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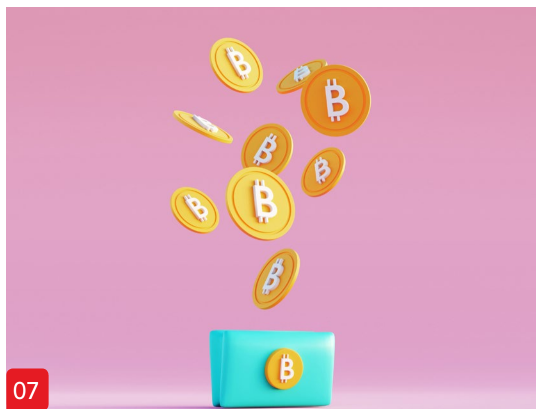
CRYPTO ASSETS
CRYPTOCURRENCIES AND EXCHANGE CONTROL

GROSS INCOME
TAX CONSEQUENCES OF RIOT INSURANCE PAYMENTS

TAX ADMINISTRATION
UNREASONABLE DISCRETION FOR PENALTIES



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TIMING OF ACCRUAL

A tax court judgment concerning a wealthy businessman who had repatriated to South Africa before his application for amnesty in 2003 and who, in his 2009 tax return, failed to disclose that he had made a capital gain was handed down electronically on 23 April 2021. The taxpayer accumulated considerable wealth from businesses outside of South Africa. By 2003 his personal net worth exceeded R119 million. It is to be noted that he earned income and accumulated this wealth while he was not resident in South Africa.

In 2003 he applied for amnesty under the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003, and began the process of repatriating his wealth and assets to South Africa. The taxpayer had accumulated these assets and wealth over a number of years during which he was not resident in South Africa.

The taxpayer disclosed to the South African Revenue Service (SARS) that he held an 82% shareholding in a company by the name of BCD Corporation, an offshore company registered and incorporated in the British Virgin Islands.

The South African Reserve Bank accepted a valuation of $11 937 258 for BCD Corporation, which translated to R95 389 436 at the prevailing exchange rate.

ADDITIONAL ASSESSMENT RAISED BY SARS

The taxpayer had also owned 53.1% in a South African company BCD SA and sold all 1 000 BCD SA shares to the Sail Group on January 29, 2009. The taxpayer did not disclose this in his 2009 tax return.

In terms of the sale agreement, the aggregate purchase price "due and payable to" the taxpayer for the sale of his shares was R66 364 587.

This was payable as follows:

- R27 944 485 in cash on the implementation date, 8 January 2009.
- R15 264 000, when the taxpayer is allotted Sail shares to the value of R16 591 304.
- R23 156 102 payable in January 2012, subject to certain warranty clauses and breach provisions in the sale agreement.

SARS found that during the 2009 tax year the taxpayer had disposed of his shares in BCD SA and raised an additional tax assessment for the capital gain, including penalties and interest.

The taxpayer argued that the so-called "warranty claims" had reduced the share price. However, the court further concluded that all the suspensive conditions had been fulfilled when the taxpayer had been paid the first amount and that there was no evidence before the court to show that the sales price had been reduced.

The court found that the amount of R66 364 587 had "accrued" to the taxpayer, that is, the "amount to which he was entitled". This is based on the Lategan principle, found in the well-known court case, *W H Lategan v CIR*, [1926].

"The court reduced the 200% additional tax imposed by SARS to 25%, but did not reduce the interest imposed by SARS, except to the extent of the reduction in the penalty."

The court found "beyond doubt" that the taxpayer had failed to disclose to the Commissioner the full circumstances regarding the sale, which he was "undoubtedly under a legal obligation to do". The taxpayer had disclosed the loss on the sale of the BCD Corporation shares and argued that this could be set off against the capital gain on the BCD SA shares.

The court agreed that "all of the shares held by the taxpayer in the group of companies should, for purposes of the assessment of CGT [capital gains tax], be treated as one 'asset' as defined in [paragraph 1 of] the Eighth Schedule" and reasoned that the "only question which remains is what is the base cost of those shares disposed of".

The court reasoned that the taxpayer had disposed of his 28.9% shareholding to other shareholders between 2003 and 2009, reducing his shareholding to 53.1%. "This disposal was however not disclosed to the Commissioner." At the time of the sale in January 2009 "there were two companies left in the Group, namely BCD SA and BCD Corporation – and the taxpayer was a 53.1% shareholder in the Group".

Capital gain tax calculation	
The court's calculation of the capital gain and the amount liable for capital gains tax	
Proceeds of sale of BCD SA shares	R66 364 578
Proceeds of sale of BCD Corporation shares	R9 980 300
	R76 344 878
Less base cost	R61 763 520
	R14 581 358
Less annual exclusion	R16 000
Capital gain	**R14 565 358**
Inclusion rate of 25%	R3 641 340

Capital gains tax is only payable on the "included amount", which is calculated at 25% (applicable for the 2009 tax year) of the capital gain.

The taxpayer is therefore liable for capital gains tax on the amount of R3 641 340.

FINALITY

The court ordered that the assessment be amended instead of referring the matter back to SARS, taking into account the time period of nine years which had elapsed since the revised assessment.

The court was of the view that the taxpayer should be charged additional tax (equivalent to a penalty under the current Act) mainly "from his failure to disclose the disposal of his shares during the 2009 tax year".

The taxpayer attempted to lay the blame for his omission on his professional advisors, and the court had "difficulty in understanding how the taxpayer, given his vast experience and exposure in the business world, could have been under the impression that the once-off amnesty exonerated and relieved him from acting in the future as a responsible taxpayer".

The court reduced the 200% additional tax imposed by SARS to 25%, but did not reduce the interest imposed by SARS, except to the extent of the reduction in the penalty.

The court remitted the penalty charged by SARS for the omission to submit VAT returns, on the basis that this would be double jeopardy.

ORDER

The court:

- Dismissed the taxpayer's appeal against the revised assessment for the 2009 year.
- SARS is to include the capital gain of R3 641 339.58 in the taxpayer's income.
- The 200% additional tax is to be reduced to 25%.
- The interest is only to be adjusted in regard to the reduced penalty.
- The penalty charged in regard to the failure to submit provisional tax returns is remitted.
- There was no order as to costs.

Barbara Curson

Acts and Bills

- Income Tax Act 58 of 1962: Eighth Schedule: Paragraph 1 (definition of "asset");
- Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003.

Cases

- *B v Commissioner for the South African Revenue Service* (13395) [2021] ZATC 5 (23 April 2021);
- *W H Lategan v CIR*, [1926] CPD 203; *2 SATC 16*.

Tags: application for amnesty; aggregate purchase price; additional tax.

CRYPTOCURRENCIES AND EXCHANGE CONTROL

On 11 June 2021, the Intergovernmental Fintech Working Group (the IFWG) published its latest position paper, and a "Frequently Asked Questions" (FAQ) document, on "crypto assets", a blanket term that includes well-known cryptocurrencies such as Bitcoin.

These documents, prepared by the IFWG's Crypto Assets Regulatory Working Group (the CAR WG), are intended to reflect the latest views of South Africa's financial sector regulators on how they will treat such crypto assets.

The IFWG's position paper and FAQ document have generated much commentary and debate regarding the future of crypto assets in South Africa.

In particular, there has been much interest in how the South African Reserve Bank (the SARB) will apply its system of exchange controls to cryptocurrencies, which South Africans have been buying and selling on exchanges and through other channels for several years.

SOUTH AFRICA'S EXCHANGE CONTROLS: "EXPORTED CAPITAL"

One of the primary purposes of South Africa's exchange controls is to ensure that all flows of capital both in and out of South Africa are recorded through the SARB's reporting system designed to track South Africa's balance of payments.

To facilitate this, all cross-border flows of capital must be processed through an Authorised Dealer (AD). An AD is a person that has been authorised to deal in foreign exchange by the SARB. In this regard, different ADs have different degrees of authority to deal in foreign exchange. Most banks operating in South Africa have some level of AD status.

In the February 2020 Budget Speech, the Minister of Finance announced that the current exchange control regime would be modernised such that all foreign currency transactions would be allowed, subject to a risk-based list of capital flow measures. When further detail was announced around these intended modernisations, the SARB made it very clear (in Exchange Control Circular 2/2020) that cross-border foreign exchange activities will continue to be conducted through ADs.

Regulation 10(1)(c), under the Exchange Control Regulations, 1961 (the regulations), stipulates that no person may, without the permission of the SARB, enter into any transaction whereby "capital" or any right to "capital" is directly or indirectly exported from South Africa.

The meaning of "capital" in this context was considered in the case of *Couve and Another v Reddot International (Pty) Ltd and Others*, [2004], in which the court held that "capital" means anything with monetary value.

However, in the case of *Oilwell (Pty) Ltd v Protec International Ltd and Others*, [2011], which involved the transfer of intellectual property rights by a resident to a non-resident, the Supreme Court of Appeal held that the term "capital" in this context must be interpreted restrictively, in a financial sense, to mean "cash for investment" and "money that can be used to produce further wealth". The court found that the term must not be interpreted to include goods on which capital has been spent, and, in particular, intellectual property rights.

"After this case, the definition of the term 'capital' (in regulation 10(4)) for the purpose of regulation 10(1)(c) was amended in 2012 to include 'any intellectual property right, whether registered or unregistered'."

In reaching the above conclusion, the Supreme Court of Appeal also made the following notable statements:

- The court found that the meaning of "capital" under the regulations was not the same as the meaning of "capital" under the Income Tax Act, 1962 – the former was unrelated to the latter.
- Importantly (though it was dealing with a different question), the court noted that the general object of the regulations is to "regulate and control foreign currency", and that the object of regulation 10(1)(c) in particular is to "control foreign exchange in the public interest and to prevent the loss of foreign currency resources through the transfer abroad of capital assets held in South Africa".

After this case, the definition of the term "capital" (in regulation 10(4)) for the purpose of regulation 10(1)(c) was amended in 2012 to include "any intellectual property right, whether registered or unregistered". In addition, the definition of the term "exported from [South Africa]" for the purpose of regulation 10(1)(c) was also amended to include, "the cession of, the creation of a hypothetic or other form of security over, or the assignment or transfer of any intellectual property right, to or in favour of a person who is not resident in [South Africa]".

By expanding the above definitions in this manner, the legislator arguably made it clear that the much wider *Couve* definition of capital is intended to apply under the law.

APPLICATION OF CURRENT EXCHANGE CONTROL RULES AND PRINCIPLES

Having regard to the *Oilwell* case and the resulting amendments in relation to regulation 10(1)(c), the SARB, working with the IFWG and the CAR WG, has pondered how best to treat crypto assets under the regulations, and the more detailed South African exchange control rules.

If one considers the fundamental features and characteristics of crypto assets, including cryptocurrencies such as Bitcoin, it is not difficult to anticipate several difficult questions:

- Is a crypto asset "capital" under the regulations, and regulation 10(1)(c) in particular?
- If a crypto asset is capital in that context, at what point in time is a crypto asset "exported from" South Africa?
- How should the SARB develop reporting requirements around crypto assets to ensure that the cross-border "balance of payments" is accurate, bearing in mind that all cross-border flows of capital should be processed through an AD and recorded on the SARB system, and that this requirement will remain even once the exchange control systems have been modernised.

