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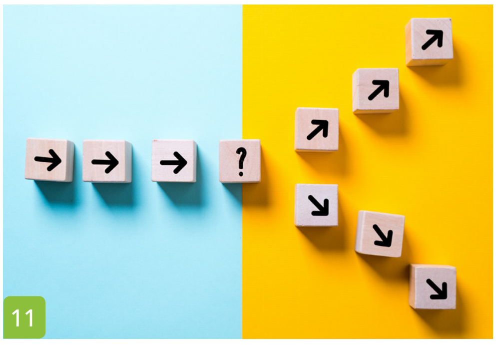
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DEFERRAL ON DISPOSAL OF LISTED SHARES TO CIS PORTFOLIO

Ms X inherited a large number of valuable shares in a blue chip listed company. She has no other material assets. She is concerned that, from a wealth-planning perspective, all her eggs are in one basket. She wishes to diversify her portfolio. If Ms X sold her shares with a view to buying a mixture of other shares or investments, she would ordinarily incur capital gains tax (CGT) on the capital gain derived in respect of the sale, assuming that she holds her shares as a long-term investment, that is, not for speculative purposes.

DEFERRAL OF TAX THROUGH ASSET-FOR-SHARE TRANSACTION

There is one possible way for Ms X to diversify her portfolio without any immediate tax consequences, namely, by undertaking an asset-for-share transaction that meets the requirements of section 42 of the Income Tax Act, 1962 (the Act). If Ms X transfers her shares in accordance with the requirements in section 42 to, say, an approved unit trust portfolio in exchange for units in the portfolio, the effects will be the following:

- She will incur no CGT when the shares are transferred to the portfolio. She will only incur CGT if and when she disposes of units in the portfolio in future;
- No securities transfer tax will arise on the transfer of the shares; and
- As the portfolio is exempt from CGT, the portfolio may be able to rebalance its investments subsequently thereby selling the shares free of CGT and utilising the proceeds to acquire different shares, provided the shares disposed of are still held on capital account. We discuss this issue later in this article.

Asset-for-share transactions are regulated by section 42. In terms of this section, if a person disposes of a capital asset to a company that is resident in South Africa in exchange for equity shares issued by that company, then there is a deferral of tax liability. Notably, in this context, the term "company" includes a portfolio of a regulated collective investment scheme in securities (CIS), and the term "equity share" includes a participatory interest in such a portfolio (see section 41(1) of the Act).

TAX CONSIDERATIONS APPLICABLE TO A CIS

A number of requirements must be met before a person will qualify for the relief offered by section 42. Notably, the market value of the asset being transferred must exceed the base cost of the asset and, if the transferor holds the asset as a capital asset, then the portfolio must also acquire the asset as a capital asset.

It is the latter requirement that has sometimes caused uncertainty in practice. The problem is that, if the manager of the portfolio intends selling the asset immediately after having acquired it from the transferor who held it as a capital asset, the question arises whether the portfolio itself also acquired the asset as a capital asset. In other words, given the short timeframe in which the portfolio acquires and then disposes of the asset, the issue that arises is that the asset may be converted from being a capital asset (in the hands of the transferor) to a revenue asset, that is, trading stock (in the hands of the portfolio).

In addition, under section 42, certain anti-avoidance provisions apply if the transferee disposes of the assets it acquired within 18 months of acquisition.

Generally speaking, while a CIS portfolio is a taxpayer in its own right, it pays no CGT (paragraph 61(3) of the Eighth Schedule to the Act) and it only pays income tax on revenue receipts that it does not pay over to investors within 12 months of receipt (section 25BA of the Act). A CIS portfolio is effectively a conduit: investors pay CGT only when they dispose of units in the CIS portfolio, and they pay income tax on revenue distributions from CIS portfolios (typically, interest).

But, if it could be said that a CIS portfolio was selling certain shares on revenue account, and if it did not distribute the proceeds of the sale to its investors within 12 months, then the CIS portfolio could be liable itself for income tax on the proceeds.

In 2018, National Treasury proposed amending the Act to state that any share sold by a CIS within less than 12 months of its acquisition, would automatically be considered to have been sold on revenue account. Following numerous submissions by the public regarding the proposal, National Treasury decided in the same year not to proceed with that proposed amendment.

SARS' PREVIOUS VIEW

In 2016, there was a merger of a large local listed company with an international company. Shareholders in the local company were advised by some fund managers that, instead of selling their shares as part of the merger, they should transfer their shares to a CIS portfolio, thereby deferring their CGT and diversifying their portfolios.

At the time, SARS took a very dim view of the scheme, to the extent of releasing a press statement on 30 September 2016 warning against the scheme on the basis of the capital versus revenue issue above, and on the basis that the scheme may have amounted to impermissible tax avoidance – the statement is still available on the SARS website.

SARS adopted that view despite the fact that it had previously ruled that such a scheme would benefit from the roll-over relief and that

> "[n]otwithstanding the short period that would have lapsed, the subsequent transfer of the participatory interest in the CIS to the third party will not change the character of the holding of the assets by the Applicant on the basis of it being held on capital account" (see SARS Binding Private Ruling 186, dated 12 February 2015).

BINDING PRIVATE RULING 344

The type of transaction discussed under the previous heading was again the subject matter of the recent SARS Binding Private Ruling 344, dated 4 June 2020. The facts in the ruling were that a fund manager wished, on behalf of certain of its clients, to transfer the listed shares of the clients to a CIS portfolio in exchange for units issued by the portfolio. After disposal of the shares by the clients, the CIS portfolios may have become obliged by their investment mandates to rebalance their portfolios by disposing of some of the shares acquired from the clients under the transaction. The disposals would have been undertaken in accordance with the normal investment authority and mandate of the relevant portfolio, and might have taken place within 18 months of the transaction, thereby potentially triggering the relevant anti-avoidance provisions in section 42.

SARS ruled that the transaction would meet the requirements for an asset-for-share transaction, and that the tax relief afforded by section 42 would apply. It ruled further that, while the 18-month anti-avoidance provision in section 42(7)*(a)* would, in principle, apply to the subsequent disposal of the shares, the effect of its application would be nil. This is due to the application of paragraph 61(3), the provision which exempts CIS portfolios from CGT.

SARS did provide the following warning, however:

> "The relief available in terms of this ruling does not preclude the subsequent application, if appropriate, of any general anti-avoidance provisions to the proposed transaction."

BINDING PRIVATE RULING 339

SARS Binding Private Ruling 339, dated 21 February 2020, also provides guidance. In that ruling, the trustees of a discretionary trust wished to transfer certain listed shares of the trust, together with the related investment management and administration functions, to a professionally managed and administered investment fund (that is, a CIS portfolio). In that case, SARS also ruled that the transaction would meet the requirements for an asset-for-share transaction, and that the tax relief afforded by section 42 would apply.

"It is important to note that under the Tax Administration Act, 2011, a binding private ruling is only binding on the taxpayers who applied for and are party to the ruling."

It is important to note that under the Tax Administration Act, 2011, a binding private ruling is only binding on the taxpayers who applied for and are party to the ruling. In practice, such a ruling is indicative of SARS' view in respect of a certain set of facts and therefore another taxpayer (who is not a party to the ruling) can only place persuasive reliance on the rationale for a ruling if it adopts a tax position based on that ruling. Importantly, SARS is not bound to apply what is stated in that ruling to anyone other than the specific taxpayer applicant.

Practically, it appears that the effect of the recent rulings is that, if an investor owns listed shares, and if the investor transfers the shares to a CIS portfolio in exchange for units issued by the portfolio, the relief afforded by section 42 could potentially apply in the following circumstances:

- The transaction must not be implemented to avoid tax impermissibly. In practice, this means that the transaction must not fall foul of the general anti-avoidance rules (GAAR) in sections 80A to 80L of the Act or constitute a sham or simulated transaction under the common law.
- If the portfolio disposes of the shares shortly after acquiring the shares, it should do so as part of a rebalancing of investments required by its investment policies. In other words, any disposals should be driven by commercial reasons. By its nature, a CIS is not a share trader even though it sells and buys assets on a daily basis. The mandate of a CIS, generally, is to realise capital growth over the medium to long term.
- The investor should be transferring its shares so as to move the management of the shares from itself to a professional fund manager for commercial reasons.

CONCLUSION

To return to the example at the beginning of the article, Ms X would need to exercise great caution if she wishes to diversify her portfolio through the asset-for-share arrangement. If her only desire is to diversify her investment pool, and if the CIS portfolio disposes of her shares shortly after acquiring the shares simply for the sake of diversifying her portfolio (and not because the portfolio is doing a "rebalancing" exercise pursuant to its investment policies), adverse tax consequences may still arise.

Cliffe Dekker Hofmeyr

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding private ruling* has a binding effect *between SARS and the applicant only*, and is published for general information. It does not constitute a practice generally prevailing. A third party may not rely upon a binding private ruling under any circumstances. In addition, published binding private rulings may not be cited in any dispute with SARS, other than a dispute involving the applicant or any co-applicant(s) identified therein.

Acts

- Income Tax Act 58 of 1962: Sections 25BA, 41(1), 42 & 80A to 80L; Eighth Schedule: paragraph 61(3);
- Tax Administration Act 28 of 2011.

Other documents

- Binding private rulings: 186, 339 & 344.

Tags: collective investment scheme in securities; listed company; asset-for-share transaction; listed shares.

INTRA-GROUP TRANSACTIONS

The perennial drive for efficiency in business and evolving demands of the commercial landscape often require corporate groups to dispose of parts of their commercial undertakings, to acquire strategic businesses, or to reorganise to achieve a set of commercial goals, such as securing external financing, attracting equity investment or entering into new partnerships.

