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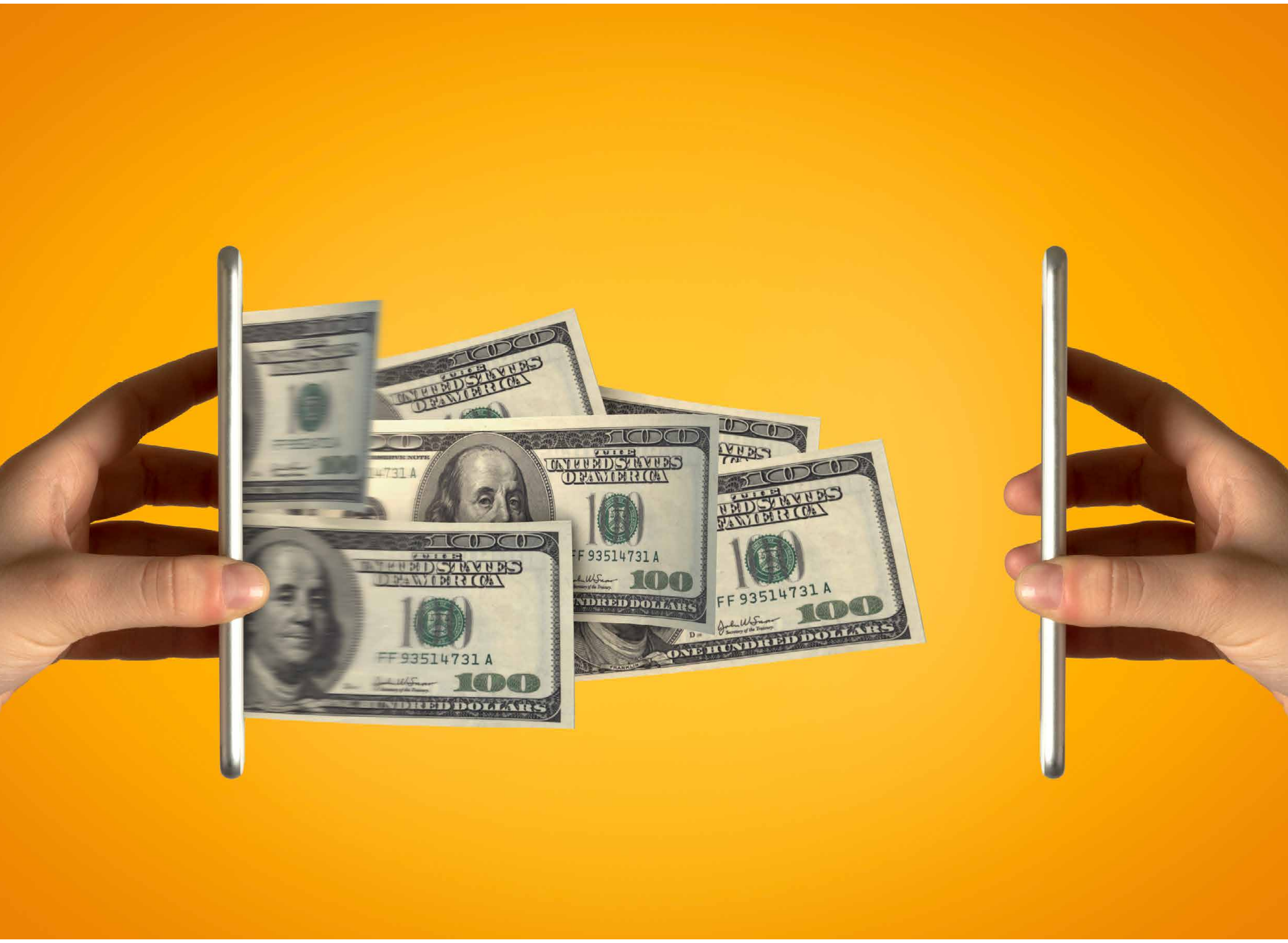

DEDUCTIONS AND ALLOWANCES
THE CONSTITUTIONAL COURT RULES ON SECTION 24C

TAX ADMINISTRATION
APPOINTMENT OF THIRD PARTY TO COLLECT DEBTS

VALUE-ADDED TAX
SINGLE AND SEPARATE SUPPLIES

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Paying tribute to Mr Zweli Mabhoza

The Editorial Panel of Tax Chronicles Monthly is saddened to report the sudden passing of our dear friend, our respected colleague and longtime member of our panel. His contribution to the work of the team will be very sorely missed. We extend to his wife, Cindy, and the rest of his family our deepest sympathies in their tragic loss.

Tax Chronicles Monthly is published as a service to members of the tax community and includes items selected from the newsletters of firms in public practice and commerce and industry, as well as other contributors. The information contained herein is for general guidance only and should not be used as a basis for action without further research or specialist advice. The views of the authors are not necessarily the views of the editorial panel or the South African Institute of Tax Professionals.

BROADENING THE TAX SCOPE

The use of cryptocurrencies and other crypto assets is becoming increasingly popular, especially in an economic climate in which fiat currency exchange rates are unsteady and volatile. In the South African tax context, the authorities previously considered, to a large extent, only the tax treatment of cryptocurrencies. The intended tax treatment of cryptocurrencies has manifested in three distinct ways:

1. The SARS announced, in a media statement issued on 6 April 2018, that it would apply normal income tax rules to cryptocurrencies, in terms of which specific regard will be had to the revenue or capital nature of the cryptocurrencies held;

2. Early in 2019, the Income Tax Act, 1962 (the Act), was amended to include cryptocurrencies in the definition of "financial instrument" in section 1(1). The Act was further amended to provide, in terms of section 20A, that the acquisition or disposal of cryptocurrencies will constitute a trade in respect of which any losses that are incurred will be ring-fenced; and

3. In the Value-Added Tax Act, 1991 (the VAT Act), the definition of "financial services" was amended to include the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency (see section 2(1)*(o)*).

Given the renown of the concept of cryptocurrencies and their growing popularity, it is unsurprising that the lesser known types of crypto assets have received much less consideration from the tax authorities. However, there are, at present, mainly four types of crypto assets, namely:

- Cryptocurrencies;
- Platform tokens or cryptocommodities;
- Utility tokens; and
- Transactional tokens.

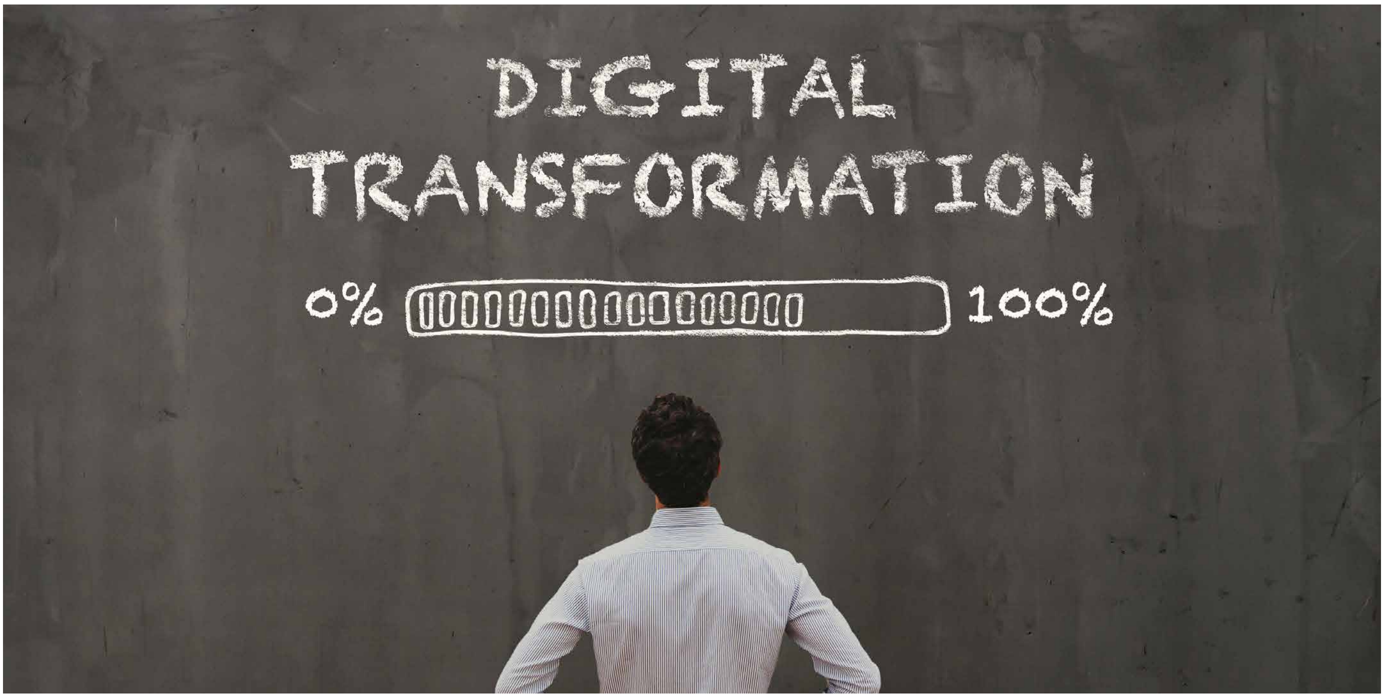
Each of these types of crypto assets utilises cryptography and a public ledger to regulate the creation of new crypto asset units, to verify transactions, and to secure those transactions through the use of peer-to-peer networking, thereby eliminating the need for a "middleman".

There has been significant speculation regarding how these other crypto assets will be treated for tax purposes and whether the tax treatment will be the same as that of cryptocurrencies. Many international jurisdictions are not drawing any distinction between the various types of crypto assets; it appears from the Taxation Laws Amendment Bill, 2020 (the TLAB), which was introduced in the National Assembly on 28 October 2020, that National Treasury has elected to follow suit. The TLAB proposes amendments to the definition of financial instrument in section 1(1) and to section 20A of the Act, which provisions will now make reference to the wider concept of crypto assets, rather than just to cryptocurrencies.

The statutory inclusion of all crypto assets in the relevant provisions of the Act suggests that the normal tax treatment that is to be applied to cryptocurrencies as per the media statement issued by SARS will apply equally to all types of crypto assets.

However, while the TLAB is proposing amendments to the provisions of the Act with regard to the taxation of crypto assets, there is no proposed amendment to the definition of financial services in section 2(1)*(o)* of the VAT Act. This has the effect that the Act will be widely applicable to all crypto assets, while the exemption provided for in the VAT Act will apply only to transactions pertaining to cryptocurrencies and not to transactions utilising other types of crypto assets.

It is uncertain whether this is an unintended oversight or whether it is intended that the exemption from VAT provided for in respect of financial services in the VAT Act be limited only to cryptocurrencies.



Cliffe Dekker Hofmeyr

Acts

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "financial instrument") & 20A;
- Value-Added Tax Act 89 of 1991: Section 2(1)*(o)*.

Other documents

- Taxation Laws Amendment Bill 27 of 2020.

Tags: cryptocurrencies; crypto assets; financial instrument cryptography; public ledger.

HOME OFFICE EXPENSES

In these difficult times, it appears that many employers are receiving questions from their employees regarding whether, and how, they can assist their employees in being able to claim a personal tax deduction in respect of working from home. In this article, we will be discussing the possible deduction an employee could claim for home office expenditure and to what extent, if any, an employer can assist employees in making such a claim.