In its latest position paper, the IFWG and the CAR WG have adopted the following definition of a "crypto asset": "a digital representation of value that is not issued by a central bank, but is capable of being traded, transferred or stored electronically by natural and legal persons for the purpose of payment, investment and other forms of utility, applies cryptographic techniques and uses distributed ledger technology".

In the same paper, the IFWG and the CAR WG recommend, amongst other things, that –

- the Financial Surveillance Department of the SARB (Finsurv) should ask the Minister of Finance to, *inter alia*, include crypto assets in the definition of "capital" for the purposes of regulation 10(1)(c) (recommendation 12);
- Finsurv should explicitly allow individuals to purchase crypto assets within their single discretionary allowance (SDA) and the foreign capital allowance (FCA) framework (recommendation 13);
- Finsurv should amend the manual for ADs to enable ADs to facilitate the accurate reporting of cross-border crypto asset trades, including the transfer of fiat money to acquire crypto assets abroad (recommendation 14);
- a new dispensation should be created, under the exchange control framework, to allow appropriately licensed crypto asset trading platforms (CATPs) to source or buy crypto assets offshore for the purpose of selling these crypto assets in the local market (recommendation 16); and
- an exemption should be provided for appropriately licensed market makers or arbitrageurs of crypto assets (recommendation 18).

Recommendation 14 is desperately needed as individuals and entities trading with crypto assets otherwise face much difficulty in practice. By way of example, if an item is exported from South Africa and payment is received in the form of crypto assets, there is no way to record, for exchange control purposes, that the payment of crypto assets has been received.

This leads to exchange control difficulties because payments for exported items must be settled within a prescribed period under the relevant exchange control rules.

Recommendations 12 and 13 are puzzling, however. The question arises as to whether they are included for the sake of clarification or whether they are included as a suggestion that the law currently does not allow for such activities. For example, why is recommendation 12 necessary, to expand the definition of "capital" to expressly include crypto assets? If such an expansion is needed, does this mean that until the proposed change is implemented, it is not possible to contravene exchange controls through the transfer of crypto assets offshore?

WHETHER CRYPTO ASSETS CONSTITUTE "CAPITAL" UNDER REGULATION 10(1)(c)

In the *Oilwell* case, the court found that "capital" in this context should be interpreted restrictively, in a financial sense, to mean "cash for investment" and "money that can be used to produce further wealth". The court went further in clarifying this finding, noting that "capital" in this sense could not be goods (ie, the property or rights on which that capital was spent).

The 2021 IFWG position paper states that, "[p]olicymakers, regulators and central banks have been clear that crypto assets are not 'money' in the legal tender sense of the word, although they perform some of the functions of money."

For example, although one can "invest" with crypto assets, and although they "can be used to produce further wealth", they are not regarded as "cash" or "money" in a legal sense. This is the case not only in South Africa, but in almost every other country, with the recent exception of El Salvador.

The term "capital" under regulation 10(1)(c) has also, as we have noted above, been amended to include any "intellectual property right", whether registered or unregistered. Given the apparent context of this amendment, as a direct response to the *Oilwell* decision, one could assume that "intellectual property right" should be interpreted to mean "trademarks", "patents", "designs" or "copyright", which the *Oilwell* decision was concerned with.

It is submitted that the actual, doctrinal legal classification of crypto assets under South African law is a very complicated question. However, in the absence of further clarification, the IFWG's adopted definition of a "crypto asset" (ie, "a digital representation of value") does not appear to include an "intellectual property right" in the context of a "trademark", "patent", "design" or "copyright".

In light of this, it appears arguable that crypto assets do not constitute "capital" that can be "exported" under regulation 10(1)(c), which would mean that recommendation 12 above is indeed necessary.

However, the *Oilwell* case also noted that the object of regulation 10(1)(c) is to "control foreign exchange in the public interest and to *prevent the loss of foreign currency resources* through the transfer abroad of capital assets held in South Africa" (our emphasis). When interpreting any document or provision, our courts must consider, amongst other things, its "apparent purpose" (*Natal Joint Municipal Pension Fund v Endumeni Municipality*, [2012]).

It is a practical reality that, despite the difficulties inherent in regulating crypto assets, cryptocurrencies are already easily exchangeable for foreign currency. The IFWG acknowledges that crypto assets can be used to circumvent exchange controls and to facilitate the flow of capital out of South Africa, without reporting through the appropriate channels.

If the term "capital" under regulation 10(1)(c) is interpreted with the above *purpose* in mind, an argument could be made that crypto assets must be regarded as "capital", otherwise the purpose of regulation 10(1)(c) would be undermined. If a crypto asset is regarded as "capital", the question then remains: at what point does one "export" the crypto asset (ie, the capital)?

IF CRYPTO ASSETS CONSTITUTE "CAPITAL" UNDER REGULATION 10(1)(c), WHEN ARE THEY "EXPORTED"?

Because crypto assets perform some of the functions of money, we often talk about them in the same way that we talk about money. For example, we talk about storing cryptocurrencies in "wallets", and we talk about "sending" cryptocurrencies to other "wallets" held by ourselves, or third parties.

However, the casual language we use when talking about crypto assets and cryptocurrencies should not distract from the fundamental differences between them and money. If you "buy" a crypto asset, such as Bitcoin, you do not actually "receive" a coin or any other kind of asset. Your purchase is recorded on a "public ledger", or "blockchain", which is technically "visible" to everyone. This ledger is not stored on any one computer or network.

In the case of Bitcoin, for example, the ledger is stored on thousands of computers, called "nodes". Because the ledger is public, all of these computers are able to track and verify transactions, and "new" Bitcoins that are "mined" by "miners" are continuously added to the ledger. It is therefore almost impossible for someone to "cheat" the system and claim that they have more Bitcoin than they actually do.

Balances of Bitcoin are kept using public and private "keys". A public key can be compared to a bank account number – it is a number that you can share publicly, and it is the "address" to which third parties may send Bitcoin. A private key can be compared to an ATM PIN – it allows people to access their own balances of Bitcoin, and it must therefore be kept secret in order to protect that balance of Bitcoin.

A Bitcoin "wallet" is either "hot" (ie, it is essentially a piece of software linked to the internet) or "cold" (ie, it is software or hardware, like a USB stick or even a piece of paper) that is not linked to the internet.

It is not really accurate to say that Bitcoin is stored "in" such a wallet: the Bitcoin in question will always be "stored" *at* the above-mentioned public key, on the public ledger or blockchain, as we have described above. The wallet effectively provides Bitcoin "holders" with a mechanism by which they can store and use their *private keys*, in order to access the Bitcoin linked to their public keys.

In light of these fundamental features, the difficulties in talking about "exporting" a crypto asset or cryptocurrency become apparent – despite the SARB's intention that this word be interpreted generally.

If, for example, Jane, being a South African exchange control resident, buys Bitcoin in South Africa, she will then "hold" the relevant amount of Bitcoin on a public key, on a public ledger or blockchain, which is "stored" on thousands of computers around the world. Jane may "hold" that Bitcoin in a "hot" wallet, which is to say, she uses a software programme to store and use her private key, so that she can access her Bitcoin.

Say Jane "sends" that Bitcoin to the "hot" wallet "held" by her friend, John, in Belgium. The Bitcoin is not transferred from South Africa to Belgium. Rather, the transfer is added to the public ledger or blockchain, again stored on thousands of computers globally, and John can now access that Bitcoin using his own private key. Has Jane "exported" Bitcoin to John? Possibly, but arguably not in the "ordinary" sense of the word "exported".

But what if Jane does not transfer Bitcoin to John – she merely gives John her private key, so that John can now access her Bitcoin on the public ledger or blockchain. Has she "exported" Bitcoin? Perhaps this scenario seems less clear-cut than the one above.

Or, what if Jane had stored her Bitcoin on a "cold" wallet, such as a USB drive, and then happened to carry the USB drive with her when she visited John in Belgium? The Bitcoin still sits on the public ledger or blockchain – it is accessible to Jane in Belgium only because she accidentally packed the USB drive in her luggage. Has she "exported" Bitcoin? Depending on your perspective, you may view this scenario as being more or less clear-cut than the others.

There are no easy answers in the above examples. They simply highlight the complex challenges faced by the SARB in regulating crypto assets. However, in our view, these scenarios demonstrate that, in developing the exchange control regime to accommodate crypto assets, it is critical to keep in mind their unique features and the fundamental differences between them and traditional money.

Robyn Berger & Rob Hare

Bowmans

Acts and Bills

- Income Tax Act 58 of 1962 (the meaning of "capital").

Other documents

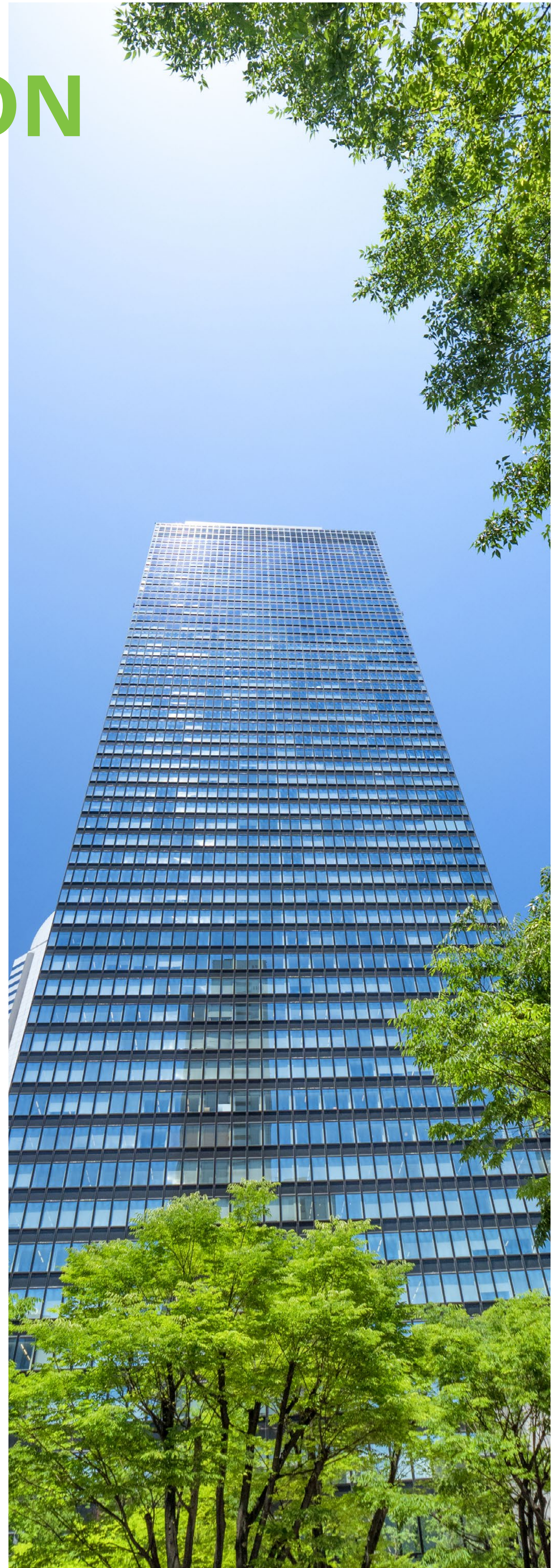
- 2021 Position paper on crypto assets (published by the Intergovernmental Fintech Working Group (IFWG) and prepared by the Crypto Assets Regulatory Working Group (CAR WG) of the IFWG): Specifically Recommendations 12, 13, 14, 16 & 18;
- A Frequently Asked Questions (FAQ) document on crypto assets published by IFWG;
- Exchange Control Circular 2/2020 of the South African Reserve Bank;
- Exchange Control Regulations, 1961: Regulation 10(1)(c) & (4) (definitions of "capital" and "exported from the Republic").

