Issue 31 | 2021
FEBRUARY

sait South African Institute of Tax Professionals

Unstructured CPD 150mins

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

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VALUE MISMATCHES IN ASSET-FOR-SHARE TRANSACTIONS

INTRODUCTION

The exchange of assets in return for shares (commonly referred to as asset-for-share transactions) is prevalent in practice, especially in business formations and restructuring. If these transactions are taxed, tax may become a hindrance to economic activity. Part III of Chapter II of the Income Tax Act, 1962 (the Act), provides relief to assist businesses to structure their affairs in the most efficient economic manner on a tax-neutral basis.

This article takes a closer look at an amendment made to section 40CA of the Act as part of the 2019 legislative cycle and a potential anomaly that affects asset-for-share transactions.

To understand the anomaly, it is necessary to briefly consider the tax consequences of a disposal of an asset to a company in exchange for that company issuing shares as consideration.

PRINCIPLES IF ROLL-OVER RELIEF IS NOT AVAILABLE

In the absence of roll-over relief, the transferor of the asset is taxed on the value of the consideration (shares issued by the company) as proceeds from the disposal. The company is deemed to have incurred expenditure equal to the market value of the shares issued immediately after the asset is obtained (section 40CA(1)*(a)*). However, this rule has recently been extended by the introduction of section 40CA(1)*(a)*(ii), as discussed in more detail below.

ROLL-OVER RELIEF (SECTION 42)

Section 42 provides roll-over relief for an "asset-for-share transaction", as defined in subsection (1) of that provision. The person who transfers the asset to the company is deemed to have disposed of the asset at its tax cost at the date of exchange. It is further deemed to have acquired the shares in the company for this tax cost of the asset. Hence, no capital gain or capital loss arises from the disposal. No amount of previous capital allowances claimed is recouped. The transferor and the company are deemed to be one and the same person for (i) the *acquisition date*; (ii) the *cost* and the *date* on which such cost was incurred; and (iii) the *method of use* of the asset.

SECTION 24BA

If a person transfers an asset (or assets) to a company in exchange for shares in that company on non-arm's length terms this may facilitate value to be shifted between the company's shareholders. By way of illustration: A holds all the shares of Z Ltd. These shares are valued at R1 million. B contributes an asset that is worth R100 000 to Z Ltd in exchange for Z Ltd issuing the number of shares necessary for B to hold a 50% interest in the company after the transaction. This means that the value of A's shareholding decreased from R1 million to R550 000 (being R1,1 million x 50%). This R450 000 decrease in the value of A's shareholding effectively accrues to B, who only contributed R100 000, but now holds shares to the value of R550 000.

Section 24BA aims to intercept and tax the mismatches between the values of the asset and shares, which facilitates the value-shifting illustrated above. This mismatch is not defined on a mathematical basis. Rather, section 24BA applies where a company issues shares as consideration for the acquisition of an asset, and that consideration is different from the consideration that would have applied if that asset would have been acquired in terms of a transaction between independent persons dealing at arm's length. Whether or not this is the case, is a factual question. A mismatch in values may, however, be a strong indicator that the consideration does not reflect arm's length terms.

Section 24BA applies irrespective of whether or not the roll-over relief provided for asset-for-share transactions in terms of section 42 applies (see section 41(2)). Section 24BA does not apply if paragraph 38 of the Eighth Schedule, which deems disposals between connected persons that do not occur at arm's length terms to be made at the market value of the asset, applies (section 24BA(4)*(b)*). Given the improbability that persons who deal with each other at arm's length will agree to consideration that does not reflect arm's length terms and the exclusion of transactions that are subject to paragraph 38, we submit that section 24BA is arguably primarily aimed at related-party transactions that use the roll-over relief while attempting to shift value without tax consequences in the process.

Where a high-value asset is transferred to the company in return for the issue of lower-value shares, the difference between the values of the items being exchanged is deemed to be a capital gain for the company that issued the shares (section 24BA(3)*(a)*(i)). With effect from 1 January 2020, section 40CA was amended to increase the cost of the asset acquired for the company by this same amount. This amendment aimed to clarify the interaction between section 24BA and section 40CA. National Treasury (NT) explained the rationale for the amendment as:

> "Potential double taxation will arise in the instance that the company subsequently disposes of the asset due to the fact that the company would have paid tax on the capital gain triggered by section 24BA which is currently not deemed to be expenditure incurred."

THE POTENTIAL ANOMALY

It appears as if an anomaly exists between what the amended section 40CA was intended to achieve and its actual effect for normal tax purposes. The anomaly is evident from the following scenarios that illustrate the application of the amendment to section 40CA in light of the current wording in section 41(2).

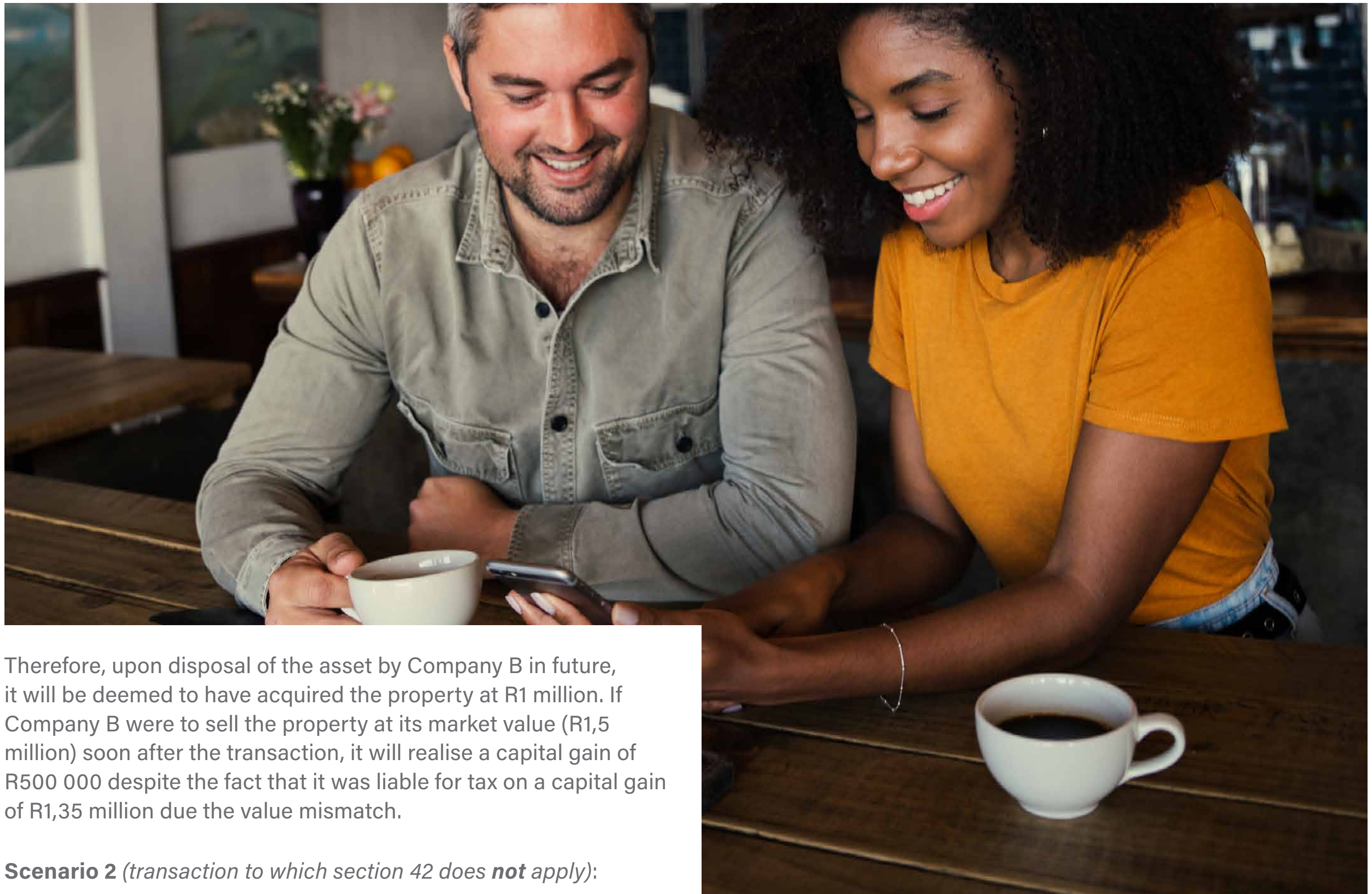
Scenario 1 *(transaction to which section 42 applies)*:

Company A disposes of a property with a market value of R1,5 million (original cost was R1 million one year ago) to Company B in exchange for 10% equity shares in Company B with a market value of R150 000.

Company A is deemed to dispose of the property for proceeds equal to its base cost of R1 million at the date of exchange. No capital gain or loss is realised. Company B is deemed to have acquired the property at a cost of R1 million.

Section 41(2) determines that section 42 overrides most of the other provisions of the Act (including paragraph 38 of the Eighth Schedule and section 40CA), but not section 24BA. This means that section 24BA is applicable if the consideration in respect of shares issued as consideration is different from the consideration that would have applied between independent persons dealing at arm's length. It is necessary to understand why Company A was willing to exchange its property to Company B on these terms. Further examination may reveal, for example, that the remaining 90% of the shares of Company B are held by a family trust that is connected to Company A's shareholder and this is why the parties agreed to these terms. If it is concluded that parties transacting at arm's length would not have agreed to this consideration, section 24BA applies. Since the market value of the asset (R1,5 million) exceeds the market value of the 10% shareholding (R150 000) on the date of exchange, and because paragraph 38 does not apply, the difference of R1,35 million (ie R1,5 million less R150 000) is deemed to be a capital gain realised by Company B in respect of the disposal of its shares (section 24BA(3)*(a)*(i)).

Company B is not allowed to apply section 40CA, including the recent amendment, since section 41(2) determines that section 42 takes precedence. Company B cannot apply the recent amendment to section 40CA to determine the tax cost of the asset. Hence, Company B cannot increase the tax cost of the property acquired with the amount of the deemed capital gain (R1,35 million) that arose under section 24BA.



Therefore, upon disposal of the asset by Company B in future, it will be deemed to have acquired the property at R1 million. If Company B were to sell the property at its market value (R1,5 million) soon after the transaction, it will realise a capital gain of R500 000 despite the fact that it was liable for tax on a capital gain of R1,35 million due the value mismatch.

Scenario 2 *(transaction to which section 42 does* ***not*** *apply)*:

Company A disposes of a property with a market value of R1,5 million (original cost was R1 million one year ago) to Company B in exchange for 1% equity shares of Company B with a market value of R15 000.

Since Company A does not hold a qualifying interest in Company B, this transaction does not meet the definition of an asset-for-share transaction in section 42. Company A realises a capital loss of R985 000, being the difference between the value of the shares received as consideration (R15 000) and the base cost of the property (R1 million), from the disposal of the property.

Assuming the parties involved are not connected persons and it is concluded that consideration in respect of shares issued as consideration is different from the consideration that would have applied between independent persons dealing at arm's length, section 24BA applies. Company B realises a deemed capital gain (R1 485 000) in terms of section 24BA(3)*(a)*(i), being the difference between the market value of the property (R1,5 million) and the shares (R15 000). The net gain from the transaction is R500 000 (being the difference between the capital loss of R985 000 and the deemed capital gain of R1 485 000). This gives the same result as if Company A disposed of the asset at its market value.

The amended section 40CA can now be applied. The cost of the asset acquired by Company B is equal to the sum of R15 000 (the market value of the 1% equity shares issued immediately after the asset was acquired) and R1,485 million (the section 24BA(3)*(a)*(i) deemed capital gain). The cost of the asset for Company B is therefore essentially equal to the market value of the asset (R1,5 million). It is submitted that this scenario, where an asset is exchanged for shares as consideration that does not reflect arm's length terms, is highly unlikely to occur between persons who are not connected to each other.

CONCLUSION

It is questionable whether the legislature intended the double tax effect only to be eliminated in instances such as described in scenario 2. It appears to be an anomaly that a transaction that otherwise qualifies for roll-over relief is negatively impacted by this, while the double tax is eliminated in the case of a highly improbable transaction that does not qualify for roll-over relief. Until NT provides further insight into the rationale for the amendment to section 40CA, or makes amendments to eliminate this concern, taxpayers and their advisors should take note of this anomaly when entering into asset-for-share transactions.

Pieter van der Zwan and Herman Viviers

Editorial comment: Other tax and donation tax consequences that may arise from disposing of an asset for an inadequate consideration are not dealt with in this article.

