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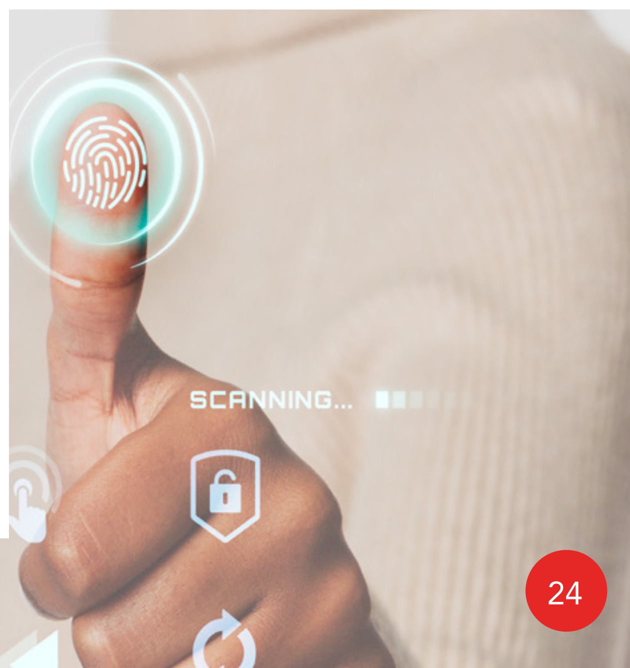
DEDUCTIONS AND ALLOWANCES
RENEWABLE ENERGY INCENTIVES

INTERNATIONAL TAX
CFCS AND THE FOREIGN BUSINESS ESTABLISHMENT

TRUSTS
LOW-INTEREST LOANS



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Mr KG Karro (Chairman), Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Ms MC Foster, Prof DA Tickle, Ms D Hurworth

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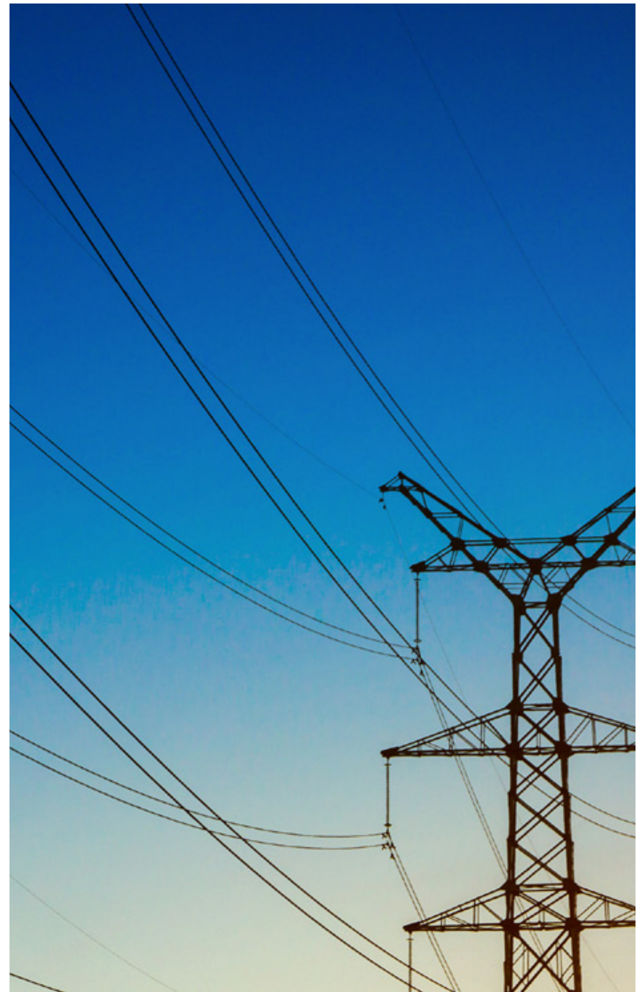
RENEWABLE ENERGY INCENTIVES



Every South African is faced with the ongoing negative effects of rolling electricity blackouts, which is euphemistically referred to as "loadshedding".

It affects our businesses, our homes, our livelihoods, our safety and our faith in the future of our country. It is no wonder that the theme on everyone's lips leading up to the 2023 Budget was whether Government would come to the party and provide some type of incentive or initiative that would help alleviate the pressure on the national grid and return the country's energy supply to some semblance of normality.

Vietnam is a case in point. While electricity consumption in Vietnam has increased substantially since the early 1990s, it has enacted various reforms to keep up with this increased consumption, thereby ensuring no electricity crisis. Included in these reforms are various tax incentives such as preferential tax rates for income derived from renewable energy, import duty incentives and other indirect tax incentives. On the other side of the spectrum is Venezuela, which suffered a complete collapse of its national grid that took a week to restore due to the ongoing neglect of infrastructure and rampant corruption.

While National Treasury and SARS have already played a role by granting renewable energy incentives, the most well-known of which is the accelerated capital allowance on renewable energy assets referred to in section 12B of the Income Tax Act, 1962 (the Act), many South Africans have increasingly called for an expansion of the existing incentives and initiatives to fast-track the uptake in rooftop solar and wind energy. Those listening to the Budget speech in February 2023 therefore breathed a collective sigh of relief when learning of the various announcements made by Government. Some of the key announcements are highlighted in this article.

EXPANDED 125% RENEWABLE ENERGY TAX INCENTIVE FOR BUSINESSES

Currently, the section 12B allowance provides that businesses can deduct the costs of certain renewable energy installations over a one- or three-year period, which creates a cash flow benefit in the early years of a project. Under the expanded incentive announced in the Budget, businesses will be able to claim a 125% deduction in the first year for all renewable energy projects with no thresholds on generation capacity.

This means, irrespective of the capacity of the renewable energy assets (ie, less than or more than 1 MW), one will be able to claim the 125% deduction. This is a departure from the existing incentive, which made a distinction between projects generating less than 1 MW (which could be depreciated by 100% in year one) and those generating more than 1 MW (which could be depreciated over a three-year period). This also aligns with the recent increase in the licensing threshold for embedded generation to 100 MW.

The adjusted incentive for business will only be available for investments brought into use for the first time between 1 March 2023 and 28 February 2025. If, for example, a renewable energy investment of R1 million is made by a business, that business will qualify for a deduction of R1,25 million. According to National Treasury, this deduction could reduce the corporate income tax liability of a company by R337,500 in the first year of operation.

On 21 April 2023, the "Draft Taxation Laws Amendment Bill (Initial Batch), 2023" (the Draft Bill), was published by National Treasury for public comment. It contains a proposed new section 12BA to be inserted into the Act that will deal with the 125% capital depreciation allowance. Public comments on the draft legislation were due on Monday, 15 May 2023.

Practically, it has been proposed that the private solar energy incentive can be used to offset an individual's personal income tax liability for the 2023/24 tax year up to a maximum tax rebate of R15,000 per individual. The Draft Bill proposes the insertion of a new section 6C into the Act.

IMPACT ON THE FISCUS

National Treasury has indicated that tax relief amounting to R13 billion in 2023/24 will be provided to taxpayers. Notably, R9 billion of this amount is provided to encourage households and businesses to invest in renewable energy, supporting the clean energy transition and addressing the electricity crisis. More specifically, R4 billion in relief is provided for households that install solar panels and R5 billion to companies through the expansion of the existing renewable energy incentive.

In comparison to the negative impact that loadshedding has on South Africa's economy and its people's psyche, this is a small price to pay. Every South African will welcome these announcements with a view to hopefully having the lights being switched back on.

RENEWABLE ENERGY INCENTIVES FOR PRIVATE HOUSEHOLDS

A further welcome proposal relates to rooftop solar incentives for individuals to invest in solar PV. Individuals will be able to receive a tax rebate (or tax credit) to the value of 25% of the cost of any new and unused solar PV panels. Notably, to qualify for the rebate, the solar panels must be purchased and installed at a private residence, and a certificate of compliance for the installation must be issued between 1 March 2023 and 29 February 2024.

Even though inverters and batteries form a substantial cost of any home energy installation, the rebate will be limited to solar PV panels, and not inverters or batteries. This is even though inverters form a critical component of a solar system, without which the system would not be operable. National Treasury states that this is to ensure a focus on the promotion of additional generation of energy. This is likely to be in anticipation of allowing homeowners to sell electricity back into the grid to alleviate pressure on Eskom. In fact, it was also announced that the start of feed-in tariffs in some municipalities (eg, the City of Cape Town) may require amendments to the Act to cater for additional revenue from electricity sales.

