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Transfer Pricing

Border Control

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FIND US

Postal address
PO Box 712
Menlyn Retail Park
0063

Editorial head office
Summit Place Business Park
Building 3, Ground Floor
221 Garsfontein Road, Menlyn
Pretoria
South Africa
0081

Advertising sales
Muzikayise Mike Maseko
mmaseko@thesait.org.za

THE TEAM

Editor at Large
Hellen Phushela
publications@thesait.org.za

Supporting Editor
Dr Annamarie Mostert

Editorial Advisors
Keith Engel
Muzikayise Mike Maseko

Design and Layout
Neo Wilma Makaleng
neo.makaleng@thesait.org.za

Cover Illustration
Neo Wilma Makaleng

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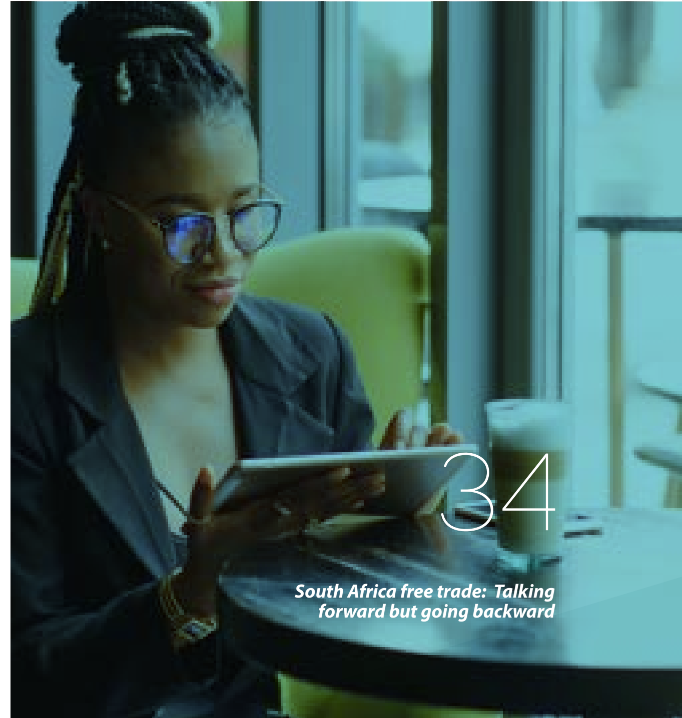

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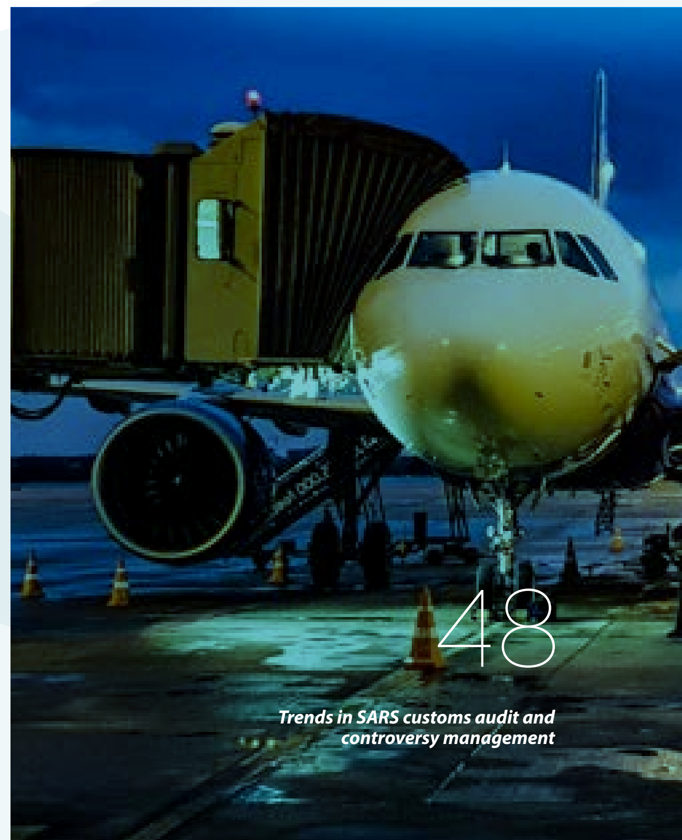
South Africa free trade: Talking forward but going backward



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Trends in SARS customs audit and controversy management

GUEST CONTRIBUTORS

Alison van den Berg
alison@avdblaw.co.za/ +27 82 823 4397

Alison is a Director of Alison van den Berg Attorney Inc. She specialises in customs & excise and international trade-related law & disputes. Alison holds a BCom, LLB.