Acts

- Income Tax Act 58 of 1962: Sections 24BA (specifically section 24BA(3)*(a)*(i) and (4)*(b)*) & 40CA (40CA(1)*(a)*(ii)); Chapter 2 Part III (sections 41 to 47); more specifically sections 41(2) & 42 (including in subsection (1), the definition of "asset-for-share transaction"); Eighth Schedule: paragraph 38.

Tags: asset-for-share transactions; tax-neutral basis; high-value asset; at arm's length.

DEDUCTIBILITY OF INTEREST

In situations where there is a huge amount of debt being incurred by taxpayers, it is useful to remind ourselves in what general circumstances interest is deductible for income tax purposes by taxpayers, including companies that form part of a banking group.

In this regard, the provisions of section 24J of the Income Tax Act, 1962 (the Act), regulate, amongst others, the incurral or accrual of interest on financial instruments. It enacts the principle that "interest" accrues on a "yield to maturity" basis and applies to all "instruments" (defined in section 24J(1) as including "any interest-bearing arrangement or debt").

Section 24J(2) of the Act deals with the deductibility of interest. In particular, in terms of section 24J(2), interest is deductible whether or not the interest is seen as capital in nature.

Section 24J(2) provides that where a person is the "issuer" in relation to an instrument during any year of assessment, such person shall for purposes of the Act be deemed to have incurred an amount of interest during such year of assessment which is equal to the sum of all accrual amounts in relation to all accrual periods falling wholly or in part within such year of assessment in respect of such instrument. Such interest must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.

An "issuer" is defined as any person who has incurred interest or has any obligation to repay an amount in terms of an instrument.

Accordingly, in terms of section 24J(2) of the Act, a person (the "issuer") may deduct an amount of interest (calculated in accordance with section 24J) "from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income".

"Section 24J(2) of the Act deals with the deductibility of interest. In particular, in terms of section 24J(2), interest is deductible whether or not the interest is seen as capital in nature."

For interest to be deductible, it must thus be incurred "in the production of income" as part of a "trade".

THE "TRADE" REQUIREMENT

The term "carrying on any trade" is not defined in the Act. However, the term "trade" is widely defined in section 1(1) of the Act and, *inter alia*, includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property.

In *Burgess v Commissioner for Inland Revenue*, [1993], the court considered whether the appellant was carrying on a trade within the meaning of the general deduction formula contained in section 11*(a)* read with section 23*(g)* of the Act. The court described the principle that "trade" should be given a wide interpretation as being "well established". Regarding the meaning of "venture", the court stated as follows:

> "...although an element of risk is included in the concept of a 'venture' in its ordinary meaning, I must not be taken to suggest that a scheme like the present would only constitute a 'trade' if it is risky. *Whether it would or not would depend on its own facts*. If there is no risk involved, it might still be covered by giving an extended meaning to 'venture' or by applying the rest of *the definition, which is in any event not necessarily exhaustive*". (emphasis added)

In *Commissioner for South African Revenue Service v Tiger Oats Ltd*, [2003], the court considered whether an investment holding company listed on the Johannesburg Stock Exchange was in fact carrying on a business for purposes of the application of the Regional Services Councils Act, 1985. In this regard, the court held, *inter alia*, that:

> "in a very real commercial sense the respondent [was] *actively involved* in the business of its subsidiaries and associated companies and it [was] its making of investments in those companies which enabled it to be actively involved; ... [the respondent was] *not simply a passive investor* in [its subsidiaries and associated companies], equatable with a member of the public who invest[ed] in listed shares on the stock exchange". (emphasis added)

The principles regarding "carrying on any trade" as distilled from case law can be summarised as follows:

- The term "trade" should be given a wide interpretation;
- the definition of "trade" is not exhaustive;
- merely "watching over" investments does not constitute a trade – it requires something more, for example, dealing in securities; and
- the test as to whether a taxpayer carries on a "trade" is a factual enquiry and no single set of rules can be laid down in this regard.

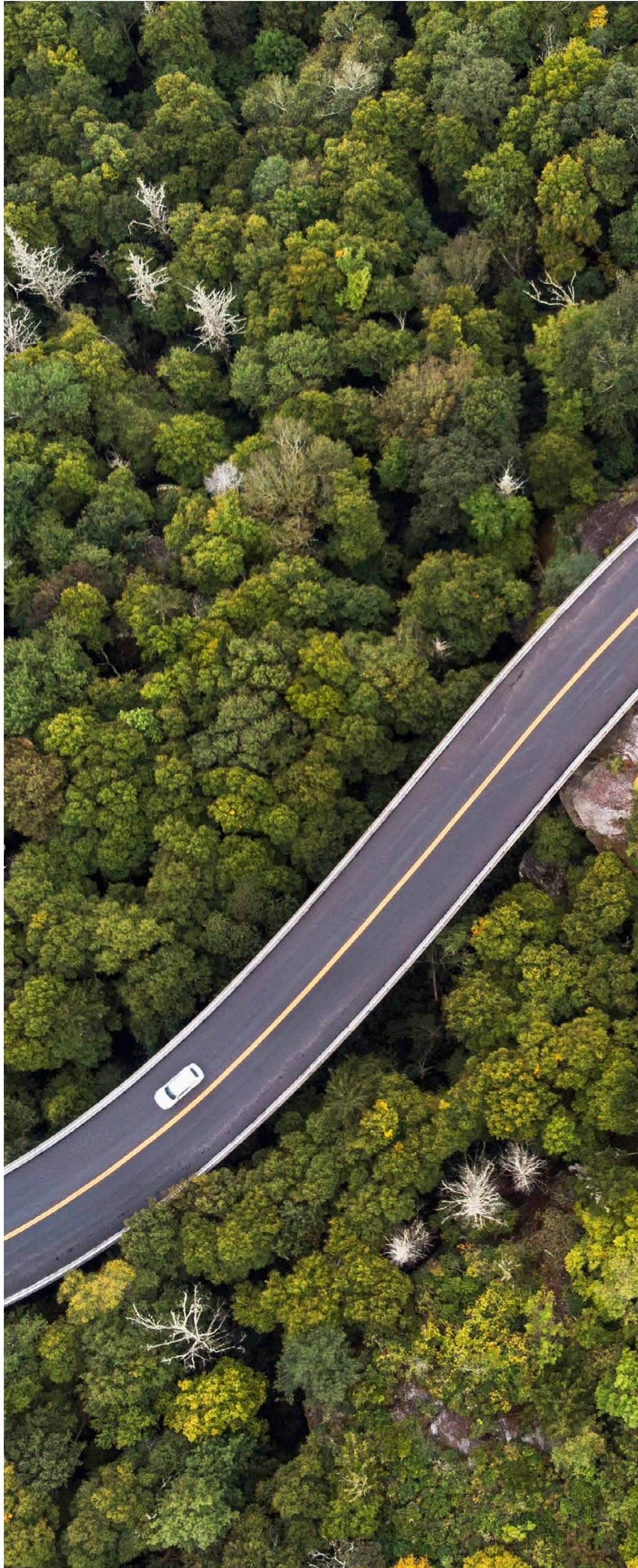
In practice, the South African Revenue Service (SARS) generally allows the deduction of expenditure incurred in the production of income even though the receipt or accrual of the income does not constitute the carrying on of a trade. This practice of SARS is set out in Practice Note 31 (income tax: interest paid on moneys borrowed) (PN31). Although PN31 provides that the practice set out therein will be followed by SARS, PN31 is not binding in terms of South African law.

THE "IN THE PRODUCTION OF INCOME" REQUIREMENT

The *locus classicus* on when expenditure will be incurred "in the production of income" (albeit in the context of the general deduction formula in section 11*(a)* read with section 23*(g)* of the Act) is *Port Elizabeth Electric Tramway Company Ltd v CIR*, [1936], where Watermeyer AJP formulated the test in terms of which the following questions need to be asked:

- Is the purpose of the act to which the expenditure is attached, to produce income; and
- is the expenditure linked closely enough to this act?

"Provided all the requirements of section 24JB(2) are met, in terms of section 24JB(2) any positive (increase in) fair value movements arising in respect of a 'financial liability' would provide a 'covered person' with a deduction against its income."



In respect of the first leg of the test, in accordance with, *inter alia*, *CIR v Allied Building Society*, [1963], the purpose to be determined, is the dominant purpose of the taxpayer in question. In *Sub-Nigel Ltd v CIR*, [1948], it was established that the words "incurred in the production of the income" do not mean that before a particular item of expenditure may be deducted it must be shown that it produced any part of the income for the particular year of assessment. The important question is whether the expenditure has been or is to be incurred for the purpose of earning "income" as defined in section 1(1) of the Act, whether in the current or in a future year of assessment.

SECTION 24JB – "COVERED PERSONS"

Section 24JB of the Act deals with the taxation of any profit or loss recognised by "covered persons" in the statement of comprehensive income in respect of "financial assets" and "financial liabilities".

"Covered person" is defined in section 24JB(1) and includes, *inter alia*, a bank, a branch of a bank or any company that forms part of a "banking group" as defined in section 1(1) of the Banks Act, 1990.

For purposes of section 24JB, the terms "financial asset" and "financial liability" are defined in subsection (1) as a financial asset or liability defined in and within the scope of International Accounting Standard (IAS) 32 of International Financial Reporting Standards (IFRS) or any other International Accounting Standard that replaces IAS 32.

In terms of section 24JB(2), subject to *inter alia* section 24JB(4), there must be included in or *deducted from the income of any covered person* for any year of assessment all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that are measured at fair value in profit or loss in terms of IFRS 9. Certain specified amounts (such as amounts in respect of a dividend or foreign dividend received by or accrued to a covered person) are excluded.

The essential elements in order for section 24JB(2) to find application, thus permitting a deduction against the taxpayer's income, are:

- the taxpayer must constitute a "covered person";
- the relevant amounts must be in respect of a "financial liability";
- amounts in respect of the "financial liability" must be recognised in profit or loss in the covered person's statement of comprehensive income; and
- that financial liability must be recognised in profit or loss of the covered person in terms of IAS 39.

As set out above, section 24JB(2) is subject to section 24JB(4). Section 24JB(4) contains an anti tax-avoidance provision and states that 24JB(2) does not apply to any amount in respect of a financial asset or financial liability of a covered person where:

" *(a)* a covered person and another person that is not a covered person, are parties to an agreement in respect of a financial asset or financial liability; and

(b) the agreement contemplated in paragraph *(a) was entered into solely or mainly for the purpose of a reduction, postponement or avoidance of any liability for tax*, which, but for that agreement, would have been or would become payable by the covered person." (emphasis added)

Provided all the requirements of section 24JB(2) are met, in terms of section 24JB(2) any positive (increase in) fair value movements arising in respect of a "financial liability" would provide a "covered person" with a deduction against its income.

Section 24JB(2A) further requires a covered person to include in or deduct from income for a year of assessment a realised gain or realised loss that is recognised in a statement of other comprehensive income as contemplated in IFRS if that realised gain or realised loss is attributable to a change in the *credit risk* of the financial liability as contemplated in IFRS.

Section 24JB(3) provides that any amount to be taken into account in determining the taxable income of a person in terms of any provision of Part I of Chapter II of the Act (normal tax), or in determining any assessed capital loss of a covered person in respect of a financial asset or a financial liability contemplated in section 24JB(2), must only be taken into account in terms of section 24JB.

ENSafrica

Editorial note: There are other sections (for instance sections 23M and 23N) in the Income Tax Act, 1962, that, in particular instances, deal with interest deductibility as well.

Acts

- Income Tax Act 58 of 1962: Sections 1(1) (definitions of "income" and "trade"), 11*(a)*, 23*(g)*, 24J (including definitions of "instrument", "interest", "issuer" and "yield to maturity" in subsection (1)), 24JB (including definitions of "covered person", "financial asset" and "financial liability" in subsection (1)); Chapter II: Part I (sections 5–37H);
- Regional Services Councils Act 109 of 1985;
- Banks Act 94 of 1990: Section 1(1) (definition of "banking group").

Other documents

- International Accounting Standards 32 & 39 (IAS 32 & IAS 39);
- International Financial Reporting Standard 9 (IFRS 9);
- Practice Note 31 (Income tax: Interest paid on moneys borrowed).

Cases

- *Burgess v Commissioner for Inland Revenue* [1993] (4) SA 161 (AD);
- *Commissioner for South African Revenue Service v Tiger Oats Ltd*, [2003] 65 SATC 281;
- *Port Elizabeth Electric Tramway Company Ltd v CIR* [1936] CPD 241, 8 SATC 13;
- *CIR v Allied Building Society* [1963] (4) SA 1 (A); 25 SATC 343;
- *Sub-Nigel Ltd v CIR* [1948] 15 SATC 38; 1948 (4) SA 580 (A).