Cases

- *Couve and Another v Reddot International (Pty) Ltd and Others* [2004] (6) SA 425 (W);
- *Oilwell (Pty) Ltd v Protec International Ltd and Others* [2011] (4) SA 394 (SCA);
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* (920/2010) [2012] ZASCA 13 (15 March 2012); [2012] (4) SA 593 (SCA).

Tags: cross-border flows of capital; intellectual property right; public ledger; blockchain.

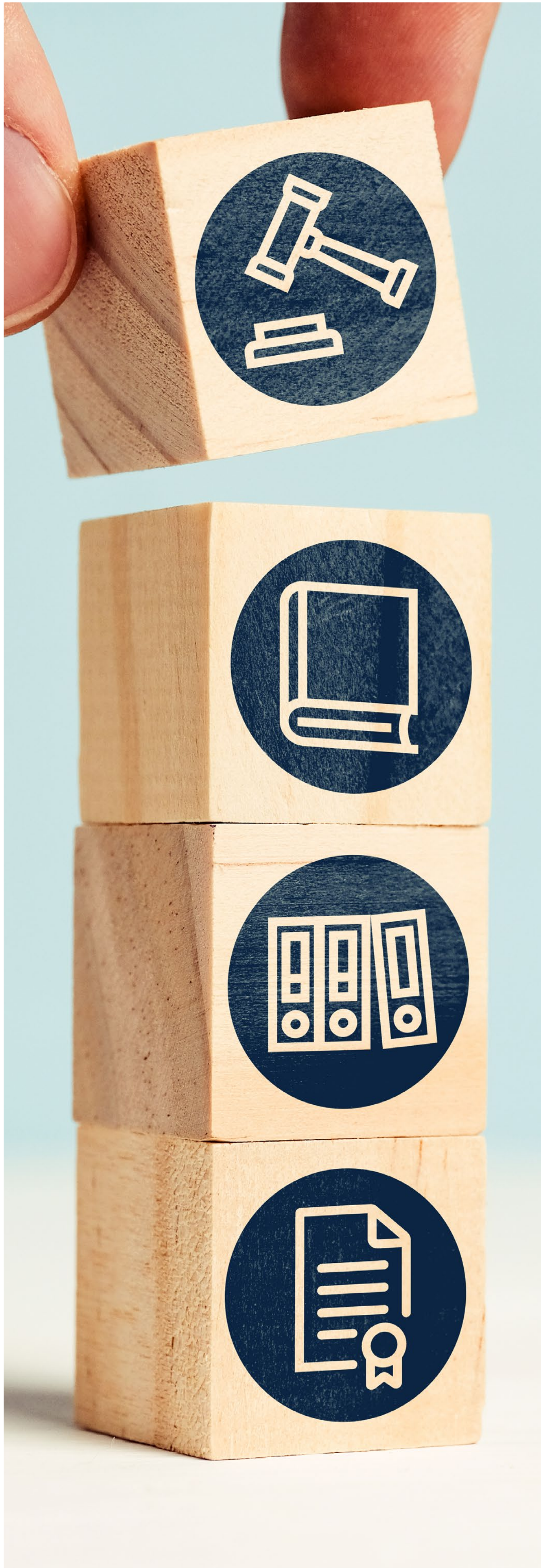
MODIFICATION OF THE INTEREST LIMITATION PROPOSALS



In 2019 Treasury released a discussion document dealing with the proposed interest limitation rules that would apply where a South African company with foreign group members has borrowed money. This kind of proposal is very common throughout the world, especially as part of giving effect to the OECD's and G20's initiative to curb Base Erosion and Profit Shifting (BEPS). This occurs inter alia *by means of payment of what is considered to be excessive amounts of interest that legitimately rank as deductions, but where the interest is taxed at lower rates in a foreign country.*

It was intended that, following assessment of the responses to the discussion document, the legislation would be passed in 2020 to take effect in 2021. However, because of COVID-19 and the lockdown, it was decided to defer the legislation for a year, and also give additional time for response to the discussion document.

On 11 November 2021 the Minister of Finance, as part of delivering his Medium Term Budget Policy Statement, tabled the Taxation Laws Amendment Bill, 2021 (the TLAB 2021), in Parliament, which *inter alia* included the amendment to the Income Tax Act, 1962 (the Act), in relation to interest limitation. At the outset, it must be said that the approach as evidenced by the amendment in the TLAB 2021 is to be welcomed, as it represents a considerably softer touch than originally proposed, and adopts a far more sensible and practical approach. The fact is that the original approach in the discussion document followed too closely the approaches of more developed and capital-exporting countries in Europe and North America, as opposed to considering the more unique requirements of the South African economy.



THE DISCUSSION DOCUMENT

It does not serve any purpose to go into a detailed analysis of the discussion document. Suffice it to say that there were a number of key issues contained therein, some of which were, in the view of many in the private sector, problematic.

The following were the core issues:

- The default position was that, in qualifying circumstances, a company's interest deduction would be limited to 30% of EBITDA for tax purposes (tax EBITDA).
- The discussion document proposed a *de minimis* deduction of R5 million, so that if the amount of interest was, say, R8 million, and 30% of tax EBITDA was, say, R2.5 million, a deduction of R5 million would still be allowed, with the excess of R3 million being carried forward.
- The limitation of 30% of tax EBITDA applied whenever there was a cross-border element involving a foreign group company and there was cross-border borrowing. Moreover, the 30% limitation was to apply to *all* interest paid, whether paid to affiliated parties or to South African independent third parties. This could give rise to an anomalous situation where, for example, a South African group (the SA group) borrows money from the banks and also has a relatively small subsidiary in a foreign country to which it had lent money. In this situation the SA group could find itself with a 30%-interest limitation on its borrowings, even though those borrowings were funding assets completely unrelated to the foreign subsidiary. The real BEPS problem in a capital-importing country like South Africa is where the South African taxpayer is a subsidiary of a foreign group and has borrowed money – not where a South African group has lent money to its foreign subsidiaries and fellow subsidiaries.
- Section 31 of the Act, dealing with transfer pricing, also affects the amount of interest that can be deducted, first, because of the requirement not to be thinly capitalised (ie, not to have a large debt: equity ratio), and, secondly, because the rate of interest on loans from connected persons must be arm's length. It was (wisely) indicated in the discussion document that the legislation would take into account the interaction of the two provisions, including the possibility of introducing safe harbour provisions in section 31 (for example a safe harbour debt: equity ratio and interest rate).

EXISTING LEGISLATION

Currently, apart from section 31, there are two specific interest-limitation provisions contained in the Act, being sections 23M and 23N. The latter applies purely domestically in relation to borrowed funds being used to acquire new subsidiaries or their businesses and essentially reliance is being placed on the corporate restructuring rules, such as contained in section 45 or 47 of the Act (intragroup transactions or liquidation distributions), and nothing further needs to be said in relation to this section.

Section 23M, however, was designed to limit deductibility of interest where a company had borrowed abroad from a person who directly or indirectly holds 50% or more of the equity shares or voting rights, such person being in, what is defined in section 23M(1) as, a "controlling relationship". The provision applies where

the interest received is not subject to South African tax in the hands of the recipient, and, as far as foreign lenders are concerned, this would occur only if, under a relevant double tax agreement with the foreign country, no withholding tax in South Africa is payable on that interest. (It should be noted, however, that section 23M does not apply only in respect of interest paid tax-free to a foreign lender – it can apply even where the lender is in South Africa but does not pay tax; for example, a pension fund or a PBO.)

Section 23M also limits interest to a percentage of tax EBITDA, but the percentage was somewhat more generous, in that it was based on 40% of the repo rate plus 400 basis points. So, for example, if the repo rate was at 5%, the interest was effectively limited to (40% of 9%) x 10 = 36% of tax EBITDA.

THE AMENDMENTS

Rather than introducing a completely new section into the Act, the decision has been taken to amend section 23M.

The main features of the amendments are as follows:

- Instead of the formula basis for determining the percentage of tax EBITDA, a flat 30% will now be used.
- Whereas previously the amount of interest to be limited was calculated based on "ordinary" interest as defined in section 24J of the Act, now the amount to be limited includes (a) amounts incurred or accrued under interest swap agreements, (b) the finance cost element included in lease instalments in a finance lease (the finance cost element to be determined based on IFRS16), and (c) amounts taken into account as realised foreign exchange gains and losses under section 24I.
- Certain anti-avoidance provisions have been included which enabled parties to avoid the application of section 23M.
- Where interest is paid to a foreigner and there is withholding tax deducted, that interest will be taken into account in determining whether section 23M should apply, but the interest paid to be taken into account for the interest limitation is adjusted to recognise that a portion of the interest has been taxed. So, for example, if the full 15% withholding tax has been deducted, the interest would not be taken into account in calculating the 30% of tax EBITDA. But if, say, 10% interest was withheld because of a reduction under a DTA, the amount to be taken into account would be adjusted proportionally, ie, only one-third of the interest would be taken into account in calculating the 30% of tax EBITDA.

It is evident that some of the more unfortunate proposals have not been included in the legislation, including the fact that it would apply even where the South African company has not borrowed from a foreign affiliate but has merely invested abroad. There is also no *de minimis* exemption but given the fact that the scope of the limitation has been reduced so dramatically, the absence of a *de minimis* exemption may not be that serious.

What is a little disappointing is that there is no further legislation to harmonise the interaction between this interest limitation rule and the transfer pricing rules under section 31 of the Act.

Ernest Mazansky

Werksmans

[*Editor's comment*: In terms of the draft Taxation Laws Amendment Bill, published on 28 July 2021, the amendments to section 23M were to have taken effect on 1 April 2022. In the TLAB 2021, however, the commencement date provision reads that the amendments will come into operation "on the date on which the rate of tax in respect of the taxable income of a company is first reduced after announcement by the Minister of Finance in the annual National Budget and applies in respect of years of assessment commencing on or after that date." This date may of course well be later than the originally anticipated 1 April 2022.]

Acts and Bills

- Income Tax Act 58 of 1962: Sections 23M (including definition of "controlling relationship" in subsection (1)), 23N, 24I, 24J (definition of "interest" in subsection (1)) & 31 (transfer pricing rules);
- Taxation Laws Amendment Bill 22 of 2021 (introduced on 11 November 2021);
- Draft Taxation Laws Amendment Bill, 2021 (published for comment on 28 July 2021).

Other documents

- IFRS16;
- Medium Term Budget Policy Statement.

Tags: Base Erosion and Profit Shifting (BEPS); tax EBITDA; interest swap agreements; foreign exchange gains and losses; *de minimis* exemption.

REITS: DEDUCTION OF EXCESSIVE INTEREST

In Chapter 4 of the 2021 Budget Speech Review Documents, National Treasury confirmed Government's intention to restructure the corporate tax regime in a revenue-neutral manner. It was initially announced in February 2021 that the corporate tax rate would be reduced from 28% to 27% with effect from years of assessment commencing on or after 1 April 2022, but that this would be done in conjunction with a broadening of the tax base.