"A further welcome proposal relates to rooftop solar incentives for individuals to invest in solar PV. Individuals will be able to receive a tax rebate (or tax credit) to the value of 25% of the cost of any new and unused solar PV panels."

Jerome Brink

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 12B.

Tags: renewable energy incentives; tax rebate; personal income tax liability.

SIGNING WILLS: COMPLY WITH THE ACT

In Delport v Le Roux and Others, *[2022], the court's judgment, delivered on 24 November 2022, is a reminder of the importance of complying with the provisions of the Wills Act, 1953 (the Wills Act).*

Not for the first time in our judicial history, a will was declared invalid because of defective witnessing. And a certain accountant must be feeling somewhat rueful.

Mr DC le Roux, the deceased, was married in community of property to Mrs ME le Roux. The marriage foundered and the deceased relocated from Gauteng to Durban, where he moved in with his cousin, Ms Delport, the applicant in this case. Together with her partner, she cared for and nursed the deceased through the three years preceding his death from severe diabetes. The care included attending to his recovery from a leg amputation occasioned by the diabetes.

According to the applicant, the deceased wished to prepare his last will, and a neighbour introduced him to the accountant. Acting on the deceased's instructions, the accountant prepared the will and presented it to the deceased, who signed it. The accountant then had the will signed as witnesses by his partner's wife and the neighbour, neither of whom had been present when the deceased signed it. How the accountant saw fit to procure, let alone condone, this fatal breach of section 2(1) of the Wills Act is a question only he could answer.

In terms of the will, 70% of the estate would devolve upon the applicant and 10% to each of the deceased's two children and the applicant's partner. The applicant contended that this

apportionment was fair, given that she and her partner had cared for the deceased, during which period he had no contact at all with his wife and their two children, an assertion the children denied. (By the time the case came to court, the wife had died). They pointed out that the deceased had not changed the beneficiaries on his policies, which had been divided according to his wishes stated in the policies.

The requirements of section 2(1) of the Wills Act are peremptory: the will must be signed by the testator or by some other person in the presence of and by the direction of the testator; in the presence of two or more competent witnesses present at the same time; the testator and the witnesses must sign in each other's presence; and each page must be signed by all parties.

Section 2(3) of the Wills Act, on which counsel for the applicant relied in his argument, reads:

> "If a court is satisfied that a document or the amendment of a document drafted or executed by a person who has died since the drafting or execution thereof, was intended to be his will or an amendment of his will, the court shall order the Master to accept that document, or that document as amended, for the purposes of the Administration of Estates Act, 1965 (Act 66 of 1965), as a will, although it does not comply with all the formalities for the execution or amendment of wills referred to in subsection (1)."

"The accountant then had the will signed as witnesses by his partner's wife and the neighbour, neither of whom had been present when the deceased signed it. How the accountant saw fit to procure, let alone condone, this fatal breach of section 2(1) of the Wills Act is a question only he could answer."

In *Logue and Another v The Master and Others*, [1995], the court stated that section 2(3) requires that, in order to have a defective will validated, the applicant "must demonstrate and persuade the court that the deceased intended the document to be his will". It did not mean that it was unnecessary to comply with the formalities, but that it was not necessary to comply with all the formalities.

In *Webster v The Master and others* [1996], the following passage appeared in the headnote of the judgment:

> "...s 2(3) of the Act was in most peremptory terms: when the Legislature provided that a document which was sought to be declared to be the will of the deceased in terms of s 2(3) of the Act had to be 'drafted or executed by a person who had died since the drafting or execution thereof', it required that the document had to be drafted by such person personally".

In the present matter the deceased had not personally drafted the will. There was no certainty that he had signed the will. The accountant had drafted the will on the deceased's instruction but was not a witness to the will. The peremptory requirement in section 2(3), referred to in *Webster* was therefore not met. The applicant had failed to substantiate why the formalities had not been complied with. Section 2(3) could not be relied upon "successfully to validate a document that was drafted by a professional person who ought to have complied with the formalities of a valid will but for no valid reason failed to do so".

Accordingly, the court found that the will was invalid for want of compliance with the statutory requirements. This had been the view of the Master, who had rejected the will.

Prof Peter Surtees

Acts and Bills

- Wills Act 7 of 1953: Section 2(1) & (3);
- Administration of Estates Act 66 of 1965.

Cases

- *Delport v Le Roux and Others* (D1703/2021) [2022] ZAKZDHC 51 (24 November 2022);
- *Logue and Another v The Master and Others* [1995] (1) SA 199 (N) [at 203E–F];
- *Webster v The Master and Others* [1996] (1) SA 34 (D).

Tags: execution or amendment of wills; validate a document.

CFCS AND THE FOREIGN BUSINESS ESTABLISHMENT

In February 2023, in the case of Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd, *[2023], SARS continued its winning streak in the Supreme Court of Appeal (SCA).*

The SCA held in that case that an Irish company, forming part of the Coronation group of companies, was not conducting its primary business operations in Ireland and therefore the South African holding company of the Coronation group had to impute the profits of that Irish entity for South African tax purposes.

This was because of the SCA's interpretation and application of the controlled foreign company (CFC) rules to the specific facts of the case. It is therefore notable that on the back of this victory, it was announced in the 2023 Budget Review (the Budget) that certain additional amendments to the CFC regime would be introduced that will provide further clarity to the findings in the *Coronation* case.

CONTEXT: CONTROLLED FOREIGN COMPANY REGIME

Section 9D of the Income Tax Act, 1962, contains anti-avoidance rules aimed at taxing South African residents on the net income of a CFC, a concept defined in section 9D(1). The purpose of this provision is to strike a balance between protecting the South African tax base and enabling South African multinationals to compete offshore. Given this, the CFC rules contain various exclusions and exemptions for certain types of income. For instance, if the CFC is located in a high-tax jurisdiction, then the CFC's net income will not be imputed in the hands of South African tax residents.

Furthermore, amounts that are attributable to a foreign business establishment (FBE) (as defined in section 9D(1)) of a CFC, are excluded from the net income of the CFC. This aligns with the thought that if the foreign company has a suitable physical presence in the foreign country that has sufficient substance, then it should only be taxed in the source country. In simple terms, an FBE consists of a fixed place of business located outside South Africa that is used or will continue to be used for the business of the CFC for at least one year.

However, to fully benefit from the FBE exemption, an FBE must also satisfy requirements relating to the nature of the business. In this context, the fixed place of business should be suitably staffed with onsite managerial and operational employees of that CFC and its offices should be suitably equipped and have suitable facilities for conducting the "primary operations" of the business. Determining what constitutes the "primary operations" of the business is therefore critical.

Coronation case

In the *Coronation* case, the SCA had to determine whether the Irish Coronation group company had sufficient substance for its operations and complied with all the requirements of the FBE definition. To the extent that it did not qualify for the FBE exemption, the Coronation holding company in South Africa would have to impute profits of the Irish entity in its South African tax return.

It was accepted that the Irish entity had a fixed place of business that was staffed by on-site operations and managerial employees. However, the key issue was whether the office was suitably equipped and staffed for conducting the "primary operations" of the Irish entity. Coronation contended that its primary operation in Ireland was "fund management" which included the active management of its service providers, plus regulatory compliance.

It furthermore submitted that the functions that it outsourced and did not conduct in Ireland comprised the larger fund management services (ie, "investment management") provided to investors in conjunction with the investment manager, which was not its primary operation. The argument was therefore that because it outsourced its investment management functions to other entities, that was not its primary business operation and therefore its FBE in Ireland did not need to be suitably staffed by individuals conducting the "investment management" services.

The SCA disagreed with Coronation's submissions and held that the argument that "investment management" is not the Irish entity's core business was at odds with what was stated in its founding documents, which specifically referred to establishing specified collective investment undertakings and carrying on the business of investment and financial management. In addition, the fact that the Irish entity's primary source of income was from investment was, according to the SCA, another indication that its core function was investment management.

> "It was accepted that the Irish entity had a fixed place of business that was staffed by on-site operations and managerial employees. However, the key issue was whether the office was suitably equipped and staffed for conducting the 'primary operations' of the Irish entity."

OUTSOURCING

The SCA also discussed the concept of outsourcing and commented that even though the Irish entity was permitted to outsource functions, this did not mean that the scope of its business was confined to the supervision of the functions which it has outsourced, together with regulatory compliance. Instead, its operations must be determined with reference to the activities under which it was granted its licence. If it chooses to outsource those activities to another entity, this does not mean those functions fall outside of its business. It was specifically held as follows:

> "These functions had to fall within the ambit of its business in order to be outsourced. An agent cannot perform a function which does not form part of the business of the principal. In other words, [the Irish entity] could not outsource a function that it did not possess in the first place."