Tags: yield to maturity; carrying on any trade; covered persons; financial assets; financial liabilities; anti tax-avoidance provision.

LOSSES ON SHAREHOLDER LOANS

INTRODUCTION

When operating in a distressed economy, it is an inevitable consequence that shareholders will be disposing of companies for less than they paid for them, whether or not the companies were formed or purchased by those shareholders. Moreover, it has always been, and remains, very common to fund private companies in South Africa with nominal share capital and large shareholders' loans, often interest-free. While there are some advantages in having loans rather than share capital, those advantages are far fewer than they used to be (mainly because it is now far simpler to repay share capital than it was in the past) and, in any event, business realities demand that these loans are *de facto* fixed capital.

Where there is more than one shareholder, typically the loans are advanced proportional to shareholding, and the shareholders' agreement will ensure that this is always the case (or, if not, the shareholders who provide additional funding will be compensated to a greater degree). Despite this, the Income Tax Act, 1962 (the Act), does not recognise the economic substance of the situation that these loans are, in commercial reality, fixed capital of the company, commercially no different to share capital in many respects.

In 1991 (what is now) the Supreme Court of Appeal (SCA) decided the case of *Burman v CIR*, [1991]. In the case a company was funded by numerous individuals in such a manner. For all parties concerned, ie the company itself and each of its shareholders, the investment was a pure speculation in that the company was a township developer, acquiring stands for development and immediate resale at a profit. Mr Burman held a very small percentage interest in the company. The venture turned sour and Burman disposed of his shares and loan at a loss. The SCA refused to allow the loss on the loan as this was held to be of a capital nature, and not floating capital or trading stock, even though the shares were held to be trading stock and the loss thereon deductible (though minimal). Commercially this seems unreasonable, but that is how the SCA found the law to be (though two of the five judges in minority judgments found otherwise and in favour of the taxpayer).

THE CURRENT LEGAL POSITION

The case above was decided before South Africa introduced capital gains tax (CGT). Had we had CGT in our law at that stage, SARS would have been obliged at least to allow the loss on the loan as a capital loss. This might have been small comfort to Mr Burman if he had no capital gains. The reason is that, while trading losses shelter both income and capital gains, capital losses are ring-fenced and only shelter capital gains.

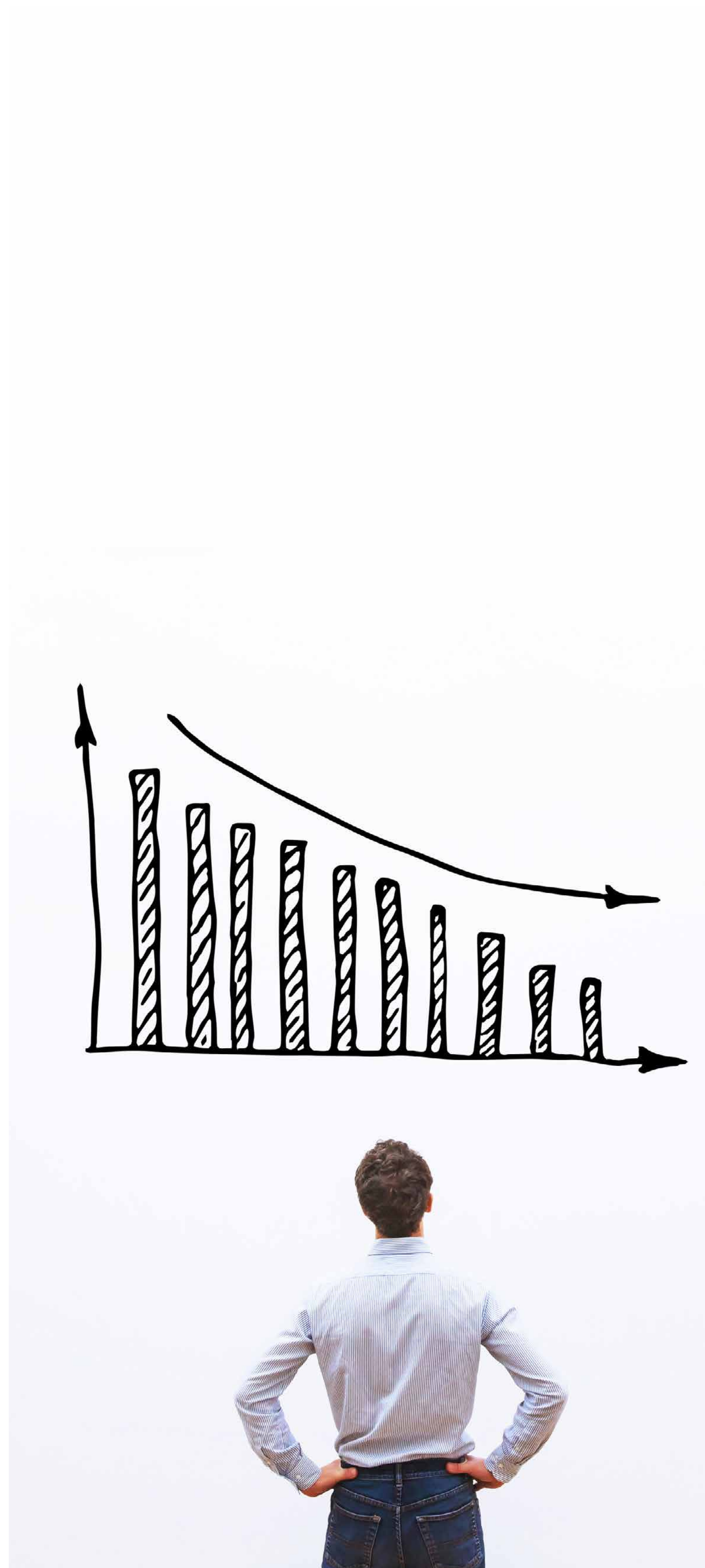
But not every loss on a shareholder's loan will necessarily be allowed as a capital loss which can shelter other capital gains. The reason is that paragraph 56 of the Eighth Schedule to the Act states that where a creditor disposes of a debt owed by a debtor, and they are "connected persons" as defined in the Act, then the creditor must disregard any capital loss as a consequence of the disposal. It

"But not every loss on a shareholder's loan will necessarily be allowed as a capital loss which can shelter other capital gains."

will be noted that a disposal can arise in a number of different ways, including where the loan is ceded to another, say in a sale of shares and claims agreement, or by way of forgiveness or waiver, or even if, say, the debtor company is liquidated and the loan is written off as a bad debt. The definition of "connected person" in section 1(1) of the Act is very broad, but for this purpose, as a rule of thumb, one can assume that if the debtor and creditor form part of the same group of companies, or, in the case of a shareholders' loan, the shareholder holds at least 20% of the equity shares in the debtor company, they will likely be connected persons.

There are, however, exceptions to the prohibition in paragraph 56, and if those exceptions apply then the creditor will, indeed, be allowed to claim the capital loss.

The first exception would be if the disposer can show that the acquirer of the loan will pay income tax or CGT on the same amount as was claimed as a loss. It must be kept in mind that, because the loan has been disposed of to a third party, together with the shares, at a loss, it means that the purchaser has acquired the loan at a discount to face value. If, under the purchaser's guidance the company is restored to profitability and is in a position to repay the loan in full, the excess of the amount received (ie equal to face value) over the cost of the loan will be taxable in the purchaser's hands. If the purchaser acquired the company as a speculation, then the gain will be subject to income tax. If it was acquired as a capital asset, then the gain will be subject to CGT. On the other hand, if the purchaser happens to be, say, a non-resident, then the gain will not be subject to tax in South Africa, in which case the seller will not be entitled to the loss.



As has been indicated, however, the disposal might be through, say, a waiver or forgiveness – maybe in order to restore the company to solvency – or simply because the debt is extinguished by reason of the company having been liquidated on insolvency. In the case of a waiver or forgiveness the possibility of a "debt benefit" arises, either under section 19 of the Act, in relation to deductible expenses or allowances, or under paragraph 12A of the Eighth Schedule, in respect of capital assets or capital gains. In the event that the creditor can show that the forgiveness resulted in a reduction of the tax cost or base cost of an asset, or gave rise to a reduction of the deductible expenditure or assessed loss of the debtor, or as a capital gain, under section 19 or paragraph 12A, as the case may be, the creditor will be allowed to claim the capital loss.

In other circumstances the loss will therefore not be able to be claimed. Thus, particularly on insolvency, the extinction of the liability due to insolvency will not in any way give rise to a fiscal benefit to SARS in the company, as it will be in liquidation, and thus no loss will be claimable by the creditor.

CONCLUSION

The current CGT rules and *Burman's* case share a common theme: in both cases shareholders' loans are, in commercial or economic substance and reality, but not legally, fixed and permanent capital, yet it might not be easy to claim losses on disposal. If, on the other hand, the economic and legal substance had been the same, ie, if the investment had initially been solely in the form of share capital, the taxpayer in *Burman's* case would have had no difficulty in claiming the income tax loss on disposal, and under today's CGT rules, a shareholder will have no difficulty in claiming capital losses on disposal of the shares in the circumstances.

As has previously been intimated, investing in companies with minimal share capital and large shareholders' loans is probably a legacy from the past when loans were useful mechanisms to enable shareholders to extract profits free of tax without distributing taxable dividends and to withdraw their capital easily without the complicated company law rules that applied to reductions of share capital, such as obtaining a court order or the consent of all creditors. Nowadays it is no more difficult to have a reduction of share capital than it is to distribute an ordinary annual dividend, and both objectives, ie withdrawing cash generated by profits otherwise than by way of taxable dividends, or reducing capital, can be achieved in this manner. The only remaining advantage of a loan over share capital is that the shareholder, as a creditor, will rank in competition with other creditors of the company on insolvency, whereas as a shareholder this is not the case. In practice, however, if the company is distressed, it is likely that the shareholder has subordinated or back-ranked the loan, in which case that benefit has fallen away as well.

Werksmans

Acts

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "connected person") & 19; Eighth Schedule: paragraphs 12A & 56.

Cases

- *Burman v CIR* [1991] (1) SA 533 (A); 53 SATC 63.

Tags: capital gains tax (CGT); equity shares.

MANUFACTURED DIVIDENDS

The Income Tax Act, 1962 (the Act), levies dividends tax of 20% on dividends paid by South African resident companies and non-resident companies (but in the latter case, only if the shares are listed in South Africa).

Where a company borrows listed shares, the lender would typically be entitled to a manufactured dividend paid by the borrower to the extent that a dividend was declared on the shares. The manufactured dividend is not regarded as a dividend as defined in the Act (whether for income tax or dividends tax purposes). This is because the manufactured dividend is paid in terms of a contractual arrangement between the lender and the borrower and not in respect of shares held by the lender in the borrower.

In order to levy dividends tax on certain manufactured dividend payments, section 64EB(2) was introduced into the Act in 2012. This section has since been amended on a number of occasions.

Currently, section 64EB(2) deems any amount paid by a borrower of a listed share or by the recipient of a listed share in terms of a collateral arrangement, to be a dividend paid by that borrower or recipient of the collateral, if the borrower or recipient of the collateral:

- is a resident company or includes the dividend in its income;
- holds the listed shares; and
- receives a dividend in respect of those shares or if a dividend accrues to the borrower or recipient.