Amongst the COVID-19 tax changes that have been announced so far, as well as in the tax proposals in the Taxation Laws Amendment Bill, 2020, nothing has been announced in terms of any special relief provisions for employees now needing to work from home. Therefore, one should look to existing legislation and guidelines to determine any relief available. Although there have been some requests for specific changes to this legislation in light of the COVID-19 developments, National Treasury has resisted any pressure in this regard, presumably on the basis that current provisions suffice.

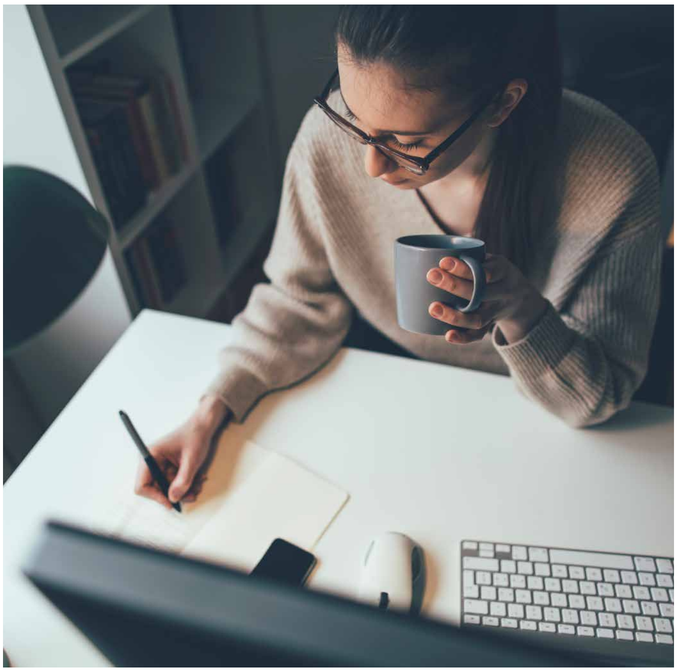
GENERAL REQUIREMENTS TO BE MET

Without getting too technical, one needs to understand some basic mechanisms of the Income Tax Act, 1962 (the Act). The first is that taxpayers are not permitted to deduct private or domestic expenditure in their tax return, except in a few specific instances (eg, retirement fund contributions, etc). A general deduction needs to meet the requirements of sections 11*(a)* and 23*(g)* of the Act to be an allowable deduction. These requirements are that an expense or loss –

- must actually be incurred;
- must be in the current year of assessment;
- must be in and for the purposes of carrying on of any trade (including employment);
- must be incurred "in the production of income"; and
- may not be capital in nature.

REQUIREMENTS SPECIFIC TO AN EMPLOYEE

Further to the above requirements, section 23*(m)* limits the possible deductions that are available for an employee in particular, once again to certain specific expenses (eg, retirement fund contributions, certain legal fees, depreciation, etc). In other words, even if all the above requirements are met, one would still need to ensure that section 23*(m)* does not limit that expenditure. Fortunately, home office expenditure is permitted under section 23*(m)*.



Where an employee is incurring (non-capital) expenditure during COVID-19 in respect of an office at home in order to render services to an employer, one would be satisfied that, on the face of it, the above requirements are met. However, it is worth mentioning that one must always ask the question "are my expenses incurred directly related to my employment, or in the production of my income?"

Improvements to one's home, such as building on an additional room to use as an office, will not be deductible, since that expense is typically capital in nature. Allowable non-capital home office expenses usually include stationery, telephone bills, rent, rates and taxes, interest on bond repayments, cleaning expenses, wear and tear on assets, internet expenses and repairs. It is also important to note that any items that the employer provides to the employee, such as laptop computers, 3G cards or office furniture, would in any event not be deductible in the employee's hands since it is not an amount actually incurred by the employee. The tax consequences of employer-provided equipment and furniture are not discussed in depth in this article.

Once one is satisfied that the above requirements are met (ie, in principle the expenses are deductible in terms of section 11*(a)* and not specifically prohibited in terms of section 23*(m)*), an employee or office holder in receipt of remuneration must ensure that the requirements of section 23*(b)* are also met. In order for the home office expense to qualify under this section (being typically a pro rata percentage of mortgage interest, rates and utilities, rent and/or levies, based on the floor area of the office compared to the total floor area of the house), once again the normal rules governing employees being able to claim a tax deduction for such expenses would apply. In terms of section 23*(b)*, an employee would only be entitled to claim such an expense if –

- the area used as a home office is specifically equipped for purposes of the taxpayer's trade only; and
- the area in question is regularly and exclusively used for such purposes (ie, it cannot be a dining room table or a desk in a spare bedroom, but must be an area specifically set up as an office and used only for that purpose); and
- the employee's income consists mainly of commission or other variable payments which are based on the employee's work performance *or* the employee's duties are mainly* performed in the home office. [*The word "mainly" has been interpreted to mean more than 50%.]

From the above specific requirements of section 23*(b)*, it is clear that not all employees who have been working from home during the lockdown period will qualify for a home office deduction. Only those who meet all of the required provisions will qualify and the onus will be on them to prove these facts, should SARS query the claim.

REQUIREMENTS TO WORK MAINLY FROM HOME

The question has arisen as to whether the fact that the employee's duties must be performed in the home office in light of COVID-19 requirements is sufficient to meet that part of the requirement, or whether the employer must specifically direct the employee to work from home. There is some guidance from the courts on this matter.

In *Kommissaris van Binnelandse Inkomste v Van der Walt*, [1986] (a case that was decided before the current versions of section 23*(b)* and *(m)* were in force), it was held that a university lecturer could claim his home study expenses, where he worked after hours as a lecturer and doctoral candidate. He established the necessary connection between expenditure claimed and his earnings, since he showed that he had, in good faith, incurred the expenditure for the more efficient discharge of the duties of his employment. This leads one to conclude that there is no requirement for the employer to expressly instruct the employee to work from home in order to meet this requirement. It is a factual enquiry as to whether the employee did in fact mainly perform their duties of employment in their home office or not. If the employee is able to prove that they mainly performed their duties from their home office, then this requirement should be met. Nevertheless, it would still be preferable if the employee was able to prove that working from home was a requirement by the employer.

CAPITAL GAINS TAX CONSEQUENCES

An often overlooked but important point to note is the future capital gains tax consequences of the above for the employee. Where an employee works at home and claims a tax deduction in respect of home office expenses, that home office now becomes a place of trade and no longer forms part of the employee's primary residence. Normally, when a primary residence is sold, there is an exclusion from the capital gains tax calculation for such primary residence, known as the primary residence exclusion. A person who has claimed a tax deduction in respect of home office expenditure will now have to apportion the primary residence exclusion to only the portion of the house that is used for residential purposes, ie they will have to exclude the square metres of the home office. For example, if the area of the home office is 10% of the total area of the house, then the primary residence exclusion up to R2 million can only be claimed on the 90% remaining portion of the capital gain on the disposal of the property.

"As is evident from the above, the rules for claiming home office expenses are very strict and not of general application, since very specific requirements need to be met to enable an employee to claim such an expense as a tax deduction."

CONCLUSION

As is evident from the above, the rules for claiming home office expenses are very strict and not of general application, since very specific requirements need to be met to enable an employee to claim such an expense as a tax deduction. From a practical perspective, the employee would need to complete the ITR12 tax return to claim such expenditure and can expect some practical challenges in being able to claim the expense in their tax return on efiling. Since the onus of proof is on the taxpayer, SARS will very likely ask a taxpayer making a home office claim to prove that all the above requirements are met and will typically disallow the expenditure if they are of the view that all the necessary requirements have not been met or if the employee is unable to prove the expenditure claimed.

Since there appears to be much misinformation in the public domain regarding this matter, employers are advised to inform their employees of the requirements to qualify to claim home office expenses as a tax deduction in their tax returns and also to point out the potential implications for them if they do. Employees should be counselled to proceed with caution as regards claiming a tax deduction for home office expenses and preferably be advised to obtain tax advice from a reputable tax adviser before embarking on the process. If the demand warrants it, employers could consider holding information sessions for their employees (via an appropriate online forum) where the requirements are explained, risks are pointed out, employees afforded an opportunity to ask questions, and misinformation clarified by a suitably qualified tax expert.

PWC

Editorial comment: See also Interpretation Note 28.

Acts

- Income Tax Act 58 of 1962: Sections 11*(a)* & 23*(b)*, *(g)* & *(m)*.

Other documents

- Taxation Laws Amendment Bill 27 of 2020;
- ITR12 tax return;
- Interpretation Note 28 (Issue 2).

Cases

- *Kommissaris van Binnelandse Inkomste v Van der Walt* [1986] (4) SA 303 (T); 48 SATC 104.

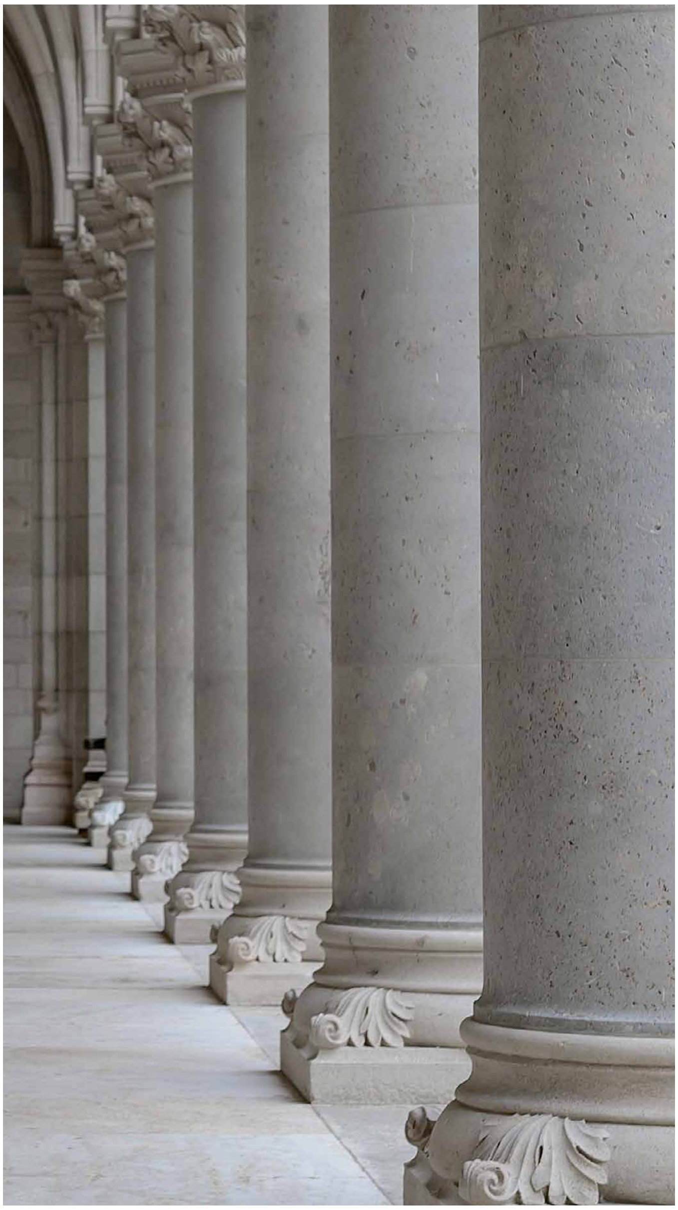
Tags: home office expenditure; non-capital home office expenses; primary residence.

