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CAPITAL GAINS TAX
PRIMARY RESIDENCE EXCLUSION

FOREIGN EXCHANGE
RULING EXCHANGE RATES FOR FOREX GAINS AND LOSSES

TAX ADMINISTRATION
SUSPENSION OF PAYMENT REQUESTS

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PRIMARY RESIDENCE EXCLUSION

A taxpayer with just enough passing acquaintance to tax legislation to be dangerous had a bright idea in relation to the primary residence exclusion in the Eighth Schedule to the Income Tax Act, 1962 (the Act). Having read five years ago that the first R2 million of a gain on disposal of your primary residence is excluded from the CGT provisions, she set about applying this exclusion to her advantage. In the opinion of her new tax consultant, however, she was headed for trouble.

She would buy a residential property and live in it while she refurbished it and put it back on the market a few months later. Having sold it at a gain, she would buy another property and repeat the process. This went on to the point where she had bought, refurbished and sold five properties in four years, in each case using the primary residence exclusion to avoid paying tax on her gains. In each instance both the purchase price and selling price were below R2 million.

Her new tax consultant was concerned when she saw the taxpayer's property dealing history and warned her that SARS could decline to allow her the primary residence exclusion on the grounds that her conduct amounted to a trade. The taxpayer was adamant that so long as she ticked the primary residence box on her annual tax return, which she was entitled to do because she at any particular time owned only one property, in which she resided, it was axiomatic that the exclusion applied. Therefore, whenever she sold a property it was her primary residence and she was entitled to the exclusion.

The tax consultant said she would decline to tick the primary residence box on the taxpayer's tax return, because she was concerned that this was an offence under the Tax Administration Act (the TAA). It was possibly fraud, certainly misrepresentation, and non-disclosure of material facts. She was concerned about being seen to collude with the taxpayer in committing a tax offence. Not only would she be exposed to sanctions by SARS, but her recognised controlling body (RCB) would be likely to take a dim view of her action. She warned the taxpayer that, should SARS at any time challenge her claim for the primary residence exclusion, SARS could reopen previous assessments for as far back as the taxpayer had been conducting this activity. The three-year prescription period for assessments does not apply where there has been fraud, misrepresentation, or non-disclosure of material facts.

The taxpayer poured scorn on the tax consultant's opinion, which she described as misguided and ill-informed. In her view, SARS was the tax expert, not the tax consultant, and if SARS accepted her claim for the exclusion it was no business of the tax consultant to second-guess SARS. Needless to say, the taxpayer and the tax consultant parted ways.

Who is correct in this situation? Has the tax consultant acted correctly in terms of the tax legislation?

Gross income is defined in section 1(1) of the Act as the total amount, in cash or otherwise, received by or accrued to or in favour of a person, excluding receipts or accruals of a capital nature. When we consider whether a receipt or accrual is capital in nature, and then potentially subject to the provisions of the Eighth Schedule, it

is necessary to consider case law, and in particular the question of the intention of the taxpayer. For example, in *Commissioner: South African Revenue Service v Capstone 556 (Pty) Ltd*, [2016], the Supreme Court of Appeal held that in order for a profit to be revenue in nature "the gain must be acquired by an operation of business in carrying out a scheme for profit-making". In so finding, the court drew on a long line of decisions. A good example relevant to the taxpayer is *Natal Estates Ltd v Secretary for Inland Revenue*, [1975], where the court found that in determining whether any particular case is one of realising a capital asset or carrying on a business of selling land for profit, the totality of the facts of the case must be considered in their relation to the ordinary commercial concept of carrying on a business or embarking upon a scheme for profit. Considerations will include, *inter alia*, the intention of the taxpayer both when acquiring and selling the land; the owner's activities in relation to the land prior to the decision to sell, and the light that these considerations throw on the owner's statements of intention.

> "The tax consultant would be vulnerable under all but paragraph (*f*) if she permitted the taxpayer to claim the primary residence exclusion, on the facts before her."

In the present matter the taxpayer set about using the primary residence to her advantage and proceeded to acquire, refurbish and sell her primary residences five times in four years. She argued, correctly, that at any particular time she owned one residence and used it as her primary residence. However, paragraph 45 of the Eighth Schedule, after providing in subparagraph (1)*(b)* that the gain on disposal of a primary residence is excluded from CGT if the proceeds do not exceed R2 million, then provides in subparagraph (4)*(b)* that subparagraph (1)*(b)* does not apply to the disposal of a primary residence where the taxpayer "used that residence or a part thereof for the purposes of carrying on a trade". It is submitted that the tax consultant was correct to conclude that the taxpayer was conducting a trade in acquiring, refurbishing and selling residential properties. It did not avail the taxpayer that at each material time whichever property she then owned was her primary residence. Subparagraph (1)*(b)* prohibited the exclusion. And the tax consultant was wise to decline the appointment. SARS could report the tax consultant to her RCB under section 241(2) of the TAA, which provides that a senior SARS official may lodge a complaint with an RCB "if a registered tax practitioner has, in the opinion of the official–

(a) without exercising due diligence prepared or assisted in the preparation, approval or submission of any return, affidavit or other document relating to matters affecting the application of a tax Act;

(b) unreasonably delayed the finalisation of any matter before SARS;

(c) given an opinion contrary to clear law, recklessly or through gross incompetence, with regard to any matter relating to a tax Act;

(d) been grossly negligent with regard to any work performed by a registered tax practitioner;

(e) knowingly given false or misleading information in connection with matters affecting the application of a tax Act or participated in such activity; or

(f) directly or indirectly attempted to influence a SARS official with regard to any matter relating to a tax Act by the use of threats, false accusations, duress, or coercion, or by offering gratification as defined in the Prevention and Combating of Corrupt Activities Act 2004 (Act 12 of 2004)."