The importance of corporate agility to economic activity has been recognised in the corporate roll-over relief provisions largely contained in Part III of Chapter II of the Income Tax Act, 1962 (the Act). The roll-over relief provisions allow corporate groups to reorganise without bearing the immediate income tax and capital gains consequences associated with certain intra-group transactions. This tax neutrality is, however, subject to certain prerequisite conditions and anti-avoidance rules.

The Taxation Laws Amendment Bill, 2020 (the TLAB), introduced in the National Assembly on 28 October 2020, proposes changes to the intra-group transaction provisions contained in section 45 of the Act. The TLAB proposes inserting a new subsection into section 45 (subsection (3B)), to avoid anomalous consequences which arise from the application of certain anti-avoidance rules, where an intra-group transaction is funded by debt or the issue of non-equity shares.

INTRA-GROUP TRANSACTIONS

An intra-group transaction under section 45 allows one company to transfer an asset to another company forming part of the same group, on a tax-neutral basis, and to defer the tax liability that would ordinarily have been incurred. Section 45, however, contains anti-avoidance provisions aimed at preventing the abuse of the tax relief afforded to companies through intra-group transactions.

The proposed amendments in the TLAB deal with the interaction between the "degrouping charge" contained in section 45(4) and the "zero-base cost rule" contained in section 45(3A).

INTRA-GROUP ANTI-AVOIDANCE PROVISIONS

The degrouping charge provides that if the transferor and the transferee companies cease to form part of the same group within six years of the implementation of the intra-group transaction, then any deferred tax benefit obtained from the transaction is triggered in the hands of the transferee. This is aimed at discouraging companies from implementing the intra-group transaction (thereby benefiting from the tax deferral) but then ceasing to form part of the same group soon thereafter.

The zero-base cost rule applies, in summary and subject to further considerations, where an asset is transferred by the transferor to the transferee in exchange for debt or non-equity shares and the debt or non-equity shares are deemed to have been acquired by the holder for nil expenditure. The rule implies that debt and non-equity shares issued as consideration under an intra-group transaction are deemed to have a zero-base cost in the hands of the transferor. Further, any repayment (capital repayment in respect of debt, or redemption of the non-equity shares) will not give rise to any income or gain in the hands of the holder of the shares or debt, provided the companies form part of the same group of companies when the repayments are made.

However, to the extent that the holder disposes of the debt or non-equity shares to a person outside of the group, tax must be accounted for on this disposal, having regard to the nil base cost of the debt and non-equity shares. This is aimed at adding a tax cost where companies engage in debt or non-equity share funded intra-group transactions, and then subsequently transfer the debt or non-equity shares outside of the group.

"To address this issue, the TLAB proposes inserting a subsection (subsection (3B)), which applies where the degrouping charge rule has been triggered in respect of an intra-group transaction where the zero-base cost rule was applied."

THE ANOMALY

In certain instances, an intra-group transaction can be implemented in a manner where the transfer of an asset is funded by the issue of debt or non-equity shares by a group company, and a degrouping subsequently occurs within a period of six years. Ordinarily, the degrouping charge would apply and "reverse" the tax deferral benefit obtained. However, the zero-base cost rule in this scenario has the effect that the holder still remains with a nil base cost in respect of the debt or non-equity shares. Essentially, this in effect creates a "double whammy", namely the reversal of the tax benefit in terms of the degrouping charge and a greater capital gain on the disposal of the debt or non-equity shares in terms of the zero-base cost rule.

PROPOSED CHANGES

To address this issue, the TLAB proposes inserting a subsection (subsection (3B)), which applies where the degrouping charge rule has been triggered in respect of an intra-group transaction where the zero-base cost rule was applied. The effect of the proposed subsection will be that the tax attributes of the debt or non-equity shares will be reinstated to reflect those that would have existed on the date of that degrouping, had tax deferral not applied at all. This means that a debt or non-equity share in respect of which the zero-base cost rule applied should be deemed to have a base cost equal to its face value on the date of the intra-group transaction less any repayments made prior to the degrouping.

COMMENT

A Draft Taxation Laws Amendment Bill, containing some of the proposed amendments discussed here was published by National Treasury and SARS on 31 July 2020 for public comment by 31 August 2020. The TLAB, introduced in the National Assembly on 28 October 2020, is subject to a further public participation process.

Taxpayers should welcome the resolution of the anomalous result brought about by the application of the two anti-avoidance rules discussed in this article. The amendments proposed in the TLAB appear to be aimed at striking a fairer balance between the need to prevent abuse and the agility provided to corporate groups through the corporate roll-over relief provisions, including intra-group transactions.

Cliffe Dekker Hofmeyr

Acts

- Income Tax Act 58 of 1962: Part III of Chapter II (sections 41 to 47 – in particular section 45).

Other documents

- Draft Taxation Laws Amendment Bill, 2020 (published on 31 July 2020);
- Taxation Laws Amendment Bill 27 of 2020 (introduced on 28 October 2020).

Tags: non-equity shares; tax-neutral basis; intra-group transactions; corporate roll-over relief.

DEDUCTIONS FOR COMMISSION EARNERS

Commission earners could make an argument to SARS that they should be allowed to deduct their normal range of business expenses, even if commission is no longer more than 50% of their total remuneration under the exceptional circumstances of the COVID-19 pandemic.

WHO IS A COMMISSION EARNER?

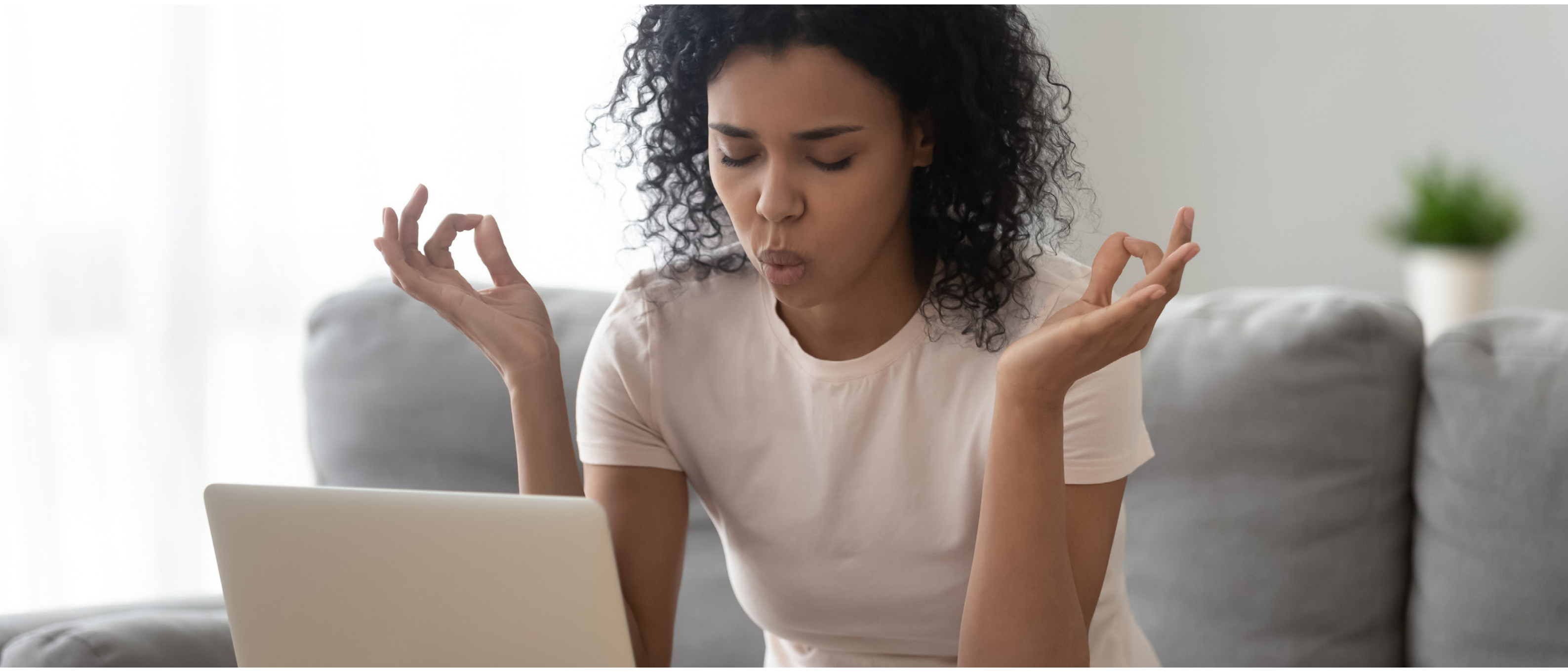
Commission earners who earn more than 50% of their total remuneration as commission income are not limited in the type of business expenses they can claim, as long as these are incurred in the production of their income and are not capital or personal in nature.

To determine if these commission-earning employees are entitled to claim business expenses, commission income recorded under code 3606 should be more than 50% of the total remuneration on the IRP5, which is the sum of gross retirement funding income (3697) and gross non-retirement funding income (3698). Total remuneration includes basic salary, medical aid contributions, group life premiums and any retirement fund contributions made by the employer.

REMUNERATION SUBJECT TO PAYE

A commission can be a flat fee or a percentage of transaction value. It is an amount paid for executing a transaction. Although a commission earner can be referred to as an "agent" or "representative", the individual is regarded as an "employee", as defined in paragraph 1 of the Fourth Schedule to the Income Tax Act, 1962. Commission income is variable income. The employer is deemed to incur the commission expense and the employee is deemed to accrue the amount in the month of payment, regardless of when the sales or turnover amounts forming the basis of the commission calculations have taken place.