THE CONSTITUTIONAL COURT RULES ON SECTION 24C

On 21 July 2020, the Constitutional Court (the CC) handed down judgment in Big G Restaurants (Pty) Ltd v Commissioner for the South African Revenue Service, *[2020], which concerned section 24C of the Income Tax Act, 1962 (the Act). At issue before the CC was whether future expenditure incurred in terms of a franchise agreement was deductible against income derived by the taxpayer, Big G Restaurants (Pty) Ltd (Big G) from operating its franchise business.*

In terms of section 24C, a taxpayer can claim an allowance in respect of future expenditure to be incurred, if certain requirements are met. The requirements are the following:

- Income must be received by or accrue to the taxpayer in terms of a contract;
- The income received by or accruing to the taxpayer must be used in whole or in part to finance future expenditure which will be incurred by the taxpayer; and
- The expenditure must be incurred by the taxpayer in the performance of the taxpayer's obligations under such contract.



BACKGROUND

Big G is a franchisee operating a number of Spur and Panarottis restaurants in terms of various written franchise agreements concluded with a franchisor, the Spur Group (Pty) Ltd (Spur Group). Big G claimed a section 24C(2) allowance for the 2011–2014 years of assessment for the future costs of revamping its restaurant premises. The costs of revamping its premises were the direct result of a stipulation in the franchise agreements that Big G should periodically revamp the premises.

"The Supreme Court of Appeal rejected Big G's arguments and reasoned that the income was received as a result of the contracts Big G concluded with individual patrons."

Big G claimed the allowance on the basis that, for purposes of section 24C(2), the income that it received from patrons in terms of individual contracts of sale, was income received in terms of the franchise agreements between it and the Spur Group. Therefore, it argued that the costs of revamping the premises constitute "future expenditure" as envisaged in section 24C. Future expenditure is defined as an amount of expenditure which will be incurred after the end of a year of assessment –

- in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or
- in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of the Act.

The Commissioner for the South African Revenue Service (SARS) disallowed the allowance claimed by Big G, on the basis that an allowance in terms of section 24C can only be claimed in respect of income that accrued in terms of the same contract that imposes the obligation to incur future expenditure for the allowance being claimed. The income in respect of which Big G was claiming the allowance was income that accrued in terms of contracts concluded by it with individual patrons at its restaurants and the obligation to incur future expenditure is not imposed by those contracts. SARS argued that the future expenditure was imposed by different contracts, these being the franchise agreements between Big G and the Spur Group.

TAX COURT

The stated case before the Tax Court was that there were two questions of law to consider:

- firstly, whether the income received by Big G from operating its franchise businesses includes or consists of any amount received by or accruing to it in terms of the franchise agreements; and
- secondly, whether the expenditure required to refurbish or upgrade is incurred by Big G in the performance of its obligations under such contract as envisaged in section 24C.

According to the Tax Court, the franchise agreements imposed an obligation on Big G to actively provide and sell meals to patrons and although the patrons were not parties to those agreements, the proximate cause of those sales was this obligation. It further held that the expenses to be incurred in making the refurbishments by Big G were sufficiently certain to warrant an allowance in terms of section 24C.

The Tax Court therefore concluded that Big G was entitled to claim the allowance under section 24C for the 2011–2014 years of assessments.

SUPREME COURT OF APPEAL

In the Supreme Court of Appeal, Big G conceded that it would not earn any income if it did not provide meals to patrons, but persisted with the contention that it was obliged do so in terms of the franchise agreements, which was its source of income and which stated how it had to operate its restaurant.

The Supreme Court of Appeal rejected Big G's arguments and reasoned that the income was received as a result of the contracts Big G concluded with individual patrons. Accordingly, it found that the income did not accrue to Big G in terms of the franchise agreements.

According to the Supreme Court of Appeal there is a direct and immediate connection between the requirements of section 24C, meaning that in order for Big G to claim the allowance, the income must be earned from the same contract in terms of which the obligations are incurred. The fact that the income and obligations must originate from the same contract, pointed to the conclusion that the allowance in section 24C was intended to apply to cases where income earned in terms of a contract is received before expenditure will be incurred to perform obligations under the same contract.

The Supreme Court of Appeal also rejected Big G's argument that the franchise agreement and the contracts with patrons were inextricably linked, and that both contracts required Big G to service meals to its patrons to earn income, out of which franchise fees were payable to the franchisor. According to the Supreme Court of Appeal, section 24C required Big G to incur expenditure in the performance of its obligations in terms of the same contract under which income is received. The operative concept according to the Supreme Court of Appeal was one of contract and not a scheme or transaction.

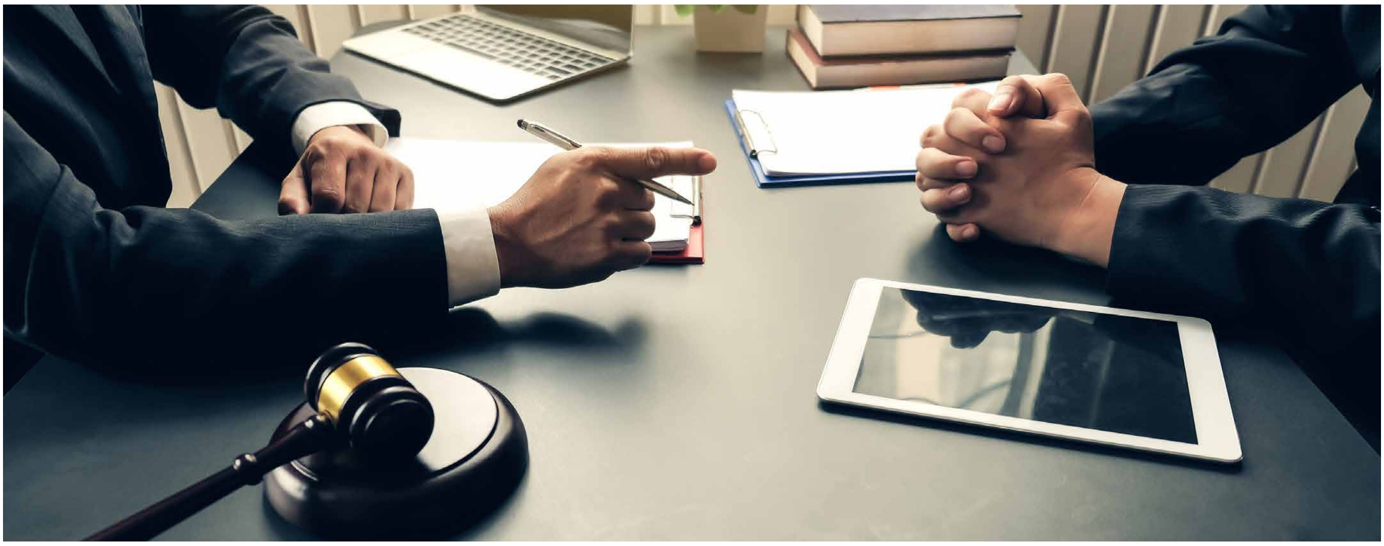
CONSTITUTIONAL COURT

On appeal in the CC, Big G argued that the matter turned on the interpretation of the words "in terms of" in section 24C, and this raised an arguable point of law of general public importance which ought to be considered by the CC.

The majority of the CC, per Madlanga J, agreed with Big G that the interpretative question was a quintessential point of law that engaged the jurisdiction of the CC. The CC held that the matter required the interpretation of the relevant contracts, so as to determine whether they were so interlinked as to fall within section 24C(2) and this in turn, required an interpretation of section 24C(2).

On the merits, Big G submitted that the countless contracts of sale of food are, and have to be read as, part of the franchise agreement. So read, the income earned in terms of the sale of food contracts is income earned in terms of the franchise agreement.

"According to the Supreme Court of Appeal, section 24C required Big G to incur expenditure in the performance of its obligations in terms of the same contract under which income is received."



Big G also placed reliance on the judgment of the Tax Court, which held that the franchise agreement itself imposed an obligation on the franchisee to sell food, something which constitutes the sole business of the franchisee in terms of that agreement and therefore the income generated from the sale of those meals is as a result of that contract.

According to the CC, under section 24C the contract in terms of which income is received or accrues (income-earning contract) must be the same contract that imposes the obligations, the performance of which are to be financed with that income (obligation-imposing contract). This to the CC demonstrated a requirement of "sameness". However, the CC did not read the sameness requirement in the section to connote that there must be one single contract stipulating for the earning of income and the imposition of future expenditure. Two or more contracts may be so inextricably linked that they may satisfy this requirement.

The CC was, however, not satisfied that Big G had been able to place the contracts in terms of which it earns an income from its patrons within the ambit of the income-earning contract envisaged in section 24C. Furthermore, the obligations that Big G has to perform are imposed, not by the sale of food contracts, but by the franchise agreements. This lack of correlation between the income-earning contracts and obligation-imposing contracts plainly made section 24C inapplicable.

Furthermore, according to the CC, Big G was not without recourse as it would be entitled to a deduction in terms of section 11 of the Act. It is just that it will not be able to make an upfront deduction under section 24C.

In a separate concurrence, Majiedt J agreed with the outcome and order of the main judgment but disagreed on the finding that the matter engaged the jurisdiction of the CC. According to Majiedt J, it could not be that an enquiry into which of two contracts gives rise to the income, or whether they can be regarded as a single contract for the purpose of interpreting the phrase "in terms of", amounts to a constitutional issue or an arguable point of law of general public importance.

COMMENT

There are two important issues that emerge from this judgment, the first being that from a practical perspective in order for a taxpayer to claim the allowance in terms of section 24C, there is a sameness requirement that it must satisfy.

The second issue is that whereas the Supreme Court of Appeal rejected the argument that two separate contracts could be so inextricably linked as to meet the requirements of section 24C, it appears that the CC accepted this argument. It reasoned that the requirements of section 24C did not preclude the existence of two or more contracts that may be so inextricably linked, under which circumstances the allowance could potentially be claimed. However, it seems that the CC left open the question regarding the degree to which two or more contracts had to be interlinked in order to satisfy the sameness requirement in section 24C.

Cliffe Dekker Hofmeyr

Acts

- Income Tax Act 58 of 1962: Sections 11 & 24C.

Cases

- *Big G Restaurants (Pty) Ltd v Commissioner for the South African Revenue Service* [2020] ZACC 16; 2020 (6) SA 1 (CC).

Tags: future expenditure; income-earning contract.

WEAR-AND-TEAR ALLOWANCE

IN BRIEF

On 24 March 2020, the SARS published Issue 4 of Interpretation Note 47 (IN47), which deals with the wear-and-tear or depreciation allowance that is provided for in section 11*(e)* of the Income Tax Act, 1962 (the Act). The new IN47 is important on the basis that it constitutes a binding general ruling made under section 89 of the Tax Administration Act, 2011. The changes apply in respect of any qualifying asset brought into use on or after 24 March 2020.

The purpose of this article is to provide a brief overview of the most important changes to IN47 compared to the previous version.

OVERVIEW OF THE CHANGES

The annexure to IN47 (ie, the schedule of write-off periods acceptable to SARS (the Schedule) provides a list of assets and the relevant write-off periods that SARS considers acceptable. Certain assets have been added to this list, and there has been a change to the proposed write-off period for certain types of computer software.