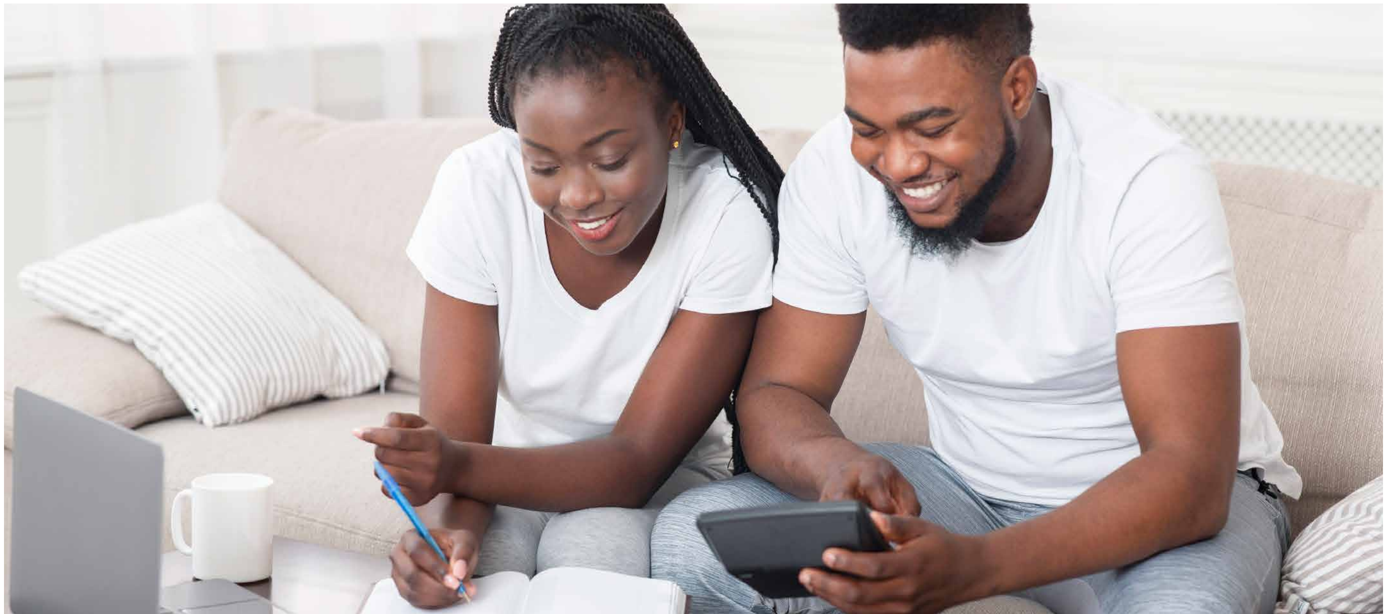
If section 64EB(2) applies to a payment, then that payment is deemed to be a dividend paid by the borrower or recipient of the collateral and subject to dividends tax and the payor has a withholding obligation. If the payor incorrectly withholds (or fails to withhold) then it may be liable for the withholding tax.

In the February 2020 Budget Review, the following was stated in respect of the lending of listed shares and the transfer of listed shares as collateral:

> **"Refining the tax treatment of transfer of collateral in securities lending arrangements**
>
> The Income Tax Act contains rules to address dividend tax avoidance transactions whereby listed shares are lent or transferred as collateral from a person that would be liable for the tax to a tax-exempt person.
>
> The borrower or recipient of the collateral receives the exempt dividend and pays a manufactured dividend to the lender or provider of the collateral. It is proposed that the anti-avoidance rules be extended to also cover situations where additional exempt parties are involved to facilitate the avoidance transactions."

Following on the 2020 Budget announcements made in February 2020, the 2020 draft Taxation Laws Amendment Bill (the DTLAB) was published on 31 July 2020 and the Taxation Laws Amendment Bill, 2020 (the TLAB), was introduced in the National Assembly on 28 October 2020. The TLAB, as amended, was agreed to by Parliament early in December 2020. The Bill proposes certain amendments to section 64EB(2) in terms of which payments are deemed to be dividends for purposes of the dividends tax.

"In our view, the proposed changes should not impact on a lender or collateral provider that is entitled to an exemption from dividends tax or in a situation where the amount is subject to income tax."



In this regard, the draft Explanatory Memorandum on the DTLAB states that:

> "…it is proposed that the current provisions of section 64EB(2) of the Act be amended to adjust the anti-avoidance trigger that currently requires the person paying a manufactured dividend to a person that is subject to dividends tax, to hold a share in the company declaring the dividend. The holding of a share requirement is to be deleted."

In terms of the TLAB it is proposed that the relevant provisions of section 64EB(2) be amended to apply where, *inter alia*,:

1. a person that is a resident company or a person that includes the dividend in its income, borrows a listed share or acquires a listed share in terms of a collateral arrangement; and
2. a dividend in respect of that share or any amount determined with reference to a dividend in respect of that share is received by or accrues to that person.

If these requirements are met, then for purposes of the dividends tax provisions, any amount paid by that person (ie the borrower/collateral recipient) to that other person (ie the lender/collateral provider) not exceeding that dividend or amount determined with reference to a dividend in respect of that share will be deemed to be a dividend paid by that person for the benefit of that other person.

The proposed amendments therefore delete the current requirement that the listed share be held by the borrower/collateral recipient.

In our view, the proposed changes should not impact on a lender or collateral provider that is entitled to an exemption from dividends tax or in a situation where the amount is subject to income tax.

However, these provisions may apply to cross-border arrangements where the lender or collateral provider is not subject to income tax on the receipt of the manufactured dividend.

As such, the payor of a manufactured dividend should take note and consider whether it may have a withholding obligation and the recipient of the manufactured payment should consider if it is liable for dividends tax or whether it may qualify for relief in terms of a double taxation agreement and what it should do in order to obtain such relief.

In terms of the TLAB, it is proposed that the amendments come into operation on 1 January 2021 and apply in respect of amounts paid on or after that date in respect of shares that are borrowed or acquired in terms of a collateral arrangement.

ENSafrica

Acts

- Income Tax Act 58 of 1962: Section 64EB(2).

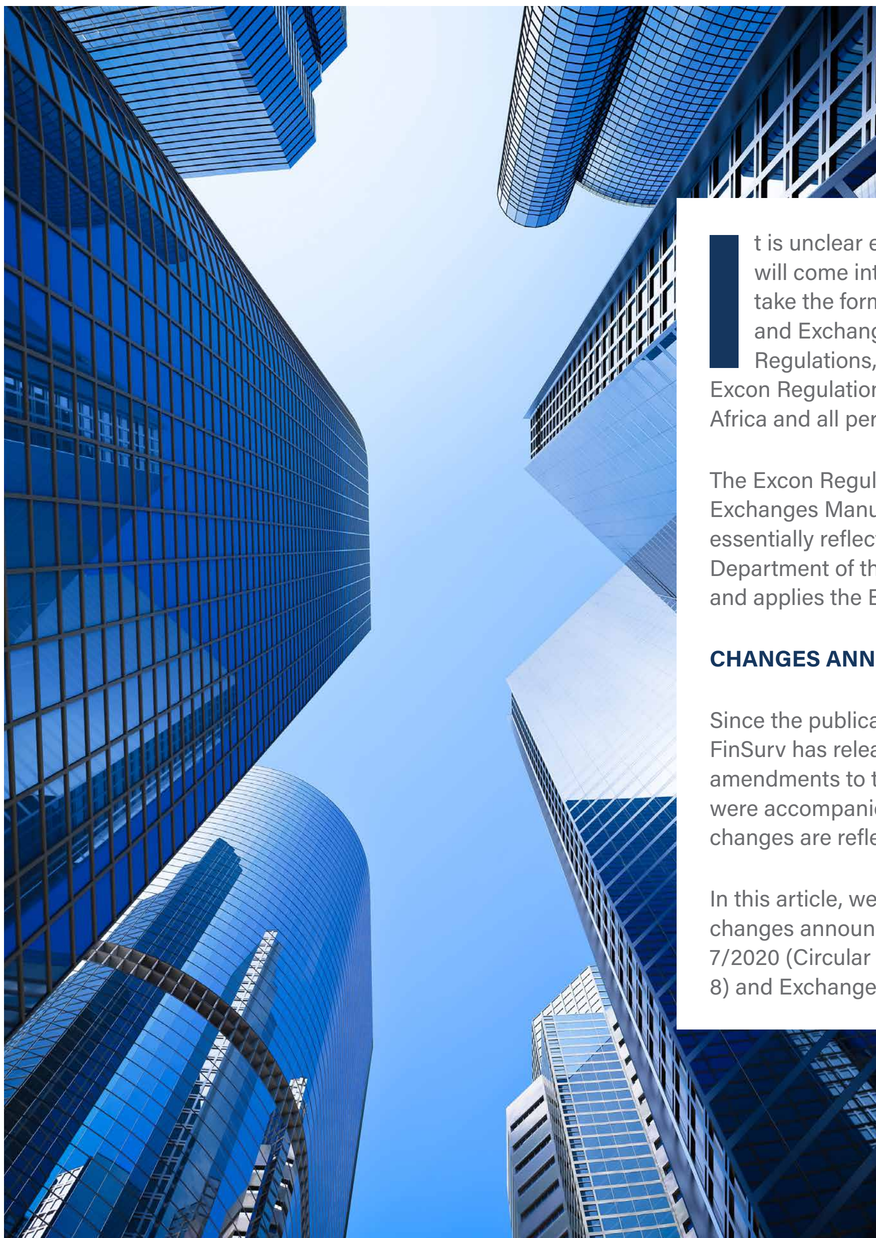
Other documents

- Budget Review (February 2020);
- Taxation Laws Amendment Bill 27B of 2020;
- Draft Taxation Laws Amendment Bill, 2020;
- Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2020.

Tags: dividends tax; manufactured dividend; double taxation agreement.

FURTHER DEVELOPMENTS

In the 2020 Budget Review, it was announced that South Africa's exchange control (Excon) regime would be replaced by a new capital flow management system in 2021. During workshops on the draft Taxation Laws Amendment Bill, 2020, and the draft Tax Administration Laws Amendment Bill, 2020, National Treasury confirmed that this change would take place in 2021 and that the tax proposals tied to this change would likely be implemented in 2021.



It is unclear exactly when the capital flow management system will come into effect and whether the rules of the system will take the form of regulations published under the Currencies and Exchanges Act, 1933, similar to the Exchange Control Regulations, 1961 (Excon Regulations). While in effect, the Excon Regulations still govern the exchange control laws in South Africa and all persons must comply with them.

The Excon Regulations must be read with the Currency and Exchanges Manual for Authorised Dealers (AD Manual), which essentially reflects the manner in which the Financial Surveillance Department of the South African Reserve Bank (FinSurv) interprets and applies the Excon Regulations.

CHANGES ANNOUNCED BY FINSURV

Since the publication of the Budget Review on 26 February 2020, FinSurv has released more circulars, in which it announced amendments to the rules of South Africa's Excon regime, which were accompanied by amendments to the AD Manual, where these changes are reflected.

In this article, we will briefly discuss some of the most recent changes announced, as contained in Exchange Control Circular No 7/2020 (Circular 7), Exchange Control Circular No 8/2020 (Circular 8) and Exchange Control Circular No 9/2020 (Circular 9).

CIRCULAR 7: TRANSACTIONS WITH COMMON MONETARY AREA RESIDENTS

Pursuant to the publication of this circular, foreign currency may now be sold to Common Monetary Area (CMA) residents residing and working in South Africa, provided the CMA resident can substantiate that the value of such funds is reasonable in relation to the income-generating activities in South Africa. CMA residents who travel overland to and from other CMA countries through other Southern African Development Community countries may be accorded foreign currency equivalent of an amount not exceeding R25 000 per calendar year. This allocation will not form part of the permissible travel allowance for residents.

Circular 7 further states that CMA investors who directly approach authorised dealers for the purpose of acquiring foreign asset exposure, would first have to obtain an approval letter from the relevant central bank or an appropriate mandated body of the CMA country. While not explicitly stated in the circular, the relevant approval letter would likely only need to be obtained by residents from eSwatini, Lesotho and Namibia. The circular finally notes that CMA residents may enter into rand transactions with South African institutional investors, but that the requirement to obtain an approval letter does not apply in respect of the discretionary business of the South African institutional investor.

CIRCULAR 8: MACRO-PRUDENTIAL LIMIT FOR AUTHORISED DEALERS

The circular notes that to address interpretational issues on the macro-prudential limit return raised by authorised dealers and their external auditors, section B.2(I) of the AD Manual has been deleted and replaced in its entirety. Some of the differences between the old section B.2(I) and the amended section B.2(I) are the following:

- Section B.2(I)(i) now expressly states that the macro-prudential limit is only applicable to authorised dealers and restricted authorised dealers who are not branch operations of foreign institutions.

- The foreign exposure for the macro-prudential limit has been clarified to mean all foreign assets held where such assets are foreign currency denominated, except for the dispensations in section B.2(I)(iv)(b), namely the following:

    - foreign exposures directly related to infrastructural development by the authorised dealer;

    - outward foreign direct investment by authorised dealers, including the acquisitions in terms of section 52 of the Banks Act, 1990;

    - current foreign currency (CFC) account balances; and

    - foreign currency denominated facilities made available to South African companies in respect of *bona fide* foreign direct investments; infrastructural development; trade finance facilities relating to the import and export of goods from South Africa; and working capital loan facilities to residents.

Most of these dispensations were included in the old section B.2(I), but were not as clearly delineated. Previously, these were loosely listed in section B.2(I)(viii).

CIRCULAR 9: VARIOUS AMENDMENTS TO THE AD MANUAL

The circular indicates that to address market terminology misalignment, various terms in the AD Manual were reviewed and new definitions have been added under Section A.1 of the AD Manual. Some of the definitions include references to the Pension Funds Act, 1956, Insurance Act, 2017, and the Financial Markets Act, 2012.