In many ways, the deductions for business expenses available to these commission earners are similar to those available to individuals who are sole proprietors or independent contractors. Typically, these commission earners would apply for fixed percentage directives using the IRP3(b) form, which requires a detailed income and expenditure statement to be included with the application. The detailed income and expenditure statement should contain projected income amounts, which can be based on amounts earned in the latest year of assessment, adjusted for any increases, and a breakdown of anticipated expenses with corresponding upward adjustments. The fixed percentage directives would provide for the percentage of employees' tax (PAYE) that their employers should withhold on remuneration paid to them.



"Other expenses which commission earners can claim include any service fees such as accounting, legal, administration, and sales and marketing fees paid to service providers."

TYPES OF EXPENSES CLAIMED AS DEDUCTIONS

Unlike other salaried employees, these commission earners are able to claim actual travel expenses as deductions even if they do not receive a travel allowance or the use of a company vehicle from their employers. They will be able to claim wear-and-tear allowances on vehicle costs, interest and fees on the instalment sale agreements, and maintenance, fuel, licence and insurance costs. They should maintain logbooks recording business kilometres with dates, kilometres travelled and purposes of travel. The logbook will assist in apportioning travel expenses according to business versus total kilometres.

These commission earners are also able to claim home office expenses proportionate to the area used for business on rent, rates, water and electricity, interest and fees on the mortgage bond, cleaning, internet connectivity, and wear-and-tear allowances on business equipment. Cell phone invoices with a sample of business use relative to personal use calls should be maintained for verification purposes. Repairs to the home office specifically will be allowed in full. Repairs to the building in general, however, must not be included in total costs.

Unlike other salaried employees, the room containing the home office need not be regularly and exclusively used by the individual to work for the employer from which they earn remuneration. These commission earners can claim for home office expenses if their work performance and duties are mainly in their home offices, ie more than 50%.

Other expenses which commission earners can claim include any service fees such as accounting, legal, administration, and sales and marketing fees paid to service providers. (Non-commission salaried earners are only allowed accountancy fees if they receive income other than salary, pension or annuities.)

Commission earners can claim entertainment expenses for various sales and marketing initiatives. It would be advisable to compile a spreadsheet together with the names of clients and reasons for the expenses which reconciles with the relevant invoices, receipts or statements of account. Notably, other salaried employees who do not earn commissions at all, or who earn less than 50% of total remuneration in commissions, cannot claim any entertainment expenses. These salaried employees should rather claim reimbursements for entertainment expenses from their employers, based on supporting invoices.

As with any claims for deductions, supporting documents in the form of schedules, invoices, receipts, statements of account and calculations with amounts on schedules reconciling with the source documents should be retained for five years and submitted to SARS if the ITR12 return is selected for verification. Bank statements or credit card statements are not accepted as supporting documents. An apportionment calculation of square meter of home office area relative to the total residence, with the same ratio applied to expenses such as rates and interest, must also be submitted. Expenses which are not allocated a code on the ITR12 should be claimed using code 4016.

REDUCTION IN COMMISSION INCOME DUE TO COVID-19 LOCKDOWNS

Unfortunately, the COVID-19 lockdown conditions have resulted in devastating reductions in commission income for some of these individuals. Where the anticipated commission income in the 2021 year of assessment is likely to fall below 50% of total remuneration due to the economic impact of the lockdown, there is an argument to be made that these commission earners should still be allowed to claim all the business expenses regardless. This is because their remuneration is *normally* derived mainly from commissions based on sales or turnover attributable to them. COVID-19 times are unprecedented and the OECD has acknowledged this period is exceptional and temporary in nature, ie not normal. The same should be the case in determining whether a commission earner meets the 50% threshold in the 2021 year of assessment.

It would be a good idea to anticipate this issue in a verification, to prevent SARS from disallowing expenses claimed and having to object to the additional assessment. The commission earner should provide a schedule with commission income amounts (code 3606) comprising more than 50% of the total remuneration in the 2019 years of assessment and before. Communication from the employer on pre-lockdown sales targets to be reached in 2020 and further communication with reduced lockdown targets would also assist in demonstrating that the decrease in sales (and corresponding decrease in commission income) is due to the lockdown and exceptional in nature.

Where the decrease in commission income is not expected to fall below 50% of total remuneration, the commission earner could request a revised fixed percentage directive to reduce the percentage of PAYE to be withheld by the employer due to the reduced remuneration. Commission earners should consult their tax advisers on whether to submit a new request. Their employers should continue to withhold PAYE according to the existing fixed percentage directive until provided with a new directive.

Webber Wentzel

Acts

- Income Tax Act 58 of 1962: Fourth Schedule: paragraph 1 (definition of "employee").

Other documents

- IRP3(b) and IRP5 forms;
- ITR12 return.

Tags: business expenses; income and expenditure statement; employees' tax (PAYE); additional assessment.

DOUBTFUL DEBT ALLOWANCES

IN BRIEF

The Taxation Laws Amendment Bill, 2020 (the TLAB), introduced in the National Assembly on 28 October 2020, proposes a number of amendments to paragraphs *(j)* and *(j*A*)* of section 11 of the Income Tax Act, 1962 (the Act). These provisions deal with what is commonly referred to as the "doubtful debt allowance".

If these proposed amendments are ultimately enacted, they will result in the following:

- A change to paragraph *(j*A*)* to ensure consistency between "covered persons" (the term is defined in section 24JB of the Act) and other taxpayers;
- Changes to paragraph *(j)* to ensure consistency between taxpayers that apply IFRS 9 and those that do not; and
- Changes to both paragraphs to permit taxpayers that apply IFRS 9 for financial reporting purposes to claim the allowance in respect of lease receivables that have been included in income (currently this allowance is not available in respect of any lease receivables).

IN DETAIL

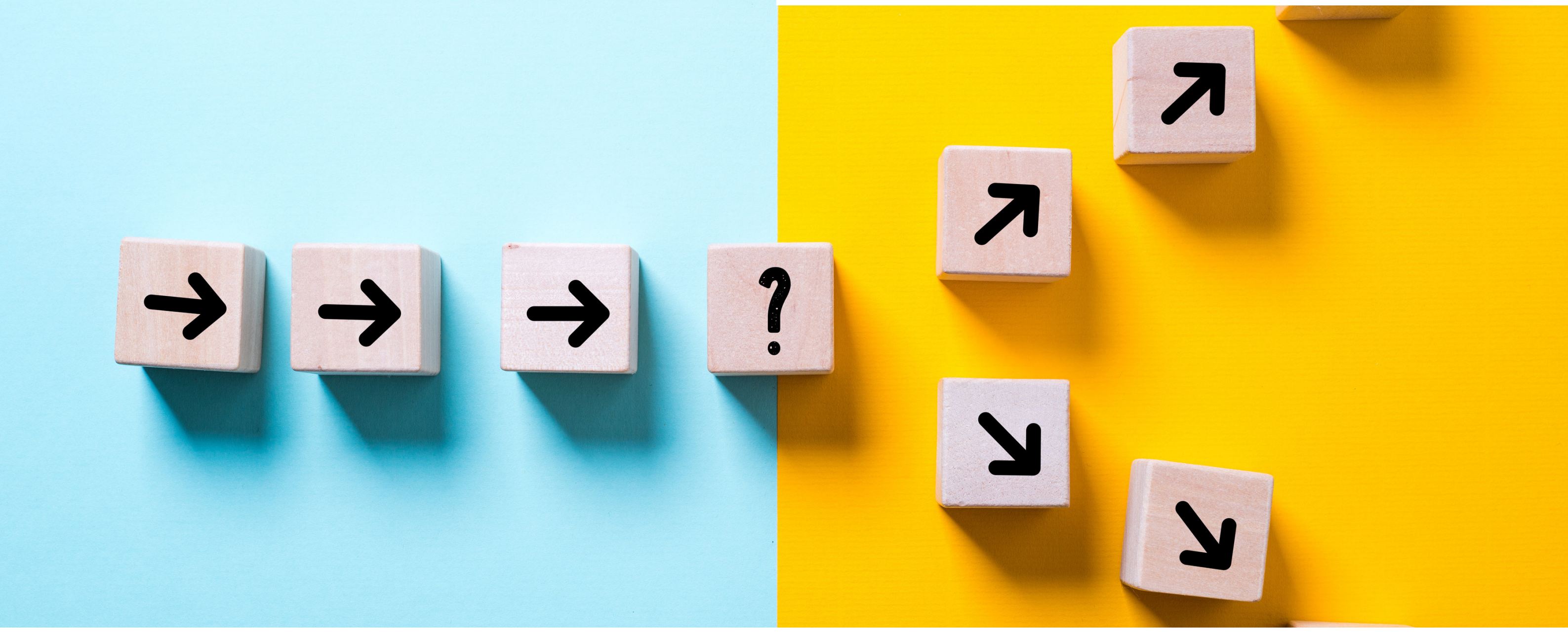
Consistency between "covered persons" and other taxpayers

Currently, taxpayers are given relief for any provision of doubtful debt raised by way of a doubtful debt allowance determined in terms of paragraph *(j)* or *(j*A*)*.

Paragraph *(j*A*)* applies to certain "covered persons", while paragraph *(j)* applies to taxpayers that do not fall under paragraph *(j*A*)*.

One of the key differences between the two provisions is that, under paragraph *(j)*, a taxpayer is required to prove that a deduction will be allowed if the debt becomes irrecoverable. Paragraph *(j*A*)* does not, however, impose such a requirement. In order to address this inconsistency, it is proposed that paragraph *(j*A*)* be amended to include this requirement. This will ensure consistency of treatment between non-bank lenders and banks.

This could have an impact on most banks, on the basis that measures would need to be put in place in order to ensure that the allowance is calculated only in respect of debts that will be deductible under paragraphs *(a)* or *(i)* of section 11 when they become irrecoverable. For example, any loss allowance relating to credit cards and overdrafts with undrawn amounts will no longer qualify for the section 11*(j*A*)* allowance. This may require certain modifications to systems used by banks to calculate the doubtful debt allowance appropriately.