In addition, the following new paragraphs have been inserted into IN47:

- Paragraph 4.1.3 ("improvements to existing assets");
- Paragraph 4.2.7 ("limitations of allowances to lessors of certain assets"); and
- Paragraph 4.3.10 ("personal-use assets commencing to be used for trade purposes").

THE REVISED SCHEDULE

The following changes have been made to the Schedule:

- The proposed write-off period for *computer software (main frames) – self developed* has been increased to five years from one year.
- Certain assets have been added to the Schedule, ie:
  - Computer tablet and similar devices (with a proposed write-off period of two years); and
  - Magnetic resonance imaging scanners (with a proposed write-off period of five years).

IMPROVEMENTS TO EXISTING ASSETS (NEW PARAGRAPH 4.1.3 OF IN47)

This new paragraph draws attention to the distinction between expenditure incurred on repairs that qualifies for immediate deduction under section 11*(d)* of the Act and amounts that qualify for deduction over a period under section 11*(e)*.

A brief discussion on the principles that apply in making a determination as to whether a particular expense constitutes a repair or an improvement is provided. In this regard, reference is made to case law (the principles set out in *ITC491* [1941] and *ITC617* [1946] are briefly discussed). In terms of these decisions, a repair generally involves the replacement or renewal of something that has become defaced or worn out through use or wear-and-tear, while a renewal (or improvement) generally involves some form of reconstruction of the "entirety" of the thing being improved (which is not necessarily the whole but is substantially the whole).

Finally, it is stated in this paragraph that where an improvement results in the extension of the useful life of an asset, any remaining pre-existing tax value (plus the cost of the improvements) must be written off over the remaining useful life of the asset.

LIMITATION OF ALLOWANCES TO LESSORS OF CERTAIN ASSETS (NEW PARAGRAPH 4.2.7)

This paragraph briefly discusses the interaction of sections 23A and 23G of the Act with section 11*(e)*.

Section 23A effectively limits capital allowances (including the section 11*(e)* allowance) claimable on any "affected asset" (ie, generally, certain assets that are let) to the taxable income of the lessor derived from "rental income".

In the case of section 23G, a lessor of an asset in a sale and leaseback arrangement will be denied an allowance on that asset under section 11*(e)* if the receipts or accruals of the lessee in that arrangement do not constitute income.

PERSONAL-USE ASSETS COMMENCING TO BE USED FOR TRADE PURPOSES (NEW PARAGRAPH 4.3.10)

This new paragraph draws attention to SARS' view that, although the section 11*(e)* allowance is generally based on cost, it is unacceptable to use the original cost when the asset has been diminished in value by personal use before it is used for trade purposes.

IN47 therefore states that, in such circumstances, the expected useful life of the asset must be determined on the date that it is brought into use in the trade, having regard to its condition, and it must be written off over that period.

Although not specific to personal-use assets, this new paragraph also deals with the situation in which an asset was originally acquired for no consideration (or for a non-arm's length consideration). In these circumstances, IN47 requires that the asset be depreciated based on the lower of the original market value at the date of acquisition and the market value at the time that it is brought into use in the taxpayer's trade.

"This new paragraph draws attention to SARS' view that, although the section 11*(e)* allowance is generally based on cost, it is unacceptable to use the original cost when the asset has been diminished in value by personal use before it is used for trade purposes."

PWC

Acts

- Income Tax Act 58 of 1962: Sections 11*(d)* & *(e)*, 23A & 23G;
- Tax Administration Act 28 of 2011: Section 89.

Other documents

- Interpretation Note 47 (Issue 4).

Cases

- *ITC491* [1941] 12 SATC 77;
- *ITC617* [1946] 14 SATC 474.

Tags: write-off period; personal-use assets; rental income.

TAX PROCEDURES DURING LIQUIDATION

In CSARS v Pieters and Others, *[2018], the Supreme Court of Appeal (SCA) was tasked with deciding whether liquidators were required to withhold employees' tax from payments made to employees under section 98A of the Insolvency Act, 1936. The company in question was an insolvent transport company which had employed approximately 700 people. Forty-five days after the appointment of the liquidators, the employment contracts for these employees were terminated under section 38(9) of the Insolvency Act.*

"The key issue that the SCA had to decide was whether the liquidators were obliged to withhold employees' tax on payments made in terms of section 98A of the Insolvency Act."

During the liquidation process, the employees accrued salary entitlements, leave pay and severance pay. The liquidators determined the quantum thereof and paid amounts owing to them in terms of the provisions of the Insolvency Act.

SARS objected to the liquidation and distribution (L&D) account lodged by the liquidators, on the basis that no provision had been made for the payment of employees' tax (PAYE) in respect of the payments made by the liquidators. The Master of the High Court accepted SARS' objection and ordered the liquidators to amend the L&D account to reflect the employees' tax as administration costs and deduct the actual employees' tax payable from their liquidators' fee.

As stated above, the key issue that the SCA had to decide was whether the liquidators were obliged to withhold employees' tax on payments made in terms of section 98A of the Insolvency Act.

SARS argued that the liquidators fell within the definition of "employer" where they made these payments. The Master of the High Court agreed and ordered the liquidator to amend the liquidation and distribution account.

The SCA held that the provisions in the Insolvency Act were clearly social justice provisions aimed at alleviating the plight of being unpaid as an employee as a result of the financial woes of an employer. The court held that the provisions in the Fourth Schedule to the Income Tax Act do therefore not apply to payments made under section 98A of the Insolvency Act. To categorise PAYE as costs of administration would have the effect that income tax, attributable to the company's trade before liquidation and which thus becomes payable before the liquidation, would also be a cost of administration. That is plainly untenable. On this basis, SARS' appeal was dismissed.

mstGROUP

Acts

- Insolvency Act 24 of 1936: Sections 38(9) & 98A;
- Income Tax Act 58 of 1962: Fourth Schedule.

Cases

- *CSARS v Pieters and Others* (1026/17) [2018] ZASCA 128 (27 September 2018).

Tags: employees' tax; liquidation and distribution account; cost of administration.

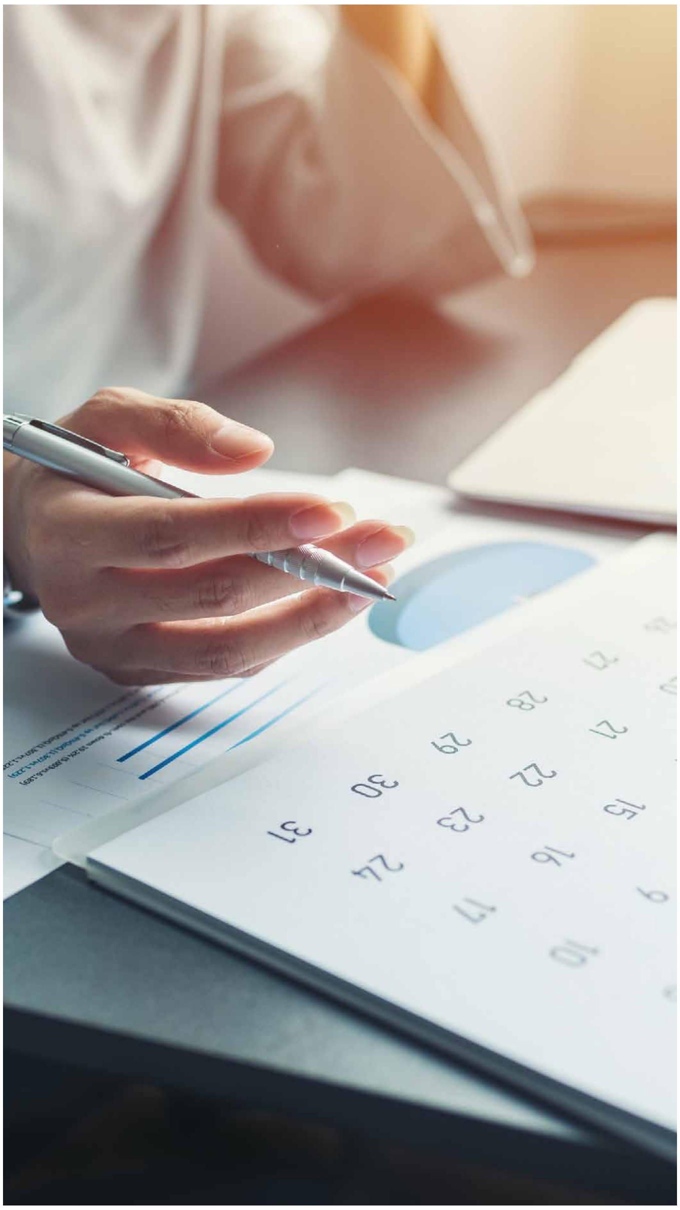
TAX DUE DILIGENCE

The Coronavirus (COVID-19) crisis has presented significant challenges to many companies and the disruption continues to evolve. Undertaking detailed performance and liquidity operational improvement initiatives, streamlining corporate structures, reducing complexity and focusing on core activities are what most businesses are currently looking at. Divesting non-core activities in an effort to focus resources exclusively on core operations has become an important consideration.

Buyers with abundant cash who are looking at effective deployment of their capital have been presented with such opportunities. In the context of extremely subdued industries, assets can come at bargain prices. Distressed asset acquisitions can provide buyers with increased revenue streams through the expansion of a geographic footprint, access to new technologies or other elements within a supply chain and elimination of competition through which the acquisition capacity, technology or other advantages are prevented from falling into the hands of a competitor.

One area that could be overlooked in the excitement of wanting to seize the opportunity quickly is tax due diligence which, if disregarded, can put a buyer at significant risk, particularly with respect to a possible share purchase. In a share purchase, a buyer takes the company "warts and all": all assets and liabilities of the target company remain with the target and the buyer becomes responsible for any liabilities associated with the target including those found after the sale is complete.

On the buyer's side tax due diligence seeks, *inter alia*, to investigate the target's business operations in order to identify actual and potential tax risk exposures arising out of overstated losses, underreported tax liabilities, non-filing exposures, failure to charge taxes, payroll errors, and other tax miscalculations in the various jurisdictions in which the target has sufficient business connection to be subject to tax. Failure to understand the tax issues of the target could be a threat to the return of a buyer's investment. Buyers should carefully scrutinise the taxation history of the target to identify any hidden or unforeseen tax liabilities in order to incorporate in their deal negotiations mitigation strategies such as adequate structuring of representations and warranties, consideration of escrows, alternative transaction structures, a purchase price reduction or an earn-out or seizing an opportunity to require the target to regularise its tax affairs or enter into a voluntary disclosure to mitigate the issue before the purchase takes place.



On the seller's side tax due diligence conducted in order to recognise and remedy any major tax issues that could be of concern to even the most demanding purchaser before launching a formal sale process can also not be understated. The seller's tax due diligence affords the seller an analysis of its business with a buyer's perspective in mind enabling the seller to anticipate a buyer's view on taxes. A solid "tax health", an attractive business tax policy and tax risk management framework and a clear understanding of key tax negotiating points when it comes to the target could provide the seller with an "upper hand" during the sale negotiation process.

Whether on the buyer's side or seller's side, the tax due diligence investigation will include, *inter alia* –

- examining the tax effects of significant, unusual and complex transactions entered into, including tactical or uncertain tax positions before the time of the sale or purchase;

"In a share purchase, a buyer takes the company 'warts and all': all assets and liabilities of the target company remain with the target and the buyer becomes responsible for any liabilities associated with the target including those found after the sale is complete."