Two of the tools which National Treasury and the South African Revenue Service (SARS) intend using to further this objective include the limitation of assessed losses and the limitation on the deduction of excessive interest. The draft Taxation Laws Amendment Bill, 2021 (the Draft TLAB), published on 28 July 2021 for public comment, gave further insight in relation to these two proposed limitation rules. After the public consultation process and parliamentary hearings, National Treasury proposed further amendments to the proposed changes as per the Taxation Laws Amendment Bill, 2021 (the TLAB 2021), introduced in the National Assembly on 11 November 2021. In this article, we discuss the proposed changes to the limitation on the deduction of excessive interest including specifically the impact of the proposed changes on real estate investment trusts (REITs).

BACKGROUND: SECTION 23M OF THE INCOME TAX ACT

Essentially, section 23M of the Income Tax Act, 1962 (the Act), furthers the aim of the Government to ensure that base erosion and profit shifting (BEPS) from South Africa does not occur. Importantly, section 23M is applied after the application of the transfer pricing provisions of the Act contained in section 31. While there has been some uncertainty as to which provision takes precedence, National Treasury's Draft Response Document on the Draft TLAB (the Response Document), states that Government has always maintained that applying section 31 should precede the application of section 23M. The Response Document confirmed Government's view that an interpretation note would be the best mechanism to address this uncertainty.

Section 23M limits excessive interest deductions in respect of debts owed to persons not subject to tax in South Africa if the debtor and the creditor are in a controlling relationship (or a debt owed to a creditor where that creditor obtained funding for the debt from a person in a controlling relationship with the creditor). A controlling relationship basically encompasses the scenario where the creditor holds at least 50% of the equity shares or voting rights in the debtor. To the extent that section 23M applies, the deduction of interest in the hands of the debtor is limited by way of a specific calculation. Notably, the TLAB 2021, in clause 19(1)*(c)*, proposes broadening the definition of "controlling relationship" to include so-called "brother/sister" group companies (ie, companies that are horizontally part of the same group).

The calculation is set out in section 23M(3) and has undergone one or two changes since it first came into effect, but essentially provides that interest deducted cannot exceed the sum of:

- the total interest received or accrued to the debtor;
- plus a percentage (linked to the repo rate) of "adjusted taxable income" of the debtor;
- less any interest incurred in respect of debts owed (other than debts caught by section 23M).

Importantly, the limitation hinges on the definition of "adjusted taxable income", which is essentially the tax equivalent of earnings before interest, taxation, depreciation and amortisation (EBITDA). The definition of "adjusted taxable income" is currently calculated as follows:

Starting point	Taxable income (before applying section 23M)
(Less)	Interest received or accrued
	Controlled foreign company income
	Recoupments on capital allowance assets
Plus	Interest incurred that is allowed as a deduction
	Capital allowances
	Assessed losses

PROPOSED CHANGES: GENERAL

A review of the tax treatment of excessive debt financing has been in the making for the last couple of years in order to align South Africa's rules more closely with the OECD/G20 BEPS Action 4 recommendation. As a result of the review, National Treasury has proposed making several changes as per the TLAB 2021 including the following:

- an expansion of the definition of "interest" beyond the current definition contained in section 24J of the Act which shall also include foreign exchange gains and losses taken into account in determining taxable income in terms of section 24I(3) and (10A);
- the percentage of "adjusted taxable income" to be fixed at 30% as opposed to being flexible and linked to the repo rate;
- broadening the scope of the application of section 23M to include back-to-back loans within a chain of companies that are in controlling relationships with each other; and
- where a resident debtor makes an interest payment and the payment attracts the withholding tax on interest at a rate higher than zero, a portion of the deduction of the interest expense will be subject to section 23M.

The proposed changes will thus broaden the scope of interest to which section 23M applies. According to the draft Explanatory Memorandum on the TLAB (the Memo), National Treasury is of the view that the current definition of "interest" is too narrow when compared to the OECD/G20 BEPS recommendations. In particular, it does not consider avoidance scenarios where interest can be labelled as other types of payments to circumvent the application of these rules. The proposal intends specifically including payments under interest rate swap agreements, any finance cost element included in finance lease payments and foreign exchange differences. Many comments were submitted to National Treasury in relation to the amendments to the definition of "interest" and the TLAB 2021 includes some technical revisions as well as a specific carve-out for recharacterised interest that is subject to the hybrid debt rules.

Furthermore, the limitation will be fixed to 30% of adjusted taxable income. In the Memo, National Treasury stated that SARS data shows that applying a fixed ratio of 30% would be fair in that the majority of taxpayers would be able to deduct all their interest and equivalent payments without restriction. Over and above this, the Memo stated that introducing a fixed ratio limitation of 30% based on adjusted taxable income does not result in much change given that the existing formula yields a 30% restriction in any event. This is driven by the current low repo rate; however, this position is unlikely to continue indefinitely and the South African Reserve Bank's Monetary Policy Committee in fact hiked rates in its November 2021 meeting.

During the public consultation process, comments were made that the proposed 30% ratio is generally applicable to developed countries and not developing countries such as South Africa. It was commented that by fixing the ratio at 30%, Government will make South Africa unattractive as an investment destination. National Treasury did not accept these comments as per the Response Document and stated that South Africa is not the only developing country that has implemented these rules as recommended by the OECD/G20 BEPS Project. National Treasury referred to countries like Botswana and India that have also implemented a fixed ratio rule at 30%. The fixed ratio thus remains in the TLAB 2021.

PROPOSED CHANGES: REITS

Subject to various provisos, a REIT is not taxed on the income it derives due to a deduction for "qualifying distributions" made by it. In other words, REITs are treated as "flow-through vehicles" as per the special taxation regime afforded to REITs in section 25BB of the Act. However, in the Memo, National Treasury accepts that section 23M currently does not provide for any distinct treatment for REITs.

In certain instances, the deduction of a qualifying distribution may result in zero taxable income for a REIT. National Treasury has identified that the deduction for qualifying distributions of REITs would distort their "tax EBITDA" and would result in their having a much lower tax EBITDA than other taxpayers. As a result of this, it was proposed (as per the Draft TLAB) that a change be made to the definition of "adjustable taxable income" in section 23M(1) to take into account a "qualifying distribution" of a REIT.

DISCUSSION

In instances where a REIT is funded by a tax-exempt entity (say a pension fund or non-resident) and that pension fund or non-resident is in a "controlling relationship" in relation to that REIT, then any debt advanced between these two entities may be caught within the provisions of section 23M. With the broadening of the scope of the definition of "interest" as well as the application of section 23M to back-to-back loans within a chain of companies in controlling relationships with one another, section 23M may apply to a broader set of circumstances from now on. This is in addition to the proposed amendments that are intended to ensure that interest subject to the withholding tax on interest does not altogether escape the application of section 23M.

As indicated in the Memo, under current legislation, a REIT's "adjusted taxable income" may be zero as its starting point taxable income may be zero to the extent that it makes sufficient qualifying distributions in that relevant year of assessment to fully reduce its income. Under those circumstances, the REIT would in essence be limited in its deduction of interest to the extent that it receives interest. However, a REIT's main forms of income are more likely to be dividends, qualifying distributions from subsidiaries and rental income. Hence under the current dispensation, a REIT would be discouraged from raising funding from a related-party creditor that is not subject to tax, given that it will only be allowed to deduct a portion of that interest that equals the interest it receives (if any).

Say for example, a REIT makes sufficient qualifying distributions and has an "adjusted taxable income" of nil. It furthermore receives or accrues interest in an amount of R100 in a year of assessment and incurs interest of R200 to a creditor that is caught by section 23M. The REIT would then only be able to deduct R100 of the R200 interest incurred. R100 of the section 23M interest will be subject to tax in the REIT's hands and to the extent that that amount is distributed as a "qualifying distribution" it will be subject to further tax in the hands of the REIT shareholder.

The proposed amendment to the legislation now makes provision for the fact that a REIT makes qualifying distributions, and this must be taken into account when calculating a REIT's "adjusted taxable income" for section 23M purposes. In following the example above, if the REIT now has an adjusted taxable income of R500 (given that the REIT's qualifying distributions will be added back in full as per the amended section 23M formula), the REIT will be able to fully deduct the interest incurred in relation to the controlling creditor. In other words, in terms of the section 23M calculation, the REIT would theoretically be able to deduct up to R250 interest on the loan funding advanced by controlling creditors on the basis that it received R100 interest and 30% of R500 is R150.

During the public hearings, the comment was made that the proposal would increase the interest that is allowed as a deduction for a listed REIT, relative to the unlisted property sector in which these amounts are being limited. It was submitted that this would have a negative impact on the return on investments of unlisted property companies which would make them unattractive to institutional investors. National Treasury did not accept this comment and responded that the Act currently makes a distinction between the tax treatment of listed REITs versus unlisted property companies for good reason. In other words, the rationale for the different tax treatment stems from the fact that listed REITs are regulated by the JSE whereas unlisted property companies are not formally regulated.

The TLAB 2021, as amended, has been approved by the National Assembly and is expected to be promulgated early in 2022. However, REITs (and other corporate taxpayers) would be well advised to consider the proposed legislation and its impact on their tax position and funding requirements.

EFFECTIVE DATE

There was robust discussion and debates regarding the proposed changes to the limitation of deduction of excessive interest rules during the public consultation process. Some comments were accepted by National Treasury and the revised amendments of section 23M in the TLAB 2021 look a bit different to those in its predecessor. What is especially notable is National Treasury's response to the proposed effective date of the amendments. Initially, it was expected that the amended legislation would come into effect on 1 April 2022; however, based on the revised legislation, the effective date will now be linked to the reduction of the corporate tax rate. Reading between the lines, given current economic circumstances, it may be that the reduction of the corporate tax rate will not come into effect next year but will likely be postponed.

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Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 23M(1) (definitions of "adjustable taxable income", "controlling relationship" and "interest") and (3)), 24I(3) & (10A), 24J(1) (definition of "interest"), 25BB (definition of "qualifying distribution"), 31 (transfer pricing provisions);
- Taxation Laws Amendment Bill 22 of 2021;
- Draft Taxation Laws Amendment Bill, 2021.

Other documents

- OECD/G20 BEPS Action 4 recommendation;
- Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2021.

Tags: corporate tax rate; assessed losses; excessive interest; base erosion and profit shifting (BEPS); excessive interest deductions; foreign exchange gains and losses; adjusted taxable income; controlling relationship; qualifying distribution.

DEFINITION OF "EMPLOYEE"

The employment tax incentive (ETI) was introduced in 2014 for purposes of encouraging employers to hire young and less experienced work seekers. It was thus specifically aimed at increasing employment and skills levels in South Africa's unemployed youth. Notwithstanding this critical purpose, the July 2021 unrest in South Africa raises important questions in relation to its efficacy. There is no question that South Africa faces an ever-increasing unemployment problem, particularly among the youth, and incentives such as the ETI are intended to play a critical role in rectifying this problem. However, certain developments have thrown the incentive into the spotlight.

On 6 July 2021, the South African Revenue Service (SARS) published Binding Private Ruling 367 (BPR 367), which determined that students in a proposed training programme would not be considered "employees" as contemplated in the Employment Tax Incentive Act, 2013 (the ETI Act), and that the applicant taxpayer would not be entitled to claim any ETIs in respect of them. This ruling was published on the back of much public debate and discussion around certain schemes utilising the ETI.