The circular further notes that section B.2(H) of the AD Manual, which deals with rules pertaining to South African institutional investors, was amended to highlight the requirements to which authorised dealers must adhere when facilitating the transfer of funds on behalf of institutional investors and the requirements to which institutional investors must adhere in obtaining foreign exposure. It also outlines the conditions under which existing local and offshore assets can be transferred between institutional investors or between managing institutions.

Circular 9 further notes that a dispensation has been granted for institutional investors to open customer foreign currency accounts to accept foreign currency deposits emanating from the disinvestment proceeds of foreign assets, pending the reinvestment of the funds offshore.

The circular also notes that the AD Manual has been amended to outline the circumstances in which discretionary foreign assets under the management of a discretionary financial services provider may be registered in the name of the underlying retail client as the beneficial owner.

Finally, the AD Manual has been amended to outline measures that may be taken by FinSurv, as administrator of the Excon system, in respect of any deviation or non-compliance by an institutional investor with –

- the Excon Regulations;
- the requirements of the AD Manual;
- specific authorities granted; and
- any other requirements or conditions as may be stipulated from time to time by FinSurv.

COMMENT

Entities or persons affected by the amendments discussed in this article, in particular South African institutional investors, should take note of the amendments and ensure that they comply with them, while the Excon Regulations and the AD Manual remain in effect.

As stated in the introductory part of this article, it is unfortunately unclear for how long the Excon Regulations, read with the AD Manual, will remain in effect and exactly when they will be replaced by the capital flow management framework. While this situation is not ideal, persons would be well served to ensure that they continue complying with the existing Excon framework, including any amendments thereto. It is possible that parts of the capital flow management framework may be based on the Excon Regulations read with the AD Manual, in which case it should be simpler for entities governed by that part of the capital flow management framework to ensure compliance.

"As stated in the introductory part of this article, it is unfortunately unclear for how long the Excon Regulations, read with the AD Manual, will remain in effect and exactly when they will be replaced by the capital flow management framework."

Cliffe Dekker Hofmeyr

Acts

- Currencies and Exchanges Act 9 of 1933;
- Banks Act 94 of 1990: Section 52;
- Pension Funds Act 24 of 1956;
- Insurance Act 18 of 2017;
- Financial Markets Act 19 of 2012.

Other documents

- Draft Taxation Laws Amendment Bill, 2020;
- Draft Tax Administration Laws Amendment Bill, 2020;
- Exchange Control Regulations, 1961;
- Currency and Exchanges Manual for Authorised Dealers (AD Manual):
  - *Amended* section A.1 (new definitions have been added and terms have been reviewed);
  - *old* section B.2(I) (including B.2(I)(viii));
  - *amended* section B.2(I) (including section B.2(I)(i) & B.2(I)(iv)(b)) & section B.2(H);
- 2020 Budget Review (published on 26 February 2020);
- FinSurv circulars (since publication of Budget Review on 26 February 2020), announcing amendments to the rules of South Africa's Excon regime (accompanied by amendments to the AD Manual, where these changes are reflected);
- Exchange Control Circulars Nos 7, 8 & 9/2020.

Tags: capital flow management system; foreign currency; macro-prudential limit; offshore assets; institutional investor.

RETIREMENT FUND ANNUITISATION

New tax rules regarding the annuitisation of provident funds will come into effect on 1 March 2021.

These rules were first mooted in 2013 and formed part of the process to harmonise the tax treatment of the different kinds of retirement funds. In the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2013, National Treasury (NT) stated that:

> "A strong link exists between insufficient retirement income for retired members of provident funds and the lump sum payouts made by provident funds at retirement. In short, the absence of mandatory annuitisation in provident funds means that many retirees spend their retirement assets too quickly and face the risk of outliving their retirement savings. In view of these concerns, it is Government's policy to encourage a secure post-retirement income in the form of mandatory annuitisation."

These proposals (referred to as the "T-Day reforms") were originally intended to come into effect on 1 March 2015. However, there was an outcry from some parts of South Africa that the Government was trying to nationalise retirement funds, which led to a delay in the introduction of some of the proposed changes.

The tax treatment of contributions to retirement funds has already been aligned. Since 1 March 2016, contributions to pension funds, provident funds and retirement annuity funds (RAs) are subject to the same rules regarding deductibility. However, due to strong opposition, the proposed annuitisation of provident funds was postponed. It appears that the annuitisation rules will now take effect, six years after their original anticipated effective date.

THE ANNUITISATION RULES

In terms of the annuitisation rules, members of retirement vehicles, irrespective of whether the vehicle in question is a pension fund, a provident fund or an RA, will be subject to similar rules regarding access to cash on retirement.

With specific exceptions provided in the "grandfathering" provisions, from 1 March 2021, members of all retirement funds will only be able take one-third of the total value of their retirement fund interest by way of a lump sum with the balance being taken as an annuity.

This is further subject to an exception where the total retirement interest does not exceed R247 500, in which case the full amount may be taken in cash.

The grandfathering provisions ("vested right protection") exist to ensure that the restriction will only apply to amounts contributed to funds on or after 1 March 2021 and not to members who are close to retirement. So, the rules will not apply to:

- the credit in the fund as at 1 March 2021 and subsequent fund return on that amount; or
- members of provident funds and provident preservations funds aged 55 years and older on 1 March 2021 who will be entitled to take their full benefits on retirement (including the fund return) as well as any contributions made to the provident fund after 1 March 2021.

IMPACT ON PROVIDENT FUNDS AND THEIR ADMINISTRATORS

Provident funds and their administrators will need to keep accurate member records indicating the pre-March 2021 contributions and growth, and post-March 2021 contributions and growth.

This is in addition to the work that will be required as a result of several legislative changes affecting the retirement fund industry, such as the draft Conduct of Financial Institutions Bill (the draft CoFi Bill), 2020, which are currently being considered.

The draft CoFi Bill was published for public comment on 29 September 2020 and contains significant proposed changes to the Pension Funds Act, 1956. One of the changes will result in the renaming of the Pension Funds Act to the "Retirement Funds Act" and the addition of a definition of "provident fund".

As currently drafted, the proposed definition of "provident fund" in the draft CoFi Bill reads "a retirement fund where a member may receive the member's full benefit upon retirement", which is different from the definition of "provident fund" in the Income Tax Act, 1962 (the Act). We assume that this definition in the draft CoFi Bill will change to align with the definition in the Act.

While this work is being done, it would be worth considering the relevance of the definitions of the different retirement fund vehicles in the Act. After all those who are subject to the grandfathering provisions have exited the system, it will be necessary to consider whether there is any point in retaining the concepts "pension funds" and "provident funds".

ACCESS TO FUNDS ON EMIGRATION

The Taxation Laws Amendment Bill, 2020, which was tabled by the Minister of Finance on 28 October 2020, indicates that, notwithstanding objections to the proposed amendments to the withdrawal of funds from preservation funds and RAs upon emigration, NT is going ahead with the amendments.

In terms of current legislation, members of a preservation fund or an RA may, as a general rule, not access these funds before retirement (age 55 at the earliest). However, there are some exceptions to this rule, such as the rule that a member who emigrates from South Africa, if that emigration is recognised by the SARB for exchange control purposes (referred to as financial emigration), may withdraw his/her funds from the preservation fund or RA.

"Provident funds and their administrators will need to keep accurate member records indicating the pre-March 2021 contributions and growth, and post-March 2021 contributions and growth."

The proposal by NT is to only allow the withdrawal when the individual has been tax non-resident for an uninterrupted period of three years or longer.

There was substantial opposition to this proposal. One of the comments made to NT was that the three-year waiting period would place a financial burden on individuals as the amounts received from retirement funds are often used to cover settling in costs in a new country.

NT was not swayed. In their view, the three-year waiting period is a mechanism to ensure that there is a sufficient lapse of time for all emigration processes to have been completed with certainty, without affecting such workers whose residence status changes for reasons other than emigration.

The only "concession" seems to be that the current rule will still apply in respect of applications for emigration received on or before 28 February 2021.

It is unfortunate that many potential emigrants will now feel that they have no choice other than to formalise their emigration in the next couple of months in order to obtain access to retirement funds.

It is important for potential emigrants to understand that the proposed rules apply only to preservation funds and RAs, not to current membership of a pension fund or provident fund. The full after-tax value of a withdrawal benefit in respect of a pension fund or provident fund will continue to be available to current members of these funds, after 1 March 2021.

Bowmans

Acts

- Pension Funds Act 24 of 1956: Section 1(1) (proposed insertion of definition of "provident fund"); proposed amendment of short title to "Retirement Funds Act" (in draft CoFi Bill);
- Income Tax Act 58 of 1962: Section 1(1) (definition of "provident fund").

Other documents

- Taxation Laws Amendment Bill 27B of 2020;
- Draft Conduct of Financial Institutions Bill (CoFi Bill): Schedule 5 (Laws amended and repealed);
- Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013..

Tags: annuitisation of provident funds; withdrawal benefit.

SARS' DECISION TO AUDIT

Administrative action (being the exercise of public powers and the performance of public functions by organs of state) may be taken on review by members of the public that have been adversely affected by a decision that is taken by any public authority.

In the judgment of *Cart Blanche Marketing CC and Others v Commissioner for the South African Revenue Service*, [2020], the High Court of South Africa had to determine whether the decision taken by the South African Revenue Service (SARS) to audit a taxpayer constituted administrative action and whether the said decision was capable of being reviewed under South African administrative law.

FACTS

The first two applicants in this case were close corporations involved in the supply of commercial transport services to their clients. The third applicant was a member of each of the first two applicants.

In 2014, SARS selected the applicants for audit in accordance with section 40 of the Tax Administration Act, 2011 (the TAA). This decision was made following investigations into the customs, income tax and value-added tax (VAT) compliance of the applicants, which investigations were undertaken after SARS' Tax and Customs Enforcement Unit had been made aware of "suspicious activities" that had come to light pursuant to the ongoing customs litigation between SARS and various companies that were affiliated with the applicants.

In the notice informing the applicants of the intended audit, they were advised that the audit was based on a risk assessment that had been done by SARS and they were requested to make available certain records to facilitate a proper audit. After the failure by the applicants to provide the necessary records, SARS conducted the audit on the basis of the documentation in its possession and subsequently informed the applicants of its intention to issue additional assessments in respect of income taxes that had been underpaid.

On 24 March 2015, the applicants informed SARS that they would be instituting review proceedings, contending that the decision to audit on a risk assessment basis was unlawful as no income tax risk pertaining to the applicants had been established by SARS. In support of this contention, the applicants argued that –

1. SARS' failure to provide the written risk assessment served as proof that no risk assessment existed at the time that the decision was made; and
2. the issuance in the past of tax clearance certificates demonstrated that they had always been fully compliant with all of their obligations under the tax Acts.

The applicants further advised SARS that the review proceedings would be instituted by no later than 14 April 2015 and requested that SARS refrain from proceeding with the audit or issuance of further assessments until such time as the review had been finalised. However, on 13 April 2015, SARS issued the additional income tax assessments and refused to suspend the obligation to make payment of the disputed tax raised by means of those assessments.

In the review proceedings that followed, the applicants sought to review SARS' decision to audit on the basis that the decision was unlawful given that the decision was –

1. taken for an ulterior purpose;
2. taken for a reason not authorised by the empowering legislation (being the TAA);
3. irrational; and
4. taken in bad faith.

In opposing the review application, SARS contended that the decision to audit did not constitute administrative action that was capable of being reviewed, or alternatively that the decision was lawful and should therefore not be set aside.