- examining past and ongoing tax audits conducted by the tax authorities having regard to what prompted the audit, and whether there is a risk of assessment of additional taxes;
- reviewing all pending disputes and examining formulated response strategies;
- understanding any past voluntary disclosure applications, past and still in-force tax rulings and tax directives;
- analysing the tax returns filing status;
- reviewing the tax risk management framework, including the tax relevant processes;
- where business activities are carried out offshore, reviewing any permanent establishment, transfer pricing and foreign tax credit issues including exchange control compliance;
- analysing business contracts entered into with third and related parties, employment contracts and share incentive plans, etc;
- particularly for international investors, checking whether the target should be purchased directly or through a holding company leveraging the investment; and
- making a prudent decision on whether an asset deal, a share deal or a merger is the suitable option.

A tax due diligence empowers a seller or buyer to make more informed decisions pertaining to the transaction. One can opt for an in-depth tax due diligence analysis or a red flag tax due diligence that only identifies the riskiest or possible deal-breaker tax issues.

The old expression has it that there are only two things in life that we can't avoid, death and taxes and when it comes to taxes what you do not know can hurt you. So, on whichever side you find yourself, whether on the buyer side or seller side, you cannot afford not to be diligent.

ENSafrica

Tags: tax due diligence; tax liabilities; tax audits; exchange control compliance.

APPOINTMENT OF THIRD PARTY TO COLLECT DEBTS

In SIP Project Managers (Pty) Ltd v Commissioner for the South African Revenue Service*, [2020], the Gauteng Division of the High Court ruled against SARS on the appointment of a third party (Standard Bank, in this case) to collect tax debts from taxpayers' accounts. The matter was an application for declaratory relief against SARS for such an appointment to be set aside and declared null and void, and for SARS to repay an amount of R1,261,007 which had been paid over by Standard Bank as the third-party agent to SARS.*

In its application, SIP contended that no letter of demand was received from SARS as is required in section 179 of the Tax Administration Act, 2011 (the TAA). SIP also submitted that if the court found that the letters had been delivered, then these had been premature, and that no debt was yet due or payable at that time, and that the 10 business days (as is required in the TAA) had not expired before the delivery of the third-party notice.

The TAA stipulates that a notice to a third party may only be issued after delivery of final demand for payment, which must be delivered at least 10 business days before the issue of the notice, and it also stipulates the recovery steps that may be taken by SARS and the further relief mechanisms available to the taxpayer. This is a peremptory step required to be taken before issuing a third-party notice for recovery of outstanding tax debt.

The court stressed that the existence of a final demand is not enough. A final demand should actually have been delivered in accordance with the Rules for Electronic Communication prescribed in terms of the TAA, and if an acknowledgement is not received the communication is not regarded as having been delivered except if delivered via eFiling.

As SARS had not furnished proof of the letter being sent via eFiling, and there was no other proof of delivery, the court held that SARS had not delivered a final demand to SIP before appointing Standard Bank as the third-party agent.

The notice issued is therefore unlawful and was declared null and void by the court; SARS was required to repay the full amount, with costs, to SIP.

"As SARS had not furnished proof of the letter being sent via eFiling, and there was no other proof of delivery, the court held that SARS had not delivered a final demand to SIP before appointing Standard Bank as the third-party agent."

mstGROUP

Acts

- Tax Administration Act 28 of 2011: Section 179.

Other documents

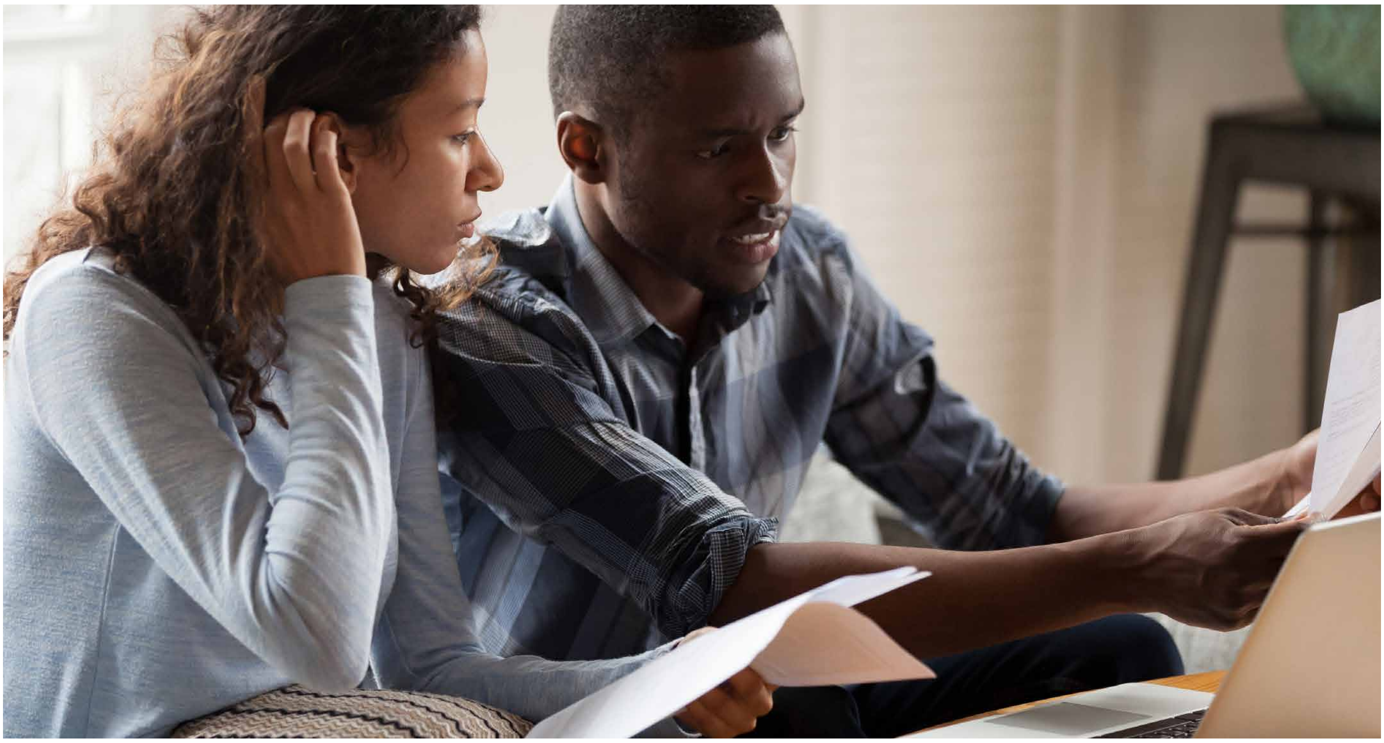
- Rules for Electronic Communication (prescribed in terms of the Tax Administration Act).

Cases

- *SIP Project Managers (Pty) Ltd v Commissioner for the South African Revenue Service*, [2020] ZAGPPHC 206 (29 April 2020).

Tags: declaratory relief.

TAX DEBTS AND CIVIL JUDGMENTS



Under the Tax Administration Act, 2011 (the TAA), the SARS has various powers to collect and enforce the payment of tax debts owing to it. One of the ways in which it can do so is by applying for a civil judgment for the recovery of tax, which is provided for in section 172 of the TAA.

On 15 May 2020, the Western Cape Division, Cape Town (WCHC), delivered judgment in *Barnard Labuschagne Inc v South African Revenue Service and Another*, [2020], which concerned the application of sections 172 and 174 of the TAA. More specifically, the taxpayer, Barnard Labuschagne Inc, sought to rescind a statement filed by SARS under section 172. The judgment deals with a number of related issues, but we focus mainly on the WCHC's interpretation of the TAA provisions.

FACTS

- The taxpayer is a law practice which encountered some difficulties with SARS in respect of the payments that it made which were not properly allocated to the taxpayer's relevant accounts.

- Over the years, the taxpayer had encountered some difficulties with SARS in respect of the payments that the taxpayer made and which it alleged were not properly allocated to the relevant accounts.

- The taxpayer alleged that in 2013, SARS had previously filed with the registrar of court a similar statement to the one which the taxpayer sought to rescind in the current matter.

- The taxpayer further alleged that it opposed that statement on the basis that the payments to SARS were not allocated correctly. SARS had raised interest and penalties on the amounts that were paid on time and upon being advised of the payment allocation issue, SARS considered the unallocated amounts and the amount which SARS alleged the taxpayer owed decreased significantly. The judgment granted against the taxpayer was subsequently withdrawn.

- During 2013 and 2014, SARS made a further effort to resolve the payment allocation issue and made one of its employees available to the taxpayer on a full-time basis. This exercise resulted in a considerably reduced tax debt.

- However, by September 2015, the taxpayer's tax debt had shot up again.

- SARS engaged with the taxpayer to resolve the issue regarding the tax debt that had increased again, but due to the taxpayer's perceived failure to co-operate, SARS issued a letter of final demand for the payment of outstanding tax debt in 2017.

- As the taxpayer did not respond to the final demand, SARS issued a third-party payment instruction to Absa, but after receiving a negative response from the bank, SARS sent a letter to the taxpayer advising it of its intention to file a section 172 statement.

- After the taxpayer had not responded to SARS' letter, SARS continued to obtain a judgment against the taxpayer on 15 December 2017.

- The applicant subsequently brought an application to have the judgment rescinded.

ISSUE

The main issue that the court had to consider was whether the section 172 statement could be rescinded.

The taxpayer also challenged the constitutionality of sections 172 and 174, which aspect we deal with briefly.

ARGUMENTS BEFORE THE WCHC

Some of the arguments raised by the taxpayer were the following:

- The grounds for rescission of the judgment were not based on an objection against an assessment or decision of SARS as referred to in section 104 of the TAA.

- The taxpayer argued that it applied for rescission as SARS had not raised assessments or made decisions referred to in section 104, against which the applicant could object or appeal. The taxpayer argued that it was therefore entitled to bring these proceedings before the WCHC in terms of section 105 of the TAA.

In opposing the application, SARS raised numerous arguments, including the following:

- It argued that the taxpayer had several dispute resolution mechanisms at its disposal before approaching the WCHC.

- The considerations underpinning the "pay now, argue later" principle were of importance in this matter. These considerations include the public interest in obtaining full and speedy settlement of a tax debt and the need to limit the ability of recalcitrant taxpayers to use the objection and appeal procedures strategically to defer payment of their taxes.

- It was further contended by SARS that it serves the public interest to have a mechanism to collect tax debts relatively swiftly and to bring finality to disputes relatively quickly.

- There were numerous mechanisms available to the applicant in order to safeguard its rights. There was no prejudice or unfairness to the taxpayer who failed to timeously pay its tax liabilities and further repeatedly failed to comply with the procedures as set out in the TAA.

"The main issue that the court had to consider was whether the section 172 statement could be rescinded."

The Minister of Finance, who had been joined as second respondent following the constitutional challenge brought by the taxpayer, raised certain arguments, including the following:

- The taxpayer's interpretation was untenable as it overlooked the clear language of the TAA.

- Section 174 of the TAA explicitly requires section 172 certificates to be treated as though they are civil judgments which were lawfully given and if the court were to treat the certificates as capable of rescission as per the taxpayer's argument, the order so granted would be unlawful.