On the back of this, National Treasury and SARS published the 2021 draft Taxation Laws Amendment Bill (2021 Draft TLAB) on 28 July 2021, which gave effect to the announcements made in the 2021 Budget Speech pertaining to tax policy proposals. The 2021 Draft TLAB included proposed amendments to the ETI Act, specifically the definition of "employee" in that Act. On 11 November 2021 the Taxation Laws Amendment Bill, 2021 (the 2021 TLAB), was introduced in Parliament.

This article discusses the impact of SARS' ruling and the proposed amendments on all relevant stakeholders of the ETI, including taxpayers claiming the ETI as well as proposed employees or beneficiaries of these schemes.

HOW DOES THE ETI WORK AND WHO CAN CLAIM IT?

Before unpacking the recent developments, it is worthwhile revisiting how the ETI generally works and what requirements need to be met in order to claim it. If an employer is eligible to receive the ETI in respect of a "qualifying employee", the employer may reduce the total amount of employees' tax generally payable to SARS – this serves as an incentive to organisations to employ youthful job seekers.

Importantly, to claim the ETI, an organisation must qualify as an "eligible employer" in accordance with section 3 of the ETI Act. In addition, the eligible employer must hire a "qualifying employee" (defined in section 1(1) of the ETI Act). "Employee" is specifically defined in section 1(1) as a natural person –

- who works for another person; and
- who receives, or is entitled to receive remuneration, from that other person, but does not include an independent contractor.

The definition of "employee" in the ETI broadly encompasses a combination of the labour law concept of an employee and the tax law concept of an employee as contemplated in the Fourth Schedule to the Income Tax Act, 1962 (the Act).

BACKGROUND FACTS OF BPR 367

In BPR 367, a resident company (the Applicant) and a resident non-profit company (Company B) proposed entering into an agreement with the stated purpose that students would be employed by the Applicant for purposes of obtaining a qualification.

The Applicant would then sign agreements with the students for a period of 12 months and pay the students a monthly salary. The Applicant would not be under any obligation to employ the students after the 12-month training programme had been completed.

The students would then consent to forfeit their monthly salaries in order to be trained by Company B. The students would be on the Applicant's payroll and protected by its group life policy. However, importantly, the students would not be required to do any work for the Applicant. The main duty of a student would be to attend training courses "virtually" at the skills centres hosted by Company B. Furthermore, there would be no expectation that a student would have to report to the Applicant's offices on a daily basis.

However, there was the possibility that the students would be expected to make themselves available to perform specific forms of work such as marketing, printing and distribution of pamphlets for the Applicant. Practically, the Applicant would only call on them to perform these ad hoc activities to the extent that doing so would not interfere with their studies. Company B would, for all intents and purposes, exercise supervision and control over the students by way of mentors assigned to each of them, and these mentors would monitor and supervise the students to ensure they progressed successfully through the training course.

SARS RULING

Based on the specific set of facts, SARS ruled the following:

- no student would meet the definition of an "employee" in section 1(1) of the ETI Act; and
- the Applicant would not be entitled to claim an incentive, as contemplated in the ETI Act, in respect of any of the students.

IMPLICATIONS OF BPR 367 FOR TAXPAYERS

In terms of section 83 of the Tax Administration Act, 2011 (the TAA), a binding private ruling applies to a person only if –

- the provision or provisions of the Act at issue are the subject of the advance ruling;
- the person's set of facts or transaction is the same as the particular set of facts or transaction specified in the ruling;
- the person's set of facts or transaction falls entirely within the effective period of the ruling;
- any assumptions made or conditions imposed by SARS in connection with the validity of the ruling have been satisfied or carried out; and
- the person is an applicant identified in the ruling.

When considering the above, one should keep in mind that binding private rulings are not binding on taxpayers and do not constitute "practices generally prevailing", as defined in section 1(1), read with section 5, of the TAA; however, BPR 367 certainly made it clear that these schemes are under SARS' microscope. While published rulings are fact-specific and do not reveal all the facts pertaining to them, it is interesting that the facts in BPR 367 did not make it clear that the students would have to render meaningful services to the Applicant during the 12-month "employment period". However, even if the legal agreements envisaged the students possibly rendering some services to the Applicant, the issue is often in the implementation of these schemes, as it may be the intention of the contracts and agreements that services be rendered, but in practice very little is in fact implemented.

PROPOSED AMENDMENTS TO THE DEFINITION OF "EMPLOYEE" IN THE ETI ACT

In the Draft Explanatory Memorandum on the 2021 TLAB (the Memo), National Treasury states that it has identified that some taxpayers have implemented certain schemes where they claim the ETI in respect of individuals who do not work for them, thereby failing to meet the definition of "employee" as outlined in section 1(1) of the ETI Act. The Memo comments that the nature of these schemes is (simply) to market and utilise the ETI as a means of facilitating the entry of qualifying, unskilled, inexperienced, previously disadvantaged South Africans into the modern economy.

Page 6 of the Memo clarifies the arrangement that is under Government's microscope (the facts of which are similar to BPR 367):

> "Eligible participants are recruited by a recruitment agency and employed by a participating employer for a fixed term period of 12 to 24 months. Participating employers engage with the recruitment agency to recruit eligible participants. Contracts signed by the eligible participants indicate the receipt of remuneration while 'employed' by the participating employer. Once 'employed', participants are trained by a training institution (over the 12 to 24 month period) and, in some cases, enrolled in Sector Education and Training Authority (SETA) accredited courses. The training institution is contracted by the participating employer at a cost equal to the remuneration stated in the eligible participant's contract. The remuneration stipulated in the contract is paid to the training institution as opposed to being paid to the eligible participant."

In some cases, the eligible participants are exposed to work-based exercises and activities by an independent company. The independent company is able to utilise the eligible participants for a fixed monthly fee, which similar to the remuneration, is not paid to the eligible participant. Once the training programme is completed, the eligible participant may work for the participating employer for the remainder of the 12- to 24-month period. In accordance with the said scheme, the participating employer is then able to claim the ETI for the 12- to 24-month period that the eligible participant is supposedly "employed" by the employer.

PROPOSED CHANGES

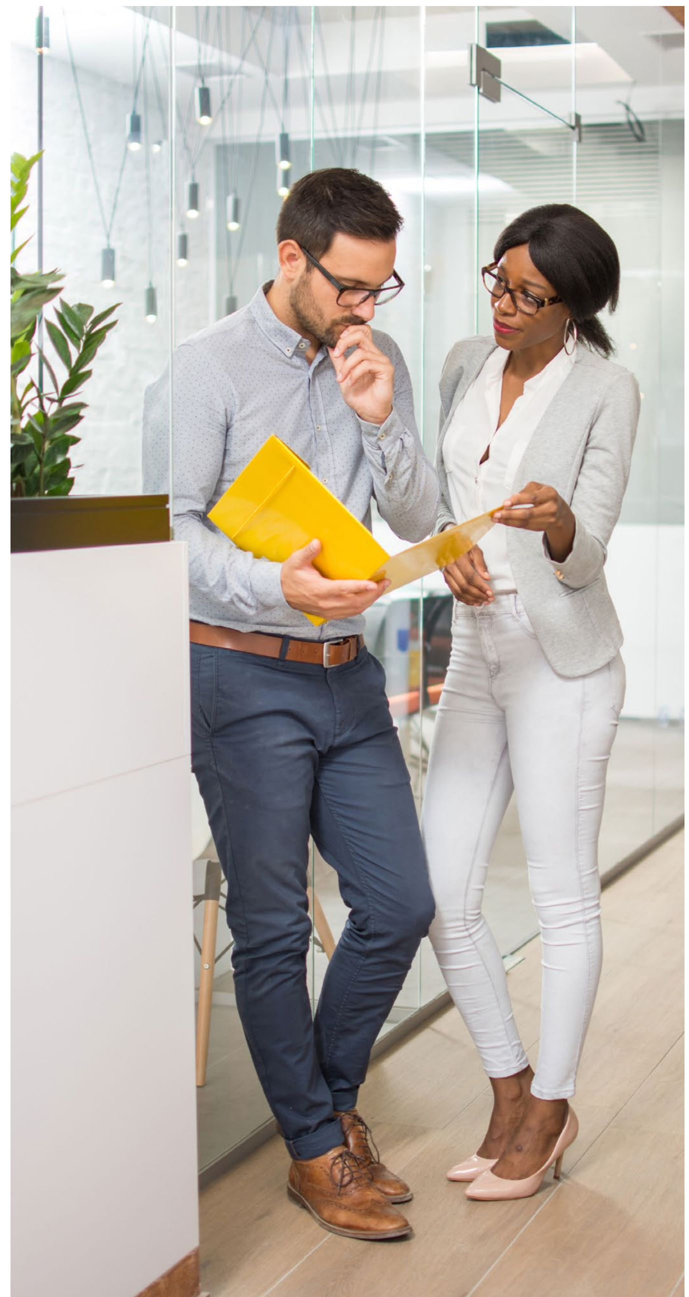
The Memo states that in order to address the contraventions identified by Government, it is proposed that changes be made to the ETI Act to clarify that substance over legal form will be considered when assessing an employer's ability to claim the ETI. In this manner, it is National Treasury's view that "work" must actually be performed in terms of an employment contract and an employee must be documented in an employer's records as envisaged in the record keeping provisions contained in section 31 of the Basic Conditions of Employment Act, 1997 (the BCEA).

Clause 58(1) of the 2021 TLAB proposes inserting the following two additional requirements into the definition of "employee" in the ETI Act:

- a natural person who in any other manner directly or indirectly assists in carrying on or conducting the business of that other person; and
- who is documented in the records of that other person as envisaged in the record keeping provisions in section 31 of the BCEA.

Over and above this, clause 59(1) of the 2021 TLAB proposes inserting a specific proviso to section 6 of the ETI Act which sets out the requirements of a "qualifying employee". The proviso states that an employee must not, in fulfilling the conditions of their employment contract, be mainly involved in the activity of studying, "unless the employer and employee have entered into a learning programme as defined in section 1 of the Skills Development Act, 1998 . . ., and, in determining the time spent studying in proportion to the total time for which the employee is employed, the time must be based on actual hours spent studying and employed".

While not stated in the Memo, one should note that in *Sekretaris van Binnelandse Inkomste v Lourens Erasmus (Eiendoms) Bpk*, [1966], the court held that in the context of determining whether total net profit was derived solely or mainly from dividends, the word "mainly" prescribed a purely quantitative standard of more than 50%. This meaning of "mainly" is also applicable in the context of other provisions in the Act, such as the definition of "impermissible trade" in section 12J. It is possible that the word "mainly" in the proposed proviso to section 6 of the ETI Act, will also be interpreted to mean more than 50%.



"The draft interpretation note makes for interesting reading and deals with how the definition of 'employee' in section 1(1) of the ETI Act is applied, specifically in the context of arrangements entered into by parties, typically as part of a composite arrangement involving learning institutions."

EFFECTIVE DATE AND DISCUSSION

The proposed amendments are to come into operation on 1 March 2022 and apply to years of assessment commencing on or after that date. BPR 367 and the proposed amended legislation evidently have implications for many entities claiming the ETI in relation to schemes akin to the one highlighted in the Memo by National Treasury and in the ruling. SARS' intent in clarifying its interpretation of the ETI Act is further evidenced by the publication of a draft interpretation note on 3 November 2021. The draft interpretation note makes for interesting reading and deals with how the definition of "employee" in section 1(1) of the ETI Act is applied, specifically in the context of arrangements entered into by parties, typically as part of a composite arrangement involving learning institutions.