The tax consultant would be vulnerable under all but paragraph *(f)* if she permitted the taxpayer to claim the primary residence exclusion, on the facts before her. She has therefore acted correctly in declining to act for the taxpayer.

Professor Peter Surtees

Acts:

- Income Tax Act 58 of 1962: section 1(1) (definition of "gross income"); Eighth Schedule: paragraph 45;
- Tax Administration Act 28 of 2011: section 241(2);
- Prevention and Combating of Corrupt Activities Act 12 of 2004.

Cases:

- *Commissioner: South African Revenue Service v Capstone 556 (Pty) Ltd* [2016] 78 SATC 231 ZASCA; [2016] (4) SA 341 (SCA);
- *Natal Estates Ltd v Secretary for Inland Revenue* [1975] 37 SATC 193; [1975] (4) SA 177 (A).

Tags: primary residence; registered tax practitioner.

PREPAID EXPENDITURE

The application of section 23H of the Income Tax Act, 1962 (the Act), was one of the issues recently considered by the Supreme Court of Appeal (SCA) in the case of Telkom SA SOC Limited v The Commissioner for the South African Revenue Service *[2020] in relation to upfront cash incentive bonuses paid by Telkom to Velociti (Pty) Ltd for facilitating the conclusion of 24-month subscription contracts with customers on Telkom's behalf.*

APPLICATION OF SECTION 23H TO PREPAID EXPENDITURE

From an accounting perspective, a prepaid expense refers to an expense that is incurred in one financial year in respect of an asset that will only be consumed during one or more subsequent financial years, or an expense that relates to a later year than the one in which it was incurred. It is disclosed as an asset on the balance sheet during the financial year in which it is incurred and it is only expensed to the income statement in subsequent financial years to the extent that it is consumed in or applies to such years.

Section 23H of the Act governs the extent of the deduction that may be claimed during any particular year of assessment in respect of prepaid expenditure which otherwise qualifies for a deduction in terms of section 11*(a)* (the general deduction formula), *(d)* (repairs), *(c)* (legal costs) or *(w)* (key man insurance policies) of the Act. Its purpose is to limit the amount of the deduction during any particular year of assessment to the extent of the goods supplied, services rendered or other benefits to which the person will become entitled during such year of assessment.

In the case of a benefit, the expense is apportioned on a time basis, based upon the number of months over which the benefit will be enjoyed. One of the instances in which section 23H does not apply is if all the goods or services will be supplied to the taxpayer within six months from the end of the year of assessment during which the expenditure is incurred, or if the taxpayer will obtain the full enjoyment of the benefit to which the expenditure relates within such six-month period.

The matter went on appeal to the tax court, which held that the benefit attaching to the cash incentive bonus scheme was the conclusion of the contracts with new customers and that the cash incentive bonuses were not paid by Telkom for services to be rendered by Velociti after the end of its tax year.

TELKOM CASE

Up to 30 September 2011, Telkom operated a cash incentive bonus scheme in respect of which it paid certain suppliers a one-off incentive bonus for each new 24-month customer contract concluded on its behalf in respect of a particular tariff plan. In addition to and separate from this scheme, Telkom also paid its suppliers a commission over the term of the 24-month contracts for the benefit it derived from the subscription fees.

During its 2012 tax year, Telkom paid R178 788 421 to Velociti as a cash incentive bonus for the total number of customer contracts concluded on its behalf during such year. In its tax calculation for the year, Telkom claimed the full amount as a deduction in terms of the general deduction formula. The South African Revenue Service (SARS) disallowed R136 531 542 as a deduction in terms of section 23H, on the basis that the period to which the expenditure related extended beyond Telkom's 2012 tax year.

The matter went on appeal to the tax court, which held that the benefit attaching to the cash incentive bonus scheme was the conclusion of the contracts with new customers and that the cash incentive bonuses were not paid by Telkom for services to be rendered by Velociti after the end of its tax year. The tax court, therefore, held that the benefit of the cash incentive bonuses did not extend over the 24-month term of the customer contracts and that section 23H accordingly did not apply to the cash incentive bonus payments.

On appeal to the SCA, the issue was whether or not the benefit of the cash incentive bonus payments extended over the 24-month term of the customer contracts. In considering the issues, the SCA was first required to determine what the benefit was and, secondly, when and how this benefit was enjoyed by Telkom.

The SCA held that Telkom enjoyed no immediate benefit upon the conclusion of customer contracts in respect of which the cash incentive bonuses were paid. The benefit to Telkom was rather to have customers who pay monthly subscription fees over the 24-month term of their contracts. Accordingly, it was held that Telkom enjoyed the benefit of the cash incentive bonus payments over the 24-month period of the relevant contracts and that SARS was correct in limiting Telkom's expenditure in terms of section 23H. The SCA held that the commission payments made by Telkom over the term of the contracts did not alter the fact that the benefit of the incentive bonus payments (ie, the monthly income) is enjoyed by it over the term of the contracts. SARS' appeal was, accordingly, upheld by the SCA.