"Lease receivables are specifically excluded from paragraphs *(j)* and *(j*A*)* of section 11 (ie they do not qualify for the doubtful debt allowance)."

Consistency between taxpayers that apply IFRS 9 and taxpayers that do not apply IFRS 9

Taxpayers that do not apply IFRS 9 to the classification of doubtful debts claim allowances according to the number of days that a doubtful debt is outstanding in terms of section 11*(j)*. Currently, the allowance is calculated on the face value of the debt. The draft amendment proposed to section 11*(j)* will require these taxpayers to exclude the value of any security backing the debt from the calculation of the doubtful debt allowance. Again, this is aimed at ensuring consistency between taxpayers that apply IFRS 9 and taxpayers that do not.

Certain lease receivables

Lease receivables are specifically excluded from paragraphs *(j)* and *(j*A*)* of section 11 (ie they do not qualify for the doubtful debt allowance). Consequently, taxpayers that apply IFRS 9 for financial reporting purposes cannot claim the doubtful debt allowance in respect of lease receivables.

This results in an anomalous situation for taxpayers that have lease receivables that have accrued but are in arrears. Such taxpayers are unable to claim doubtful debt allowances in respect of such lease receivables.

In order to address this anomaly, it is proposed that section 11*(j)* be amended to allow taxpayers that apply IFRS 9 to claim a doubtful debt allowance in respect of lease receivables that have been included in income (ie that have accrued) and that are in arrears.

IN CLOSING

The above proposed amendments are subject to change before they are enacted. It is anticipated that the TLAB, which may still be amended by Parliament, will be passed by both Houses of Parliament by early December 2020.

PWC

[*Editorial comment*: International Financial Reporting Standards (IFRS) are issued by the International Accounting Standards Board (IASB). IFRS 9 contains three main topics: classification and measurement of financial instruments, impairment of financial assets and hedge accounting.]

Acts

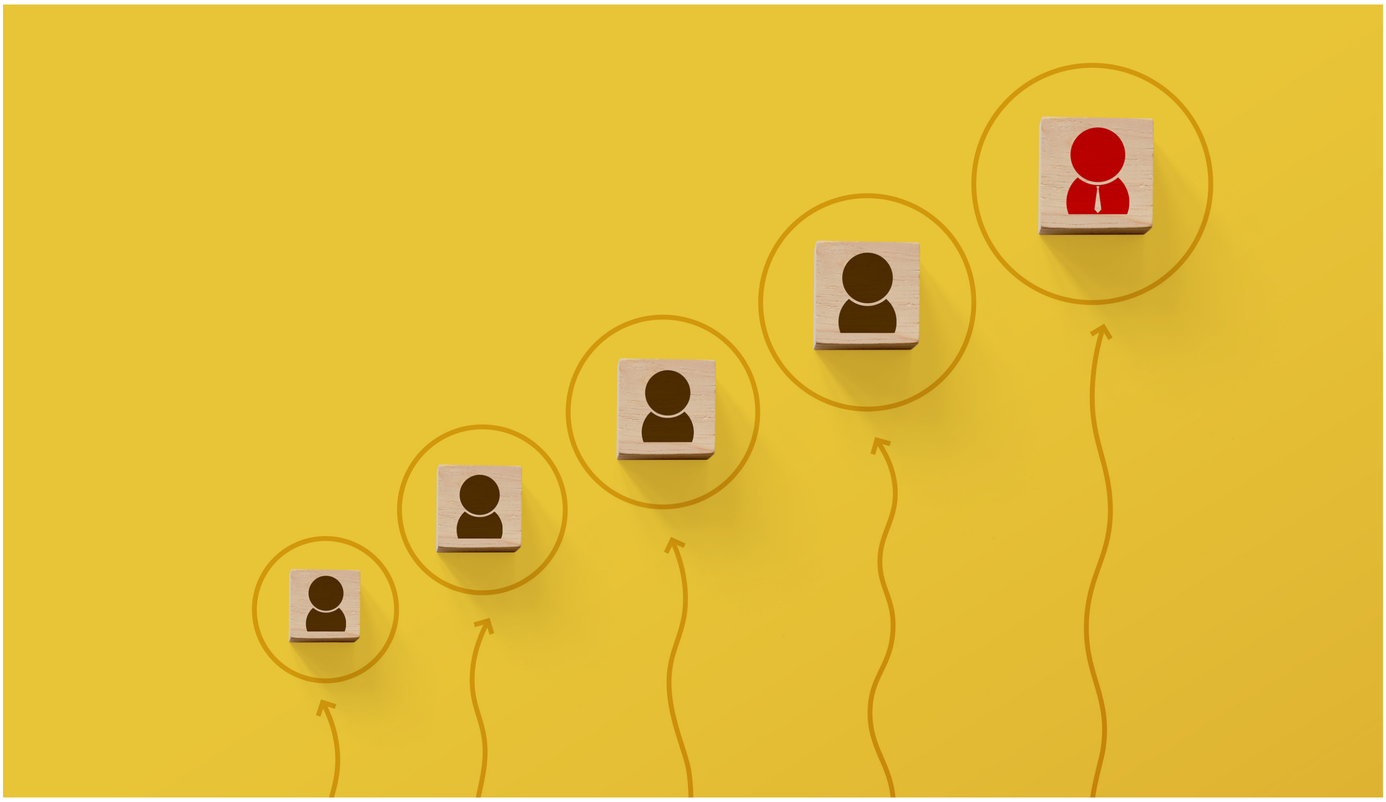
- Income Tax Act 58 of 1962: Sections 11 (paragraphs *(a)*, *(i)*, *(j)* and *(j*A*)*) and 24JB (definition of "covered person").

Other documents

- Taxation Laws Amendment Bill 27 of 2020 (introduced on 28 October 2020);
- International Financial Reporting Standard 9 (IFRS 9).

Tags: doubtful debt allowance; covered persons.

SUBORDINATION AGREEMENTS



Due to the ongoing COVID-19 pandemic and the impact of the lockdown measures implemented, many South African entities have found themselves in financial distress. As a result, companies may enter into subordination agreements whereby they subordinate related-party loans in favour of third-party loans. Such subordination agreements may also be entered into on the advice of auditors in order to avoid the issuing of a modified audit opinion or an emphasis of matter on the basis that the company is not a going concern. Subordination is essentially where a related creditor agrees to make no claim for payment of their loans until the assets (fairly valued) of the company exceed its liabilities.

Subordination agreements fall within the scope of section 8F of the Income Tax Act, 1962 (the Act), which deals with hybrid debt instruments. The aim of this section is to recharacterise loans which have equity- or dividend-like features.

Paragraph *(b)* of the definition of a hybrid debt instrument in section 8F(1) states that a hybrid debt instrument includes an arrangement whereby

> "the obligation to pay an amount so owed on a date or dates falling within that year of assessment has been deferred by reason of that obligation being conditional upon the market value of the assets of that company not being less than the amount of the liabilities of that company".

Where companies have entered into such agreements the Act prescribes that two things must happen. Firstly, the interest payable on the debt is recharacterised and is deemed to be a dividend *in specie* declared and paid by such a company on the last day of the year of assessment. Secondly, such interest will not be deductible for income tax purposes.

It should be noted, however, that whilst the dividend *in specie* may be exempt from dividends tax for declarations deemed to have been made to South African resident companies, the same will not

"Where a subordination agreement has been entered into solely because of going concern problems, section 8F will not be applicable (ie the debt recharacterisation rules will not apply)."

apply to declarations deemed to have been made to non-resident entities. In such instances the obligation to declare and pay the dividends tax will be on the South African resident company declaring the dividend.

Where a subordination agreement has been entered into solely because of going concern problems, section 8F will not be applicable (ie the debt recharacterisation rules will not apply). The rules will only apply if the company is in receipt of certification by a person registered as an auditor in terms of the Auditing Profession Act, 2005. Such certification must state that the subordination agreement was entered into due to going concern problems. The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016, states:

> "It is envisaged that the auditor's certification of the subordination of the related-party debt for purposes of this exclusion should be evidenced in a separate letter."

Taxpayers that are in possession of such certification may deduct the interest incurred on the subordinated loans and such interest will not be recharacterised into a dividend *in specie*.

It is therefore important that where taxpayers have entered into subordination agreements due to going concern difficulties, documentation in the form of certification by a registered auditor is maintained and kept so as to avoid the application of section 8F to such loans. The burden of proof that an amount is deductible is on the taxpayer and as such appropriate documentation should be kept at all times.

PKF

Acts

- Income Tax Act 58 of 1962: Section 8F (definition of "hybrid debt instrument" in subsection (1));
- Auditing Profession Act 26 of 2005.