As such, all taxpayers claiming or intending to claim the ETI would be well advised to consult with professional tax advisors to assess the impact of the pending amendments (as well as historical arrangements) for purposes of ensuring compliance and remedying any deficiencies. Should a taxpayer be uncertain whether it would qualify for the ETI by entering into a specific arrangement, it should consult with its professional tax advisors beforehand. It can also consider applying to SARS for an advance tax ruling, as the applicant in BPR 367 did. It is worthwhile noting that audits of ETI claims are on the increase and taxpayers should be aware that SARS may impose penalties and interest in appropriate circumstances.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 12J (definition of "impermissible trade"); Fourth Schedule (tax law concept of an employee);
- Employment Tax Incentive Act 26 of 2013: Sections 1(1) (definitions of "employee" and "qualifying employee"), 3 & 6;
- Tax Administration Act 28 of 2011: Section 1(1), read with section 5 (definition of "practices generally prevailing"); section 83;
- Basic Conditions of Employment Act 75 of 1997: Section 31;
- Skills Development Act 97 of 1998: Section 1(1) (definition of "learning programme");
- Taxation Laws Amendment Bill 22 of 2021: Clauses 58(1) and 59(1);
- Draft Taxation Laws Amendment Bill, 2021 (published on 28 July 2021).

Other documents

- Binding Private Ruling 367 (published on 6 July 2021);
- Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2021: Page 6;
- 2021 Budget Speech;
- Draft interpretation note ("Meaning of 'employee' for purposes of the Employment Tax Incentive Act") (3 November 2021).

Cases

- *Sekretaris van Binnelandse Inkomste v Lourens Erasmus (Eiendoms) Bpk* [1966] 28 SATC 233.

Tags: employment tax incentive; qualifying employee; practices generally prevailing; eligible participant; impermissible trade.

FOREIGN ENTERTAINERS AND SPORTSPERSONS – TAX AND EXCHANGE CONTROL

Although COVID-19, and the concomitant lockdown, has had an adverse impact on the South African entertainment and sports industry, South Africa has always been host to a number of international artists and sports events, which were attended by South Africans all and sundry. Where a South African person or entity operating in the entertainment industry arranges an event involving the performance of foreign entertainers or sportspersons in South Africa, the South African person or entity that is liable to pay for such person's services must appreciate that there are specific tax and exchange control rules that need to be complied with. In this article, we provide a brief overview of these considerations.

"In terms of section 47B(1) of the Income Tax Act, 1962 (the Act), the tax on foreign entertainers and sportspersons must be paid in respect of any amount received by or accrued to any person who is not a South African tax resident in respect of any specified activity exercised or to be exercised by that person or any other person who is not a resident."

TAX CONSIDERATIONS

General principles

In terms of section 47B(1) of the Income Tax Act, 1962 (the Act), the tax on foreign entertainers and sportspersons must be paid in respect of any amount received by or accrued to any person who is not a South African tax resident in respect of any specified activity exercised or to be exercised by that person or any other person who is not a resident.

Section 47B(2) states that this tax is a final tax and is levied at a rate of 15% on all amounts received by or accrued to foreign entertainers and sportspersons, as defined. The rate of tax may also increase, if the Minister of Finance announces such an increase in the national annual budget contemplated in section 27(1) of the Public Finance Management Act, 1999. Such increase will be effective from the date mentioned in that announcement.

The phrase "entertainer or sportsperson", to whom the tax applies, is defined in section 47A*(a)* of the Act to include any person who for reward –

- performs any activity as a theatre, motion picture, radio or television artiste or a musician;
- takes part in any type of sport; or
- takes part in any other activity which is usually regarded as of an entertainment character.

The phrase "specified activity", as used in section 47B, is defined in section 47A*(b)* and means any personal activity exercised in South Africa or to be exercised by a person as an entertainer or sportsperson, whether alone or with any other person or persons.

Exceptions

One should note that, in terms of section 47B(3), this tax on foreign entertainers and sportspersons will not apply to any person who is not a South African tax resident if that person –

- is an employee of an employer who is a South African tax resident; and
- is physically present in South Africa for a period or periods exceeding 183 full days in aggregate during any 12-month period commencing or ending during the year of assessment in which the specified activity is exercised.

ADMINISTRATIVE CONSIDERATIONS

A resident who is liable to pay to a taxpayer any amount contemplated in section 47B(1) must deduct or withhold from that payment the amount of tax for which the taxpayer is liable under that section in respect of that amount. Where an amount has been withheld in this manner by the resident, such resident must pay the amount withheld to SARS before the end of the month following the month during which that amount was so deducted or withheld.

EXCHANGE CONTROL

The applicable exchange control rules are contained in section B.14 of the Currency and Exchanges Manual for Authorised Dealers (the AD Manual). In short, the section states that net earnings of foreign artistes, entertainers, sportsmen and similar professionals engaged by residents, may on departure be processed by authorised dealers (certain South African banks). This may happen, provided that the authorised dealers view documentary evidence from SARS confirming that all tax commitments have been met.

Section B.14 of the AD Manual further states that where a contract requires that an upfront or advance payment be transferred prior to completion of the non-resident's contractual obligations, such payment may only be credited to an escrow account and may only be released proportionately after the completion of each performance.

Where one seeks to make payment to a foreign artist, entertainer or sportsperson for services not yet rendered, in other words, payment in excess of the proportion of services rendered, the South African resident making payment will likely have to obtain prior approval from the South African Reserve Bank to do so.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 47A*(a)* (definition of "entertainer or sportsperson") & *(b)* (definition of "specified activity"), 47B(1), (2) & (3);
- Public Finance Management Act 1 of 1999: Section 27(1).

Other documents

- Currency and Exchanges Manual for Authorised Dealers (AD Manual): Section B.14.

Tags: tax resident; entertainer or sportsperson; specified activity; Currency and Exchanges Manual for Authorised Dealers.

DISCLOSING RENTAL INCOME

ALERT FOR THOSE EARNING RENTAL INCOME

In the global online age it is easy for a taxpayer to advertise and rent out part of their home, or investment property, to paying guests. Many people are using online platforms, which can then monitor booking and assist with the logistics in the collection of the rental income. As easy as it is for a homeowner to add his property to such an online site, so easy is it for SARS, as the "prospective" renter, to find out the details of who has rental accommodation on the market and what the going rate per night is.

Since the appointment of Edward Kieswetter as the SARS Commissioner on 1 May 2019, there has been a strong drive by SARS to address the matter of non-compliance.

In a presentation to Parliament's Standing Committee on Finance, Kieswetter was quoted as saying "Taxpayers and traders who negligently, deliberately, aggressively, or criminally stay out of the tax system or do not comply, will be detected immediately when non-compliance occurs".

One of the areas of non-compliance that SARS has identified, is taxpayers who have taken advantage of the easy access to the online platforms available to them and have been receiving rental income which they have not been declaring to SARS.

SARS released a media statement early in 2021 advising that they are currently improving their system capabilities in order to detect potential defaulters and have warned this is an area that they will be targeting.

In addition to the online platforms, South African financial institutions are obligated to provide SARS with details of your banking transactions on a six-monthly basis. Should SARS systems get to the point where they can identify patterns of income earned, any undisclosed income will definitely be detected by SARS.

SARS is encouraging taxpayers who have not previously disclosed their rental income to SARS, to approach SARS as soon as possible, making use of the SARS Voluntary Disclosure Programme (VDP) to regularise any previous omissions. Depending on the taxable income not declared to SARS and number of years that the taxpayer has been in default, submitting a VDP application may mitigate the penalties that SARS may impose if they find you before you submit a VDP application. Taxpayers could then also ensure that the deductions allowed against rental income are properly accounted for; this includes the cost of advertising the property, rates and taxes, bond interest, commission fees, cleaning costs, property levies, etc.

Failure to declare any taxable income to SARS may result in severe penalties being imposed by SARS or even in criminal action being taken.

In addition to the income tax obligations, it should also be remembered that where you are lucky enough to receive short-term rental income of more than R1 million in a 12-month period, you may also be obligated to register as a VAT vendor and levy VAT on your rentals in terms of sections 7 and 23 of the Value-Added Tax Act, 1991.

Should you find yourself in a position where you have not declared your rental income, we would suggest that you seek advice as to how to proceed to make a voluntary disclosure to SARS as soon as possible to avoid the payment of penalties.

Sharon MacHutchon

Mazars

Acts and Bills

- Value-Added Tax Act 89 of 1991: Sections 7 & 23.

Tags: undisclosed income; short-term rental income.

TAX CONSEQUENCES OF RIOT INSURANCE PAYMENTS

Businesses that are able to claim from the South African Special Risks Insurance Association (Sasria) for damage to premises or equipment from the July 2021 unrest need to be aware of the tax implications of payouts.

The destruction of an asset is a capital gains tax event. To put it in legal terms (ie, drily), "you are deemed to have disposed of your asset".

If your office building, which some years ago cost R900,000 to build, burnt down (whether due to "insurrection" or otherwise), and you receive an insurance payment of R2 million, you have realised a capital gain of R1.1 million. If you did not have insurance against this event, you have incurred a capital loss.

Unfortunately, a capital loss does not reduce taxable income. A capital loss can only be used to reduce a capital gain. That means you will have to wait until you have a capital gain before you can use the capital loss.

If you have a short-term insurance policy covering your assets, you will probably only be able to claim if you have Sasria insurance. This is a separate policy which provides cover for special risks excluded by your short-term insurer. A Sasria policy covers losses arising from civil commotion, riot, strike, lock-out, public disorder, rebellion, revolution and terrorism, but not war or war-related activities. Cover will be provided in terms of the Sasria policy issued to you, which may not match your underlying cover. Cover is, however, subject to the underlying policy being in place and premiums having been paid.

Sasria is a VAT vendor. If you are a VAT vendor, you can claim back the VAT on your Sasria premiums from SARS, but you also have to pay VAT to SARS when you receive any indemnity payments from Sasria. In legal terms, "the indemnity payment is deemed to be consideration for a service". SARS regularly checks whether VAT vendors who received indemnity payments declared the VAT due on those payments, since it is often overlooked.

In terms of section 8(8) of the Value-Added Tax Act, 1991, VAT on indemnity payments must be paid if –

- the insured is registered for VAT;
- the insured loss was incurred in the course of carrying on an enterprise; and
- the insurer made an indemnity payment.

If the insured assets are replaced, the VAT vendor can end up in a tax-neutral position. For example, if a machine insured for R150,000 is destroyed, and the insurer pays out R150,000, the insured will become liable for output tax in the amount of R150,000 x (15/115) = R19,565. Assuming the insured business purchases a replacement machine for R150,000, the insured will then also become entitled to claim input tax of R150,000 x (15/115) = R19,565. As a result, the insured will end up in a tax-neutral position, as long as the insured asset is replaced.

Timing is important. Replacing the insured items in the same VAT period that the indemnity payment is received will avoid the problem of having to pay output VAT in one period, while only being able to claim input tax in a later period, when the asset is replaced.