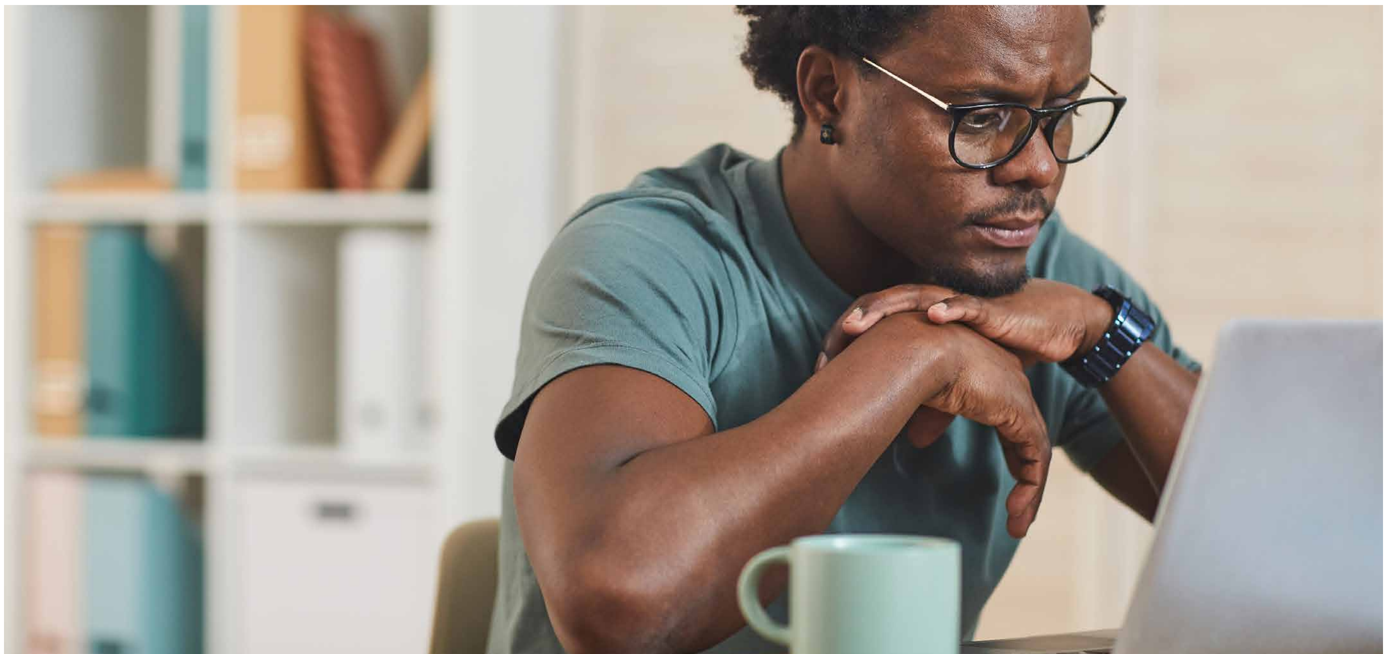
"The court concluded that the decision taken by SARS to audit the applicants did not constitute administrative action that stood to be reviewed and the review application was dismissed with costs."

JUDGMENT

Decisions by organs of state can be reviewed either on the basis of the provisions of the Promotion of Administrative Justice Act, 2000 (PAJA), or alternatively, on the principle of legality to the extent that PAJA does not apply. In the present matter, PAJA did not find application and as such, the court had to consider whether the decision by SARS to audit was reviewable under the principle of legality. In order to make this determination, the court undertook a step-by-step analysis of the application of the facts of this case to the elements underlying the principle of legality.

The powers bestowed on SARS by the empowering provision (section 40 of the TAA)

The court highlighted that one of the purposes of the TAA is to ensure the effective and efficient collection of tax by prescribing the powers and duties of persons engaged in the administration of a tax Act, including SARS. This should be understood in conjunction with the South African Revenue Service Act, 1997, which states that SARS must secure the efficient and effective, and widest possible, enforcement of the tax Acts in order to effectively collect revenue (amongst other objectives). On this basis, it was held that SARS is not only empowered to use the available administrative mechanisms to collect all taxes, but is also legally obliged to do so in order to properly carry out its functions.



In terms of section 40 of the TAA, SARS has the power to select a person for audit on the basis of any consideration relevant for the proper administration of a tax Act. To this end, it is worth noting that "administration of a tax Act" includes obtaining full information in relation to anything that may affect the liability of a person for tax in respect of a previous, current or future tax period. It was the finding of the court that there would be no limitation to the considerations on which a decision to select a taxpayer for audit is to be founded to the extent that the intended audit is to be undertaken for the proper administration of a tax Act.

The purpose behind SARS' exercise of the powers bestowed by section 40

When SARS informed the applicants of its intention to audit, it advised the applicants of the scope of the audits and the documents that were to be provided in order to facilitate the process. The court found that each of the requested documents were of the kind that would prove or disprove the correctness of the VAT and income tax returns filed by the applicants and that SARS would achieve no ulterior purpose by requesting the relevant documents. As such, it was apparent to the court that every enquiry directed by SARS was relevant for the administration of a tax Act.

"Although the TAA bestows very broad powers on SARS in order to enable it to effectively collect revenue, it is worth noting that the TAA also contains provisions and processes aimed at giving effect to taxpayers' rights."

The "ripeness" of the matter for litigation

The "ripeness" of a matter refers to the suitability of a matter to be adjudicated by a competent court. At issue here is generally the timing in respect of which proceedings are instituted and whether it is appropriate for the matter to be subject to litigation at that time.

In order for a decision to be reviewed, that decision must have had an adverse effect on the rights of a person in a manner that has a direct and external legal effect. To this end, the court noted that the request for documents by SARS could not have prejudiced the applicants as the applicants had a statutory obligation (in terms of section 29 of the TAA) to keep the relevant documents for a prescribed period of time.

The court also held that the selection of a person for audit results in an investigative process being set in motion and that this does not constitute a decision capable of review as the process has not yet come to completion such that the rights of that person will have been affected. In this regard, the court gave extensive consideration to the provisions of section 42 of the TAA, which provides that –

1. during an audit, SARS must provide the taxpayer with a report indicating the stage of completion of the audit;
2. upon the conclusion of the audit SARS must indicate the outcome of the audit, including the grounds for any proposed assessment or decision; and
3. a taxpayer must respond in writing to the facts and conclusions drawn by SARS pursuant to the audit.

The court found that section 42 affords a taxpayer reasonable opportunity to make representations regarding the audit findings by SARS and that it performs a function similar to that of section 3 of PAJA (which requires that representations be made by the aggrieved party before review proceedings can be instituted). It was held that section 42 had been available to each of the applicants but that none of them had elected to make use thereof. Ultimately, the court decided that if the processes contained in section 42 had been exhausted, the decision by SARS may (at that time) have reached the required degree of ripeness such that the decision would be subject to review.

The application of the principle of subsidiarity

The principle of subsidiarity prescribes that where legislation has been enacted to give effect to a right, a litigant must rely on that legislation (rather than a constitutional provision) in order to give effect to that right, or alternatively the litigant must challenge that legislation as being inconsistent with the Constitution.

The court found that section 42, as well as the processes relevant to the tax court, give effect to the constitutional rights that the applicants sought to protect by instituting the review application. As such, it would have been more apt for the applicants to have pursued those processes in terms of the specific tax legislation rather than to institute the review proceedings. In addition, the applicants did not challenge the constitutional validity of the appeal processes contained in the TAA. For these reasons, the court held that the applicants had breached the subsidiarity principle and that it could not entertain the review application.

Conclusion on the reviewability of the decision to audit

The court concluded that the decision taken by SARS to audit the applicants did not constitute administrative action that stood to be reviewed and the review application was dismissed with costs.

COMMENT

Although the TAA bestows very broad powers on SARS in order to enable it to effectively collect revenue, it is worth noting that the TAA also contains provisions and processes aimed at giving effect to taxpayers' rights. As such, it is important for taxpayers to understand the type, and extent, of the rights provided for, and how to ensure that those rights are protected and enforced to the fullest extent.

While SARS' decision to audit in this case was not subject to review, it does not necessarily mean that all other decisions taken by SARS are not subject to review in terms of administrative law. For example, where SARS has rejected a taxpayer's application to suspend payment of tax in terms of section 164 of the TAA, such a decision can be taken on review.

Cliffe Dekker Hofmeyr

Acts

- Tax Administration Act 28 of 2011: Sections 29, 40, 42 & 164;
- Promotion of Administrative Justice Act 3 of 2000 (PAJA): section 3;
- South African Revenue Service Act 34 of 1997.

Other documents

- Taxation Laws Amendment Bill 27B of 2020;

Cases

- *Cart Blanche Marketing CC and Others v Commissioner for the South African Revenue Service* (26244/15) [2020] ZAGPJHC (31 August 2020).

Tags: additional income tax assessments; income tax returns; principle of subsidiarity.

THIRD PARTY TAX COLLECTION AGENTS

It has been widely reported that South Africa faces a significant projected tax revenue shortfall for the 2020/2021 financial year, due to the COVID-19 pandemic and the concomitant lockdown. In light of this, taxpayers should appreciate that there is increased pressure on the South African Revenue Service (SARS) to collect outstanding tax debts. Under the Tax Administration Act, 2011 (the TAA), SARS is entitled to collect outstanding tax debt in different ways. One of its powers is to instruct a third party to pay an amount owing by that third party to a taxpayer to SARS instead, in satisfaction of the taxpayer's tax debt. Prior to issuing such a notice to a third party, SARS must follow the process laid down in section 179 of the TAA, failing which the lawfulness of the third-party notice and the collection of tax through this mechanism, can be challenged.

In the matter of *WPD Fleetmas CC v CSARS and Another*, [2020], the Gauteng Division, Pretoria (High Court) had to consider whether the third-party notice issued by SARS to the second respondent, regarding moneys owing by the applicant (WPD) to SARS, was valid. WPD brought its application to set aside the third-party notice on an urgent basis.

FACTS

WPD is a service provider to the second respondent for the supply of underground winch signalling device systems and is remunerated on a monthly basis. On 22 June 2020, SARS issued a third-party notice to the second respondent in terms of section 179 (S179 Notice). On 8 July 2020 and in terms of the said notice, the second respondent paid the amount of R6 284 915.88 over to SARS. According to WPD, only on 7 July 2020 did SARS issue and address a "final letter of demand" to it. On the other hand, SARS alleged that it sent a "final demand dated 20 May 2020" to WPD on 20 May 2020, via an "electronic filing transaction", which means that the letter was delivered via WPD's e-filing profile.

In addition to requesting the High Court to rule that the S179 Notice issued was null and void, WPD further requested the court to grant an interim interdict, interdicting and restraining SARS from initiating and/or continuing recovery proceedings against WPD.

LEGAL FRAMEWORK

Section 179(1) states the following:

> "A senior SARS official may authorise the issue of a notice to a person who holds or owes or will hold or owe any money, including a pension, salary, wage or other remuneration, for or to a taxpayer, requiring the person to pay the money to SARS in satisfaction of the taxpayer's outstanding tax debt."

Section 179(5), which was the main provision that had to be considered in this matter, states the following, in the relevant part:

> "SARS may only issue the notice referred to in subsection (1) after delivery to the tax debtor of a final demand for payment which must be delivered at the latest 10 business days before the issue of a notice, which demand must set out the recovery steps that SARS may take if the tax debt is not paid and the available debt relief mechanisms under this Act..."

The High Court also considered section 11 of the TAA, which states in subsection (4) that –

> "unless the court otherwise directs, no legal proceedings may be instituted in the High Court against the Commissioner, unless the applicant has given the Commissioner written notice of at least 10 business days of the applicant's intention to institute the legal proceedings."

JUDGMENT

Before dealing with the merits of the matter, the High Court had to consider certain preliminary arguments raised by SARS. In response to SARS' argument that the matter was not urgent, the High Court held that the matter was indeed urgent. It based this finding mainly on WPD's argument that as a result of the amount of R6 284 915.88 being paid over to SARS, it would be unable to pay its employees' salaries and its service providers for a second month, which would have a knock-on effect and result in WPD losing its service providers.

The second preliminary argument raised by SARS was that WPD had not complied with section 11(4), as it had not issued a notice to SARS indicating its intention to institute legal proceedings. On this issue, the High Court held that the provision does not require WPD to apply on notice or in the application itself to condone a failure to comply with it. The High Court is empowered with a wide discretion to condone a failure or to "direct otherwise". It was then considered that SARS had an opportunity to file not only an answering affidavit, but also a supplementary affidavit and that both parties were given an opportunity to file heads of argument and make oral arguments on all the issues. As such, the High Court held that SARS had an opportunity to present its case properly, that there was no prejudice and thus held that it should "direct otherwise" and allow the matter to proceed without the notice requirement being met.

The High Court then considered the merits of the application. The main issue was whether the final demand for payment had been delivered to WPD in the manner required by section 179(5). In support of its argument that the final demand was validly issued and delivered to WPD on 20 May 2020, SARS attached a "screen grab" indicating that a final demand for an overdue debt had been created on its system, which reflected the date of 20 May 2020. At the same time, WPD presented a "screen grab" of its e-filing profile, reflecting that no final demand had been received by WPD on 20 May 2020 for outstanding income tax.

Considering SARS and WPD's evidence, the High Court stated that the most important thing is that WPD's e-filing profile indicates that the S179 Notice was not received. The High Court held that to comply with section 179(5) in this matter, the demand had to be delivered via the electronic e-filing profile of WPD. According to the

"The judgment shows that taxpayers can successfully enforce their rights against SARS where SARS has not met the procedural requirements when using its powers to collect debt under the TAA."