COMMENT

Corporate taxpayers are specifically required to disclose in their annual ITR14 income tax returns their prepayments for the year, which are then further divided into prepaid expenditure not limited by section 23H and prepaid expenditure limited by section 23H.

We have recently noticed an increased focus by SARS on the application of section 23H to prepayments by corporate taxpayers. SARS typically requests a breakdown of the taxpayer's prepaid expenses which are not limited by section 23H, together with an explanation of the period to which such expenditure relates in order to determine whether the benefit will be enjoyed within six months of the end of the tax year.

Taxpayers are advised to exercise extra care when applying section 23H to their prepaid expenses, as understatement penalties and interest are automatically imposed in the event of any understatement as a result of the incorrect application of section 23H.

Werksmans

Acts:

- Income Tax Act 58 of 1962: Sections 11*(a)*, *(c)*, *(d)* & *(w)* & 23H.

Cases:

- *Telkom SA SOC Limited v The Commissioner for the South African Revenue Service* [2020] ZASCA 19 (25 March 2020).

Tags: cash incentive bonus; corporate taxpayers.

RULING EXCHANGE RATES FOR FOREX GAINS AND LOSSES

In the recent Supreme Court of Appeal (SCA) judgment, Telkom SA SOC Limited v The Commissioner for the South African Revenue Service, *[2020], the SCA dealt with two separate legal issues stemming from an appeal and a cross-appeal brought by the respective parties to the case.*

In the tax court, the issue pertaining to the application of section 24I of the Income Tax Act, 1962 (the Act), was decided in favour of the Commissioner for the South African Revenue Service (SARS), whereas the findings pursuant to the dispute regarding section 23H of the Act favoured Telkom SA SOC Limited (Telkom). As a consequence, Telkom brought an appeal against the findings of the tax court regarding the section 24I findings and SARS brought a cross-appeal against the findings with regard to section 23H. [*Editorial comment*: See also above, article 0203 "Prepaid expenditure", in this regard.]

THE APPEAL

Facts

During the period 2007 to 2009, a subsidiary of Telkom acquired 100% of the issued share capital of a telecommunications company that was resident in Nigeria (the Nigerian Company). In order for the Nigerian Company to become financially viable, Telkom advanced numerous shareholder loans amounting to USD877,022,900.86 to it. By 2011, USD346,000,000.00 of the loans had been converted into preference share equity while the remainder of the loans in the amount of USD531,022,900.86 were outstanding on the loan account. During Telkom's 2012 year of assessment, the equity interests of Telkom and its subsidiary in the Nigerian Company were sold to a third party. Telkom's rights in respect of its loans to the Nigerian Company were also sold to the third party for USD100.

In the 2012 year of assessment tax return, Telkom claimed a deduction in the amount of R3,961,295,256 as a foreign exchange loss in terms of section 24I. SARS disallowed the said deduction and issued an additional assessment in terms of which SARS assessed Telkom for tax in the amount of R425,188,643 as a foreign exchange gain.

"In coming to its findings, the SCA stated that the resolution of this dispute was to be found in the interpretation of the provisions of section 24I."

Judgment

In coming to its findings, the SCA stated that the resolution of this dispute was to be found in the interpretation of the provisions of section 24I. This section provides for the tax treatment of gains or losses incurred by taxpayers on foreign exchange transactions and requires that any such gain or loss must be included in or deducted from the income of a taxpayer to the extent that the provisions apply thereto.

Section 24I contains many definitions to which regard must be had in applying the section. For the present matter, the crucial definition was that of "ruling exchange rate" (RER). The pertinent aspects of the definition of "ruling exchange rate" are set out in section 24I(1) as follows:

> "ruling exchange rate" means, in relation to an exchange item, where such exchange item is –
>
> *(a)* a loan or advance or debt in a foreign currency on –
>
> (i) transaction date, the spot rate on such date;
>
> (ii) the date it is translated, the spot rate on such date; or
>
> (iii) the date it is realised, the spot rate on such date:
>
> Provided that where the rate prescribed in respect of a loan or advance or debt in terms of this definition is the spot rate on the transaction date or the spot rate on the date on which such loan or advance or debt is realised, and any consideration paid or payable or received or receivable in respect of the acquisition or disposal of such loan or advance or debt was determined by applying a rate other than such spot rate on transaction date or date realised, such spot rate shall be deemed to be the acquisition rate or disposal rate, as the case may be;".

[*Editorial note: The above was the wording of the definition at the time relevant to the present matter. The wording of the definition applicable at that stage was amended with effect from 1 February 2013.*]

At issue between the parties was the determination of the RER on the realisation date of the loan, which rate would ultimately dictate the extent of the gain or loss that was to be included in, or deducted from, Telkom's income.

It was Telkom's submission that the proviso to the definition of RER applied to the facts and that a rate other than the spot rate at the date on which the loan was realised stood to be used to determine the foreign exchange gain or loss. It was argued that the USD100 received by Telkom as consideration for the disposal of the loan was clearly not determined by applying the spot rate at the time to the transaction, as a consequence of which it was apparent that "a rate other than […] the spot rate" had been utilised.