- Only a civil judgment that has a final effect could be rescinded and on the plain reading of sections 172 and 174, the certificates were not final in nature.

- In support of arguing that the section 172 statement did not have a final effect, reference was made to section 172(2), which states that the certificate may be filed irrespective of whether or not the amount of tax is subject to an objection or appeal. Furthermore, section 175 of the TAA even envisaged a situation whereby SARS may amend the amount of the tax due, if in the opinion of SARS, the amount in the statement is incorrect.

- According to the Minister of Finance, the granting of a rescission order would also offend two statutes, that is, the dispute resolution procedures as set out under Chapter 9 of the TAA that is designed for that purpose and the requirement under section 7(2) of the Promotion of the Administrative Justice Act, 2000, which requires the exhaustion of internal remedies.

- In *Modibane v South African Revenue Service*, [2011], and *Capstone 556 (Pty) Ltd v Commissioner*, *South African Revenue Service and Another*, [2011], it was held that although the filing of a certified statement by SARS had all the effects of a judgment, it was nevertheless not in itself a judgment in the ordinary sense. It did not determine any dispute or contest between the taxpayer and the Commissioner.

JUDGMENT

In respect of the main issue, the WCHC agreed with the Minister of Finance's submission that sections 172 and 174 constituted a lawful enforcement mechanism and for one to understand their correct legal meaning the appropriate starting point was the language used.

According to the WCHC, section 172(2) was clear that SARS may file the statement irrespective of whether or not the amount of tax is subject to an objection or appeal under Chapter 9, unless the obligation to pay the amount has been suspended under section 164. This subsection confirmed that despite the application for a civil judgment, the dispute resolution would still be in motion. The upshot of this was that there was no finality to this civil judgment, and it could not be accorded the status of a judgment.

"In respect of the main issue, the WCHC agreed with the Minister of Finance's submission that sections 172 and 174 constituted a lawful enforcement mechanism and for one to understand their correct legal meaning the appropriate starting point was the language used."

Furthermore, the language used in section 174 was explicit. It states that a certified statement filed under section 172 must be treated as a civil judgment lawfully given in the relevant court in favour of SARS, but it does not, in and of itself, constitute a civil judgment.

The interpretation put forward by the taxpayer, that it is a judgment, was at odds with the interpretation that ought to be ascribed to this section. In fact, if regard was had as to how the 2013 dispute was resolved between the parties, the taxpayer knew that SARS could withdraw the judgment. It followed therefore, that the section 172 statement was not final in nature and was not capable of rescission in a manner appropriately accorded to a court judgment.

Simply put, there was no judgment to be rescinded by the court and the taxpayer was well aware that these statements were not final in nature. The judgment obtained through the registrar of the court is treated as a civilly obtained judgment for recovery purposes.

A related finding made by the WCHC was that the taxpayer should not have approached it to have the judgment rescinded. The WCHC explained that the TAA creates clearly defined dispute resolution mechanisms. It stipulates that an objection can be lodged against assessment or decision, followed by an appeal against the assessment or decision. According to the court, the TAA does not state that a party can choose where the dispute has to be adjudicated. In this regard, the WCHC stated the following:

> "The applicant [taxpayer] somehow submitted that its ground for the rescission of judgment is not based on assessment or decision of SARS as referred to in section 104 of the TAA, as SARS has not raised assessments or made decisions as referred to in section 104 of the TAA. The applicant sought to create a situation whereby a dispute such as its dispute is not provided anywhere in the TAA, hence it approached the High court. In my opinion, the fact that SARS allocated payments incorrectly and subsequently, made a decision to recover a debt based on an incorrect amount, was a legitimate reason for the applicant to have raised an objection. I find the applicant's contention opportunistic and mischievous as the applicant was bent over backwards to confer to itself its own jurisdiction to hear its dispute and thereby disregarding the dispute resolution mechanism as set out in the TAA."

With regard to the taxpayer's constitutional challenge the WCHC held that the taxpayer misconstrued the language used in sections 172 and 174. Furthermore, the WCHC held that the taxpayer had failed to lay out a basis for the constitutional challenge in its application.

COMMENT

The court's finding that a section 172 certificate is not a final judgment that can be rescinded, is consistent with the *Modibane* and *Capstone* judgments on which the court relied. However, the WCHC's suggestion that it did not have jurisdiction and that the taxpayer should have approached the Tax Court for relief is slightly odd.

In the *Rampersadh* judgment (*Rampersadh and Another v Commissioner for the South African Revenue Service and Others*, [2018]), heard by the KwaZulu-Natal High Court in Pietermaritzburg (ZAKZPHC), that court clearly explained that only where tax legislation expressly states that a decision is subject to objection and appeal, can the matter be heard by the Tax Court. In that case, the ZAKZPHC held that SARS' decision not to alter an assessment in terms of section 93 of the TAA on the ground that there was an undisputed error, had to be taken on review to the High Court. Considering the facts of the *Barnard Labuschagne* matter, it appears that the rationale applied in *Rampersadh*, should also apply here and that the taxpayer was entitled to approach the WCHC for relief. In other words, while rescission was not the appropriate remedy that could be granted in the circumstances, the taxpayer appears to have been entitled to approach the WCHC and apply for relief, other than rescission of the judgment. The judgment should also serve as a reminder to taxpayers to consistently manage their tax affairs and constructively engage with SARS to manage their tax debts, within the scope of the TAA and without undermining their rights.

Cliffe Dekker Hofmeyr

Acts

- Tax Administration Act 28 of 2011: Sections 93, 104, 105, 164, 172, 174, 175; chapter 9 (sections 101–150);
- Promotion of the Administrative Justice Act 3 of 2000: Section 7(2).

Other documents

- Section 172 certificates.

Cases

- *Barnard Labuschagne Inc v South African Revenue Service and Another*, [2020] ZAWCHC (15 May 2020);
- *Modibane v South African Revenue Service*, [2011] ZAGPJHC 152 (20 October 2011);
- *Capstone 556 (Pty) Ltd v Commissioner, South African Revenue Service and Another*, [2011] (6) SA 65 (WCC);
- *Rampersadh and Another v Commissioner for the South African Revenue Service and Others* (5493/2017); [2018] ZAKZPHC 36 (27 August 2018).

Tags: "pay now, argue later" principle; tax liabilities; dispute resolution mechanisms.

TRANSFER PRICING DEVELOPMENTS

The Coronavirus (COVID-19) crisis and its devastating effects on societies and economies across the globe have made 2020 a year of extraordinary circumstances. This makes it difficult to keep track of ongoing developments which, under normal circumstances, would be under the spotlight. Below is a short summary of some of the important international and local South African developments in the area of transfer pricing.

OECD

Digitalisation of the economy

The topic related to transfer pricing that received the most media attention in 2019 was the search for a consensus-based long-term solution to the tax challenges arising from the digitalisation of the economy. This was not only the result of the complexity of the topic, but also because it appeared to have become a pawn in the hands of widely differing economic interests. This threatened the global consensus on the arm's length principle as the basis for transfer pricing, and resulted in three competing proposals to address the tax challenges of digitalisation.

At the end of January, however, the *Inclusive Framework on Base Erosion and Profit-Shifting* (BEPS), which groups 137 countries and jurisdictions on an equal footing for multilateral negotiation of international tax rules, decided to move ahead with a two-pillar negotiation to address the tax challenges of digitalisation with the objective of working toward an agreement by the end of 2020.

It was agreed that negotiation should be pursued on the new rules on where tax should be paid ("nexus" rules) and on what portion of the profits they should be taxed ("profit allocation" rules), on the basis of a "Unified Approach" on Pillar One, to ensure that MNEs conducting sustained and significant business in places where they may not have a physical presence can be taxed in such jurisdictions. The Unified Approach agreed by the Inclusive Framework draws heavily on the Unified Approach released by the OECD Secretariat in October 2019, as a response to the three competing proposals mentioned above.

The Programme of Work, agreed in May 2019, has been revised under Pillar One, which outlines the remaining technical work and political challenges to deliver a consensus-based solution by the end of 2020, as mandated by the G20. While it was the intention of the Inclusive Framework members to meet in July in Berlin, this time frame has become obsolete as a result of the pandemic. Until a new time plan has been made public, it is also very difficult to assess how far the various parties have been able to achieve some sort of political agreement on the detailed architecture of this proposal. In particular, it will be interesting to see how the Inclusive Framework will deal with the proposal to implement Pillar One on a "safe harbour" basis, as proposed in a 3 December 2019 letter from US Treasury Secretary Steven Mnuchin to OECD Secretary-General Angel Gurría, which has raised concerns by many Inclusive Framework members.

The Inclusive Framework also welcomed the significant progress made on the technical design of Pillar Two, which aims to address remaining BEPS issues and ensure that international businesses pay a minimum level of tax. They noted the further work that needs to be done on Pillar Two.

Transfer pricing guidance on financial transactions

A topic that received less attention in the media, but which for most MNEs is as important, at least in the short to medium term, is the treatment of financial transactions from a transfer pricing perspective. This was one of the focus areas of the OECD/G20's BEPS Project; in October 2015, as part of the final BEPS package, the OECD/G20 published the reports on *Action 4 (Limiting Base Erosion Involving Interest Deductions And Other Financial Payments)* and *Actions 8–10 (Aligning Transfer Pricing Outcomes with Value Creation*).

The content of these reports, however, did not find its way into the revision of the OECD Transfer Pricing Guidelines based on the final BEPS package in October 2015 and, instead, the reports mandated follow-up work on the transfer pricing aspects of financial transactions.

On 11 February 2020, the OECD finally released its much anticipated report *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8–10*.

The report is significant, as sections A to E of this report are included in the OECD Transfer Pricing Guidelines as Chapter X, while section F is added to Section D.1.2.1 in Chapter I of the Guidelines, immediately following paragraph 1.106. As a result, it is the first time the OECD Transfer Pricing Guidelines include detailed guidance on the transfer pricing aspects of financial transactions, which was outstanding for a long time and had led to considerable uncertainty, not only in South Africa. There is, accordingly, a high expectation that the guidance contained in the report will contribute to consistency in the interpretation of the arm's length principle and help avoid transfer pricing disputes and double taxation.

The guidance in this report describes the transfer pricing aspects of financial transactions. It also includes a number of examples to illustrate the principles discussed in the report. Of particular interest is:

- Section B, which provides guidance on the application of the general principles contained in Section D.1 of Chapter I of the OECD Transfer Pricing Guidelines on Financial Transactions, in particular, on how the accurate delineation analysis under Chapter I applies to the capital structure of an MNE within an MNE group. It also clarifies that the guidance included in that section does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation (an approach which seems to be followed in South Africa – see below).