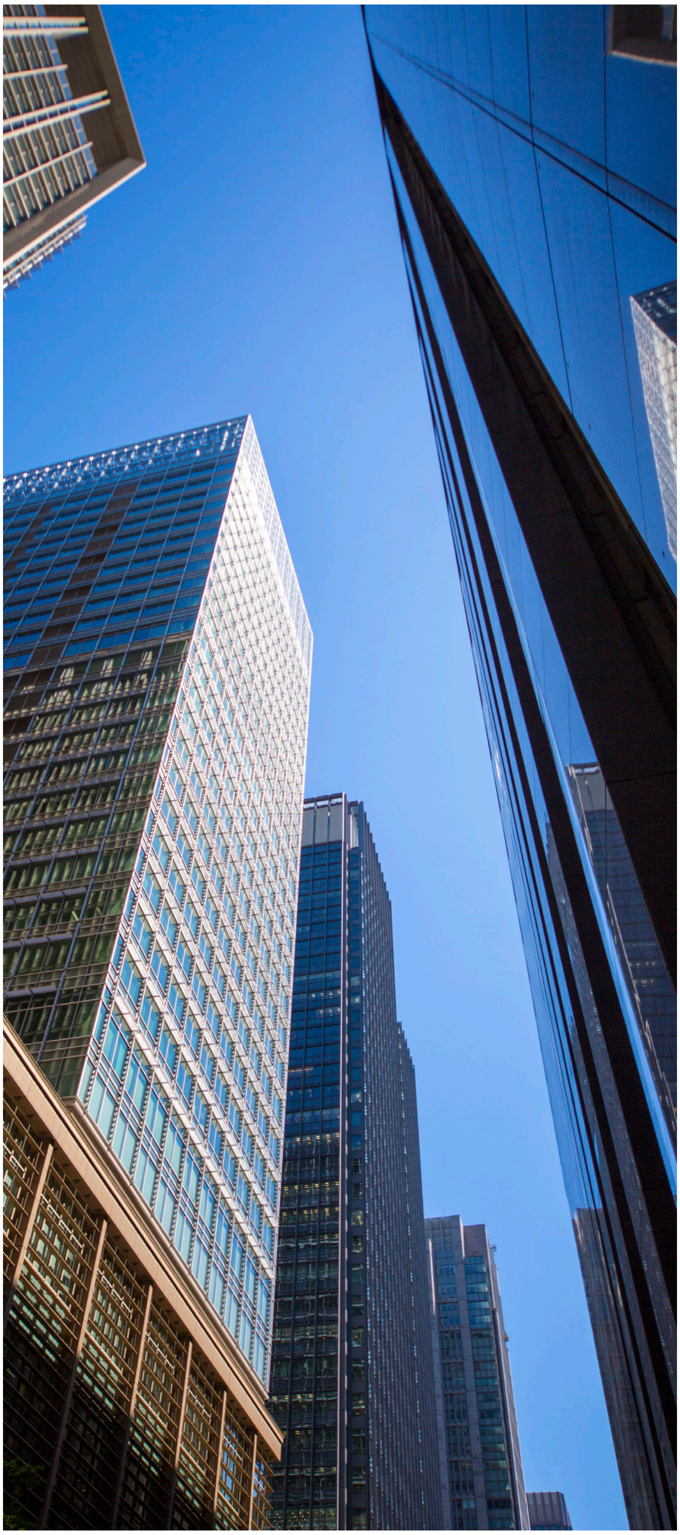
Other documents

- Taxation Laws Amendment Bill 17B of 2016;
- Explanatory Memorandum on the Taxation Laws Amendment Bill 17B of 2016.

Tags: subordination agreements; hybrid debt instruments; South African resident company.

LOOP STRUCTURES AND CFC RULES

One of the welcome announcements by the Minister of Finance in his budget speech delivered in February this year, pertained to a potential further relaxation of the Financial Surveillance Department of the South African Reserve Bank's (the SARB) prohibition against so-called "loop" structures. However, this came with a caveat; this relaxation (or possibly scrapping) would coincide with amendments to the tax laws to curtail the mischief that loop structures attempt to prevent.



A loop structure is, broadly, a structure where a resident of the Common Monetary Area (the CMA – it is a monetary union consisting of South Africa, Eswatini, Lesotho and Namibia) holds an investment in a foreign vehicle which, in turn, holds an investment in the CMA. Note that this investment could be in the form of a share or loan. The SARB regards this type of transaction as a contravention of the exchange control regulations in that they result in or have the potential to result in the direct or indirect export of capital abroad to a non-resident company or other relevant non-resident trust or entity for the ultimate benefit of a resident.

In terms of the SARB's current policy, these structures are only permitted in limited circumstances as provided for in the Currency and Exchanges Manual for Authorised Dealers and subject to approval being obtained for such an investment from the CMA resident's authorised dealer.

The Draft Taxation Laws Amendment Bill, 2020 (the Draft TLAB), was released for public comment on 31 July 2020 and detailed the proposed tax amendments alluded to in the budget speech. On 28 October 2020 the Taxation Laws Amendment Bill, 2020 (the TLAB), was introduced in the National Assembly. It is anticipated that the TLAB, which may still be amended by Parliament, will be passed by both Houses of Parliament by early December 2020.

Amendment to section 9D of the Act

A controlled foreign company (CFC) is defined in section 9D(1) of the Income Tax Act, 1962 (the Act), simplistically, as a foreign company where South African residents hold more than 50% of its shares. In the event of the CFC rules finding application, a notional

"net income" calculation must be performed for such company at the end of its "foreign tax year" in accordance with the provisions of section 9D and the proportional amount of such "net income" must be included in the income of the South African residents in proportion to the participation rights held.

Section 9D contains CFC specific exemptions which may be applied in performing the "net income" calculation. CFCs may also benefit from the normal dividend exemption contained in section 10(1)*(k)* of the Act. Thus, a CFC holding shares in a South African company would benefit from an exemption in respect of any dividends received. In terms of the TLAB, the exemption for dividends will not apply to CFCs but a proportion (calculated by the number 20 to 28) must be included in the CFCs' "net income".

In this context, it is relevant to note that this potential tax would be suffered in addition to dividends tax to which the dividend declared by the South African company to the CFC would already have been subject (subject to the application of any applicable double tax agreement). Furthermore, whilst in performing a CFC "net income" calculation, a foreign tax credit may be claimed in accordance with section 6*quat* of the Act for foreign taxes suffered. It does not appear that such credit will be available for South African taxes suffered, ie, the dividends tax suffered in respect of the dividend declared by the South African resident company to the CFC.

According to the Explanatory Memorandum to the Draft TLAB, the proposed amendment is intended to ensure that CFC structures are not used as tax-planning opportunities for South African individuals.

"According to the Explanatory Memorandum to the Draft TLAB, the proposed amendment is intended to ensure that CFC structures are not used as tax-planning opportunities for South African individuals."

Amendment to the participation exemption

The TLAB further proposes that the participation exemption in paragraph 64B of the Eighth Schedule to the Act should not apply to the sale of shares in a CFC, to the extent that the value of the assets of that CFC is attributable to assets directly or indirectly located, issued or registered in South Africa.

On the basis that the proposed amendments do not contain any thresholds, it seems that these changes will impact not only on "loop" structures which are currently prohibited, but also on permissible loop structures falling within the SARB's specific parameters and for which approval may have been obtained.

The proposed amendments will come into operation on 1 January 2021 and apply in respect of dividends received by or accrued to any CFC on or after that date and in respect of any net capital gains of any CFC arising during any foreign tax year commencing on or after that date.

ENSafrica

Acts

- Income Tax Act 58 of 1962: Sections 6*quat*, 9D (including the definition of "controlled foreign company" in subsection (1)) & 10(1)*(k)*; Eighth Schedule (paragraph 64B).

Other documents

- Currency and Exchanges Manual for Authorised Dealers;
- Draft Taxation Laws Amendment Bill, 2020 (published for public comment on 31 July 2020);
- Explanatory Memorandum to the Draft Taxation Laws Amendment Bill, 2020;
- Taxation Laws Amendment Bill 27 of 2020 (introduced on 28 October 2020).

Tags: exchange control regulations; double tax agreement; participation exemption.

SETTLEMENT OF TAX DISPUTES WITH SARS

The settlement of a tax dispute is available to taxpayers in respect of which an assessment has been issued by SARS in situations where the taxpayer has disputed the assessment under Chapter 9 of the Tax Administration Act, 2011 (the TAA). Settling a tax matter means resolving a tax dispute to the best advantage of both parties.

Either SARS or the taxpayer may initiate a settlement procedure, but neither party has the right to require the other to engage in a settlement procedure.

It is imperative for taxpayers to know at which point in the dispute reaching a settlement with SARS becomes appropriate, as this can save time, litigation costs and the utilisation of resources. Settlements can be a useful tool where a taxpayer weighs up the amount of tax at stake, legal arguments, facts and evidentiary difficulties / insufficient documentary evidence against one another and foresees difficulties in this regard. For taxpayers, this is important, as the taxpayer bears the onus of proving:

- that an amount, transaction, event or item is exempt or otherwise not taxable;
- that an amount or item is deductible or may be set off;
- the rate of tax applicable to a transaction, event, item or class of taxpayer;
- that an amount qualifies as a reduction of tax payable;
- that a valuation is correct; or
- whether a "decision" that is subject to objection and appeal under a tax Act is incorrect.

A settlement may not be entered into if SARS is of the opinion that it is not to the best advantage of the state to settle a dispute, for example where, in the opinion of SARS, the circumstances laid out in section 146 of the TAA (set out below) do not exist and a taxpayer has intentionally evaded tax or committed fraud, or where the settlement would violate the law or practice generally prevailing. Additionally, if a taxpayer has failed to comply with the provisions of a tax Act and the non-compliance is serious, SARS is precluded from settling the matter. Settlement is also inappropriate if it is in the public interest to have judicial clarification of the issue and the case is appropriate for this purpose or the pursuit of the matter through the courts will significantly promote taxpayer compliance with a tax Act and the case is suitable to achieve this.

Section 146 of the TAA provides for the circumstances where a settlement is appropriate and where it is fair and equitable to both parties, having regard to:

- whether the settlement would be in the interest of good management of the tax system, overall fairness and the best use of SARS' resources;
- SARS' cost of litigation in comparison to the possible benefits with reference to the prospects of success in court;
- whether there are any complex factual issues in contention or evidentiary difficulties which may make the case problematic in outcome or unsuitable for resolution through the alternative dispute resolution procedures or the courts;
- a situation in which a participant or a group of participants in a tax avoidance arrangement has accepted SARS' position in the dispute, in which case the settlement may be negotiated in an appropriate manner required to unwind existing structures and arrangements; or
- whether the settlement of the dispute is a cost-effective way to promote compliance with a tax Act.