The SCA thus determined that the primary operation of the Irish entity's business (and, therefore, the business of the CFC as defined) was that of "fund management" which included "investment management" and that these operations were not conducted in Ireland. It was commented that such an interpretation would give credence to the rationale that the CFC regime is in force for purposes of limiting a situation where a tax exemption is obtained in relation to earnings in a low-tax jurisdiction when the primary operations of the business are not conducted there.

TIGHTENING OF THE SCREWS ON OUTSOURCING OF OPERATIONS BY CFCS

Despite SARS' victory in the SCA, it was announced in the Budget that Government has identified that some taxpayers are retaining certain management functions but outsourcing other important functions for which the CFC is also being compensated by its clients. National Treasury states that this is against the policy rationale of the definition of an FBE. It has therefore been proposed that tax legislation be clarified such that, to qualify as an FBE, all important functions for which a CFC is compensated need to be performed by the CFC or by the other company meeting certain conditions.

In this manner, National Treasury states that the definition of an FBE does allow for the structures, employees, equipment and facilities of another company to be taken into account if these are all located in the same country as the CFC's fixed place of business; the other company is subject to tax in the same country where the CFC's fixed place of business is located; and it forms part of the same group of companies as the CFC. In other words, the outsourcing of certain functions is allowed but only under certain conditions.

While the judgment in the *Coronation* case may have been a bitter pill to swallow for many taxpayers, their medication may just get even more unpalatable. It is anticipated that the proposed amendments will build on the commentary and findings in the *Coronation* case to ensure that outsourcing in the context of the CFC regime is only allowed under certain strict conditions and circumstances. All South African tax resident shareholders with CFCs would be well advised to analyse their existing offshore operations in light of these developments.

Jerome Brink

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 9D (contains anti-avoidance rules aimed at taxing South African residents on the net income of a CFC); (with emphasis on definitions of "controlled foreign company" (CFC) & "foreign business establishment" (FBE) in subsection (1)).

Other documents

- The 2023 Budget Review.

Cases

- *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (07 February 2023).

Tags: controlled foreign company (CFC); CFC rules; anti-avoidance rules; foreign business establishment (FBE); fixed place of business; investment management functions.

CORRECT PROCEDURE ON OBJECTION

Policies and procedures are often put in place for a variety of reasons, but an overarching reason includes the desire to streamline even the most chaotic of events. Procedure allows for predictability, flow and, more importantly, appeasement of the courts by one's good form.

When that procedure is blatantly disregarded, one risks walking away with a bigger burden than what was originally at stake. Such was the case in the matter of *Applicant X v The Commissioner for the South African Revenue Service,* [2022], which involved a dispute over an amount claimed by the applicant for certain home office expenses. Derogation of court procedure found the applicant walking away with a bit more than she could chew.

FACTS

During the completion of her 2021 tax return, the applicant had made a claim for home office expenditure in the sum of R137 118. The South African Revenue Service (SARS) had issued her with an original assessment on the same day of her filing her return, and later an additional assessment which reconsidered the original assessment issued. Dissatisfied with this, the applicant filed a notice of objection on 16 September 2021, insisting that she had incurred home office expenditure in the sum of R100 501 and disputing the additional assessment raised by SARS. She filed another objection on 26 October 2021 after SARS had failed to respond to her earlier objection. (Note: The judgment elsewhere makes reference to the lodging of an appeal on 26 November 2021 and to SARS invalidating the initial objection on 18 January 2022. However, the court's finding does not turn on these facts and whether the dates are correct.)

When she had not received a response from SARS, the applicant sought a default judgment order arguing that because SARS had failed to respond timeously to the notice delivered in terms of Rule 56 of the Tax Court Rules (the Rules), the original assessment ought to be reinstated.

SARS, on the other hand, believed the matter was not brought before the court in the proper manner. The applicant had brought her notice in terms of Rule 56 while SARS was of the opinion that it ought to have been brought

under Rule 52(1)(b). SARS further argued that the applicant did not comply with Rule 56, specifically as a notice indicating the applicant's intention to apply for default judgment within 15 business days if SARS does not remedy the default within that period, was not delivered to SARS (Rule 56(1)(a)). It also alleged that Rule 56(1)(b) was not complied with.

JUDGMENT

Notwithstanding the issues of merit, it was clear to the court that the question of procedure ought first to be resolved. The key question being: Was the application properly delivered in terms of Rule 56(1)(a) and 56(1)(b)?

The court considered Rule 50 of Part F of the Rules to understand what constitutes "delivery". It provides that when determining the address to which applications on notice ought to be delivered, one should refer to the address as stipulated under Rule 2. Rule 2 goes on to state that the address for delivery may include an address that –

- the taxpayer or appellant must use or has selected under these rules;
- SARS has specified under these rules or, in any other case, the Commissioner has specified by public notice as the address at which the documents must be delivered to SARS; or
- is determined under Rule 3 as the address of the clerk or the Registrar.

Within the context of this case, the address as stipulated by the Commissioner in a public notice was key. The public notice in question was in *Government Gazette* 38666 dated 31 March 2015, which indicated the physical and email address to which delivery of any document, notice or dispute request must be addressed.

It was quickly apparent that the applicant did not in fact deliver the notices in terms of Rule 56(1)(a) and 56(1)*(b)* to the SARS Tax Court Litigation Unit, as required by the Rules. The applicant delivered the notices to an email address of the Registrar of the Tax Court only and not to the Tax Court Litigation Unit. For this reason, the court found it unnecessary to go into the merits of the case as the application for default judgment stood to fail at that point.

COSTS

The court granted SARS' request for costs against the applicant on an attorney and client scale. While the court was aware that the imposition of costs on such a scale is limited to circumstances where the conduct of a party is quite clearly vexatious and reprehensible, the behaviour of the applicant was found to be exactly so. The court believed that the applicant's application was vexatious and imposed a financial burden on SARS to oppose it. Thus, the court awarded costs on a punitive scale.

COMMENT

This case is a testament that hours of preparation into a performance can easily be rendered meaningless if not presented on the correct stage. It is an age-old reminder that while the merits of the case are exceptionally important, failure to follow the correct procedure can be the difference between you walking away with a win or a loss and then some. One can appreciate that the taxpayer in this case may have been desperate to obtain a positive outcome and avoid paying additional tax, given that the dispute arose during the COVID-19 lockdown, which took a financial toll on many. However, the case is a reminder that taxpayers should obtain proper advice when pursuing tax disputes against SARS, to ensure that simple procedural errors are not a stumbling block to achieving success. This is even more important in cases such as this, where it appears that the amount in dispute was a deduction of approximately R100 000, whereas the legal costs incurred (including the cost order) would likely exceed this.

"SARS, on the other hand, believed the matter was not brought before the court in the proper manner. The applicant had brought her notice in terms of Rule 56 while SARS was of the opinion that it ought to have been brought under Rule 52(1)(b)."

Esther Ooko & Louis Botha

Cliffe Dekker Hofmeyr

Other documents

- Tax Court Rules: Rules 2, 3, 50, 52 (specifically subrule (1)*(b)*) & 56 (more specifically subrule (1)*(a)* and (b));
- *Government Gazette* 38666 (31 March 2015).

Cases

- *Applicant X v The Commissioner for the South African Revenue Service* 2022/12 (ADM) [2022] JHB (21 December 2022).

Tags: original assessment; additional assessment; default judgment; attorney and client scale.

NEW TAX DISPUTE RESOLUTION RULES

New tax dispute resolution rules provide for, amongst others, 80 days to submit an objection and more independence of an ADR facilitator.

On 10 March 2023, the Minister of Finance published new dispute resolution rules in the *Government Gazette* in terms of the Tax Administration Act, 2011 (the TAA). These rules describe the procedures for objections and appeals, for the alternative dispute resolution (ADR) mechanism and for the conduct and hearing of appeals before a tax board or tax court.

The rules came into effect on 10 March 2023 and apply to matters already underway. Requests for reasons, objections, appeals to the tax board or tax court, ADR, settlement discussions, or interlocutory applications that were instituted under the previous rules (the 2014 rules) but have not been completed, will have to be continued and concluded under the new rules.

The notable changes in the new rules are as follows.

1. ***Extension or shortening of time periods*** (rule 4): Parties can agree to shortened time periods for various procedures if the timelines are not already regulated by the rules. The 2014 rules only allowed for parties to agree to extensions.

