value not exceeding R100.

CONCLUSION

The potential liability for VAT on imported services could be substantial, particularly for South African companies who embark on foreign expansion projects or the raising of foreign capital. The services acquired from foreign service providers should be carefully considered on a case-by-case basis to determine whether they comprise imported services, and, if so, to what extent.

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Cliffe Dekker Hofmeyr

Acts and Bills

- Value-Added Tax Act 89 of 1991: Sections 1(1) (definition of "imported services"), 7(1)*(a)* & *(c)*, 11(2)*(k)* & 14(5).

Other documents

- (2013) 25 SA MERC LJ (Juta) (at p 538) (SP van Zyl).

Cases

- *CSARS v De Beers Consolidated Mines Ltd* [2020] 74 SATC 330;
- *Consol Glass (Pty) Ltd v CSARS* [2020] 83 SATC 186; (1010/2019) [2020] ZASCA 175 (18 December 2020);
- *Metropolitan Life Ltd v CSARS* [2008] 70 SATC 162.

Tags: importation of goods; supplies of goods and services; imported services; input tax deduction; zero-rated.

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