For a taxpayer to settle a dispute with SARS they must, at the very least, show that they meet at least one of the criteria set out above.

"According to section 147 of the TAA, a participant in a settlement procedure must disclose all relevant facts during the discussion phase of the process of settling a dispute. "

According to section 147 of the TAA, a participant in a settlement procedure must disclose all relevant facts during the discussion phase of the process of settling a dispute. The settlement is conditional upon full disclosure of material facts known to the person concerned at the time of settlement.

A dispute that has been settled must be evidenced by an agreement in writing between and signed by SARS and the taxpayer, in the prescribed format, and must include:

- how each particular issue is settled;
- the relevant undertakings by the parties;
- the treatment of the issue in future years;
- the withdrawal of objections and appeals; and
- the arrangements for payment.

Record of the settlement agreement must be retained by a taxpayer, as it represents the final agreed position between SARS and the taxpayer and is in full and final settlement of all or the specified aspects of the dispute.

SARS has a legal obligation to adhere to the terms of the agreement unless material facts were not disclosed or there was fraud or misrepresentation of the facts.

Where the taxpayer or the person concerned does not pay the amount due pursuant to the agreement or otherwise fails to adhere to the agreement, SARS is empowered to regard the agreement as void and proceed with the matter in respect of the original dispute; alternatively, SARS may enforce collection of the "settlement" amount under the relevant collection provisions of the TAA in full and final settlement of the dispute.

CONCLUSION

It is imperative for taxpayers to know at which point in a tax dispute to propose or consider reaching a settlement with SARS, as this impacts the taxpayer's time, resources and litigation costs.

It is possible for taxpayers to initiate the settlement of a tax dispute (this can also be raised during an ADR process with SARS).

There is a specific set of circumstances where settlement would be regarded as inappropriate and a specific set of circumstances where settlement would be regarded as appropriate. The taxpayer must satisfy all relevant criteria for purposes of settling the matter.

Failure to adhere to a settlement agreement could result in the agreement being regarded as void, with the original dispute being revived and/or collection of the amount of tax owing being pursued by SARS.

Where taxpayers are unable to continue disputing a matter, they must be proactive and communicate with their tax advisers to assess whether a settlement of the matter will be appropriate.

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Acts

- Tax Administration Act 28 of 2011: Chapter 9 (sections 101 to 150; more specifically sections 146 & 147).

Tags: public interest; settlement agreement; settlement of a tax dispute.

TAX FILING TIMING OBLIGATIONS

Decisions of South Africa's courts are an essential source of law. The courts uphold and enforce the Constitution and develop common law that is consistent with the values of the Constitution, and the spirit and purpose of the Bill of Rights. In a taxation context, court decisions assist in how legislation must be interpreted or confirm the rights and obligations of taxpayers and the South African Revenue Service (SARS) alike. One therefore cannot appreciate the tax landscape without having regard for the decisions of our courts.

In *Joseph Nyalunga v The Commissioner: South African Revenue Service*, [2020], one Joseph Nyalunga (the Applicant) brought an application to review and set aside two decisions made by the Commissioner for SARS five years ago. The first relates to a decision on an audit finding letter and the second appears in a finalisation of audit letter, from September 2013 and February 2014, respectively.

The Applicant failed to submit tax returns to SARS and failed to lodge an objection in respect of the assessments as a result of his incarceration. During this time, SARS delivered a notice of its intention to audit the Applicant due to possible under-declaration of income tax. The Applicant initially failed to respond to the audit finding letters, but when he was able to, conveyed that he would not be able to respond any further as he was in prison and could not obtain any documents; based on this fact he would not be in a position to object. As soon as he was released, he would cooperate with SARS. SARS served a finalisation of audit letter, which served as a final assessment of the Applicant. All the letters were handed to the Applicant personally while incarcerated.

"The court's ruling was found in favour of SARS, holding that finality of the assessment was reached and the time period to raise an objection had come and gone in this matter."

The Applicant was released on 24 March 2014, and (in agreement with SARS) had until 8 May 2014 to file an objection. SARS issued a final demand on 24 February 2014 and took a judgment against the Applicant on 23 June 2014 in the amount of R15 166 511,89. A warrant of execution was issued on 21 January 2016 and the sheriff was instructed to execute on 2 February 2016. The executions were futile as the Applicant conveyed that he did not own any movable assets. The sheriff was eventually able to attach assets.

The Applicant sought condonation for late filing of the written submissions. SARS did not oppose the condonation as they sought a finalisation of the review matter once and for all. Condonation was granted to the Applicant.

The Applicant argued that, due to his incarceration, he was unable to participate as a normal taxpayer. He further contended that the procedure followed by SARS was unfair in its procedural irregularities, that the audit calculations were incorrect and finally that the decision taken by SARS was unconstitutional and infringed upon his rights and the rule of law.

SARS argued that the review application was made too late, by some four years. SARS also contended that the court did not have jurisdiction to hear the matter and that only the tax court did. Furthermore, SARS contended that the time frames for objection had passed, and the Applicant had been notified of these periods; the period for making review applications had therefore prescribed. SARS further argued that the relief sought had no practical effect.

The court's ruling was found in favour of SARS, holding that finality of the assessment was reached and the time period to raise an objection had come and gone in this matter. Four years had passed and thus the assessment had prescribed. The court further agreed with SARS' argument that the relief sought by the Applicant was not competent, as the relief sought did not set aside the court order and writ of execution previously granted. The court dismissed the Applicant's application with costs.

mstGROUP

Cases

- *Joseph Nyalunga v The Commissioner: South African Revenue Service* (90307/2018); [2020 ZAGP 6 May 2020].

Tags: under-declaration of income tax; rule of law.

TAX ENFORCEMENT

The unusual business conditions of the COVID-19 outbreak will require a more flexible approach from tax authorities when analysing transfer pricing in the 2020 year of assessment.

The COVID-19 outbreak in late 2019 / early 2020 has impacted the way we live and has had a devastating impact on the global economy. While countries struggle to revive ailing economies with interest rate cuts and capital injections, tax authorities need to be more flexible when enforcing transfer pricing for affected transactions in the 2020 year of assessment.

Most transfer pricing investigations start off as a desk audit when large amounts of data are collected and analysed by the tax administration. Most of this activity can be performed remotely. With reliable technology, the functional analysis interviews can also be conducted remotely. The main change to transfer pricing enforcement is the flexibility that tax authorities will have to exhibit when applying the arm's length principle.

One of the important comparison issues will be how business operations changed during the various levels of lockdown. Many multinationals have key individuals providing high value-add activities to the supply chain and operational effectiveness of the group. These personnel were dislocated from their normal place of work and had to carry out these substantial business activities remotely.

Many countries have provided guidance on the impact these employees have on tax resident status, employees' tax and permanent establishment issues, but very few have considered the impact on transfer pricing. Tax authorities would need to consider the people affected, the location, the duration and importance of the functions they perform and the potential impact the dislocation could have on transfer pricing models. For example, there would be an impact on the intra-group services provided remotely rather than from a central location, and an impact on the development of the group's intangible assets.

Remote working has an impact on individual employees as well as supply chains. Many companies were forced to move aspects of their supply chains to a remote operation, for example when sales and distribution centres functioned remotely.

The Organisation for Economic Co-operation and Development (OECD) is grappling with the challenge of taxing the digital economy in the traditional way (for example, Google or Amazon); now COVID-19 has caused a greater shift towards conducting business activities remotely. The draft guidance from the OECD seeks to assist tax authorities to identify and tax any profits arising in locations where a company has a digital footprint but no physical presence. With key changes in business operations to remote activities, this draft OECD guidance could also be relevant to businesses outside the traditional digital economy.

One of the greatest challenges arising from the COVID-19 lockdowns has been the impact on the economy and the "new normal". Tax authorities usually apply the arm's length principle by determining the profits from a transaction which entity XA in Country A entered into with a related party XB in Country B based on the comparability of the terms and conditions which would have existed had XA and XB transacted independently.

To justify a transaction as arm's length, taxpayers compile transfer pricing reports using benchmarked data. Benchmarking identifies internal or external comparable data using the most appropriate transfer pricing method (such as the transactional net margin method) for the relevant years, often with comparability adjustments made to the data. Tax authorities rely on this data to determine whether the company they are auditing has transacted with connected parties at arm's length. The benchmarking data is pivotal in enforcing the arm's length principle.

The challenge with comparability data is the time lag. Invariably, there is a two- to three-year lag before the data is available to be used for the year under review. An analysis supporting 2020 would normally rely on data available for 2016–2018. This data would create significant comparability issues as it would not reflect the impact of the devastating economic downturn or significant changes to business operations in 2020. Whether such data could be suitably adjusted is questionable.

Although the use of multiple-year data could provide a more reasonable comparison, it is still doubtful whether this data would truly reflect the impact of the pandemic and its associated economic recession. An alternative could be to use data from the previous recession years during the global financial crisis in 2007–2008. Although that historical data may provide a comparison for the current economic impact, it would not necessarily reflect changes in business operations as a result of more activities being carried out remotely.