"The new rules are a positive step forward in many ways. Taxpayers and their advisers are advised to be aware of the new rules, particularly on the changes to timelines."

2. ***Objection against assessment*** (rule 7(1)): A taxpayer objecting to an assessment must deliver a notice of objection (NOO) within 80 days (the 2014 rules: 30 days) of the date of the assessment. If the taxpayer requested reasons, the NOO must be delivered within 80 days of the delivery of (i) the SARS notice that adequate reasons have been provided, or (ii) the SARS letter with the reasons requested. The 80-day period excludes the 30-day extension where a taxpayer may still request additional time on reasonable grounds, and up to three years extension on exceptional grounds.

3. ***Appealing on new grounds*** (rule 10(3)): A taxpayer may appeal on a new ground not raised in the NOO unless the new ground is a new objection against a part of the assessment not previously objected to. This rule has been the subject of a few court decisions and is now clearly stated. (See also item 6 below.)

4. ***ADR facilitator appointment*** (rules 16 and 17): One of the biggest issues with the ADR process in the 2014 rules is the perceived lack of independence of the facilitator as the facilitator is appointed by SARS and is a SARS employee. Rule 16 has been amended to remove the requirement that a senior SARS official must establish a list of facilitators. The new rules also provide that the facilitator must have appropriate tax experience and be acceptable to both SARS and the taxpayer. Although the facilitator, once accepted by all parties, is still appointed by a senior SARS official within 15 days of the ADR commencement date, rule 17(3) now expressly provides that the facilitator must act independently and impartially. These positive amendments are welcomed.

5. ***Delivery of facilitator's report*** (rule 20): The facilitator is required to deliver a report within five days of a meeting, and a final report within 10 days after the ADR process ends.

6. ***New grounds in the SARS statement of grounds of assessment and opposing appeal*** (rule 31): If an appeal proceeds to the tax court, SARS is required to deliver a rule 31 statement setting out the grounds, the facts and the legal basis of their assessment, and the facts and legal basis relied on by SARS in opposing the appeal. Rule 31(3) has been amended to provide for SARS to include a new ground of assessment or basis for the partial or full disallowance of the objection. A new ground is allowed unless (i) the new ground is a novation of the whole of the factual or legal basis of the disputed assessment; or (ii) the new ground requires SARS to issue a revised assessment. As with the amendment to rule 10(3), rule 31(3) is now clear, whereas previously it was worded in the negative.

7. ***Subpoenas of witnesses to the tax board and tax court*** (rules 27 and 43): A person may be subpoenaed by the tax board clerk or the tax court registrar to attend the appeal and give evidence or provide documents on issues relevant to the appeal. The new rules also provide that the subpoena must also not be an abuse of process. If a party is of the view that the subpoena is not relevant or an abuse of process, the new rules provide for them to request the withdrawal of the subpoena, and if not withdrawn, to apply to the tax board or tax court for the withdrawal of the subpoena. The same applies where an issued subpoena was withdrawn by the clerk or registrar; the aggrieved party can then apply to the tax board or tax court, as the case may be, for the issue of the subpoena.

8. ***SARS to issue assessment within 45 days of a tax court decision*** (rule 44): Where the tax court confirms or alters the SARS decision or assessment, SARS must issue the relevant assessment within 45 days of the registrar receiving the tax court decision.

9. ***Applications on notice*** (rule 50): Applications on notice must be brought within 20 days of the cause of the application, unless parties agree to a longer period or the tax court grants an extension on good cause shown.

The new rules are a positive step forward in many ways. Taxpayers and their advisers are advised to be aware of the new rules, particularly on the changes to timelines.

Joon Chong

Webber Wentzel

Other documents

- *Government Gazette* 48187 of 10 March 2023: New dispute resolution rules in terms of section 103 of the Tax Administration Act 28 of 2011:
    - Rule 4 (Extension of time periods); 7(1) (Objection against assessment);
    - Rule 10(3) (Appealing on new grounds);
    - Rules 16 & 17 (ADR facilitator appointment), 17(3);
    - Rule 20 (Delivery of facilitator's report);
    - Rule 31 (New grounds in the SARS statement of grounds of assessment and opposing appeal), 31(3);
    - Rules 27 & 43 (Subpoenas of witnesses to the tax board and tax court);
    - Rule 44 (SARS to issue assessment within 45 days of a tax court decision);
    - Rule 50 (Applications on notice);
- 2014 Rules;
- Notice of objection (NOO);
- A rule 31 statement.

Tags: tax dispute resolution rules; alternative dispute resolution (ADR) mechanism; rule 31 statement.

TAX EVASION: CRIMINAL AND ADMINISTRATIVE OFFENCE

In the November 2022 judgment of Motloung and Another v Commissioner for the South African Revenue Service and Others, *[2022], the Free State High Court was tasked with determining whether or not a taxpayer found to have committed tax evasion can be charged an understatement penalty by the South African Revenue Service (SARS) and be held criminally liable in terms of the provisions of the Tax Administration Act, 2011 (the TAA).*

The applicants challenged sections 222 and 235 of the TAA as being inconsistent with the Constitution of the Republic of South Africa, 1996 (the Constitution), and therefore invalid, as both sections provide for two different punishments for the same offence – intentional tax evasion.

FACTS

The second applicant (Reatlehise Development CC) submitted zero returns for value-added tax (VAT) to SARS for the period from March 2014 to July 2018 and submitted zero returns for corporate income tax (CIT) for the 2015, 2016 and 2017 years of assessment. By submitting zero returns, the second applicant purported to have generated no income and incurred no expenses for these periods. SARS included the second applicant in a full scope audit.

SARS sent an audit findings letter to the second applicant indicating that it had understated its tax liability and that it would be levying understatement penalties for the relevant periods, which was not disputed by the applicants. The applicants did not respond to SARS with reasons as to why the understatement penalties should not be levied.

SARS imposed a 150% understatement penalty in respect of the understated CIT and VAT, for intentional tax evasion. The applicants admitted that SARS suffered prejudice of R819 607.09 in relation to VAT and R493 600 in relation to CIT. The applicants were subsequently criminally charged for intentional tax evasion.

The applicants complained that they cannot tender a plea contrary to SARS' finding, that is, that they were guilty of intentional tax evasion and liable for an understatement penalty on the basis of intentional tax evasion. According to the applicants, their right to a fair trial had been infringed due to their inability to plead to the contrary, which meant that they had fallen victim to the concept of double jeopardy.

DOUBLE JEOPARDY

Understatement penalty

The court explained that the concept of double jeopardy is simple and trite – nobody may be punished for the same offence twice. Double jeopardy has been included in section 106(1)*(c)* of the Criminal Procedure Act, 1977. The concept of double jeopardy is also prohibited as per section 35(3)*(m)* of the Constitution, where it is provided that an accused has the right "not to be tried for an offence in respect of an act or omission for which that person has previously been either acquitted or convicted", a fundamental right of the accused to a fair trial.

Section 221 of the TAA defines an "understatement" as:

> Any prejudice to SARS or the fiscus as a result of –
>
> - a default in rendering a return;
> - an omission from a return;
> - an incorrect statement in a return; or
> - if no return is required, the failure to pay the correct amount of tax.

Section 222 of the TAA details the penalty which will be levied in relation to an understatement made by a taxpayer, providing that an understatement penalty will be payable by the taxpayer, over and above the outstanding tax payable.

The applicants argued that the understatement penalty in terms of section 222 constitutes a criminal punishment, which is why it is distinguishable from the administrative penalties in section 208 of the TAA, that are automated and mechanical in nature. Essentially, their argument was that understatement penalties could only be imposed pursuant to an enquiry and therefore the process followed in levying understatement penalties is the same as the process in the criminal court.

The applicants relied on the foreign case of *United States v Halper* 490 US [1989] in submitting that:

> "Under the double jeopardy defence, a person who has already been punished in a criminal prosecution may not be subjected to an additional civil remedy based upon the same conduct where the civil remedy constitutes punishment."

However, the High Court noted that the decision in *Halper* was overturned by the foreign decision in *Hudson v United States* 522 US 93 [1997], where the court decided that the concept of double jeopardy is not a bar to criminal prosecution, as administrative proceedings are not criminal in nature.

Criminal prosecution

The High Court referred to the decision in *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission and Another,* [2005], where the Competition Appeal Court opined that in order to determine whether or not double jeopardy will apply, there must be a consideration as to whether there is a distinction between the proceedings. In other words, if the one proceeding is criminal in nature, and the other is non-criminal or administrative in nature, then the issue of double jeopardy will not arise.