Telkom contended that the pertinent question to be answered was whether the consideration of USD100 was determined by applying a "rate". It was submitted that "rate" should be taken to mean "the price paid or charged for a thing or class of things", with the result being that the consideration of USD100, having been agreed upon by the parties to the transaction, fell within the meaning of "rate". The basis of this argument was that the context of the word "rate" indicated that the word did not refer to an exchange rate between currencies, but rather to an agreement as to value or worth. Ultimately, Telkom concluded that the consideration of USD100 was determined using a rate other than the spot rate, and that the proviso to the definition of RER had to be applied to the transaction.

The SCA, in agreeing with the findings of the tax court and the submissions made by SARS, found that Telkom's arguments stood to be rejected for the following reasons:

1. Section 24I deals with losses or gains caused by foreign exchange fluctuations and is not applicable to a "business" loss of the kind incurred by Telkom.

2. When the proviso to the definition of RER is interpreted in the context of the section as a whole, the use of the word "rate" means an exchange rate which reflects the value of a particular currency. The rate contemplated by the proviso is a currency exchange rate, not a discount rate.

3. In order to satisfy the requirement in the proviso that the consideration must be "determined" by "applying" the rate, the consideration would have had to be the result of a process of calculation which utilised the "rate" as a factor to produce that result. The only type of rate that would have been able to perform this function was one which compared two items against one another, such as a currency exchange rate. It was apparent that the consideration for the loan of USD100 was agreed by reference only to the perceived value of the loan and that currency exchange ratios played no role in the determination of the price.

The SCA agreed that section 24I is not intended to deal with the tax consequences of commercial losses and that its operation is limited to gains and losses arising out of currency fluctuations. In the result, the SCA dismissed Telkom's appeal with costs.

THE CROSS-APPEAL

Facts

In the 2012 year of assessment, Telkom made a "cash incentive bonus" payment to Velociti (Pty) Ltd (Velociti) in the amount of R178,788,421 in respect of the connection of initial subscriber contracts relating to special tariff plans. These connections were made by Velociti on behalf of Telkom and the amount paid by Telkom as the cash incentive bonus was claimed as a deduction. However, SARS only allowed a portion thereof as a deduction and added back the remainder in terms of section 23H(1)*(b)*(ii).

Judgment

Section 23H limits the deductions claimable in a year of assessment in respect of certain expenditure that has been incurred in advance, and makes provision for the said expenditure to be claimed over a period to be determined in accordance with the provisions of the section.

"In the result, the SCA upheld the cross-appeal and found that section 23H was to be applied to the cash incentive bonus paid by Telkom."

At issue in the cross-appeal was whether SARS was entitled to apply section 23H to limit the deduction in the 2012 year of assessment, with the result that the balance paid was spread out over a number of years. The SCA embarked on an inquiry into the benefits derived by Telkom from the expenditure incurred, specifically when and how the benefit was enjoyed by Telkom, and agreed that the period to which the expenditure relates must be the period during which the benefit was enjoyed.

It was submitted on behalf of SARS that Telkom did not incur the cash incentive bonus expenditure merely to establish the new connections with customers, but rather that the benefit was derived by Telkom by means of the subscription fees paid by the customers over the fixed-term period of the contract. In this manner, Telkom only derives a benefit from the expenditure incurred when the connection turns into fee income, and this only happens over the period of the contract when subscription fees are paid by customers.

It was contended by Telkom that the cash incentive bonus was paid to Velociti in respect of the connections that had to have been made prior to 30 September 2011 and that the benefit therefore did not extend past the 2012 year of assessment, resulting in section 23H not being applicable. Furthermore, it was contended that the fact that Telkom paid a separate commission to Velociti for the benefit that it derived from the subscription fees over the period of the contracts was indicative that the cash incentive bonus was paid solely in respect of the connections that had been made and did therefore not relate to the fees paid by customers over the contract periods.

The SCA concurred with the submissions of SARS that the true benefit derived by Telkom was the monthly subscriber payments over the anticipated 24-month period and that the term of the contracts therefore represented the periods in respect of which the benefit was derived by Telkom. It was held that:

> "Although the conclusion of the contract benefitted Telkom, the enjoyment of that benefit was spread out over the period of the contract, so that the period to which the expenditure related could not be limited to the first year."

Lastly, in response to the submission by Telkom that it paid a separate ongoing commission to Velociti over the subscription period and that this commission, and not the connection bonus, was the *quid pro quo* for the subscription fees, the SCA stated that the pertinent question was whether Telkom derived a benefit from the connections over the contract period. The SCA answered this question in the affirmative and held that the fact that another payment was made by Telkom did not render this fact irrelevant. In the result, the SCA upheld the cross-appeal and found that section 23H was to be applied to the cash incentive bonus paid by Telkom.

Comment

The findings of the SCA pertaining to the interpretation of the provisions of section 24I are significant in light of the current economic climate in which South African taxpayers find themselves. The recent downgrade of South Africa's sovereign credit rating to "junk" status by rating agency Moody's Investors Service, the increasingly negative impact of the COVID-19 pandemic on South Africa's economy, and the overall weakening of the rand, have had negative repercussions for South African entities.

To the extent that the rand continues to weaken, South African entities may face substantial losses, including those arising from foreign exchange items.