Anneke Jansen van Vuuren
anneke@xagta.com/ +27 84 011 7448

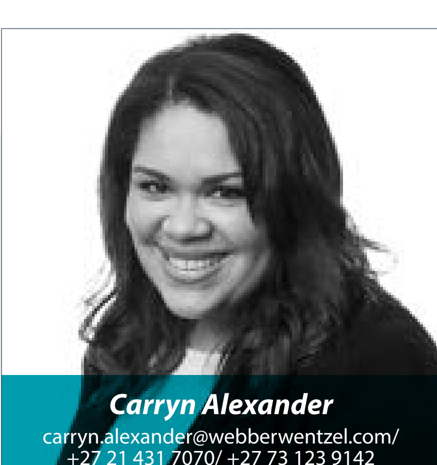
Anneke is a Trade Analyst in Economics at XA Global Trade Advisors (Pty) Ltd. She holds a Master's degree in International Trade from North-West University.

Bianca Romans
Bianca.Romans@za.ey.com/
+27 83 382 1534

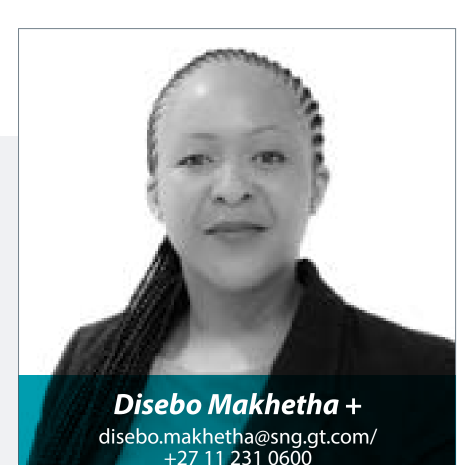
Bianca is a Manager Global Trade and Excise at EY Cova. She specialises in all global trade-related matters and a special focus on Special Economic Zones, trade agreements, rules of origin and the AfCFTA impact on business. She holds a Tax Professional Occupational Certificate.

Carridine Brooks
cbrooks@itx-advisory.co.za/
+27 78 365 6361/ +27 64 754 7774

Carridine is a Director at ITX Advisory Services (Pty) Ltd. He specialises in customs, excise and APDP and holds a Post Graduate Diploma in Taxation.


Carryn Alexander
carryn.alexander@webberwentzel.com/
+27 21 431 7070/ +27 73 123 9142

Carryn is a Partner and Tax Specialist at Webber Wentzel and holds a Masters in Tax Law/Taxation qualification. She specialises in Tax dispute resolution and controversy management with particular expertise in transfer pricing and international trade, mining tax, mining royalties, and carbon tax.


Disebo Makhetha +
disebo.makhetha@sng.gt.com/
+27 11 231 0600

Disebo is a Transfer Pricing Senior Manager at SNG. She holds an M.com SA and International Tax, B.com Law and specialises in transfer pricing tax.

Ellaine Raboroko
ellaine.raboroko@sng.gt.com/
+27 11 231 0600

Ellaine is a Transfer pricing Manger at SNG and holds a Postgraduate Diploma in Accounting. She specialises in Transfer Pricing tax.

Lutando Mvovo
lutando.mvovo@vodacom.co.za/
+27 66 488 4008

Lutando is the Executive Head: International Tax at Vodacom and specialises in international tax. He holds a Masters in Law-Tax.

Mark Alexander Goodger
mark@gmls.co.za/ +27 82 555 0565

Mark is a Chief Executive at Global Maritime Legal Solutions (Pty) Ltd. He specialises in customs compliance, global trade & supply chain expert, and holds an MCom in Maritime Studies.

Nikisha Radhakrishna-Mathura
niki.radhakrishna@gmail.com/
+27 76 938 7372

Nikisha is a Finance Solution Architect (Previously Transfer Pricing consultant) at Old Mutual Limited. She specialises in international tax, transfer pricing, and finance, She holds a Master of Commerce in International Tax degree.

Philip Fouche
pfouche@deloitte.co.za/ +27 21 427 5488

Philip is an Associate Director at Deloitte and specialises in transfer pricing. He holds a B.Com LL.B, B.Com (Honours) in Tax.

Thabiso Mohokare
tmohoks@gmail.com/ +27 72 666 1826

Thabiso is a Senior Manager - Transfer Pricing and International Tax at Liberty. He specialises in transfer pricing and international tax and holds a Masters in Taxation.

Quintus van der Merwe
qvdm@wylie.co.za/ +27 31 575 7306

Quintus is a Partner and Head of Shipping & Logistics (including customs) at Wylie. He holds a BCom, and LLB and specialises in customs, excise, vat, trade remedies, shipping & logistics.