The court also quoted paragraph 22 of *Pather and Another v Financial Services Board And Others,* [2018], as follows:

> "'Criminal law', observed Lord Atkin, 'connotes only the quality of such acts or omissions as are prohibited under appropriate penal provisions by authority of the state. The criminal quality of an act cannot be discerned by intuition; nor can it be discovered by reference to any standard but one: is the act prohibited with penal consequences?' And, criminal proceedings, according to Lord Bingham of Cornhill CJ, 'involve a formal accusation made on behalf of the state or by a private prosecutor that a defendant has committed a breach of the criminal law, and the state or the private prosecutor has instituted proceedings which may culminate in the conviction and condemnation of the defendant'."
>
> At paragraph 28 of its judgment the High Court remarked as follows about the authorities quoted above:
>
> "The above authorities demonstrate that nothing precludes civil administrative proceedings and criminal proceedings from the single act. Administrative penalties and criminal proceedings do not serve the same purpose. The other [sic] is aimed at strengthening internal controls of the administrative authority and to promote compliance while the other is aimed at correcting a behaviour that caused harm to the society."

The court stated that the main purpose of a penalty is "to deter impermissible conduct that results in violation of the TAA and to enforce compliance", and of course, to address the shortfall owed to SARS. An understatement penalty is not imposed to punish criminal conduct in the form of tax evasion, but rather serves as a regulatory function to assist SARS in respect of its obligations prescribed by the enabling legislation.

THE HIGH COURT'S CONCLUSION

The purpose of section 222 of the TAA addresses the shortfall flowing from an understatement by a taxpayer, deters impermissible conduct that violates the provisions of the TAA, and enforces compliance with the provisions of the TAA; while section 235 of the TAA criminalises intentional tax evasion and deals with the criminal state of mind of the taxpayer.

With reference to *Pather*, the High Court acknowledged that just because a penalty is designed to have a deterrent effect, it does not make it non-administrative, and a decision to consider any regulation with a deterrent purpose as criminal in nature for double jeopardy purposes, "would severely undermine the Government's ability to effectively regulate institutions". In order to maintain a stable relationship between citizens and the Government, SARS has a duty to maintain effective tax administration.

Furthermore, in relation to section 35(3)*(m)* of the Constitution, the court indicated that the section relates specifically to accused persons and the protection of their right to freedom, whose right to a fair trial could be threatened by repeated (criminal) charges for the same act. The court stated that the fact that a single act may give rise to more than one consequence is not tantamount to double jeopardy.

The court consequently held that sections 222 and 235 of the TAA do not offend an accused's right to a fair trial, and do not amount to double jeopardy, and that the sections are therefore neither invalid nor unconstitutional.

COMMENT

The significance of *Motloung* is that intentional tax evasion can give rise to more than one consequence, and the double jeopardy defence will not be coming to a taxpayer's rescue. What is curious about the case, is that the applicants seemingly made no attempt to justify why they had submitted nil returns and why understatement penalties should not be imposed for intentional tax evasion. In terms of section 42 of the TAA, once SARS has issued a letter of audit findings, the taxpayer must be given at least 21 business days to respond to SARS' audit findings. From a tax perspective, section 102 of the TAA states that SARS bears the burden to prove the facts on which the understatement penalty are based. This is one of only a few issues in respect of which SARS bears the burden of proof as opposed to the taxpayer, but one should appreciate that this is in the context of tax disputes regulated by the TAA. In a criminal trial, the burden of proof will be different and the state would be required to prove that the offence was committed beyond a reasonable doubt.

Of course, the case serves as a lesson that taxpayers should comply with their tax obligations diligently, but also that an opportunity to respond to findings made by SARS in the context of an audit, should be utilised. This is especially where SARS makes allegations pertaining to understatement penalties, where it bears the burden of proving the facts on which the understatement penalty is imposed.

"The purpose of section 222 of the TAA addresses the shortfall flowing from an understatement by a taxpayer, deters impermissible conduct that violates the provisions of the TAA, and enforces compliance with the provisions of the TAA; while section 235 of the TAA criminalises intentional tax evasion and deals with the criminal state of mind of the taxpayer."

Sasha Schermers & Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Constitution of the Republic of South Africa, 1996: Section 35(3)*(m)*;
- Tax Administration Act 28 of 2011: Sections 42, 102, 208, 221, 222 and 235;
- Criminal Procedure Act 51 of 1977: Section 106(1)*(c)*.

Cases

- *Motloung and Another v Commissioner for the South African Revenue Service and Others* (5492/2021) [2022] ZAFSHC 327 (21 November 2022);
- *United States v Halper* 490 US [1989];
- *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission and Another* [2005] (6) BCLR 613 (CAC);
- *Pather and Another v Financial Services Board And Others* [2018] (1) SA 161 (SCA): Paragraph 22.

Tags: tax evasion; corporate income tax (CIT); understatement penalties; double jeopardy.

TIME BAR FOR CORRECTING UNDISPUTED ERRORS

There are provisions in the Tax Administration Act, 2011 (the TAA), that allow taxpayers to request assessment corrections without having to rely on the often protracted dispute resolution procedures provided for in the TAA, read together with the Tax Court Rules. In particular, section 93 of the TAA deals with "Reduced Assessments" and provides (with our emphasis) as follows:

"(1) **SARS may make a reduced assessment if**—

(a) the taxpayer successfully disputed the assessment under Chapter 9;

(b) necessary to give effect to a settlement under Part F of Chapter 9;

(c) necessary to give effect to a judgment pursuant to an appeal under Part E of Chapter 9 and there is no right of further appeal;

(d) **SARS is satisfied that there is a readily apparent undisputed error in the assessment by**—

(i) SARS; or

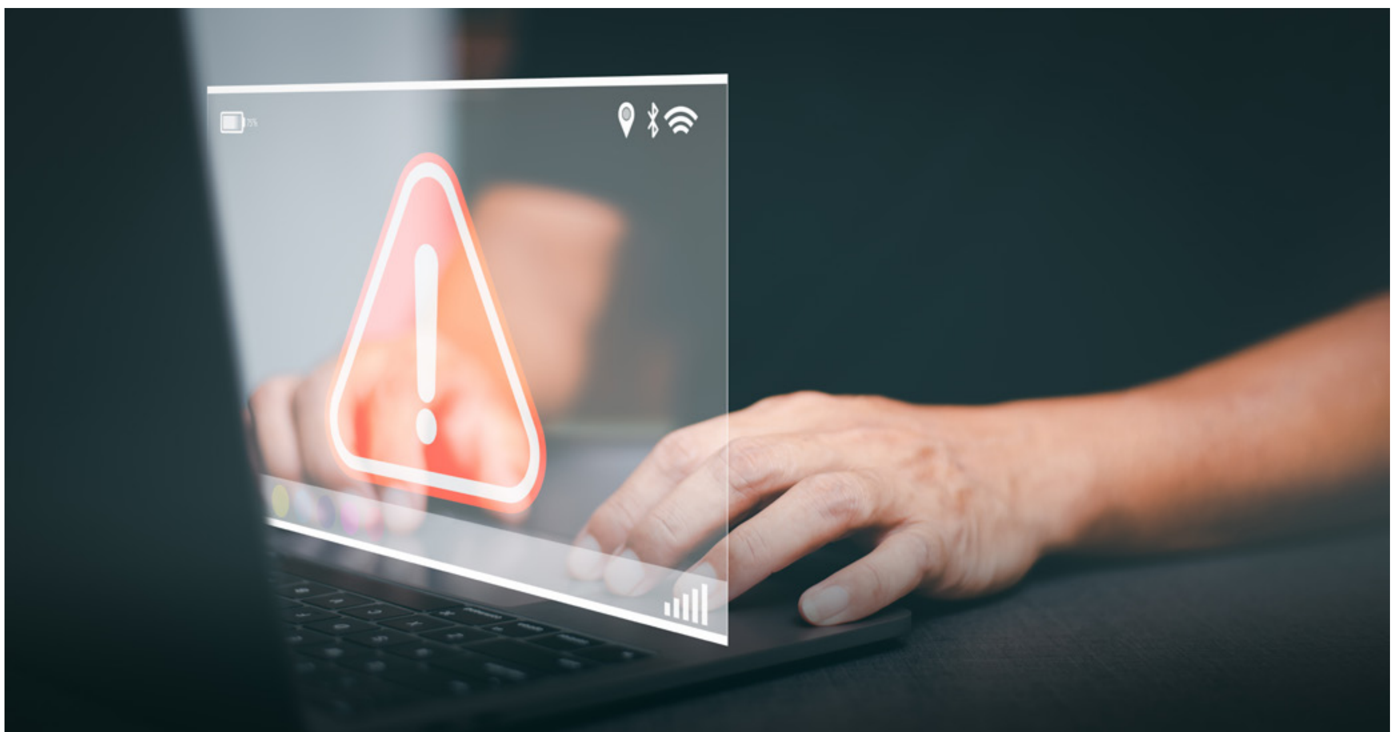
(ii) the taxpayer in a return;

(e) a senior SARS official is satisfied that an assessment was based on—

(i) the failure to submit a return or submission of an incorrect return by a third party under section 26 or by an employer under a tax Act;

(ii) a processing error by SARS; or

(iii) a return fraudulently submitted by a person not authorised by the taxpayer; or



(f) the taxpayer in respect of whom an assessment has been issued under section 95(1), requests SARS to issue a reduced assessment under section 95(6).