At present, the findings of the SCA in the Telkom matter are binding. However, Telkom has announced that it intends appealing the adverse findings of the SCA to the Constitutional Court, the outcome of which may influence the application of section 24I and section 23H in similar circumstances.

Cliffe Dekker Hofmeyr

Acts:

- Income Tax Act 58 of 1962: Sections 23H & 24I.

Cases:

- *Telkom SA SOC Limited v The Commissioner for the South African Revenue Service* [2020] ZASCA 19 (25 March 2020).

Tags: foreign exchange transactions; cash incentive bonus.

BUDGET 2020 PROPOSALS

Tax

It feels like a lifetime ago that the South African Minister of Finance delivered his 2020 Budget Speech on 26 February 2020. Given the far-reaching impact of the COVID-19 related measures on economic activity in South Africa, it goes without saying that the Budget has been dramatically overtaken by the extraordinary events that are unfolding in South Africa and across the globe.

The Budget included references to various tax amendments and announcements regarding an overhaul of exchange control rules. It remains to be seen when and how the tax-related amendments will be introduced, but given that National Treasury will be under even greater pressure to collect tax revenues once this traumatic period in the country passes, it seems likely that at least some of these proposals will be implemented.

Be that as it may, we will highlight some of the more important proposed corporate and international tax-related amendments. The draft tax legislation may be released later in the year than usual.

RELAXATION OF EXCHANGE CONTROLS

Treasury has proposed a complete overhaul and modernisation of the exchange control systems to reduce some of the burdensome and unnecessary administrative approval processes. This should be good news to local and foreign businesses alike (once economic activity resumes).

In terms of this framework, it is intended that all foreign currency transactions will be allowed, except for those that are subject to capital flow management measures and/or pose a high risk in respect of legitimate cross-border financial flows.

The Reserve Bank has indicated that the new system will be implemented over the next 12 months and will require that new legislation, such as "new capital flow management regulations", be drafted along with the implementation of relevant tax amendments. Given the current situation, it is possible that this timeline may be extended.

The concept of emigration will be phased out for individuals. However, individuals who transfer more than ZAR10 million offshore will be subject to a stringent verification process. Such transfers will also trigger a risk management test that will include certification of tax status and the source of funds and assurance that the relevant individual complies with anti-money laundering requirements prescribed in the Financial Intelligence Centre Act, 2001. This will be phased in by 1 March 2021.

PROPOSALS RELATED TO CORPORATE INCOME TAX

Restriction of assessed losses

The government proposes broadening the corporate income tax base by restricting the offset of assessed losses carried forward to 80% of taxable income for years of assessment commencing on or after 1 January 2021. [*Editorial comment*: It has been announced that this is to be deferred by one year.]

In terms of current law, a taxpayer may set off a balance of the assessed loss brought forward from the previous year of assessment against income derived by such person from carrying on a trade in the current year of assessment.

In terms of the proposed amendment it seems that if, for example, a company has an assessed loss in a previous year of ZAR1 000 and earns taxable income of ZAR100 in the current year of assessment, only ZAR80 of such taxable income may be set off against the assessed loss brought forward from the previous financial year. The remaining ZAR20 will be subject to income tax at the rate of 28%. This will have a significant impact on companies with large assessed losses since, despite these assessed losses, such companies will pay tax if they are profitable (have taxable income) in any particular year.

It will be interesting to see whether this proposal will be reconsidered in light of the adverse economic impact of COVID-19. In particular, according to the OECD, one of the most urgent measures that governments around the world have been considering to counter the current economic crisis is "increasing the generosity of loss carry-forward provisions".

Limitation on interest deductions

Government also proposes to restrict net interest expense deductions to 30% of earnings for years of assessment commencing on or after 1 January 2021. [*Editorial comment*: It has been announced that this is to be deferred by one year.] This is in order to combat base erosion and profit shifting by multinational corporations in situations where company debt or interest rates are artificially inflated and an interest deduction is claimed in South Africa whilst the interest is paid to a related party in an offshore jurisdiction with a lower tax rate.

A discussion document in respect of this issue was released by Treasury which contains more details on the proposal and invited comments by 17 April 2020. It states that the intention is to ensure that debt funding utilised by South African entities is appropriate for the level of economic activity that the multinational group is conducting in South Africa.

The discussion document proposes that the new interest limitations apply to all entities operating in South Africa that form part of a foreign or domestic multinational group and that the rules apply to total net interest expense. Of note is that it appears to be wide enough to include external and connected party debt.

"The government proposes broadening the corporate income tax base by restricting the offset of assessed losses carried forward to 80% of taxable income for years of assessment commencing on or after 1 January 2021."

As a final statement, the discussion document invited comments on a potential safe harbour approach to determine if a taxpayer needs to apply the arm's length principle to the quantum of the financing provided. It noted that the interest incurred on such financing will still be subject to transfer pricing rules and the interest limitation rule. This seems to imply a similar approach to the previous safe harbour under the thin capitalisation provisions.

Refining the corporate reorganisation rules

This first proposal deals with refining the application of anti-avoidance provisions that apply to transactions carried out in terms of the corporate reorganisation rules. In 2019, the intra-group provisions were amended to clarify the interaction between rules for the degrouping of a group of companies and the anti-avoidance rules for the early disinvestment in a transferred asset. However, according to the Budget, the interaction between the anti-avoidance rules for degrouping and the rules for the transfer of assets and the assumption of related debt may result in double taxation. It is proposed that the relevant provisions be amended to address this anomaly.