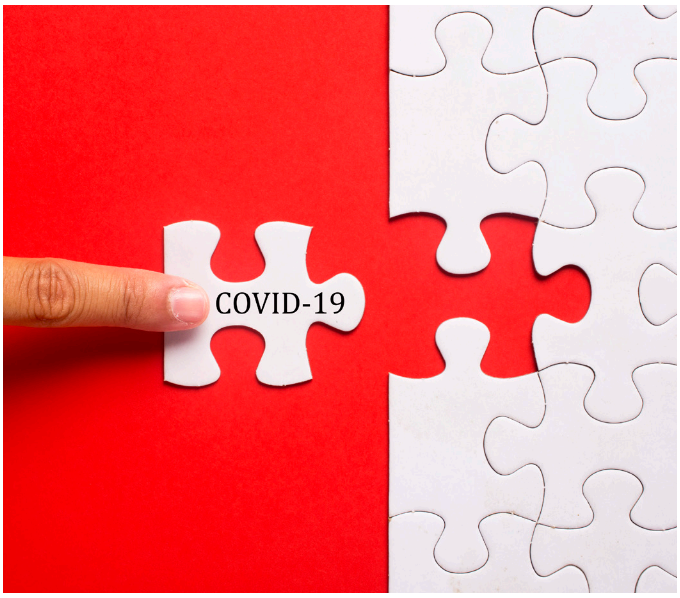
Another alternative is to consider whether comparability adjustments could be made. Tax authorities often rely on these adjustments where there are comparability defects between the benchmark data and the tested party. Economic circumstances relating to the transaction under review are a key comparability factor.

Decisions on any comparability adjustments should also be based on the nature of the transaction under investigation. For example, a distributor selling a diverse portfolio of goods may be less impacted than a manufacturer that experienced significant operational downtime. The impact of the lockdown would have also been experienced differently depending on the nature of the tested party and the industry. Businesses which were already operating remotely would exhibit less dramatic changes than those which are historically bricks-and-mortar industries. Certain industries may also be more affected than others. In South Africa, the hospitality, airline, liquor and tobacco industries have been decimated, but those providing telecommunication services and online retailers are less affected.

In a benchmarking analysis, it is common to adjust the results of the comparables. However, it may be more accurate to adjust the financial performance of the tested party to "normalise" its profits for 2020. The difficulty of doing this lies in identifying and justifying the items on the income statement which should be adjusted. For example, bad debts or inventory write-offs could be considerable and significantly higher than in previous years. The company's overall costs may also have increased significantly, requiring an adjustment to the normal levels in previous years.

More scientific adjustments or analysis can be undertaken to determine how the drop in sales impacts profitability so as to apply adjustments to the comparable data. A less scientific approach could be for the tax authorities simply to accept a more appropriate point in the range, such as the lower quartile result of the data set to be an arm's length result.

It is clear that tax authorities will have to be open to differing approaches in adjustments to comparable data when investigating and enforcing transfer pricing for transactions undertaken in the 2020 year. Taxpayers should also ensure that all commercial decisions and changes in business operations which have an impact on the existing transfer pricing model should be clearly documented and justified in anticipation of an audit by the relevant tax authorities.



The Australian Taxation Office (the ATO) is one of the first revenue authorities to issue guidance on the topic. The guidance, which is titled "*COVID-19 economic impacts on transfer pricing arrangements*", outlines the evidence and analysis taxpayers should maintain to support their transfer pricing positions.

Although drafted in the context of Australian transfer pricing legislation, the points in the guidance below (which should be adapted to the South African context) provide useful practical insights on how taxpayers should prepare documentation on the arm's length nature of their affected transactions.

The ATO states in the guidance that when undertaking transfer pricing compliance activities, they seek to understand the facts and the individual circumstances by assessing:

- the function, asset and risk profile of the Australian entity before and after COVID-19;
- the economic circumstances, where the actual economic impacts of COVID-19 on the Australian operations should be outlined and evidenced – this may include a broader analysis of how the relevant industry has been affected;
- the contractual arrangements between the Australian entity and its related parties, and whether any obligations or material terms and conditions have been varied, amended or terminated;
- evidence of the impact (if any) of COVID-19 on the specific product and service offerings of the Australian entity and how this has affected the financial results;
- evidence of changes in business strategies as a result of COVID-19, including decisions made, outcomes sought and actions taken to give effect to those strategies.

The above should be documented as they are considered and implemented.

"We note that advance pricing arrangements is on the SARS list of strategic items to be available to taxpayers in the future. We hope that this avenue will be available soon."

The ATO furthermore notes that (discussed above) analyses of comparable company benchmarking may not reliably support arm's length outcomes of continuing transfer pricing arrangements where they are impacted by COVID-19, particularly in the short term.

On this basis, the ATO will seek to understand the financial outcomes taxpayers would have achieved "but for" the impact of COVID-19. This analysis may include:

- a detailed profit and loss analysis showing changes in revenue and expenses, with an explanation for variances resulting from COVID-19 – this may include a variance analysis of budgeted (pre-COVID) versus actual results;
- details of profitability adjusted to where your outcome would have been if COVID-19 had not occurred – this should consider all factors that have a positive or negative impact on your profits and should be supported by evidence;
- the rationale and evidence for any increased allocation of costs or a reduction of sales (and subsequent changes in operating margins) to the Australian entity, taking into consideration its function, asset and risk profile;
- evidence of any government assistance provided or affecting the Australian operations.

We note that advance pricing arrangements is on the SARS list of strategic items to be available to taxpayers in the future. We hope that this avenue will be available soon.

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Other documents:

- Draft guidance issued by the Organisation for Economic Co-operation and Development (OECD) (seeking to assist tax authorities to identify and tax profits arising in locations where a company has a digital footprint but no physical presence);
- "*COVID-19 economic impacts on transfer pricing arrangements*" (guidance issued by the Australian Taxation Office, outlining the evidence and analysis taxpayers should maintain to support their transfer pricing positions).

Tags: arm's length principle; intangible assets; transactional net margin method; benchmark data.

TRANSFER PRICING AUDIT CONSIDERATIONS

*Earlier this year, Glencore Investments Ltd (the head of the Australian "consolidated tax group") successfully defended an AUD92.7-million (about ZAR1.15-billion) transfer pricing tax bill in the Federal Court of Australia (*Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*, [2019]). The Australian Tax Office (the ATO) had argued that certain sales of copper concentrate by a group company to its Swiss parent were not concluded at arm's length, which resulted in an understatement of the Australian entity's taxable income. The court disagreed, penning a landmark transfer pricing judgment in the process.*

Back at home, the South African Revenue Service (SARS) has seemingly been measured in tackling profit shifting and base erosion. This is evident from the dearth of reported cases on transfer pricing. But the time might be ripe for sharper focus: South Africa has now fully implemented master file, local file, and country-by-country requirements for certain taxpayers, and SARS has made noteworthy strides in bolstering its technical capacity. Moreover, as the national budget shortfall is expected to reach an abysmal ZAR326.6 billion in the 2020/2021 fiscal year, there will undoubtedly be pressure on SARS to collect additional tax revenue. Judge Dennis Davis has remarked that at least ZAR50 billion in additional revenue can be collected by SARS if it focused on, *inter alia*, transfer pricing. This is not surprising. From a South African perspective, the quantum of a transfer pricing assessment may include the so-called secondary adjustment, understatement penalties, and interest, which are all in addition to the primary income tax adjustment. And once the assessments are issued, the taxpayer must fight the "pay-now-argue-later" principle, pending the objection and appeal process.

While the arm's length requirement, which is inherent to section 31 of the Income Tax Act, 1962 the Act), will take centre stage during a transfer pricing audit, taxpayers must not lose sight of other important considerations that may come into play. In this article four such considerations are unpacked:

1. IT ALL STARTS (AND ENDS) WITH THE AUDIT

Chapter 5 of the Tax Administration Act, 2011 (the TAA), allows SARS to conduct an audit. It also provides SARS with wide, but not unfettered, information-gathering powers for this purpose. For instance, section 46 allows SARS to request "relevant material", and section 48 allows SARS to conduct a field audit. In the context of transfer pricing, a field audit may often include so-called functional analysis interviews by SARS with key employees of the taxpayer (and employees of its non-South African resident transacting counterparty) to understand the functions performed, assets employed, and risks assumed in the value chain.

> "At the end of the audit, SARS must provide the taxpayer with the outcome of the audit and the bases of any proposed tax adjustments."

At the end of the audit, SARS must provide the taxpayer with the outcome of the audit and the bases of any proposed tax adjustments. The taxpayer *must* then be afforded an opportunity to respond to all the "facts and conclusions" as set out in the finalisation of audit letter: section 42(2) of the TAA is prescriptive in this regard.

Rushed or lackadaisical responses to requests for relevant material and audit findings simply will not do. These will form the basis of any subsequent proceedings, whether potential settlement negotiations or tax court litigation. Taxpayers should accordingly procure professional legal assistance as soon as they receive an audit notification.

2. KNOW YOUR TAXPAYER RIGHTS – AND ENFORCE THEM

Taxpayers must take cognisance of the rights afforded to them by the TAA. Enforcing these rights may inevitably lead to questions along the lines of:

- Does SARS have the right to issue an additional assessment? Or has it prescribed in terms of section 99?
- Are taxpayers obliged to conclude extension of prescription agreements with SARS?
- What constitutes "relevant material" for purposes of section 46?
- From whom may SARS ask this relevant material?
- What about documents that are confidential or subject to foreign privacy laws?
- How does the double tax treaty between South Africa and the foreign jurisdiction impact on SARS' right to make transfer pricing adjustments?

A taxpayer's rights to just administrative action, as guaranteed by section 33 of the Constitution, 1996, fundamentally underpins the relationship between the taxpayer and SARS. Where this right is flouted, the taxpayer will not be without recourse.

3. ARE THEY "CONNECTED PERSONS", AFTER ALL?

Section 31 of the Act can only apply where an "affected transaction" has been entered into. This requires, *inter alia*, that the parties that have transacted must be "connected persons" as defined in section 1(1) of the Act.