15 minutes

RECENT GLOBAL TRANSFER PRICING CASES

▶ **NIKISHA RADHAKRISHNA-MATHURA,** Finance Solution Architect at Old Mutual Limited

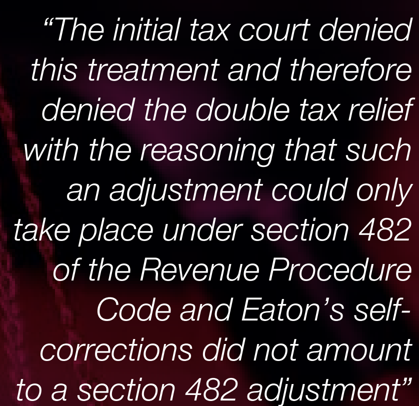
Transfer pricing remains an intricate area of taxation with issues such as choosing an appropriate method in determining an arm's length price among other complexities. While the Organisation for Economic Co-operation and Development (OECD) provides certain guidance, transfer pricing litigation across the globe is providing increasing guidance.

This article aims to provide insights into the current transfer pricing litigation landscape. It highlights the precedent set in recent notable global transfer pricing cases and what guidance those cases may provide for future transactions. For example, based on recent cases (*US vs Medtronic* and *Italy vs Ferrari SpA*) one can rely, to a certain extent, on the facts and circumstances in those scenarios to establish an appropriate method in determining an arm's length price based on a similar set of facts and circumstances. The guidance such cases provide becomes useful, not only in those countries but on a global scale.

An increasing area of focus is on advanced pricing arrangements (APAs). The OECD defines an APA as "an administrative approach that attempts to prevent transfer pricing disputes from arising by determining criteria for applying the arm's length principle to transactions in advance of those transactions taking place".

Many countries such as Russia, China, Canada, and India have implemented APAs as part of their tax framework. The United States implemented the APA programme as early as 1991.

Eaton Corporation and Subsidiaries versus Commissioner of Internal Revenue Service, Sixth Circuit, Nos. 21-1569/2674 (*Eaton vs IRS*) is a case which provides insight into the correct application of an APA.



"The initial tax court denied this treatment and therefore denied the double tax relief with the reasoning that such an adjustment could only take place under section 482 of the Revenue Procedure Code and Eaton's self-corrections did not amount to a section 482 adjustment"

Facts

Eaton Corporation (Eaton) is a multinational entity that manufactures several electrical and industrial products, more specifically, 'breakers'. Breaker products were manufactured by Eaton's subsidiaries in Puerto Rico and in the Dominion Republic and sold to third parties and subsidiaries within the Eaton Group.

Eaton entered into two APAs with the IRS. The first APA covered tax years from 2001–2005, whereas the second APA covered tax years from 2006–2010. The APAs set out the transfer pricing calculation in the following manner:

1. determining third-party prices using the comparable uncontrolled price method (CUP);
2. calculating hypothetical profits using the CUP; and
3. using the comparable profit method, the hypothetical profits had to be calibrated and compared to Eaton's Berry ratio.

Issue

During an audit in 2007, the IRS found that Eaton had applied the 'APA multiplier' incorrectly. This error resulted in a financial benefit to Eaton. Simply put, the APA multiplier is an algebraic factor that translates the calculated transfer pricing prices into a number that aligns with Eaton's bookkeeping. The incorrect application resulted in inflated transfer prices that Eaton used in its tax returns.

Upon informing the IRS of the miscalculations, Eaton proceeded to correct the same and resubmitted its tax returns. In 2011, the IRS cancelled the APAs for 2005 and 2006 due to what is called 'material deficiencies in APA compliance', amongst other errors stated by the IRS. The IRS also issued an assessment with penalties to Eaton for more than USD 90 million.

Ruling

Eaton sought an order in the United States Tax Court to challenge the IRS's decision. At trial, the IRS submitted 17 grounds as the basis on which it cancelled Eaton's APAs. The Tax Court rejected all 17 grounds put forward by the IRS and ruled that IRS had abused its discretion in cancelling both APAs. The Tax Court specifically put forward that Eaton's errors did not amount to a 'material' error in line with the APA governing revenue procedures. The assessed amounts, together with the penalties levied by the IRS, were overturned by the Tax Court.

The IRS proceeded to appeal the decision of the Tax Court. Interestingly, the IRS asserted fewer grounds than originally claimed for the cancellation of the APAs. The IRS asserted that Eaton's miscalculations had amounted to a material misrepresentation.

The court of appeal ruled on a few matters before it. Firstly, the court of appeal ruled that the burden of proof lies on the IRS to show that it did not wrongfully cancel the APAs and not Eaton.