The second proposal deals with clarifying the rollover relief for unbundling transactions provided for in section 46 of the Income Tax Act, 1962 (the Act). The current unbundling provisions are subject to an anti-avoidance rule that excludes the shareholders and the unbundling company from benefitting from the rollover relief if 20% or more of the shares in the unbundled company are held by non-residents (either alone or together with individuals connected to those non-residents) after the transaction. According to the Budget, the current provisions create a loophole and the proposal seeks to amend the provisions to make provision for the 20% rule to apply, irrespective of whether the non-resident shareholders are connected persons in relation to each other.

Refining the taxation of REITs

The definition of a real estate investment trust (REIT) contained in the Act will be updated in such a way that it will be in line with the Financial Sector Regulation Act, 2017, and that the consultation requirements regarding the listing criteria in an approved exchange be reviewed.

Treasury also proposes to clarify that the meaning of a share in the definition of a REIT excludes preference shares and non-equity shares from shares that must be listed on an exchange in order to qualify as a REIT. It has been confirmed that preference shareholders were never intended to benefit from the REIT tax dispensation as preference shares do not provide investors with equity exposure to the REIT but rather constitute a mechanism which provides funding to a REIT.

"When a company ceases to be a South African tax resident, it is deemed to have disposed of all its assets at market value, thus potentially triggering capital gains tax upon exit."

A further proposal addresses the mismatch that arises in circumstances where a REIT holds shares in a non-resident company. The mismatch arises where the foreign dividend received by the REIT qualifies for the participation exemption in terms of the Act and the REIT qualifies for a full tax deduction when it distributes profits from those foreign dividends. It is proposed that the relevant provisions in the Act be amended so that the foreign dividend is subject to tax if the recipient company is a REIT.

Refining the tax treatment of transfer of collateral in securities lending arrangements

The current anti-tax avoidance rules contained in the Act address dividend tax avoidance transactions in terms of which listed shares are lent or transferred as collateral from a person that would be liable for the tax to a tax-exempt person. The proposal seeks to extend the anti-avoidance rules to address situations where additional exempt parties are involved to facilitate the avoidance transactions. The proposed amendment may be intended to target transactions where the recipient of borrowed shares or shares received as collateral, transfers the shares to an entity which is exempt from dividends tax.

CROSS-BORDER TAX-RELATED PROPOSALS

Refinement of anti-avoidance provisions regarding change of residence

When a company ceases to be a South African tax resident, it is deemed to have disposed of all its assets at market value, thus potentially triggering capital gains tax upon exit. The Budget raised a concern that residents that hold shares in such a company could subsequently dispose of such shares to a third party and qualify for the participation exemption in respect of any capital gain so realised. It is proposed that changes be made to address this concern.

Tax amendments in the context of "loop structures"

The current exchange control provisions restrict, subject to certain exceptions, the use of loop structures, in part to protect the tax base. However, the prohibition against these structures has been gradually relaxed and this relaxation may be increased in the context of the above-mentioned relaxation of exchange controls.

However, Treasury seeks to introduce measures to combat the reduction of dividends tax and capital gains tax in such structures.

If loop structures are no longer restricted, it would be possible to set up a structure where a controlled foreign company (CFC) owns the shares in a South African company and any dividends flowing from such company to a resident individual or trust through the CFC are exempt for the individual or trust, thereby reducing the dividends tax liability for such individual or trust in respect of those dividends from 20% to a reduced rate as specified in an applicable double tax agreement.

It is thus proposed that the CFC legislation be amended to limit the dividend exemption available to a resident individual or trust relating to the accrual or receipt of dividends from a resident company to a CFC. As a result, such dividends would be taxed at an effective rate of 20% to align the tax treatment with instances where resident individuals receive dividends from resident companies.

Furthermore, if a resident disposes of shares in a CFC that owns South African assets, the unrealised gains attributable to the South African assets may not be taxed in South Africa if the resident qualifies for the participation exemption for capital gains. It is proposed that the participation exemption for capital gains on the disposal of shares in CFCs by residents should not apply to the extent that the value of those shares is derived from South African assets.

In conclusion, we now live in a time of great uncertainty and only time will reveal the long-term effects of Covid-19 on our society and our economy. How this will impact on, *inter alia*, the above proposals formulated by government at a time when the current state of affairs could not have been imagined, remains to be seen.

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Acts:

- Financial Intelligence Centre Act 38 of 2001;
- Income Tax Act 58 of 1962: section 46;
- Financial Sector Regulation Act 9 of 2017.

Tags: foreign currency transactions; anti-avoidance rules; foreign dividend.

SUSPENSION OF PAYMENT REQUESTS

Section 164 of the Tax Administration Act, 2011 (the TAA), is one of the most contentious provisions governing tax administration in South Africa, particularly given the current poor economic climate. In its essence, it watches over the balance between SARS' powers to collect tax and taxpayers' rights to request postponement of the payment of tax under appropriate circumstances.