In most cases, the definition can be applied without difficulty. It is, after all, quite broad. But having said that, the interpretation of paragraph *(d)*(vA) of the definition, relating to "management" and/or "control", is not clear at all. While SARS briefly explains its views on the subject matter in its non-binding Interpretation Note 67, there is currently no case law that has definitively pronounced on the meaning of these concepts. How exactly can one company factually "control" another company, for instance, where that "controlled company" has its own duly appointed board of directors and executive management? Do common board members warrant such a conclusion? It is important to keep in mind that "control" in this context refers to factual control, and not the type of control exercised by a shareholder who holds more than 50% of the equity shares or voting rights in a subsidiary.

As if the waters were not muddy enough, with effect from 1 January 2021, the "associated enterprises" definition in article 9 of the Model Tax Convention will be made applicable to section 31 of the Act. Not too dissimilar from paragraph *(d)*(vA), article 9 applies where there is direct or indirect "participation in the management, control or capital" of an enterprise (or enterprises) by another enterprise.

The important factor to keep in mind in this regard is simply that taxpayers should not assume that the relevant parties are "connected". A thorough "connected person" analysis must be conducted, having regard to all of the facts. SARS may of course rely on the prior, perhaps misguided, disclosures made by taxpayers in this regard. An audit is the perfect opportunity to set the record straight.

4. **TRANSFER PRICING COMPLIANCE DOCUMENTS ALONE WON'T CUT IT**

Having expensive transfer pricing documents in place may tick the compliance box. But their mere existence is not enough to discharge the burden of proof that rests on the taxpayer in terms of section 102(1) of the TAA. These documents must be supported by verifiable facts and witnesses (both factual and expert) who can testify accordingly.

Taxpayers with significant cross-border transactions should consider collating supporting evidence to support their transfer pricing documents on an annual basis, even before SARS comes knocking.

A multi-layered approach should be adopted in transfer pricing disputes. This requires an in-depth knowledge of the Act, the TAA, double tax treaties and the law of evidence. While we can only speculate, a well-managed tax audit surely played no small part in *Glencore's* ZAR1.15-billion transfer pricing victory (albeit for the time being only temporary, as the ATO has launched an appeal).

If you want peace, prepare for war!

ENSafrica

Acts

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "connected person" – more specifically paragraph *(d)*(vA)) & 31;
- Tax Administration Act 28 of 2011: Chapter 5 (sections 40 to 66, specifically sections 41, 42(2), 46 & 48); sections 99 & 102(1);
- Constitution of the Republic of South Africa, 1996: Section 33.

Other documents

- SARS Interpretation Note 67;
- Model Tax Convention (definition of "associated enterprises" in article 9).

Cases

- *Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* [2019] FCA 1432.

Tags: taxable income; just administrative action; connected person; tax audit.

MATERIALITY IN VAT DISPUTES

The tax court in Johannesburg recently handed down judgment in a dispute between a vendor and SARS in which SARS, after making a substantial refund, including interest, sought to reclaim the interest because of omissions from the VAT return which would have reduced the amount of the refund.

In case number VAT1712, there had been two issues. The first related to the claim made by the vendor in respect of input VAT for purchases of gold in a micro-refining enterprise and the second related to interest that SARS had paid to the vendor when making a VAT refund payment. Two separate judgments were issued. We discuss here the judgment relating to SARS' attempt to recover the interest that it had paid together with a refund.

The VAT returns rendered by the vendor for the months from December 2015 to March 2016 resulted in SARS being indebted to the vendor in an amount of approximately R71m. SARS conducted a limited scope audit in June 2016 and determined that the refund was indeed payable. However, based on certain risks it identified, it passed the matter to the Investigative Audit Unit for further consideration.

In September 2016, the vendor sought an order in the Johannesburg High Court to compel SARS to pay its refund together with interest. SARS did not oppose the application, and an order was granted. Payment was made of the refund due together with interest in December 2016.

"In the course of the audit, it was discovered that the vendor had not accounted for output VAT on the use of a motor vehicle by its member during three of the months in an amount of R200.36 per month."

In the course of the audit, it was discovered that the vendor had not accounted for output VAT on the use of a motor vehicle by its member during three of the months in an amount of R200.36 per month. It issued assessments for the amounts in question. The vendor's objection was disallowed, and, in the response, SARS claimed that it was entitled to repayment of the interest that it had paid in respect of the refunds for those periods.

The vendor appealed to the tax court, and judgment was given on 29 April 2020.

The law

Windell J had no difficulty in finding that the assessment to VAT in respect of the fringe benefit granted to the member by the vendor was properly made and that the vendor was liable for the amounts so assessed. The law on this issue is not discussed further.

The critical issue was whether the vendor was liable to make repayment to SARS of interest that had been paid to it by SARS in December 2016.

Section 45(1) of the Value-Added Tax Act, 1991, provides:

> "(1) Where the Commissioner does not within the period of 21 business days after the date on which the vendor's return in respect of a tax period is received by an office of the South African Revenue Service refund any amount refundable in terms of section 44(1), interest shall be paid on such amount at the prescribed rate (but subject to the provisions of section 45A) and calculated for the period commencing at the end of the first-mentioned period to the date of payment of the amount so refundable: Provided that—
>
> (i) where such return made by the vendor is incomplete or defective in any material respect the said period of 21 business days shall be reckoned from the date on which—
>
> *(aa)* the vendor rectifies the return and satisfies the Commissioner in writing that the incompleteness or defectiveness of the return does not affect the amount refundable; or
>
> *(bb)* information is received by the Commissioner to enable him to make an assessment upon the vendor reflecting the amount properly refundable to the vendor;"

SARS' case was that the vendor had filed defective returns and that the defect only became evident when the investigative audit was undertaken, and therefore any interest that related to the period prior to the identification of the defect was not lawfully payable and was required to be repaid by the vendor.

The judgment

It was determined in the judgment that the vendor was liable to pay the additional VAT of R600.09.

The vendor's argument was that the additional amount of VAT that was assessed was a trifling amount and that it could not sustain a conclusion that the returns filed were "incomplete or defective in any material respect".

Windell J summarised SARS' position at paragraph [20] of the judgment:

> "SARS's contention is the following: [the vendor's] failure to declare the fringe benefit amounted to non-compliance with the provisions of section 18(3) of the Act and constitutes an 'error'. The 'error' is material to SARS and non-compliance with the relevant provisions of the tax Acts could simply not be condoned. The Commissioner is tasked with collecting all the taxes due to the fiscus, regardless of how 'immaterial' they may seem to be. If the 'error' was so immaterial, this could have easily prompted [the vendor] to declare the output tax before it was caught by SARS."

In considering this aspect, Windell J considered the application of the concept in insurance law and at paragraph [22] quoted the following passage from *Qilingile v SA Mutual Life Assurances Society*, [1993], at 74:

> "... what has to be ascertained is whether the result likely to have been caused by the misrepresentation is material. Materiality is not a relative concept; something is either material or it is not. Etymologically the word 'material' ('wesenlik' in Afrikaans) denotes substance, as opposed to form. In legal parlance it bears a correspondent meaning: 'Of such significance as to be likely to influence the determination of a cause ... .' (The Shorter Oxford English Dictionary Vol 2 at 1289.)
>
> Conformably, its meaning in insurance law is significant in relation to the determination of the risk."

"The ability to defer the date from which interest is payable is peculiar to the VAT Act, and the provisions of section 45(1) apply, notwithstanding that there are provisions in the Tax Administration Act (the TAA) which regulate the payment of interest by SARS"

At paragraph [23] of the judgment Windell J clarified that section 45(1) is clear in its purpose in making SARS liable to interest on refunds such that:

> "SARS was thus obliged, on first principles, to make payment thereof within 21 days after the date on which [the vendor's] returns were received. It failed to make payment and was liable to pay interest, except if the returns were incomplete or defective in any material respect."

The assertion by SARS that any omission from a return is "material" was roundly rejected. Windell J found that the provisions of section 45(1) did not support such a finding. She held at paragraph [25]:

> "Section 45 is a pragmatic provision not concerned with principle but with materiality. It recognises the fact that vendors may render returns that are incomplete or defective. If it were a matter of principle then any defective or incomplete return would carry the consequence of SARS not having to pay interest. But, the Legislature, in its wisdom, determined that expedience trumps principle insofar as the payment of interest by SARS is concerned."

In the case under consideration the defect related to some R600 in relation to a refund of R71m, a ratio of 1:180 000 or 0.0006%. Windell J therefore concluded, at paragraph [26]:

> "This fraction does not satisfy the materiality test that the Legislature included in section 45 of the VAT Act. In the premises the attempt to rely on the fringe benefit errors is a transparent attempt for SARS to *ex post facto* wriggle out of its obligations vis-à-vis [the vendor]."

Judgment on this issue was given in favour of the vendor and SARS was ordered to pay the costs of arguing this issue.

Conclusion

The ability to defer the date from which interest is payable is peculiar to the VAT Act, and the provisions of section 45(1) apply, notwithstanding that there are provisions in the Tax Administration Act (the TAA) which regulate the payment of interest by SARS.

The TAA confers on SARS the right to defer the payment of a refund pending the outcome of a verification, inspection or audit of a refund. Unfortunately, the provisions of the TAA which determine the date from which interest shall be reckoned in respect of a variety of circumstances have not yet been brought into effect.

It appears that it is intended that section 45(1) will nevertheless continue to govern the payment of interest on VAT refunds even after the specific provisions are promulgated.

Vendors should examine carefully any refunds where interest paid does not appear to run from the due date of payment.

PWC

Acts

- Value-Added Tax Act 89 of 1991: Sections 18(3), 44(1), 45(1) & 45A;
- Tax Administration Act 28 of 2011.

Other documents

- The Shorter Oxford English Dictionary Vol 2.

Cases

- Case Number VAT 1712;
- *Qilingile v SA Mutual Life Assurances Society* [1993] (1) SA 69 (A).

Tags: prescribed rate; defective returns; liable to interest.