(2) **SARS may reduce an assessment despite the fact that no objection has been lodged or appeal noted**."

As is clear from the wording of section 93, this provision allows a taxpayer to correct their tax position without having to follow the time-consuming and often complicated objection and appeal process. However, there appears to be a clock ticking in respect of when a taxpayer can invoke these provisions. In the remainder of this article the focus is particularly on section 93(1)*(d)*(ii), where there is a readily apparent undisputed error made by a taxpayer in their return.

As referred to above, section 93 appears to be subject to the periods of limitations for issuance of assessments (commonly referred to as prescription) governed by section 99 of the TAA, as both sections 93 and 99 fall within Chapter 8 of the TAA (sections 91–100) and section 99 provides generally for the making of assessments (ie, including reduced assessments) in terms of Chapter 8.

As a reminder, section 99 *inter alia* provides time bars on the issuing of income tax assessments three years following the date of an original assessment and for VAT, five years following the self-assessment by a taxpayer. The best known exceptions to these periods arise where SARS can show that the fact that the full amount of tax chargeable was not assessed, was due to fraud, misrepresentation or non-disclosure (and in addition, in the case of VAT, the failure to submit a return). There are also other limited circumstances where the time bar will not apply, including where SARS becomes aware of an error referred to in section 93(1)*(d)* before the expiry of the prescription period.

What this means in the context of requesting a reduced assessment based on a readily apparent undisputed error is that unless SARS becomes aware of an error before an original assessment expires, a taxpayer will be prohibited from utilising the reduced assessment process.

While the certainty of a tax position is important, the prescription provisions themselves, specifically section 99(2), appear to be biased against taxpayers. Section 99(2) essentially provides that the prescription periods will not apply where the fact that the full amount of tax chargeable was not assessed, was due to *inter alia* misrepresentation, non-disclosure or fraud. In other words, SARS can reopen prescribed assessments in certain circumstances where potentially more tax is owed, but not where less tax is owed. If this is the correct interpretation, where a taxpayer has misrepresented a position and the correction thereof results in less tax to be paid, it appears that prescription will apply to such assessments and therefore SARS cannot reassess after the years have prescribed.

A taxpayer accordingly appears to be at a serious disadvantage where an error has been made but not picked up timeously, which is often the case.

It is interesting to note that before January 2016, section 98(1)*(d)* of the TAA, in the context of withdrawal of assessments, dealt with circumstances where a taxpayer could request a withdrawal of an assessment where there was *inter alia*:

- an undisputed factual error by the taxpayer in a return that imposed an unintended tax debt in respect of an amount on which the taxpayer should not have been taxed;
- the recovery of the tax debt under the assessment would produce an anomalous or inequitable result; there was no other remedy available to the taxpayer; and
- it was in the interest of the good management of the tax system. This provision was not subject to any time bars as it involved the withdrawal of an assessment and not the making of one.

Even though section 93(1)*(d)* was intended to be the replacement for section 98(1)*(d)*, it leaves the taxpayer at a significant disadvantage because it severely limits a taxpayer's ability to sort out the inevitable problems that arise and are not catered for not only because of the time bar but also because of the narrowed scope of the amended legislation. This should be revisited by the legislature.

"As is clear from the wording of section 93, this provision allows a taxpayer to correct their tax position without having to follow the time-consuming and often complicated objection and appeal process."

Robert Gad & Taryn Solomon

ENSafrica

Acts and Bills

- Tax Administration Act 28 of 2011: Section 26; Chapter 8 (sections 91–100): Sections 93 (emphasis on subsection (1)*(d)*(i) & (ii)), 95(1) & (6), 98(1)*(d)*, 99 (emphasis on subsection (2)); Chapter 9: Parts E & F (sections 133–150).

Tags: reduced assessment; prescription periods; undisputed factual error.

UNDERSTATEMENT POLICIES: ONUS ON SARS

In the matter of Lance Dickson Construction CC v Commissioner for the South African Revenue Service, *[2023], the High Court set aside the order of the tax court regarding penalties in favour of the South African Revenue Service (SARS) and upheld an appeal by Lance Dickson Construction CC (the Taxpayer) with costs.*

The Taxpayer, in its tax return for the 2017 year of assessment, did not declare any proceeds from the disposal of certain property to a related entity, Kwali Mark Construction CC (KMC), as it believed and as stated in the agreement of sale between the Taxpayer and KMC, that capital gains tax (CGT) would be paid by the Taxpayer when the property was on-sold by KMC to an unrelated third party and the relevant proceeds were received by the Taxpayer. Because these conditions were not fulfilled in the 2017 year of assessment, the Taxpayer did not declare proceeds on the disposal of the property in its tax return.

SARS disagreed with the Taxpayer and submitted that CGT should have been paid when the Taxpayer disposed of the property to KMC, a view with which the tax court agreed. SARS also imposed an understatement penalty, in terms of section 222 of the Tax Administration Act, 2011 (the TAA), in the event of an "understatement" and it is against the imposition of the understatement penalty imposed by SARS that the taxpayer appealed to the High Court. If there is an "understatement", SARS must then consider whether the understatement results from a "*bona fide* inadvertent error". If this is established, that is the end of the inquiry, and no understatement penalty may be levied. However, where there is no such error, SARS is required to identify the appropriate behavioural category under which a taxpayer's conduct allegedly resorts in terms of the table set out in section 223 of the TAA before it can impose an understatement penalty.

The purpose of the understatement penalty regime under the TAA is to encourage voluntary compliance and deter non-compliance and tax evasion. Thus, the purpose of the understatement penalty regime is not to raise money for the fiscus, but to ensure taxpayer compliance.

In this case, SARS established that there was an "understatement" and because the understatement did not result from a "*bona fide* inadvertent error", SARS levied a penalty of 25% on the Taxpayer for "reasonable care not taken in completing return" in terms of the "understatement penalty percentage table" in section 223(1).

In the tax court proceedings, SARS' factual witness conceded that SARS had mistakenly relied on item (ii) in the table, namely the behaviour "reasonable care not taken in completing return", instead of "no reasonable ground for 'tax position' taken" in item (iii), a behaviour that imposes an understatement penalty of 50%.

Notwithstanding this concession by SARS, the tax court claimed that although it was precluded from increasing the penalty from 25% (for behaviour (ii)) to 50% (for behaviour (iii)), the Taxpayer cannot escape liability for the understatement penalty. The tax court concluded that Taxpayer was liable to pay the 25% understatement penalty.

"The above-mentioned cases serve as a reminder that the onus of proving understatement penalties rests on SARS. Taxpayers should note that SARS is required to prove the factual basis for the determination of understatement penalties and if SARS fails to do so, there will be no basis, either in fact or law, for it to recover understatement penalties from taxpayers."

The High Court was tasked with determining whether the conclusion arrived at by the tax court was correct.

The High Court found that the tax court had erred in confirming the understatement penalty of 25% because SARS had failed to prove the factual basis for the imposition of this penalty when its determination was challenged by the Taxpayer in the tax court. The High Court found that SARS could not prove behaviour (ii) and that the court could not make a determination on behaviour (iii) because this behaviour was not alleged by SARS.

The High Court directed SARS to alter the 2017 additional assessment issued to the Taxpayer to exclude the understatement penalty imposed. In addition, the High Court held that the approach adopted by SARS in assessing the understatement penalty was unreasonable in the circumstances and therefore it would be just and equitable to order SARS to pay the taxpayer's costs in the tax court.