High Court, this was in accordance with section 179(5), which refers to a "delivery to the tax debtor of a final demand." Considering that WPD's e-filing profile reflected that no final demand for income tax had been delivered via e-filing on 20 May 2020, the High Court held that SARS failed to comply with section 179(5). As such, the High Court held that the S179 Notice issued by SARS was null and void and that the amount of R6 284 915.88 had to be paid back to WPD, with interest.

The High Court rejected WPD's request for an interim interdict, to interdict SARS from initiating recovery proceedings against WPD on the basis that this would violate the separation of powers principle.

COMMENT

The judgment shows that taxpayers can successfully enforce their rights against SARS where SARS has not met the procedural requirements when using its powers to collect debt under the TAA. While the taxpayer in this matter was not properly notified of the final demand and SARS' conduct was therefore unlawful, the judgment should serve as a reminder for taxpayers with outstanding tax debts to ensure that they comply with the TAA and not get caught off guard. While the taxpayer in this case was at least successful, it is safe to say that most taxpayers would likely want to avoid having to go to court and incur legal expenses to enforce their rights. The case lends further authority regarding the interpretation of section 179.

What is also significant, is the High Court's finding that WPD was entitled to bring the application, despite the notice requirement in section 11(4) not being met. This is particularly significant, as the section was recently amended to increase the notice period from one week to 10 business days. The judgment sheds light on the type of circumstances in which a high court application can be brought, without the notice requirement being met.

Cliffe Dekker Hofmeyr

Acts

- Tax Administration Act 28 of 2011: Sections 11(4) & 179(4) & (5).

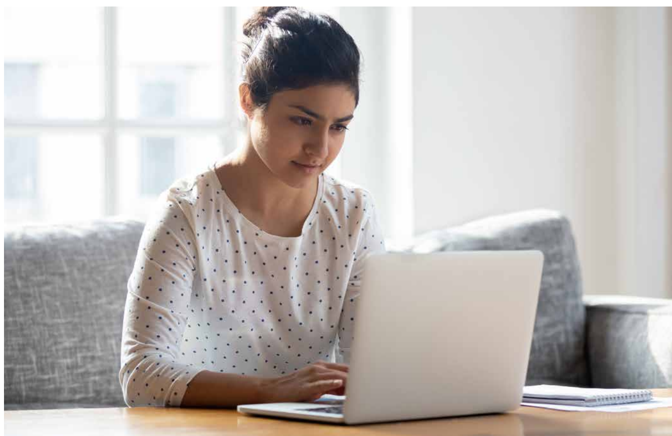
Cases

- *WPD Fleetmas CC v CSARS and Another* (31339/20) [2020] ZAGPPHC (19 August 2020).

Tags: tax debt; electronic filing transaction.

NAVIGATING TRANSFER PRICING AUDIT

Transfer pricing audits can be onerous, but taxpayers can achieve a more successful outcome by providing all information requested, anticipating areas of concern, and engaging openly with SARS.



The South African Revenue Service's (SARS') issue of seemingly arbitrary questionnaires to multinationals on the provision or receipt of intra-group services has encountered much criticism and complaint.

Although many will agree that there appears to be a lack of coordination at SARS, with many taxpayers receiving these questionnaires while already under a transfer pricing audit, it demonstrates that SARS is serious about tackling the perceived use of transfer pricing to shift profits and contribute to base erosion in South Africa.

SARS is not the only tax administration taking this view. Transfer pricing featured heavily in the BEPS programme (Base Erosion and Profit Shifting programme) and continues to be a focus of the G20/OECD (G20 countries and Organisation for Economic Cooperation and Development). Taxpayers should be prepared for an increased focus on transfer pricing practices and more questionnaires and requests for information from SARS.

How should you navigate this to achieve a liveable outcome? Below we explore some of the challenges and possible approaches that could ensure that taxpayers facing audits into transfer pricing practices emerge relatively unscathed.

The notification of an audit can quickly throw tax managers into a mood of frustration. Firstly, because in many cases SARS has already been provided with comprehensive transfer pricing documentation supporting the policies in place and seems to be asking for more irrelevant information. Secondly, because the tax manager is aware that this is the start of a long and difficult process which will tie up their already-stretched resources and detract from dealing with the day-to-day operations of the business. It is important to remember that SARS only has a snapshot of the transactions from the annual financial statements, the tax return and the transfer pricing documentation (if submitted). Obviously it does not have the same level of understanding of the business as the taxpayer does.

The request for additional information accompanying SARS' notification of the audit aims to bridge that knowledge gap. While some of the questions raised may appear pointless or irrelevant, that may indicate SARS is unsure what questions to ask and is trying to make the first request as comprehensive as possible. This is largely why the first request leads to a second request and so on. Section 46 of the Tax Administration Act, 2011 (the TAA), gives wide powers to SARS to request information which it considers to be relevant in order to apply the Income Tax Act (in this case section 31).

Clients often ask us whether they should provide information which they consider irrelevant to the audit. Our response is always the same: "What is the downside of providing the information requested?" In some cases, it is the time and resources needed to collate the information for SARS. However, if SARS considers it relevant and it is not supplied, SARS will invariably ask for it again and may view the taxpayer as being obstructive. Being co-operative in providing the information not only ensures an amicable working relationship with SARS, but may result in SARS being more amenable to granting extensions to provide that information as well as the greater possibility of penalty mitigation if the audit results in an adjustment. It is therefore worth considering this when dealing with SARS' frustrating requests. *Being prepared is being forearmed*. While the initial information requests may not indicate where SARS' concerns are, it is certainly worth taking a step back and undertaking an internal risk assessment for the years under audit. This will help to determine the best strategy to adopt throughout the audit. Revisiting the transfer pricing analysis is key. Question whether the transfer pricing analysis raised any potential problems. Touching base with the advisors who prepared the documentation could provide insight into any issues identified when the analysis was undertaken.

Checking that the documented analysis aligns with the related legal agreements and that both accurately reflect what was actually happening in the audit years is also critical. If the document analysing and supporting the transfer pricing differs either from the legal agreements in effect, or the conduct of the parties in those years, the chances are that SARS will disregard the analysis and draw its own conclusions. Being aware of these risk areas enables you to ascertain how to manage the rest of the audit and perhaps start to prepare for a likely adjustment at its end. If you know there is a problem and some of the transfer pricing practices were incorrect, it might be better to "fess up" early and bring a quick resolution to the audit. SARS would no doubt appreciate a quick win and walk away. Trying to cover an issue up is likely to lead to a long drawn-out audit which will end the same way and possibly result in other issues being identified.

Understanding SARS' area of concern will also enable you to effectively manage the audit better. It may not be possible to identify SARS' thinking from the early correspondence, but as the audit progresses this should become clearer. It is better to be prepared for the letter of findings than be taken by surprise. For instance, if the transfer pricing analysis highlights that the tested party assumes risk and is classified as a full risk entity, but in reality the risks are minimal or unlikely to occur, this could be a possible area of risk in the audit.

SARS will want to interview key individuals during the course of the audit. These individuals will include operational as well as tax and finance people. Ensuring that the non-tax individuals are briefed in advance is important to ensure that they respond appropriately and in context to the questions raised by SARS. Common issues we encounter are the use of *hearsay*. The individual is asked a question outside his or her area of expertise but responds based on an understanding or belief of what happened, rather than from first-hand knowledge. Interviewees should *remain in their lane* and only respond when they know the answer, avoid speculating and be prepared to say *I don't know,* or *you need to ask*…..

A good strategy is to interview the individuals internally first. Potential interviewees must refresh their memories by reading through relevant contemporary documents. Not only will this ensure they are prepared, it will also enable you to be sure SARS is interviewing the correct people with the requisite knowledge to respond to the questions. In some instances, SARS may be prepared to share a broad outline of the questions they will ask in advance to enable you to ensure the most experienced individuals within the right fields are interviewed. It is also a good idea to have someone present at the interview to moderate the discussion, if required, and to record the interview so that there is a clear record of what was said.

Throughout the course of the audit, large volumes of documents will be shared with SARS and there may be several meetings with SARS. Ensure that you maintain a file which includes everything provided, minutes of all meetings held, copies of all interviews held and the dates that these were provided or undertaken. On several occasions our clients have had to search for a document which was provided to SARS during the audit and on which SARS was now relying for its findings.

Information will also be shared with SARS electronically. The use of data rooms is useful to maintain the log of information shared. However, the management of these data rooms and the access is important and needs to be carefully monitored.

SARS will generally indicate once they have the information they need to reach their findings. It is also important that you are comfortable that all relevant information has been provided. It is preferable to extend the audit period to clear any outstanding items rather than leave SARS to establish its findings on part-fact and part-assumption.

Responding to the letter of findings will set the scene for how the likely adjustment is to be defended. This letter sets out SARS' position based on the facts it has analysed. Look closely at the position put forward by SARS and determine how best to respond. The period between the letter of findings and the letter of assessment provides a window to correct any misunderstandings which may exist and ensures that SARS makes any adjustment based on the correct facts. There are audits where facts are still being clarified at the alternative dispute resolution (ADR) stage.

Sometimes it may be preferable to engage with SARS by presenting the facts to them and allowing additional questions and discussion in a face-to-face meeting. This can help to deal with misunderstandings effectively. If this approach is chosen, it is important to agree with SARS who will minute the meeting and that both the taxpayer team and the SARS team must agree on the final minutes recorded.

Ensuring that you and SARS are working from the same hymn sheet is paramount to achieving an acceptable outcome.

Are there any easy wins? By analysing the letter of findings, the facts surrounding the transactions and the transfer pricing support it may be possible to identify early wins. One area which often causes clients and SARS alike to err is the application of the "connected person" definition to the entities who are party to the audited transactions. SARS has provided comprehensive guidance on the definition of "connected person" in its recently updated interpretation note (Interpretation Note 67), which also includes useful examples. If the parties are not connected, then section 31 (in its current form) does not apply – and that's the end of it. Having been through two matters where this was the case, it may frustrate SARS, but at the end of the day *the law is the law*.

One of the most common causes of disagreement between taxpayers and SARS in a transfer pricing audit relates to the fact pattern and notably whether the entity under investigation is factually doing what it is purported to do. *This is the age-old limited risk versus full risk dilemma*.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2017) provide exhaustive guidance on analysing the assumption of risk, but *the facts are the facts*. Although it is important to evidence the functions undertaken, risks assumed and assets used by the entities in the transaction under audit, the situation needs to be considered in the context of the findings. Look at the other findings from SARS. Does SARS agree with the transfer pricing method adopted and/or the comparable data used to support the position? If this is the case, and it is simply a dispute over the functional characterisation, then it is important to focus your energy on defending this. If, however, a move between full risk and limited risk is not going to make a significant impact because SARS has disregarded the transfer pricing technical support, then arguing the facts may not affect the outcome and your energy might be better served by focusing on the transfer pricing technical aspects.

An example of this could be where the transfer price for the transaction is supported using a comparable uncontrolled price method which focuses on the price charged for the goods or services as opposed to testing the profitability arising from the transaction. If SARS argues that the more appropriate method should be profit-based, the impact on the adjustment could be significant. This would not necessarily be influenced by a disagreement over the functional profile of the parties. In this case, it would be more important to refute the appropriateness of adopting a profit-based method and do extra work to support the argument that a comparable uncontrolled price method is the correct approach.

Similarly, the selection of comparables also plays an important role. Without doubt SARS will scrutinise the comparable data put forward in the analysis and probably argue that one or more of the comparable entities used to source the data should be removed. It might be necessary to argue this to some extent, but you should

also consider the impact of removing the disputed comparables. We have seen instances where SARS has removed entities from the comparable set but the result has been in favour of the taxpayer.

With comparability analysis where profit-based methods are used, the key area of negotiation is more likely to be the arm's length point in the comparable range. The functional profile of the tested party will play a role in determining this but ultimately this will probably be the negotiation which leads to the final settlement on the adjustment. Experience has taught us that being open to discussions around this can bear fruit when trying to get to a point of agreement.

Determining your strategy should be considered right from the start. Only one transfer pricing matter has gone to court so far. Most are resolved through settlement negotiations or mutual agreement procedure (MAP – Negotiation for the relief of double taxation under a relevant double tax agreement). The three different approaches to settling the dispute have different implications and should be considered as the audit progresses.