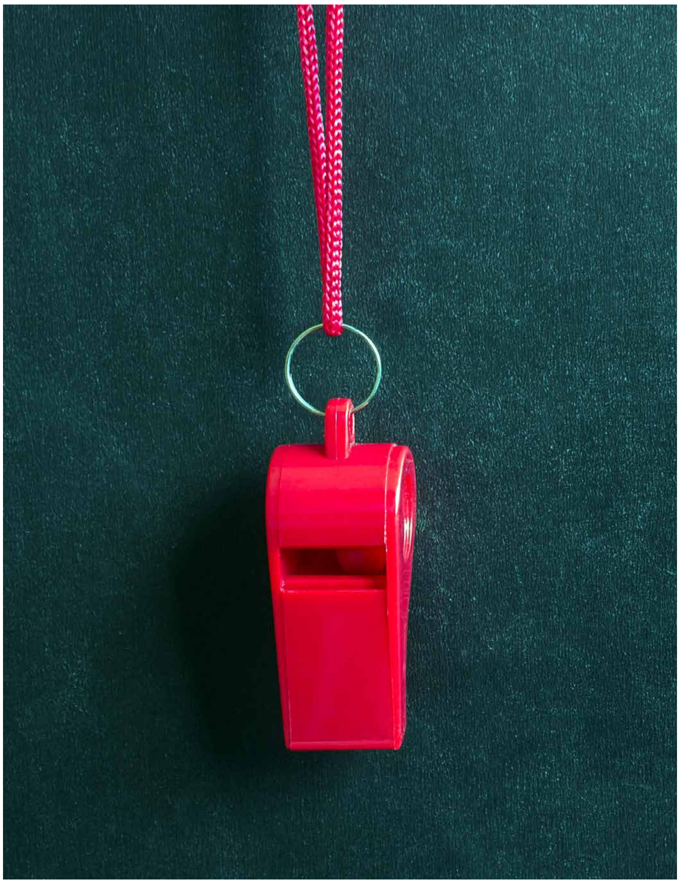
- Sections C, D and E address specific issues related to the pricing of financial transactions (eg, treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance). This analysis elaborates on both the accurate delineation and the pricing of the controlled financial transactions.

- Finally, Section F provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return.

SOUTH AFRICA

Interest limitation rules

Following the OECD Report on the Transfer Pricing Guidance on Financial Transactions, National Treasury in South Africa, on 26 February 2020, published the *Discussion Paper on Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments*. The Discussion Paper sets out government's proposal to replace the existing interest limitation rules (specifically those in section 23M of the Income Tax Act, 1962) with a more uniform approach to all interest payments flowing out of the country, based on the recommendations by the OECD. In particular, government proposes to restrict net interest expense deductions to 30% of earnings before interest, taxes, depreciation, and amortisation (EBITDA).



This proposal was one of the measures announced in the 2020 Budget to broaden the corporate income tax base (together with the proposal to limit the use of assessed losses carried forward to 80% of taxable income). Both measures were to be effective for years of assessment commencing on or after 1 January 2021 but, as a result of the COVID-19 pandemic, they have been postponed to at least 1 January 2022.

In line with this postponement, the deadline for submission of comments on the content of the Discussion Paper was also extended twice. The last due date for submissions was 30 September 2020.

Updated interpretation notes based on latest OECD guidance

While National Treasury was quick with its proposal to restrict net interest expense deductions, the South African Revenue Service has not been as responsive. In particular, SARS' Strategic Plan for 2020/2021 – 2024/2025 specifically states that the provision of clarity to ensure consistency of legal obligations as well as certainty and predictability, through *inter alia* advance pricing agreements, interpretation notes, and explanatory guidelines, is one of its key actions. Yet, it has still not finalised its draft interpretation note on thin capitalisation (which dates back to 2013), nor has it issued an interpretation note dealing with transfer pricing in general, taking into account all the latest developments and resulting updates to the OECD Guidelines as a result of the BEPS Project.

Instead of providing the clarity of legal obligations, which it regards as a strategic objective, it continues to make changes to and provide updates for the transfer pricing legislation. This creates more uncertainty, such as the ill-advised proposed inclusion of the "associated enterprise" definition into the transfer pricing legislation, which was well intended but would have resulted in expanding the application of the transfer pricing rules based on a concept that is extremely complex and open to interpretation.

"While National Treasury was quick with its proposal to restrict net interest expense deductions, the South African Revenue Service has not been as responsive."

ENSafrica

Acts

- Income Tax Act 58 of 1962: Section 23M.

Other documents

- *Action 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments)* (OECD report – October 2015);
- *Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation)* (OECD report – October 2015);
- *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10* (OECD report – 11 February 2020);
- *Discussion Paper on Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments* (published on 26 February 2020 by National Treasury).

Tags: arm's length principle; interest limitation rules; thin capitalisation.

SECTION 7C ANTI-AVOIDANCE PROVISION

Section 7C of the Income Tax Act, 1962 (the Act), contains various anti-avoidance provisions in respect of loans or credit advanced to trusts. These provisions were introduced to curb the abuse of trusts by taxpayers who transfer their wealth to trusts, tax-free, by means of low-interest or interest-free loans or credit.

At present, the anti-avoidance provisions apply to schemes in terms of which natural persons or companies, at the instance of a natural person:

1. transfer assets to a trust and allow for the purchase price that the trust owes in respect thereof to remain outstanding as a low-interest or interest-free loan or credit in favour of the natural person or company;

2. advance low-interest or interest-free loans or credit to a trust to enable the trust to use the money to acquire assets; and

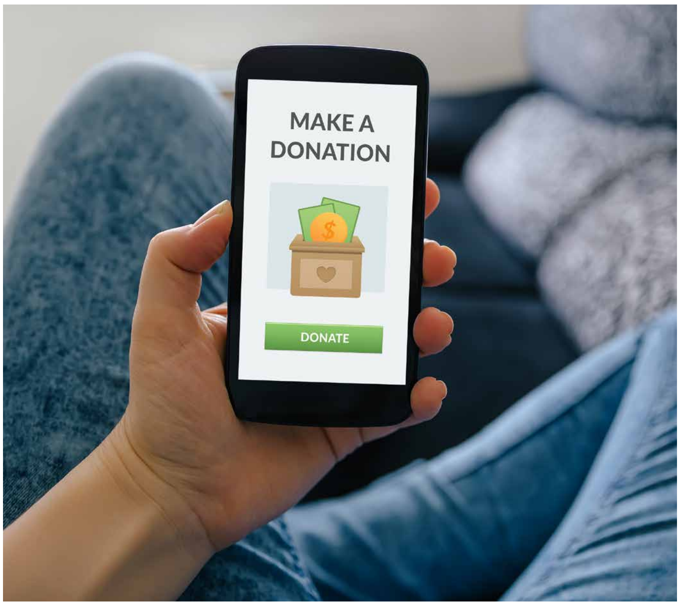
3. advance low-interest or interest-free loans to companies that are connected persons in relation to a trust.

In many of these schemes, the loan or credit would remain outstanding with no real intention of settlement, with the natural person writing off the loan or credit over time by making use of their annual donations tax allowance of R100,000. By applying the R100,000 annual allowance towards reducing the amount owing by the trust, the outstanding loan amount at the death of the natural person is reduced, thereby reducing the deceased estate's liability for estate duty. As such, by implementing these schemes, taxpayers previously avoided incurring a donations tax liability and reduced their estate duty liability at death.

The anti-avoidance provisions contained in section 7C, however, provide for an annual donation to be triggered in the hands of the natural person who advances the loan, or at whose instance the loan is advanced by a company. The amount of the deemed donation is the difference between the interest that is actually charged on the loan or credit, and the interest that would have been payable by the trust had the interest been charged at the prevailing "official rate of interest", as defined in section 1(1) of the Act.

"The anti-avoidance provisions contained in section 7C, however, provide for an annual donation to be triggered in the hands of the natural person who advances the loan, or at whose instance the loan is advanced by a company."

The Taxation Laws Amendment Bill, 2020 (TLAB), which was introduced in the National Assembly on 28 October 2020, proposes in clause 3 the insertion of a new anti-avoidance measure in section 7C in order to curb the use of schemes involving preference share funding to circumvent the application of the current section 7C provisions. These schemes have become increasingly popular and involve the subscription by a natural person for preference shares (with no or a low rate of return) in a company that is owned by a trust that is a connected person to that natural person. [*Editorial note*: The TLAB proposes to add a new subsection (6) to section 7C which states that, for the purposes of that section, "preference share" means a preference share as defined in section 8EA(1).]



It has been proposed that where a natural person, or a company at the instance of a natural person in respect of whom that company is a connected person, subscribes for preference shares in a company with a particular shareholding (NewCo), then:

1. the consideration received by NewCo for the issue of the preference shares will be deemed to be a loan in terms of section 7C(3); and

2. any dividend that is declared in respect of those preference shares will be deemed to be interest in respect of the deemed loan.

The NewCo envisaged in this new anti-avoidance measure is a company in which 20% or more of the equity shares are held (whether directly or indirectly), or of which the voting rights can be exercised, by a trust (whether alone or together with any person who is a beneficiary of that trust) that is a connected person in relation to the natural person or company subscribing for the preference shares in the NewCo.

This amendment is intended to come into operation on 1 January 2021 and will apply in respect of any dividend or foreign dividend accruing during any year of assessment commencing on or after that date.

COMMENT

The proposed amendment appears to be aimed at avoiding tax leakage and undue tax benefits accruing to taxpayers who implement schemes purely for purposes of unduly avoiding the payment of taxes, in this case, donations tax and the future payment of estate duty.

Cliffe Dekker Hofmeyr

Editorial comment: This article was written after the publication in the *Government Gazette* of the Draft Taxation Law Amendment Bill, 2020, but before the introduction of the TLAB on 28 October 2020. The content of the article has been amended to make provision for references to the TLAB instead of to the Draft TLAB.

Acts

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "official rate of interest"), 7C & 8EA(1) (definition of "preference share").

Other documents

- Draft Taxation Laws Amendment Bill, 2020 (published in the *Government Gazette* on 31 July 2020);

- Taxation Laws Amendment Bill 27 of 2020 (introduced in the National Assembly on 28 October 2020).

Tags: interest-free loans; anti-avoidance provisions; official rate of interest; equity shares; preference shares; donations tax; estate duty.

SINGLE AND SEPARATE SUPPLIES

A vendor who makes a single supply of goods or services or a single supply consisting of a combination of both goods and services that are distinct and clearly identifiable from each other, will be deemed to have made separate supplies if a single consideration is payable for the supply and such consideration would have been subject to VAT partly at the standard rate and partly at the zero rate if separate considerations were charged for the supply of goods or services or of goods and services.

In the case of *Diageo South Africa (Pty) Ltd v Commissioner for the South Africa Revenue Service*, [2020], the Supreme Court of Appeal (the SCA) ruled on the interpretation and application of section 8(15) of the Value-Added Tax Act, 1991 (the VAT Act).

FACTS

Diageo South Africa (Pty) Ltd (Diageo) is a South African VAT vendor engaged in the business of importing, manufacturing and distributing alcoholic beverages.

Diageo entered into an exclusive rights distribution agreement with foreign brand owners, which included, *inter alia*, the rights to use the foreign brand owners' trademarks, intellectual property, equipment, packages and labels in South Africa. Further to this, Diageo was responsible for the advertising and promotion (A&P) of the foreign brand owners' products in South Africa.

The foreign brand owners invested in A&P as part of an integrated and synergetic marketing campaign to build and maintain brand recognition and perception to generate sales. The foreign brand owners did not perform or undertake the A&P activities themselves but appointed Diageo to render these services for a fee.

The fee charged by Diageo was calculated with reference to the costs and expenditure incurred on the A&P activities.

Diageo was granted considerable latitude to tailor the distribution and marketing of products to align with the strategy set by the foreign brand owners, given Diageo's local market knowledge. Diageo had the discretion to determine the type of A&P activities undertaken in any year and the amounts expended on each activity.