Indemnity payments could also have income tax consequences. If you have a form of business interruption cover, any insurance payout that is intended to cover your lost revenue will also be taxable. Insurance payments for the loss of depreciable assets may result in taxable recoupments. For example, if you purchased computers for R100,000 in the previous tax year, and claimed R33,333 as depreciation in your tax return, your computers have a tax value of R66,666. If you insured your computers at their tax value, you would receive R66,666 and no recoupment will arise. However, if you insured your computers at their replacement value, and you receive an insurance payment which is more than the tax value of the computers, you will be taxed on a recoupment. Using this example, if you receive an insurance payout of R100,000, you will have to pay tax on a recoupment of R33,333. If you receive an insurance payout of R120,000, you will have a recoupment of R33,333 and a capital gain of R20,000.

If you decide to take the money and run (legally, of course) you will have to pay the capital gains tax and the income tax on the recoupment. If, however, you decide to replace the computers, you can get roll-over relief (which means you only pay the capital gains tax when you dispose of the replacement asset). To qualify for roll-over relief –

- you must “dispose of” the asset by way of theft or destruction;
- you must receive “proceeds” by way of compensation (ie, an insurance payout);
- the proceeds must be equal to or exceed the base cost of the asset;
- the full proceeds must be used to acquire a replacement asset(s) in South Africa;
- the contracts for the acquisition of the replacement asset(s) must be concluded within 12 months; and
- the replacement assets must be brought into use within three years.

So, the tax consequences of riot damage and loss to a business can be surprisingly complex and must be carefully considered. Ironically, even SARS may be out of pocket. Not everyone who receives an insurance payout will have to pay output VAT over to SARS, but Sasria is a VAT vendor and will be entitled to claim input VAT back from SARS on all of the indemnity payments made by it.

Nina Keyser & Caroline Theodosiou

Webber Wentzel

Acts and Bills

- Value-Added Tax Act 89 of 1991: Section 8(8).

Tags: capital gains tax event; indemnity payments; output VAT; input VAT.

PROVISIONAL TAX PENALTIES

Provisional tax season brings with it the heightened panic of many taxpayers upon the discovery of penalties and interest suddenly imposed by SARS. The disgruntled taxpayer seeks immediate recourse through his attorney, hoping for some sort of justice to be served, but, alas, the attorney is worn down by complex tax calculations, the onerous and incessant engagement with the South African Revenue Service (SARS) and the ambitious endeavours to deliver a favourable outcome to their client.

ATTORNEYS RESTRICTED FROM TAX PRACTICE

The average attorney, albeit being an expert in their field, is aware that increasingly complicated and ever-changing tax legislation requires specialist tax practitioners capable of providing innovative tax consulting solutions. Moreover, a notice released by the Legal Professional Council (the LPC) makes it clear that, in most cases, attorneys are quite frankly barred from providing tax services.

The notice states as follows:

1. Section 240(1) of the Tax Administration Act of 2011 (the TAA) provides that every natural person who (i) provides advice to another person with respect to the application of a tax Act (ie, any tax Act), or (ii) completes or assists in completing a return by another person must both –

1.1 register with or fall under the jurisdiction of a recognised controlling body within 21 business days after the date on which that person for the first time provides the advice or completes or assists in completing the return; and

1.2 register with SARS as a tax practitioner within 21 business days after the date on which that person for the first time provides the advice or completes or assists in completing the return.

2. In section 240(2) is stated that the provisions of subsection (1) above do not apply in respect of a person who only –

2.1 provides the advice or completes or assists in completing a return for no consideration to that person or his or her employer or a connected person in relation to that employer or that person;

2.2 provides the advice in anticipation of or in the course of any litigation to which the Commissioner is a party or where the Commissioner is a complainant;

2.3 provides the advice as an incidental or subordinate part of providing goods or other services to another person; or

2.4 provides the advice or completes or assists in completing a return –

2.4.1 to or in respect of the employer by whom that person is employed on a full-time basis or to or in respect of the employer and connected persons in relation to the employer; or

2.4.2 under the supervision of a registered tax practitioner who has assigned or approved the assignment of those functions to the person.

"While a VDP has its merits and does prevent criminal sanction, in most cases, the VDP application is inappropriate for solving a provisional tax underestimation."

WHAT CAN ATTORNEYS DO NOW?

Among the many reasons why the LPC and SARS had felt it necessary to implement such restrictions, is the fact that they intended to protect the taxpayer as well as the practitioner.

Provisional tax season alone has brought to light many cases of concern when bringing these two worlds together, being tax practice and legal practice, as a consequence of taxpayers wanting to remedy their non-compliance, while seeking a recourse on penalties and interest.

One method that taxpayers are utilising is to simply file their return and hope they can argue against penalties being imposed.

Others attempt a Voluntary Disclosure Programme (VDP) application. While a VDP has its merits and does prevent criminal sanction, in most cases, the VDP application is inappropriate for solving a provisional tax underestimation.

Should a VDP application be inappropriate, a comprehensive application for remission of penalties and interest, with legal grounds, may remedy the non-compliance.

The most effective option may be an application for a compromise of tax debt (the compromise), which brings to light the taxpayer's financial circumstances and ability to pay back the tax debt. To successfully compromise on the tax debt, the taxpayer needs to show current financial hardship, together with an estimation of their net worth. Successful engagements may result in a significant portion of the tax debt being written off.

The correct engagement with SARS ensures tax compliance without the payment of interest and penalties. However, when tax and legal professionals work hand in hand, a more favourable and rewarding outcome is certain.

Roxanna Naidoo

Tax Consulting SA

Acts and Bills

- Tax Administration Act 28 of 2011: Section 240(1) & (2).

Other documents

- Notice released by the Legal Professional Council.

Tags: Voluntary Disclosure Programme (VDP) application; compromise of tax debt.

UNREASONABLE DISCRETION FOR PENALTIES

On 23 August 2021, a full bench of the High Court, Western Cape Division, ruled that a taxpayer had reasonable grounds for the penalty imposed by the South African Revenue Service (SARS) to be remitted.

In this judgment (*PERI Formwork Scaffolding Engineering (Pty) Ltd v Commissioner for the South African Revenue Service*, [2021]), the High Court held that there had been an "unreasonable exercise of the discretion" by SARS in considering a taxpayer's grounds for requesting a remittance of a penalty of R1 064 607.69 which had been levied for the late payment of employee pay-as-you-earn (PAYE) tax. Costs were awarded against SARS.

The taxpayer, PERI Formwork Scaffolding Engineering (Pty) Ltd, paid the PAYE collected of R10 648 340.93 over to SARS on Monday, 8 January 2018, when the payment was ostensibly due on Saturday, 6 January 2018. In terms of the Tax Administration Act, 2011 (the TAA), the payment should have been made on the Friday. The taxpayer requested the remittance of the penalty. SARS rejected this, as well as the taxpayer's subsequent appeal. The taxpayer lost the matter in the tax court, and then appealed to the High Court.

"SARS was required to consider the taxpayer's reasons that were put to it in requesting a remittance of the penalty and was required to weigh these up and apply its mind as to whether these constituted reasonable grounds to waive the penalty."

THE RIGHT TO BE HEARD

The *audi alteram partem* rule, which stands for "hear the other side", is a fundamental legal principle. This is enshrined in section 33 of the Constitution of the Republic of South Africa, 1996, which provides that all administrative action must be lawful, reasonable and procedurally fair.

The Promotion of Administrative Justice Act, 2000, sets out the duties of administrators regarding procedural fairness, including that an administrator should not make a decision that adversely affects someone without consulting them first, and that the decision must be free from any impartiality, bias or prejudice. A taxpayer must therefore be able to put its case forward, which requires SARS to hear it, and to carefully consider it. In other words, SARS must apply its mind to the facts, free from any impartiality, bias or prejudice.

SARS was required to consider the taxpayer's reasons that were put to it in requesting a remittance of the penalty and was required to weigh these up and apply its mind as to whether these constituted reasonable grounds to waive the penalty. This was the taxpayer's first incidence of non-compliance and, on realising that it was short of cash, it immediately took steps to remedy the situation. In the end, the taxpayer was late by only two days.

HIGH COURT

Taxpayer's arguments

The taxpayer argued:

- That it had experienced cash flow problems. The taxpayer's bookkeeper was expecting payments from debtors in early January, which did not materialise. The PAYE was due and payable to SARS within seven days after the end of December 2017.

- That it immediately took steps to raise the funds and managed to raise in excess of R5 million. The weekend delayed the receipt of funds into the taxpayer's bank account to the Monday, at which point the taxpayer immediately paid SARS.

- That its method in calculating the number of days in which payment to SARS should be made, established that payment was only due on 8 January.

SARS' arguments

SARS did not pursue the tax court's reference to a provision in the Fourth Schedule to the Income Tax Act, 1962, which had been repealed in 2011, but which led to the tax court's finding that a taxpayer had a fiduciary duty to SARS in collecting the PAYE and paying this over to SARS.

In the High Court, SARS submitted that paragraph 2(1) of the Fourth Schedule establishes a "relationship between SARS and the various taxpayers who happen to be employers".

For the benefit of understanding, a brief summary follows of this paragraph, which provides that every employer who is a resident, and who pays or becomes liable to pay employees' tax, must pay the amount so deducted or withheld to the Commissioner for SARS within seven days after the end of the month during which the amount was deducted or withheld.

SARS deduced that this led to a relationship between SARS and the taxpayer, on the basis that the taxpayer must pay over the employees' tax withheld to SARS. SARS then expanded on this relationship and submitted to the High Court that the relationship between the taxpayer and SARS is "akin to a fiduciary relationship in that the taxpayer is required to act for the benefit of SARS".

In support of its contention, SARS then relied on the definition of "fiduciary" in Black's Law Dictionary. It is somewhat surprising that SARS resorted to a law dictionary for a definition of fiduciary, as a fiduciary is amply covered in our case law, particularly case law pertaining to company, trust and labour law. However, SARS would still have had to demonstrate how this established a fiduciary relationship between the taxpayer and SARS.

SARS argued that the taxpayer had failed in its fiduciary duty, which required the taxpayer to "observe the highest degree of care" in relation to the PAYE deducted, insulate this amount, not mix it with other business income, and not subject this money to "risks associated with non-payments by third parties". Further, SARS contended that the taxpayer should not have to borrow money from third parties to pay SARS.

"The High Court ruled against the taxpayer's arguments that it had paid SARS in time, stating that the rules set under the TAA are clear, and that if the last day of a period in which the taxpayer is meant to make payment falls on a Saturday, Sunday or public holiday, the payment must be done on the last business day before such Saturday, Sunday or public holiday."

HIGH COURT FINDINGS

Calculation of the days

The High Court ruled against the taxpayer's arguments that it had paid SARS in time, stating that the rules set under the TAA are clear, and that if the last day of a period in which the taxpayer is meant to make payment falls on a Saturday, Sunday or public holiday, the payment must be done on the last business day before such Saturday, Sunday or public holiday.

Fiduciary relationship between the taxpayer and SARS?

The High Court disagreed with SARS' contention that there was a fiduciary relationship between the taxpayer and SARS, opining that there have been "various distinctions between the accountability of a trustee to his beneficiary and the accountability of a debtor to his unsecured creditor".

The High Court referred to the judgment of *Grayston Technology Investment (Pty) Ltd and Another v S*, [2016], where the full bench was of the view that "Grayston stood in the shoes of an agent in respect of either a statutory or civil law obligation of debtor and creditor, pursuant to which relationship it attracted an obligation to pay over *in specie* to SARS or to account for the money actually received or its proceeds".