It is notable that in an earlier Supreme Court of Appeal (SCA) judgment in *Commissioner for the South African Revenue Service v Thistle Trust*, [2022], SARS conceded during its arguments that the understatement by the Thistle Trust resulted from a "*bona fide* inadvertent error" as the Thistle Trust had believed it was correct in its view and in support of its view placed reliance on an independent legal opinion. Based on this concession, the Thistle Trust was relieved from paying the understatement penalty. The SCA held that this point was correctly conceded by SARS that the understatement was a *bona fide* error and that SARS was not entitled to impose the understatement penalty.

In the February 2023 SCA judgment of *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd,* [2023], the taxpayer relied on an independent legal opinion but because it did not disclose the opinion or make the opinion available to SARS, SARS drew the inference that the tax opinion did not support the taxpayer's position and contended that this was not a *bona fide* inadvertent error. The court held that for SARS to speculate that a tax opinion must have gone against the taxpayer simply because it was not disclosed to SARS, is not sufficient to attribute *male fides* on the part of the taxpayer and therefore SARS' claim for understatement penalties must fail.

The above-mentioned cases serve as a reminder that the onus of proving understatement penalties rests on SARS. Taxpayers should note that SARS is required to prove the factual basis for the determination of understatement penalties and if SARS fails to do so, there will be no basis, either in fact or law, for it to recover understatement penalties from taxpayers.

Arnaaz Camay & Prishni Chetty

ENSafrica

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 222 & 223 (including the "understatement penalty percentage table" in subsection (1)).

Cases

- *Lance Dickson Construction CC v Commissioner for the South African Revenue Service* (A211/2021) [2023] ZAWCHC 12 (31 January 2023);
- *Commissioner for the South African Revenue Service v the Thistle Trust* (516/2021) [2022] ZASCA 153; 2023 (2) SA 120 (SCA) (7 November 2022);
- *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (7 February 2023).

Tags: understatement penalty; *bona fide* inadvertent error; independent legal opinion.

LOW-INTEREST LOANS

Section 7C of the Income Tax Act, 1962 (the Act), was introduced in 2017 to regulate the granting of low-interest or interest-free loans by natural and juristic persons to trusts. The main function of this section is to curb the tax-free transfer of wealth to trusts.

As it stands, section 7C stipulates that any interest forgone in respect of a low-interest or interest-free loan, advance or credit provided to a trust, will be a deemed donation and will be subject to donations tax.

Section 7C has been amended multiple times since its introduction to extend its scope of application. For example, in January 2021, section 7C(1B) was inserted to also include preference shares subscribed for by natural persons in companies where a connected person trust is the holder of at least 20% of the company's equity shares or can exercise 20% of the company's voting rights. The effect of this amendment was that any dividends that accrued to the holder of the preference shares, will be deemed to be interest in respect of the loan.

The 2023 Budget Review (the Budget) explains that section 7C(5) provides exceptions to the general position, such as where the low-interest or interest-free loan, advance or credit is used to purchase a primary residence for the person advancing that low-interest or interest-free loan, advance or credit to the trust, company or spouse of such person. In practice, what would often happen is for the person to sell their primary residence to the connected person trust or company contemplated in section 7C, on loan account. In other words, the company or trust becomes owner of the primary residence but owes the purchase price to the seller on loan account.

In the Budget, National Treasury has proposed two clarifications to the primary residence exception in section 7C(5).

PRIMARY RESIDENCE

The Budget indicates that the exclusion in section 7C(5)*(d)*(i) does not fully encompass what constitutes a "primary residence" in terms of the Eighth Schedule to the Act. In

paragraph 44 of the Eighth Schedule, a primary residence is defined to mean a residence –

- in which a natural person or a special trust holds an interest; and
- which that person or a beneficiary of that special trust or a spouse of that person or beneficiary –
  - ordinarily resides in or resided in as his or her main residence; and
  - uses or used mainly for domestic purposes.

The Budget proposes that the primary residence exclusion provision be amended to provide clarity in this regard.

"Although the Act contains provisions providing for the conversion of foreign currency to determine one's tax liability, such as section 25D, dealing with the accrual of foreign income, and paragraph 43 of the Eighth Schedule, dealing with foreign capital gains, neither provision would address the scenario contemplated in the Budget."

FOREIGN CURRENCY CONVERSION

In the Budget, National Treasury has expressed concern regarding the conversion of the low-interest or interest-free loans, advances or credit which are denominated in foreign currency, as section 7C does not indicate how and when this amount should be converted to South African rands (ZAR).

Although the Act contains provisions providing for the conversion of foreign currency to determine one's tax liability, such as section 25D, dealing with the accrual of foreign income, and paragraph 43 of the Eighth Schedule, dealing with foreign capital gains, neither provision would address the scenario contemplated in the Budget. Practically, section 25D contemplates conversion of foreign income into ZAR based on the spot exchange rate or average exchange rate, depending on the circumstances. It is possible that the proposed amendment to section 7C will also indicate the use of the spot exchange rate or average exchange rate, depending on the circumstances. The Budget indicates that the conversion would affect the calculation of the deemed donation and one would hope that the amendment would be written in such a way as to prevent currency fluctuations from unfairly increasing the amount of the deemed donation that is subject to tax.

Editor's note: As this is only a Budget *proposal*, it is *not* law yet. Although it is an important alert to possible future developments in the tax arena, one should remember to follow closely what happens in respect of these proposals in the coming months and to take note of what eventually is enacted as part of our tax legislation. The current proposal will likely form part of the draft tax amendment legislation to be published in July or August this year.

Sasha Schermers & Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections7C(1B), (5) (with emphasis on paragraph *(d)*(i)) & 25D; Eighth Schedule: Paragraphs 43 (dealing with foreign capital gains) & 44 (definition of "primary residence").

Other documents

- The 2023 Budget Review.

Tags: low-interest or interest-free loan; preference shares; primary residence; spot exchange rate.

SECURITIES LENDING ARRANGEMENTS

The South African Revenue Service (SARS) published Binding General Ruling 62 (BGR 62) on 12 December 2022, in which it sets out its interpretation and application of the Value-Added Tax Act, 1991 (the VAT Act), for the lender in terms of a securities lending arrangement. BGR 62 came into effect on 1 April 2023.

The value-added tax (VAT) implications of a securities lending fee as set out in BGR 62 are contrary to the VAT implications as previously set out in Practice Note 5/1999, which has been withdrawn from 1 April 2023. It is, however, arguable whether the interpretation and application of the VAT Act as set out in BGR 62 are correct.

Under a securities lending arrangement, securities are transferred temporarily from the lender to the borrower. The borrower is obliged to return the same kind and number of securities at the end of the agreed term. Title to the securities is transferred to the borrower (as in a sale) during the lending period. The reference to it being a "lending" transaction is therefore somewhat misleading. The borrower is required to place either cash or other securities with the lender as collateral to cover the risk of default by the borrower. The borrower undertakes to pay to the lender an amount equal to the dividend or interest it receives on the securities during the loan term (manufactured dividends or manufactured interest) and a lending fee.

PRACTICE NOTE 5

Practice Note 5/1999 implied that a securities lending arrangement comprises the transfer of a debt security, an equity security or the provision of credit as envisaged by section 2(1)*(c)*, *(d)* or *(f)* of the VAT Act and is exempt from VAT under section 12*(a)*. It stipulated that the fee payable by the borrower to the lender falls within the ambit of the proviso to section 2(1), and as such the fee is subject to VAT. It stipulated further that a "manufactured dividend" or "manufactured interest" constitutes consideration for the supply of a financial service, and did not constitute a fee, commission or similar charge as contemplated in the proviso. As such, these payments are exempt from VAT.

BGR 62

BGR 62 stipulates that securities lending arrangements constitute the provision of credit as envisaged in section 2(1)*(f)*, the supply of which is exempt under section 12*(a)*. In substantiation for this view, BGR 62 states that the transfer of ownership of the security is necessary to give effect to the provision of money's worth as contemplated by section 2(1)*(f)*. The transfer of ownership of the securities is, on this basis, considered to be part of the activity envisaged under section 2(1)*(f)* and is not an independent cognisable supply of goods in the form of the security. This also applies to the return of the security or instrument at the end of the lending period.

It seems therefore that SARS is of the view that the transfer of the securities between the lender and borrower is exempt from VAT under section 2(1)*(f)*, being the provision of credit, as opposed to section 2(1)*(c)* (transfer of a debt security) or section 2(1)*(d)* (transfer of an equity security).