"It was therefore held that the three jurisdictional requirements of section 8(15) were satisfied and that Diageo was liable for the output tax adjustments made by the Commissioner under section 8(15)."

The A&P activities comprised advertising in different media, as well as marketing and brand-building activities. As part of the service, Diageo provided promotional products to customers. The promotional products were used for sampling or tasting purposes. These promotional products were given away free of charge to third parties for use or consumption in South Africa.

The distribution of the promotional products by Diageo in the course of rendering the A&P services to the foreign brand owners was not undertaken as an end in itself nor as a distinct supply but simply as a means to achieve the objective of the preservation and enhancement of the brands.

The tax invoice issued by Diageo to the foreign brand owners reflected a total fee for services rendered. Although the fee charged by Diageo was calculated with reference to the annual amount spent on the A&P activities which was disclosed to the brand owners, no differentiation was made on the tax invoice between the services rendered to the foreign brand owners and goods consumed in South Africa. Pursuant to section 11(2)*(l)* of the VAT Act, Diageo levied VAT at the zero rate on the A&P services supplied by it to the foreign brand owners.

The Commissioner for the South African Revenue Service (the Commissioner), however, was of the view that section 8(15) of the VAT Act applied and deemed Diageo to have made separate supplies of zero-rated A&P services and standard-rated goods (ie, promotional products that were not exported, but consumed in South Africa).

The Commissioner assessed Diageo for additional output tax amounting to R14 million on the goods component of the supply of the A&P services. Diageo challenged the additional assessments in the Cape Town Tax Court on the basis that it had made a single supply of zero-rated A&P services and not a separate or dissociable supply of both goods and services. The Tax Court evaluated the nature of the supply made by Diageo. It concluded that the Commissioner's application of section 8(15) was correct and held that:

> "…The supply of promotional goods, as a portion of the single A&P service is, by virtue of s 8(15), a cognisable supply capable of notional separation from the total A&P service supplied to brand owners. Since it is deemed a separate supply with the goods liable to be subjected to different tax treatment, such supply does not receive double VAT treatment.
>
> The local supply of goods constitutes a supply of goods, not exported but consumed in South Africa; such supply is subject to VAT at the standard rate in terms of s 7(1)*(a)* of the VAT Act. …
>
> It matters not that the foreign brand owners did not receive or consume the promotional goods and that the local customer did. The supply was made as part of the A&P service, to achieve the benefit of enhanced brand equity and sales for the foreign brand owners, with the cost of such goods included in the fee charged by the appellant and paid by foreign brand owners … The fact that other promotional products were either not capable of or not considered for a notional separation from the single supply in terms of s 8(15) does not alter the result."

Accordingly, it dismissed the appeal and gave judgment in favour of the Commissioner. Diageo appealed against the Tax Court decision directly to the SCA.

THE ARGUMENTS

Diageo argued that section 8(15) is incapable of applying under the circumstances. Relying on foreign authorities, Diageo submitted that section 8(15) can only apply if a vendor makes

> " 'separate dissociable supplies of both goods and services' or supplies that are 'economically divisible, independent and hence dissociable' and which constitute 'an end in itself', not a means to achieve that end".

Diageo further submitted that its sole contractual obligation was to provide a service and not to supply goods. The fact that it used goods and incurred expenditure in acquiring goods for the purposes of rendering the A&P services to the foreign brand owners did not mean that it supplied both goods and services.

Diageo submitted that the purpose of section 8(15) was not to create an economically or commercially unreal outcome but rather to avoid it and contended that the Commissioner's approach erroneously sought to artificially dissect a single supply, thereby producing an artificial and insensible result.

The Commissioner, however, argued that section 8(15) is a deeming provision which brings into existence a state of affairs that does not exist.

The Commissioner held that the provisions of section 8(15) do apply, as Diageo issued an invoice to the foreign brand owners for a single supply which comprised both goods and services. The Commissioner submitted that if separate considerations had been payable by the foreign brand owners it would have resulted in tax charged partly at the standard rate and partly at the zero rate. Accordingly, each part of the said supply must be deemed to be a separate supply.

"The reality of the conclusions reached is that where, for example, packaged or delivered goods are supplied, the vendor is required to split the supply between the various components, should different rates of tax be applicable to the constituent parts."

To the extent that the supply of A&P services by Diageo constituted a supply of goods not exported but consumed in South Africa, such supply was subject to VAT at the standard rate in terms of section 7(1)*(a)*.

Therefore, the supply of promotional products by Diageo was deemed to be a separate supply for the purposes of section 8(15).

THE JUDGMENT

The SCA was unpersuaded by Diageo's reliance on foreign authorities and found that such reliance was unhelpful, as these authorities do not deal with the interpretation of statutory provisions that are the functional equivalent of the deeming provision or an apportionment provision as found in section 8(15).

The SCA held that the tests identified by foreign authorities regarding whether a supply is "economically not dissociable", "not an end in itself" or a "principal versus ancillary supply" do not have any bearing on the interpretation and application of section 8(15).

In relation to the application of section 8(15), the SCA stated that the Commissioner was correct in his argument that the section is a deeming provision that creates the existence of an artificial supply. Mbha JA observed at paragraph [12]:

> "… The intention of a deeming provision, in laying down an hypothesis, is that the hypothesis shall be carried as far as necessary to achieve the legislative purpose, but no further."

In applying the above dictum, Mbha JA held that the purpose of section 8(15) is to provide for a situation where the provisions of sections 7(1)*(a)* and 11(2)*(l)* are applicable to a single supply of goods or services or of goods and services, to ensure that the appropriate rate of tax is charged.

Summarising at paragraph [13], Mbha JA continued:

> "The jurisdictional requirements that must be met before the deeming provision can be invoked are, first, a 'single supply' of two or more types of goods or services or a combination of goods and services. Secondly, one consideration must be payable as only a single supply is made. Lastly, the circumstances must be such that if the supply of the goods or services or of the goods and services had been charged for separately, part of the supply would have been standard-rated and part zero-rated ('notional separate considerations')."

The SCA relied on the findings in *Commissioner for the South African Revenue Service v British Airways plc*, [2005], stating at paragraph [17]:

> "… The section applies to a single supply of goods or services comprising parts that would each, if they had been supplied separately, have attracted a different rate of tax. In such cases, each part of the single service is deemed to be a separate supply of goods or services – although, in truth, they are not – with the result that the separate parts each attract the tax that is levied by s 7 but at different rates (0% for that part of the service that, had it been separately supplied, would have fallen within s 11, and 14% for the remainder).
>
> A 'single supply of services' is only capable of notional separation into its component parts, as contemplated by the section, if the same vendor supplies more than one service, each of which, had it been supplied separately, would have attracted a different tax rate. If that were not so, there would be no parts of the 'single supply of services' by the vendor capable of notional separation from one another.
>
> … The section does no more than apportion the rate at which the vendor is required to pay the tax that is levied by s 7 when the vendor has supplied different goods or services as a composite whole."

It was therefore held that the three jurisdictional requirements of section 8(15) were satisfied and that Diageo was liable for the output tax adjustments made by the Commissioner under section 8(15).

THE IMPACT

A key consideration arising from this judgment is whether a vendor who charges a single consideration based on costs comprising different components, should levy VAT separately on each component merely because the vendor is capable of separating the supply into its respective cost components/parts.

One of the fundamentals of pricing is that a vendor prices its supply in a manner that allows for the recovery of costs, whether direct or indirect. There are, however, significant other aspects that are taken into account, including brand, location, competition, etc.

This judgment therefore raises the following very important question: does the evaluation of the overall cost of a supply have the ability to change the nature of that supply?

The impact of the SCA judgment is far-reaching and the following should be considered:

- When is a single supply of goods or services or of goods and services regarded as divisible components that are distinct and clearly identifiable from each other for purposes of section 8(15)? An example would be where a zero-rated product is delivered, and the consideration includes a component for the product which is zero-rated and the transport which is standard-rated.

- South Africa does not have a refund mechanism that allows foreign businesses to recover VAT charged under similar circumstances. This creates tax disparity between local and foreign businesses, as the additional VAT ultimately becomes a cost for foreign businesses.

- This judgment should further be considered in the context of section 10(22), which provides for a splitting of a single consideration between an exempt or non-supply and a taxable supply.

- The appropriate use of foreign jurisprudence. It is evident from this appeal that vendors should be careful when placing reliance on foreign authorities in making tax decisions, as the courts are hesitant to accept principles in circumstances where there is no clear correlation to the provisions in South African legislation.

THE IMPLICATIONS

The SCA judgment is important firstly for supplies to non-residents and also where zero-rated food products are supplied. The judgment raises the question as to whether, for example, a container of milk or loaf of brown bread supplied by a manufacturer to a retailer should be split between the supply of the actual product, ie the milk or bread, and the other components, for example the packaging or transport.

The reality of the conclusions reached is that where, for example, packaged or delivered goods are supplied, the vendor is required to split the supply between the various components, should different rates of tax be applicable to the constituent parts.

Consider an FMCG retailer [*Editorial note*: "Fast Moving Consumer Goods"]. If that retailer supplies any zero-rated foodstuff such as maize meal, samp, pilchards, rice, fruit and vegetables, to name a few, it will now be required to split the price charged to the consumer (which was previously fully zero-rated) between the following as a minimum:

- the product;

- the packaging; and

- the transport element.

The product will continue to enjoy the benefits of zero-rating, but the portion of the price relating to the packaging and transport will now be subject to VAT at 15%. The value of these standard-rated supplies must further be determined by having regard to the cost of such constituent parts.

The purpose of zero-rating the supply of basic foodstuffs as envisaged in Schedule 2 to the VAT Act was to alleviate the tax burden placed on lower-income households. Adding VAT to certain components will increase prices, and significantly add administration costs and create other impracticalities.

The SCA highlighted that its position cannot be said to produce an artificial and insensible result and a commercially unreal outcome and that this cannot be justified but, in our view, separating a supply, such as a zero-rated foodstuff, into its individual components and then charging VAT on certain of those components would result in a commercially unreal outcome. This does not make commercial, practical or hygienic sense.

In addition, the result obtained by the SCA in this judgment completely contradicts the rationale and purpose of Schedule 2 to the VAT Act.

The Tax Court highlighted the fact that a "deeming provision lays down a hypothesis to be 'carried as far as necessary to achieve the legislative purpose, but no further'. It must always be construed contextually and in relation to the legislative purpose."

Taking the reality of the extent of the impact of the SCA judgment into account, in light of the above obiter of the Tax Court, the context and legislative purpose of, very importantly, the zero-rating of basic foodstuffs, were not considered in enough detail, which has led to an absurd result, defying the purpose of the introduction of such zero-ratings.

The reality and impact of this judgment will have immense consequences for lower-income households as well as the broader consumer market of South Africa, especially in light of the current economic circumstances and the difficulty most households experience in making ends meet.

PwC

Acts

- Value-Added Tax Act 89 of 1991: Sections 7(1)*(a)*, 8(15), 10(22) & 11(2)*(l)*; Schedule 2.

Cases

- *Diageo South Africa (Pty) Ltd v Commissioner for the South Africa Revenue Service* (330/2019) [2020] ZASCA 34 (3 April 2020);

- *Commissioner for the South African Revenue Service v British Airways plc* [2005] (4) (SA) 231 (SCA).

Tags: standard-rated goods; zero-rated foodstuff; deeming provision.