Settlement negotiations are still the most common way to resolve a transfer pricing dispute. In a settlement it should be borne in mind that no precedent is set, leaving future years vulnerable to another audit if the transaction remains in place. Settlement may, however, result in a reasonable outcome that both the taxpayer and SARS are prepared to live with (*mutually unsatisfactory*) and can often be negotiated to encompass later years on an informal basis. Currently obtaining advanced rulings or advanced pricing agreements is not possible for transfer pricing matters. Settlement will lead to an incidence of double taxation which is often unrelievable as SARS usually requires the taxpayer to agree not to pursue MAP in settlement cases. Having said that, some countries offer unilateral corresponding adjustments under their domestic law where it can be proven that economic double taxation has been suffered.

Surprisingly, the use of MAP is not as widespread in South Africa as in other countries, probably because none of South Africa's double tax agreements has an arbitration requirement to ensure the speedy resolution of MAP cases. Entering into MAP is, however, similar to the domestic objection and appeal process and should be considered as a serious alternative to domestic remedies. The benefit is that another tax authority is involved. This could be particularly useful where the same transaction has already been audited by that tax authority and signed off as arm's length. In such cases, the foreign tax authority is unlikely to change its position, making SARS' case difficult to win. The downside is that the MAP process is closed to the taxpayer so there is limited opportunity to influence the decision. SARS has issued comprehensive guidance on the process (*Editorial Note: Guide on Mutual Agreement Procedures* (Issue 3) published on 20 March 2020.)

The guide includes the following statement:

> "A person can pursue the MAP and domestic legal remedies simultaneously. SARS may concurrently consider a case presented to the competent authority for MAP and the objection lodged by the taxpayer under domestic tax provisions against the assessment. Depending on the circumstances, the competent authorities may defer the MAP until a decision has been reached on the objection or if a taxpayer has requested a settlement."

It is useful to commence discussions with the group tax manager or tax manager overseeing the transfer pricing for the other entity to the transaction, especially where the location of that entity is in a treaty country. This would assist in deciding whether the MAP process is a contender. Also, reaching out to the group tax and transfer pricing manager may highlight instances where another entity in the group has faced a similar audit from its tax authority, providing valuable insight and ammunition in dealing with your audit.

In our view the MAP process is underutilised for transfer pricing adjustments and, if used more often, would not only benefit taxpayers by providing greater certainty, but also help to improve SARS' skills.

Taking a transfer pricing matter to court significantly changes the approach. Taxpayers tend to forget that part of the process is to go through "discovery". This is often where some of the skeletons start to come out of the closet. Additional witnesses may be interviewed and their testimonies can often highlight some red flags which until now have not been identified. If there is any chance that the matter will go to court, it is good practice to check all documents likely to be picked up in the discovery process and interview witnesses early on. This may well determine the preferred route to resolution. A decision by the court will, however, be binding on both parties which, if favourable to the taxpayer, will create certainty in future years.

In conclusion, managing a transfer pricing audit is time-consuming and requires resources both locally and overseas to collate all the information needed. Even when transfer pricing analyses are undertaken every year and documentation is meticulously maintained, this cannot guarantee that a transfer pricing audit will be avoided. Ensuring that certain steps are taken and strategic thinking is applied throughout the audit process can make it less arduous and potentially lead to a more favourable outcome.

Webber Wentzel

Acts:

- Tax Administration Act 28 of 2011: Sections 1(1) (definition of "official publication"), 5, 46 & 89; Chapter 7;
- Income Tax Act 58 of 1962: Section 31.

Other documents

- Interpretation Note 67 (Issue 4) – 28 Jan 2020;
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2017);
- Guide on Mutual Agreement Procedures (Issue 3) – 20 March 2020.

Tags: alternative dispute resolution (ADR); connected person; transfer pricing audit.

NO RELIEF FOR PROPERTY DEALERS

Property developers who develop residential properties for the purpose of sale, but who temporarily let such properties due to adverse market conditions until a buyer can be found, may find themselves again in a cash flow squeeze and out of pocket for the VAT costs incurred in developing such properties, in view of the recent Binding General Ruling 55 (BGR 55) issued by the South African Revenue Service (SARS) on 10 September 2020.

The development of residential properties by property developers for the purpose of sale is an enterprise activity and the sale of each property constitutes a taxable supply by the developer. An input tax deduction may be claimed by a VAT registered developer for the VAT on expenses incurred in developing the properties for the purpose of making such taxable supplies. The property developers are required to account for VAT at the standard rate on the sale of each developed unit.

Notwithstanding a developer's intention to sell the developed property, it often happens that in adverse market conditions the developer is unable to find a buyer at the required selling price. The property developer may then opt to let the property unit temporarily to generate some cash flow until such time as market conditions are more favourable and a suitable buyer can be found.

The letting of residential property as a dwelling is exempt from VAT. Consequently, the temporary letting of residential units developed for sale is regarded to be a "change in use" of the unit for VAT purposes, from a taxable purpose to an exempt application. The developer is then required to make an adjustment in terms of section 18(1) of the Value-Added Tax Act (the VAT Act) as a means of repaying the VAT previously claimed on the development cost. However, section 10(7) requires that an adjustment in terms of section 18(1) is to be made on the full open market value of the unit as at the date on which the property is let, as opposed to repaying only the actual input tax previously claimed.

It was recognised by the Minister of Finance in his 2010 Budget Review that the requirement that developers must account for VAT on the open market value of the units temporarily let, is disproportionate to the exempt income received by the owners of the properties and that options should be investigated to determine a more reasonable method in dealing with the temporary letting of residential properties developed for resale.

"The letting of residential property as a dwelling is exempt from VAT."

Residential property developers were then afforded temporary relief with the introduction of section 18B of the VAT Act on 10 January 2012. In terms of section 18B, no change in use adjustment was required to be performed until the expiry of a 36-month relief period which commenced from the time the property was first let, or at the time when the property was applied permanently for letting as a dwelling as contemplated by section 18B(3). The temporary relief provided under section 18B ceased to apply on 1 January 2018.

When the temporary relief measures under section 18B were introduced, it was recognised in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011, that the VAT payments due upon the temporary letting of the residential units undercut the cash-flow gains otherwise associated with temporary letting and may even force certain developers into insolvency. It was further stated that section 18B was introduced as a short-term measure to the cash flow problem faced by developers, whilst seeking a more permanent solution.

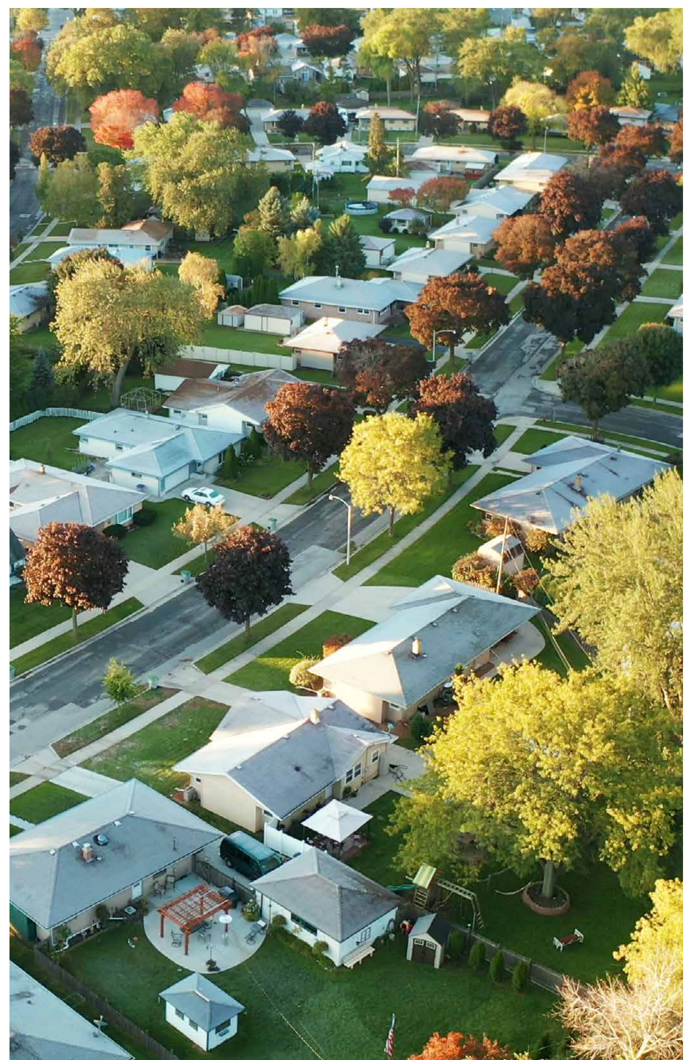
It seems that no effort was made to find a permanent solution to the problem during the period that the temporary relief under section 18B applied. Consequently, with effect from 1 January 2018, residential property developers are again required to perform the change in use adjustment in terms of section 18(1) on the open market value when the unit is let as a dwelling. However, the difficulties which are created by section 18(1) for property developers still remain, ie the requirement to account for output tax on the open market value of the unit is disproportionate to the exempt income received and it places a severe cash flow burden on the developer.

SARS previously stated in its VAT News 14 (March 2000), that where a section 18(1) adjustment was made on the temporary letting of a unit and the developer subsequently sells the unit, the developer was entitled to deduct the total amount of VAT previously paid under section 18(1), against the output tax payable when the unit is subsequently sold. This was, however, in contradiction to section 18(4) of the VAT Act, which provides for a deduction to be made only on the lesser of the adjusted cost or the open market value of the unit. Notwithstanding this contradiction, SARS nevertheless allowed input tax deductions in accordance with VAT News 14, that is, until recently upon the issuing of BGR 55.

In terms of BGR 55, SARS now holds the view that the subsequent sale of a dwelling in respect of which the developer has accounted for VAT in accordance with section 18(1) (or 18(3B)), is not subject to VAT at all and the purchaser will instead be liable for transfer duty on the acquisition of such dwelling.

BGR 55 stipulates the correct VAT position regarding units where the developer has permanently changed its intention regarding the units and the developer now holds them as capital assets to generate residential rental income. However, in our view, BGR 55 does not reflect the correct VAT position where the units are only temporarily let, and the intention of the developer remains to sell them when a buyer at a suitable price is found.

In terms of BGR 55, a developer who performs a section 18(1) adjustment when units developed for sale are temporarily let is not required to account for output tax when the unit is subsequently sold as it no longer constitutes an enterprise asset of the developer. This seems to be on the basis that SARS contemplates a permanent change in the application of the unit, even if it is only let for a very short period. However, if it remains the intention of the developer to sell the units as soon as buyers can be found, and the developer still reflects the units in its financial records as assets held for sale, there is no permanent change in the use or application of the unit. Such units are sold in the course or furtherance of an enterprise carried on by the developer and attracts VAT in terms of section 7(1)*(a)* of the VAT Act. The developer is then entitled to an input tax deduction in terms of section 18(4) on the adjusted cost of the property sold.



Whilst the eventual sale of residential units which were temporarily let will not attract VAT or transfer duty if the selling price is below the R1 million transfer duty threshold, it effectively attracts VAT on the market value when the unit is first let by the developer. However, units sold at prices in excess of the transfer duty threshold will attract VAT on their open market value when the units are first let as well as transfer duty on the selling price when the units are sold.

"Whilst the eventual sale of residential units which were temporarily let will not attract VAT or transfer duty if the selling price is below the R1 million transfer duty threshold, it effectively attracts VAT on the market value when the unit is first let by the developer."

A binding general ruling such as BGR 55 is issued under section 89 of the Tax Administration Act, 2011. It is initiated by SARS and represents the general view of SARS on the interpretation and application of a legislative provision. As a BGR is binding on SARS, but not on taxpayers, it may be cited in proceedings before SARS or the courts by either SARS or a taxpayer (Croome & Olivier: *Tax Administration*, paragraph 13.5.1). Since BGR 55 is not binding on taxpayers, residential property developers are best advised to consider the correct application of the provisions of the VAT Act in view of their specific circumstances.

It is regrettable that the real problem as identified in the 2010 Budget Review, namely that the requirement to account for VAT on the open market value of the units temporarily let is disproportionate to the exempt income received by the developer, and that it undercuts the cash-flow gains otherwise associated with temporary letting and may even force certain developers into insolvency, is not being addressed. Both the New Zealand and Australian tax authorities have successfully addressed this issue, and guidance could easily be drawn from them to find a suitable solution in a South African context.

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Acts

- Value-Added Tax Act 89 of 1991: Sections 7(1)*(a)*, 10(7), 18 (subsections (1), (3B) & (4)) & 18B;
- Tax Administration Act 28 of 2011: Section 89.

Other documents

- Binding General Ruling 55 (10 September 2020);
- 2010 Budget Review;
- Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011;
- VAT News 14 (March 2000) (SARS publication);
- Croome & Olivier: *Tax Administration*: paragraph 13.5.1.

Tags: input tax deduction; capital assets; transfer duty threshold.