The High Court (Gauteng Local Division) handed down judgment on 31 May 2019 in the matter of *Anthony Charles Peter v C:SARS*, [2018] (*Peter v C:SARS*), in respect of the application and interpretation of section 164 of the TAA. *Peter v C:SARS* is one of a handful of reported and/or published judgments on the "pay-now-argue-later" rule contained in section 164(1) and its predecessors in the Income Tax Act, 1962 (the Act), and in the Value-Added Tax Act, 1991 (the VAT Act).

It is thus prudent to consider the judgment, not only with reference to the specific facts and circumstances, but also to reflect on the current application and interpretation of section 164 with particular reference to its underlying purpose and rationale.

Context: Statutory framework

Section 164(1) states that, unless a senior SARS official directs otherwise in terms of section 164(3), the obligation to pay tax; and the right of SARS to receive and recover tax, will not be suspended by an objection or appeal or pending the decision of a court of law pursuant to an appeal under section 133 of the TAA. The constitutionality of the "pay-now-argue-later" principle in respect of its predecessor in the VAT Act was discussed and confirmed in, amongst others, *Metcash Trading Ltd v C:SARS*, [2001].

Section 164(2) provides that a taxpayer may request a senior SARS official to suspend the payment of tax or a portion thereof due under an assessment if the taxpayer intends to dispute or disputes the liability to pay that tax under Chapter 9 of the TAA. Notably, a taxpayer is not required to have lodged its objection before it can submit a section 164 request for suspension of payment. For example, where a taxpayer requests reasons for the assessment prior to lodging its objection, it is still well within its rights to request suspension of payment of the tax debt as a parallel process.

Section 164(3) empowers a senior SARS official to suspend the payment of tax and sets out the factors that should be taken into account when deciding whether to suspend or not. The list of factors is not exhaustive, but includes the following prescriptive factors:

- whether the recovery of the disputed tax will be in jeopardy or there will be a risk of dissipation of assets;
- the compliance history of the taxpayer with SARS;
- whether fraud is *prima facie* involved in the origin of the dispute;
- whether payment will result in irreparable hardship to the taxpayer not justified by the prejudice to SARS or the fiscus if the disputed tax is not paid or recovered; or
- whether the taxpayer has tendered adequate security for the payment of the disputed tax and accepting it is in the interest of SARS or the fiscus.

In terms of section 164(5), a senior SARS official may deny a request for suspension or revoke a decision to suspend payment with immediate effect if satisfied that:

- after the lodging of the objection or appeal, the objection or appeal is frivolous or vexatious;
- the taxpayer is employing dilatory tactics in conducting the objection or appeal;
- on further consideration of the factors referred to above, the suspension should not have been given;
- there is a material change in any of the factors referred to above, upon which the decision to suspend payment of the amount involved was based.

It should be appreciated that a taxpayer does not have rights to object and/or appeal against a decision by SARS not to suspend payment of the tax debt. Instead, taxpayers' remedies are limited to taking the matter to the High Court on review. This is not only a costly exercise, but also provides for narrower grounds on which a court may potentially set aside the decision, being that, amongst others, no due process was followed and/or SARS did not properly consider the matter.

Peter v C:SARS

In *Peter v C:SARS*, SARS refused to grant the applicant's request to suspend payment in terms of section 164 and the applicant thus approached the High Court to review and set aside SARS' decision to deny the suspension of payment request. The applicant raised various grounds of review, including, amongst others, the following key grounds discussed below.

- That the relevant SARS committee that made the decision was not authorised to do so given that it did not have the requisite authority and was not empowered to do so.
- That the SARS committee acted irrationally in finding that the applicant's tax appeal was frivolous and vexatious and being employed for dilatory purposes.
- In taking into account that the applicant failed to offer payment of security, the SARS committee acted irregularly in that the applicant was demonstrably unable to provide security.

" It thus follows that where a taxpayer is able to demonstrate that its appeal is based on legitimate and reasonable grounds, SARS would be hard pressed to invoke section 164(5)*(a)* in denying the suspension of payment request."

Pillay AJ upheld the first-mentioned ground of review on the basis that SARS failed to show that the relevant SARS committee was empowered to take the decision and thus it lacked the necessary requisite authority. This is notable for taxpayers in the sense that section 164 decisions must be made by a duly delegated official, which delegation must comply with, amongst others, section 10 of the TAA. This is not always clear from the section 164 notices issued by SARS. In respect of the third-mentioned ground of review, the High Court held that it must fail on the basis that the applicant failed to provide complete and accurate financial information and thus SARS would have been unable to assess the applicant's net asset position with reference to whether he could provide security.

Of most interest, was the court's finding in respect of the second-mentioned ground of review. The applicant contended that SARS' reliance on section 164(5)*(a)* and *(b)* to deny the suspension of payment request due to the applicant's appeal being frivolous or vexatious and being employed solely to delay the process was irrational. In fact, the applicant contended, that there were good prospects of success on appeal (in the main dispute) given the possibility of prescription of a number of years in dispute and that SARS was in fact delaying the finalisation of the appeal.

In considering the application of section 164(5)*(a)*, Pillay AJ held that SARS failed to show that the applicant's appeal was an abuse of process or lacking any serious purpose. Instead, SARS focused on proving that the appeal was lacking in merit, which was not the test for considering whether an appeal was frivolous or vexatious. On the basis that there was no evidence placed before the court to show that the appeal was an abuse of process and/or was purely intended to cause annoyance, Pillay AJ held that there was no rational connection between the decision made by the relevant SARS committee in denying the suspension of payment in terms of the factor listed in section 164(5)*(a)*, being a frivolous or vexatious appeal, and the material placed before it. Pillay AJ thus upheld this ground of review.