The High Court clarified that the taxpayer was not precluded from utilising the PAYE money or obliging it to be ring-fenced.

Did the taxpayer have reasonable grounds for the remittance of the penalty?

The High Court found that:

- The taxpayer had a clean record with SARS, and this was the first instance of non-compliance.
- When the taxpayer realised that it would be short of funds it immediately took steps to rectify this. The process of the payment of the additional funds raised by the taxpayer occurred over the weekend and was therefore delayed.
- The taxpayer therefore had reasonable grounds for the penalty imposed to be remitted.

The court held that the taxpayer's appeal must succeed, and the penalty be remitted.

PUNISH THOSE WHO ARE OUTSIDE THE SYSTEM

A penalty should be imposed where a taxpayer has not only abused the tax system but does so consistently. A compliant taxpayer should not be dealt with so harshly where it missed the deadline for a payment for the first time, and where it could provide reasonable grounds for doing so. It appears that the taxpayer's grounds for the remittance of the penalty were not considered.

This harsh treatment of a compliant taxpayer who made an error in calculating its cash flow leaves a bad taste.

Barbara Curson (*first published in Moneyweb*)

Acts and Bills

- Income Tax Act 58 of 1962: Fourth Schedule: Paragraph 2(1);
- Constitution of the Republic of South Africa, 1996: Section 33;
- Promotion of Administrative Justice Act 3 of 2000;
- Tax Administration Act 28 of 2011.

Other documents

- Black's Law Dictionary (definition of "fiduciary").

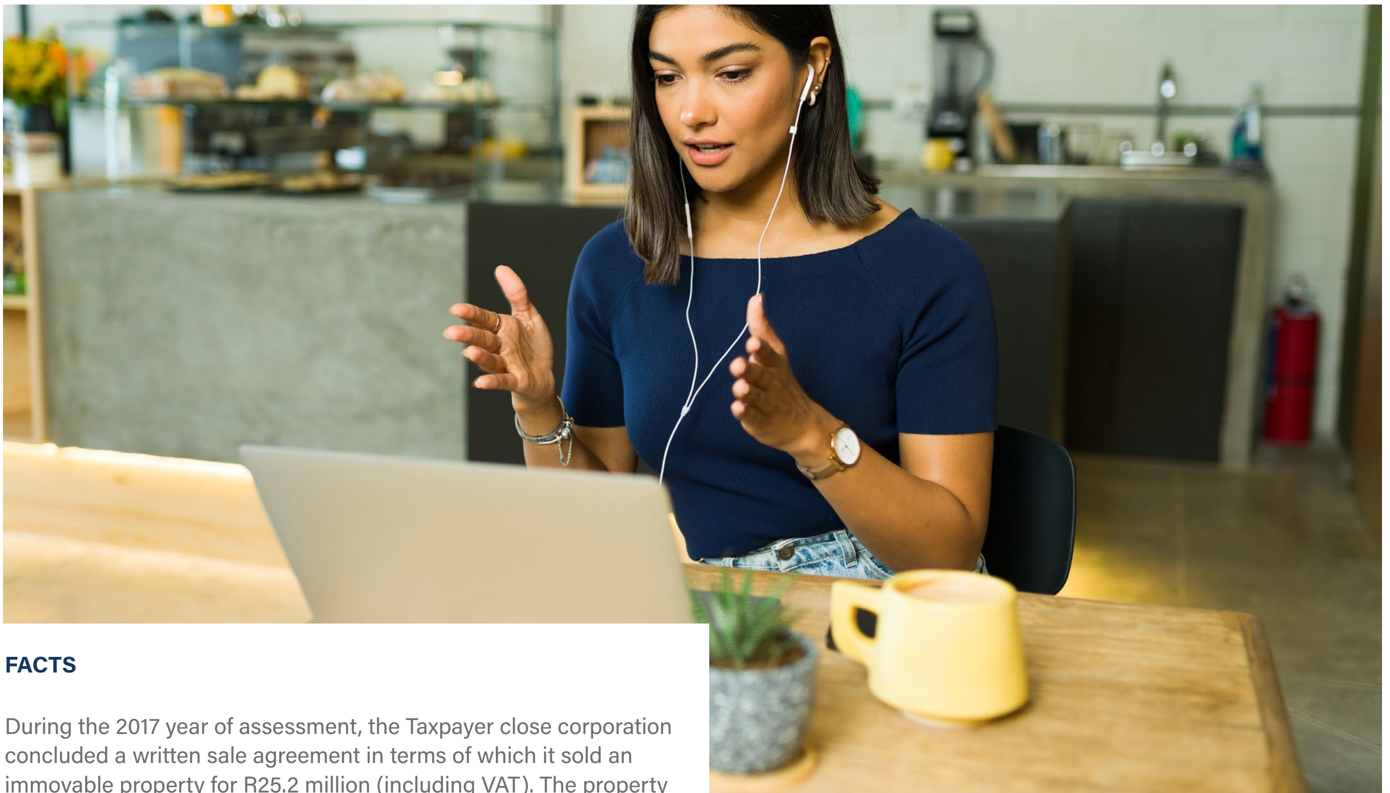
Cases

- *PERI Formwork Scaffolding Engineering (Pty) Ltd v Commissioner for the South African Revenue Service* (A67/2020) [2021] ZAWCHC 165 (23 August 2021);
- *Grayston Technology Investment (Pty) Ltd and Another v S* (A225/2014) [2016] ZAGPJHC 249; [2016] 4 All SA 908 (GJ) (23 September 2016).

Tags: fiduciary relationship; remittance of the penalty.

UNDERSTATEMENT PENALTIES

In the judgment of LDC Taxpayer v The Commissioner for the South African Revenue Service, *[2021], the tax court had to determine whether the South African Revenue Service (SARS) was entitled to impose understatement penalties on LDC Taxpayer (the Taxpayer) and, if so, what the extent of those penalties should be.*



FACTS

During the 2017 year of assessment, the Taxpayer close corporation concluded a written sale agreement in terms of which it sold an immovable property for R25.2 million (including VAT). The property comprised a piece of land with development rights allowing for the subdivision of the property into 72 erven and it was a term of the agreement that the purchase price would be payable to the Taxpayer in tranches on the transfer of each erf to the end user.

On this basis, the sale agreement was entered into, and the transfer of the property was effected in the Taxpayer's 2017 year of assessment. While the Taxpayer accounted for the sale of the property from a VAT perspective in the relevant period, it did not declare the capital gain that arose from the sale of the property in its 2017 tax return as it was of the view that the capital gain would only accrue on the transfer of the individual erven to the third-party end users. As such, the capital gains tax due to SARS as a consequence of the sale was paid by the Taxpayer during the subsequent years of assessment when the erven were on sold.

After an internal audit was conducted by SARS (it was instituted as a result of the inconsistencies between the Taxpayer's VAT return and its income tax return) SARS issued an additional assessment, which included the tax on the relevant capital gain and imposed an understatement penalty (USP) of 25%. The USP was imposed in terms of sections 222 and 223 of the Tax Administration Act, 2011 (the TAA) on the basis of "reasonable care not taken in completing a return".

JUDGMENT

As the dispute regarding the capital gain had been previously resolved between the parties, the tax court appeal instituted by the Taxpayer pertained only to the USP and the tax court was required to determine:

- whether there was an understatement (in the form of an omission in a tax return) which caused prejudice to SARS or the fiscus; and
- if so, whether the understatement arose from a behaviour on the part of the Taxpayer that may appropriately be described as "reasonable care not taken in completing a return".

While the Taxpayer conceded that its failure to disclose or declare the capital gain in its 2017 tax return constituted "an omission" as contemplated in section 221 of the TAA, it contended that no prejudice had been suffered by SARS or the fiscus as a result of the omission. This was due to the fact that all of the tax that had been due to SARS had ultimately been paid by the Taxpayer, albeit in years of assessment other than the year in which the gain originally arose.

The court reiterated that the prejudice suffered by SARS or the fiscus (as contemplated in the TAA) need not necessarily be financial prejudice and disagreed with the Taxpayer's contention that no prejudice had been suffered. This finding was made on the basis that, firstly, the capital gains issue in dispute was complex and the auditor who identified the risk had spent a considerable amount of time considering the matter and verifying the risk. As such, SARS had expended significant time and human capital resources on the matter, which could have been utilised elsewhere, had the Taxpayer not failed to declare the capital gain.

Secondly, despite the full tax liability having been settled by the Taxpayer in subsequent years of assessment (and the issue largely being one of timing), SARS is mandated with collecting targeted amounts of taxes annually. Where the taxes due in a particular year are not recovered in that year, the delay affects SARS' ability to collect revenue as mandated and this ultimately affects the government's ability to fulfil its constitutional obligations to its citizens.

As there had been an omission by the Taxpayer that had caused prejudice to SARS or the fiscus, the court held that there had been an understatement by the Taxpayer in its 2017 tax return which entitled SARS to impose a USP.

In deciding whether SARS had correctly categorised the understatement as being the result of "reasonable care not taken in completing a return", the court had regard to the testimony of the SARS' auditor who had stated that, in hindsight, SARS had incorrectly categorised the understatement penalty. It was indicated by the auditor that the penalty should rather have been based on "no reasonable grounds for 'tax position' taken" (which would have attracted a penalty of 50%). To this end, the court accepted that SARS had erred in imposing a USP of 25% rather than 50%.

The court was then confronted with an additional issue of whether or not it was entitled to increase the USP from 25% to 50% and give effect to the correct classification of the understatement.

In coming to its decision, the court considered section 129(3) of the TAA, which states that, in the case of an appeal against an understatement penalty imposed by SARS under a tax Act, the tax court may reduce, confirm or increase the understatement penalty imposed.

Regard was also had to the judgment of the Supreme Court of Appeal in the case of *Purlish Holdings (Proprietary) Limited v Commissioner for the South African Revenue Service*, [2019], in which it was held that the tax court may only reduce or increase a USP if such increase (or reduction) has been properly raised for adjudication before the court.

As SARS had not raised the matter of an increase of the USP in its statement of grounds of assessment, the tax court found that it was not competent to increase the 25% USP to 50%. The court did, however, conclude that its inability to increase the USP in this instance did not allow the Taxpayer to escape liability for the USP that SARS imposed. As such, the Taxpayer's appeal was dismissed, and the Taxpayer was ordered to pay the USP of 25%.

COMMENT

This judgment serves as another reminder of the importance of detailing all of the issues that are to be adjudicated before the tax court in either SARS' statement of grounds of assessment, or the taxpayer's statement of grounds of appeal. The failure to do so may have a significant impact on the issues to be decided by the tax court.

It is worth noting that the rules promulgated in terms of section 103 of the TAA make provision for the amendment of the aforementioned statements either by agreement between SARS and the taxpayer or, in the absence of such agreement, by means of an application to the tax court to amend the relevant statement.

Louise Kotze

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 103, 129(3), 221, 222 & 223.

Cases

- *LDC Taxpayer v The Commissioner for the South African Revenue Service* (IT 24888) [2021] ZATC 6 (18 June 2021);
- *Purlish Holdings (Proprietary) Limited v Commissioner for the South African Revenue Service* (76/18) [2019] ZASCA 04; 2019 JDR 0301 (SCA).

Tags: additional assessment; understatement penalty.