Regarding the securities lending fee, BGR 62 states that this fee does not relate to any other service forming part of the activity of the securities lending arrangement, but only for the use of the security during the period. It concludes on this basis that the proviso to section 2(1) does not apply to the securities lending fee and such fee is consequently consideration for an exempt supply.

THE LEGAL POSITION

Section 2(1)*(f)* applies to the provision of credit under an agreement by which money or money's worth is provided by a person to another person, and the latter agrees to pay in the future a sum or sums exceeding, in the aggregate, the amount of such money or money's worth. Such activity is deemed to be a financial service, the supply of which is exempt under section 12*(a)*.

Although one can consider the transfer of the security to the borrower as comprising the provision thereof, and it has a monetary value on the date of transfer, it does not mean that credit in the form of money's worth has been provided. The monetary value of the securities is not stated in the lending agreement, the lender is not required to provide securities of a specified monetary value, and the borrower is under no obligation to return securities of a specified value. The value of the securities fluctuates throughout the term of the agreement, and the borrower is only obliged to return a stated number of securities.

It is arguable whether the undertaking to return a specified number of securities comprises an agreement to "pay" a "sum" as envisaged by section 2(1)*(f)*. In any event, there is no obligation that such "sum" must exceed the value of the securities transferred by the lender. The transfer of the securities to the borrower is exempt from VAT under section 2(1)*(c)* (debt securities) or 2(1)*(d)* (equity securities). However, it is somewhat academic whether the transfer falls under section 2(1)*(f)* or section 2(1)*(c)* or *(d)*, because it is exempt from VAT under all these provisions.

The proviso to section 2(1) provides that the activities contemplated in, amongst others, section 2(1)*(c)*, *(d)* and *(f)* are deemed not to be financial services to the extent that the consideration payable in respect thereof is any fee, commission or a similar charge.

The question that arises, is whether the ruling in BGR 62 that the securities lending fee is consideration for an exempt supply, and that it falls outside the scope of the proviso to section 2(1), is correct.

The intention of the proviso to section 2(1), which was introduced following the recommendations of the Katz Commission, is to tax fees and commissions for providing the services as specified in section 2(1)*(c)*, *(d)* and *(f)*. The securities lending agreement specifically refers to the amount payable by the borrower as being a "fee". This fee is charged for providing the securities under the securities lending agreement and would thus fall within the ambit of the proviso to section 2(1).

The Supreme Court of Appeal held in the case of *Commissioner for the South African Revenue Service v Tourvest Financial Services (Pty) Ltd*, [2021] *(Tourvest)*, that the proviso creates a mixed supply out of the identified activity, and the effect of the proviso is to add a taxable element to what is, and at its core remains, an exempt financial service. It therefore turns the activity into a partly exempt and a partly taxable supply. The ruling in BGR 62 that the securities lending fee does not fall within the proviso to section 2(1) seems to be contrary to the principles laid down in the *Tourvest* judgment.

BGR 62 stipulates that a manufactured dividend or manufactured interest comprises consideration for a VAT exempt supply, which is exempt from VAT.

STATUS OF BGR 62

Binding general rulings are issued by SARS on matters of general interest or importance and clarify the Commissioner's application or interpretation of the relevant tax law relating to these matters. They are binding on SARS but not on the taxpayer. A binding general ruling is an "official publication" as defined in the Tax Administration Act, 2011 (the TAA), and the application of the tax Act as stated therein comprises a "practice generally prevailing" as envisaged by section 5(1) of the TAA. SARS is, therefore, in terms of section 99(1)*(d)* of the TAA precluded from raising an additional assessment if the original return was submitted in accordance with the practice generally prevailing.

CONCLUSION

The transfer of the underlying securities under a securities lending transaction, is exempt from VAT. There may be a debate on the question as to under which section of the VAT Act the exemption applies. There is no dispute that the payment of manufactured dividends or manufactured interest is exempt from VAT, being consideration for the supply of an exempt financial service. However, it is arguable that the securities lending fee is subject to VAT, which is contrary to what is stated in BGR 62.

Gerhard Badenhorst

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 1 (definition of "official publication"), 5(1) (definition of "practice generally prevailing"), 99(1)*(d)*;
- Value-Added Tax Act 89 of 1991: Section 2(1)*(c)*, *(d)* & *(f)* & proviso to section 2(1); section 12*(a)*.

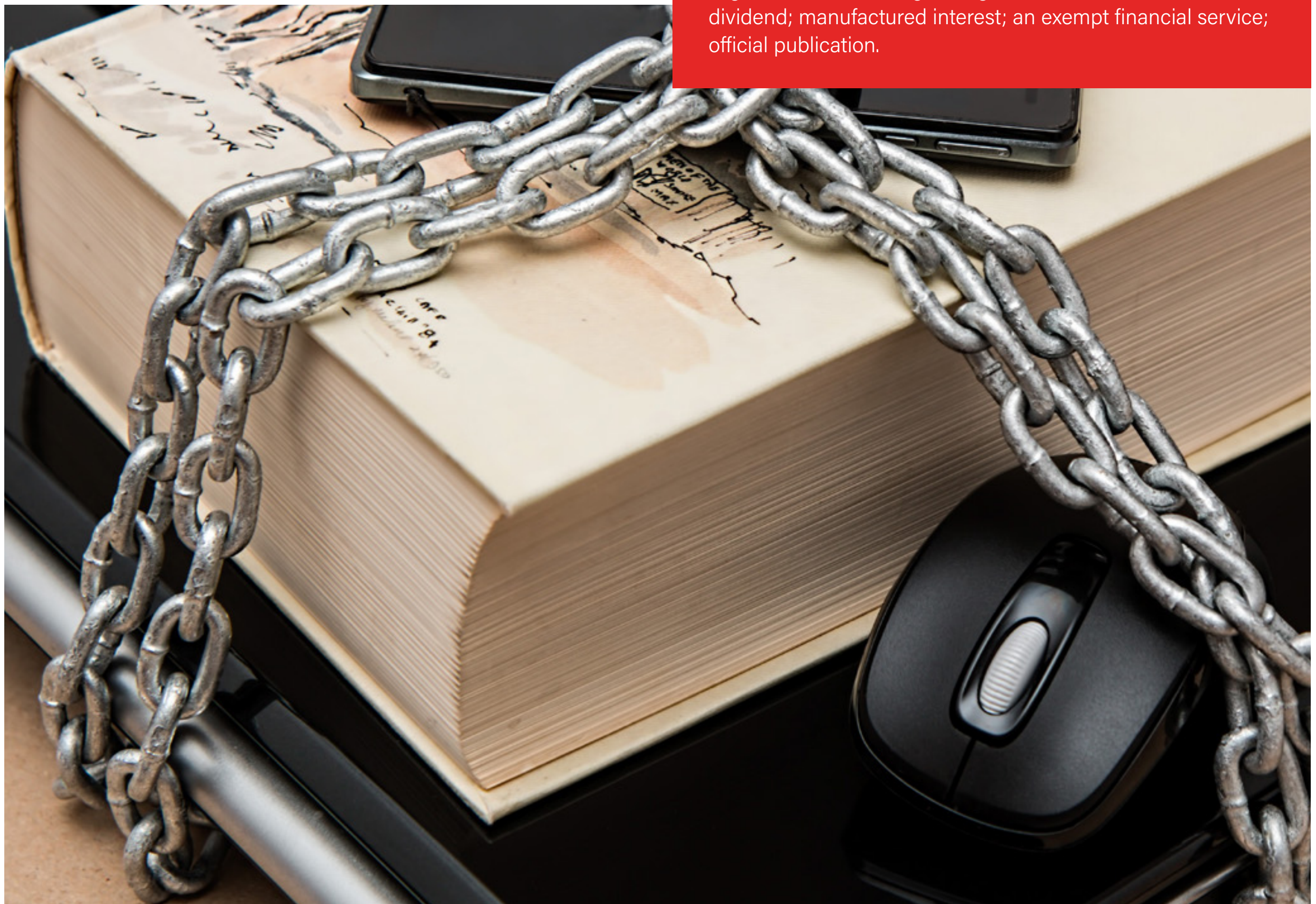
Other documents

- Binding General Ruling 62 ("Value-added tax implications of securities lending arrangements" – 12 December 2022);
- Practice Note 5/1999 ("Tax Implications for lending arrangements in respect of marketable securities").

Cases

- *Commissioner for the South African Revenue Service v Tourvest Financial Services (Pty) Ltd* (435/2020) [2021] ZASCA 61; [2021] (5) SA 86 (SCA).

Tags: securities lending arrangement; manufactured dividend; manufactured interest; an exempt financial service; official publication.



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