Given that the High Court upheld several of the applicant's grounds of review, Pillay AJ ordered that SARS' decision not to grant suspension of payment was reviewed and set aside and remitted back to SARS for reconsideration. SARS was also ordered to pay costs, save for the costs incurred in respect of an interlocutory issue.

The finding of the High Court in *Peter v C:SARS* was notably in favour of the taxpayer and it was interesting that the court found that a taxpayer, in terms of section 164(5)*(a)*, is not required to prove good prospects of success on appeal but rather that SARS must show that the taxpayer is appealing for no serious purpose and is abusing the process. It thus follows that where a taxpayer is able to demonstrate that its appeal is based on legitimate and reasonable grounds, SARS would be hard pressed to invoke section 164(5)*(a)* in denying the suspension of payment request. The merits are therefore an important consideration.

SARS' powers and taxpayer's rights within the context of section 164

Given the finding of the High Court in *Peter v C:SARS*, it is sensible to assess the balance between SARS' powers and taxpayers' rights in the context of section 164 requests for suspension of payment. In particular, the question arises whether section 164 is being used by SARS and taxpayers alike, within the confines of the initial purpose and rationale for the provision. This is especially important given the rationality test in our law and the grounds of review contained in section 6(2)*(f)*(ii)*(aa)* to *(dd)* of the Promotion of Administrative Justice Act, 2000 (PAJA), which states that a decision will be reviewable in terms of section 6(2)*(f)*(ii)*(aa)* to *(dd)* if:

> *(f)* the action itself – [...]
>
> (ii) is not rationally connected to –
>
> *(aa)* the purpose for which it was taken;
>
> *(bb)* the purpose of the empowering provision;
>
> *(cc)* the information before the administrator; or
>
> *(dd)* the reasons given for it by the administrator.

Binns-Ward J summed up the purpose and rationale for section 164 succinctly in *Capstone 556 (Pty) Ltd and Another v C:SARS*, [2011], wherein the following was stated:

> The considerations underpinning the "pay now, argue later" concept include the public interest in obtaining full and speedy settlement of tax debts and the need to limit the ability of recalcitrant taxpayers to use objection and appeal procedures strategically to defer payment of their taxes.

It is fundamental to the sustainability of a constitutional democracy that it has the ability to collect taxes that fund public finances. SARS performs a critical function in this regard and the empowering provisions in the TAA provide the framework for SARS to undertake this important public prerogative, including in particular the "pay-now-argue-later" principle in section 164. Potentially, there are taxpayers who object or appeal for strategic and tactical reasons, including to delay the matter in the possible hope that SARS may agree to settle the matter on terms more favourable to the taxpayer. Section 164 therefore enables SARS to deal with those taxpayers accordingly by demanding payment upfront notwithstanding that the taxpayer disputes the tax debt.

On the other hand, taxpayers are entitled to just administrative action that is lawful, reasonable and procedurally fair; furthermore, the decision must be rationally connected to the purpose of the empowering provision. Where there is a legitimate dispute between SARS and taxpayers (particularly compliant, honest and reputable taxpayers), concerning the interpretation and/or application of an especially complex provision in a fiscal statute, SARS would probably be hard pressed to show that a taxpayer is employing objection or appeal procedures solely for strategic reasons. In fact, the argument would be that those circumstances are exactly what was envisaged when the suspension of payment provisions in section 164(3) was introduced. This argument is probably supported by the judgment in *Peter v C:SARS* and the fact that SARS will in any event be paid interest at an attractive rate on the outstanding tax debt to the extent that the taxpayer is ultimately unsuccessful in respect of the merits. Furthermore, from a SARS perspective, the rate at which interest is charged on amounts due to SARS is always in excess of the rate charged in respect of refunds due to taxpayers.

The current poor economic climate that may extend into the future will probably place ever increasing pressure on SARS to consider denying requests for suspension of payment to meet budgeted targets. However, one should always balance this against taxpayers' rights in an open and democratic society governed by the Constitution of the Republic of South Africa, 1996, which is the supreme law of the land. It will be interesting to assess whether the favourable judgment for taxpayers in *Peter v C:SARS* has any impact on the practical application and interpretation of section 164 by SARS.

"It will be interesting to assess whether the favourable judgment for taxpayers in *Peter v C:SARS* has any impact on the practical application and interpretation of section 164 by SARS."

Cliffe Dekker Hofmeyr

Acts:

- Tax Administration Act 28 of 2011: Sections 10, 133 & 164; Chapter 9;
- Income Tax Act 58 of 1962;
- Value-Added Tax Act 89 of 1991;
- Promotion of Administrative Justice Act 3 of 2000: section 6(2)*(f)*(ii)*(aa)* to *(dd);*
- Constitution of the Republic of South Africa, 1996.

Cases:

- *Anthony Charles Peter v C:SARS* (Case No 3158/2018);
- *Metcash Trading Ltd v C:SARS* 63 SATC 13 [2001];
- *Capstone 556 (Pty) Ltd and Another v C:SARS* [2011] 74 SATC 20.

Tags: "pay-now-argue-later" principle; frivolous or vexatious.