Secondly, the court looked extensively at the grounds for cancellation submitted by the IRS. The IRS's main assertion, as mentioned above, is that Eaton materially misrepresented its pricing and thereby its tax returns. Failing to disclose Eaton's use of the APA multiplier, was the main focus of the misrepresentation as put forward by the IRS. The court ruled that Eaton's use of the APA multiplier was purely a tool for translation and not for determination of the transfer price. Therefore, Eaton did not have the intention of materially misrepresenting its books; it was purely an error that was later disclosed to the IRS in any event.

Lastly, the court ruled on the penalties issued by the IRS. The IRS initially levied penalties prior to the trial and used its calculation method on which to base its assessment. It is noteworthy that this calculation did not make use of the CUP method which was central to the APAs that Eaton and the IRS agreed to. After the trial, the IRS revised its penalty calculation and based it on the self-correction amounts that had Eaton submitted. Since the IRS had calculated the penalty subsequent to trial and did not have the Tax Court's approval in the proceedings at the time of trial, the IRS forfeited its claim to the penalties.

In addition to the above matters, the appeal court also ruled on the double taxation relief claimed by Eaton. Due to miscalculations, Eaton's US-based income was inflated resulting in inflated tax liability. The overseas subsidiaries had additional income that it needed to repatriate after the corrections were made, which led to another income tax liability. Eaton moved to fix this issue by treating the additional cash to its subsidiaries as a loan and upon repatriation, the payment would be treated as a repayment. The initial tax court denied this treatment and therefore denied the double taxation relief with the reasoning that such an adjustment could only take place under section 482 of the Revenue Procedure Code and Eaton's self-corrections did not amount to a section 482 adjustment. However, the court of appeal found that the self-corrections were section 482 in nature; therefore, the relief from double taxation could most definitely be allowed.

This case highlighted the contractual obligations between revenue authorities and taxpayers in the context of APAs. An APA can be regarded as a binding agreement and cannot be arbitrarily cancelled due to immaterial errors on the part of the taxpayer. It may amount to an abuse of discretion should an APA be cancelled without just cause.

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SOUTH AFRICAN

ADVANCE PRICING AGREEMENTS— COMING AT LAST

▶ **PHILIP FOUCHÉ,** Associate Director at Deloitte

After many years of reluctance, SARS has finally issued a discussion document indicating that the time has come for South African APAs. This article explores their likely implementation along with the status of APA updates from other African countries.

The case for APAs

Currently, South African taxpayers are only able to rely on their own transfer pricing documentation and related recordkeeping to support the arm's length nature of their cross-border transactions with related parties. This provides no guarantee that SARS will concur that the transactions in question were conducted at arm's length.

In fact, we often see disputes relating to fundamental aspects of a South African taxpayer's transfer pricing policy. For example, where the South African subsidiary of a multinational enterprise (MNE) manages the transfer pricing of its various business units on a consolidated basis, the tax authority may be of the view that the results of the underlying business units should be segmented and tested separately. Conversely, in cases where the taxpayer manages the transfer pricing of different business units separately, it might be argued that the profit margin of the company should be tested on a consolidated or whole-of-entity basis. This may give rise to large additional tax assessments being issued by SARS after a transfer pricing audit and lengthy disputes.

Therefore, MNEs looking to invest in South Africa may question whether they would be able to implement their global transfer pricing policy without material risk here. If the risk is material, they might rather consider locating their operations in another country to reduce the risk. The successful implementation of an APA programme, as proposed by SARS, could mitigate this risk significantly.

According to the OECD, an APA is essentially an agreement into which the taxpayer and the tax authority enter (in advance of the transactions in question) to agree on a set of criteria to be followed in determining the transfer pricing for the transactions over a fixed period of time.

Therefore, the aim of APAs is to provide taxpayers and tax administrations with advanced tax certainty; APAs supplement the traditional tax dispute resolution processes by seeking to avoid disputes from occurring in the first place.

APAs may be negotiated and entered into between the taxpayer and the revenue authority in its tax jurisdiction (referred to as unilateral APAs) but often involve negotiations and arrangements between the taxpayer, one or more related parties, and the related parties' tax administrations (referred to as bilateral APAs in the case of two tax administrations or multilateral APAs, where more than two countries participate in the arrangement).

The criteria to be agreed on in terms of an APA may include, amongst various other aspects, the transfer pricing method to be applied, the comparable information to rely on for benchmarking purposes, critical assumptions in respect of future events, and the effective period of the APA.

MNEs place a high value on the tax certainty derived from APAs and seek such certainty when selecting an African jurisdiction as a gateway into the rest of the African continent. As other major African jurisdictions have already promulgated related legislation, we fully support SARS' initiative of a phased introduction of APAs locally in order for South Africa to remain competitive as a regional investment hub.

Local developments regarding APAs

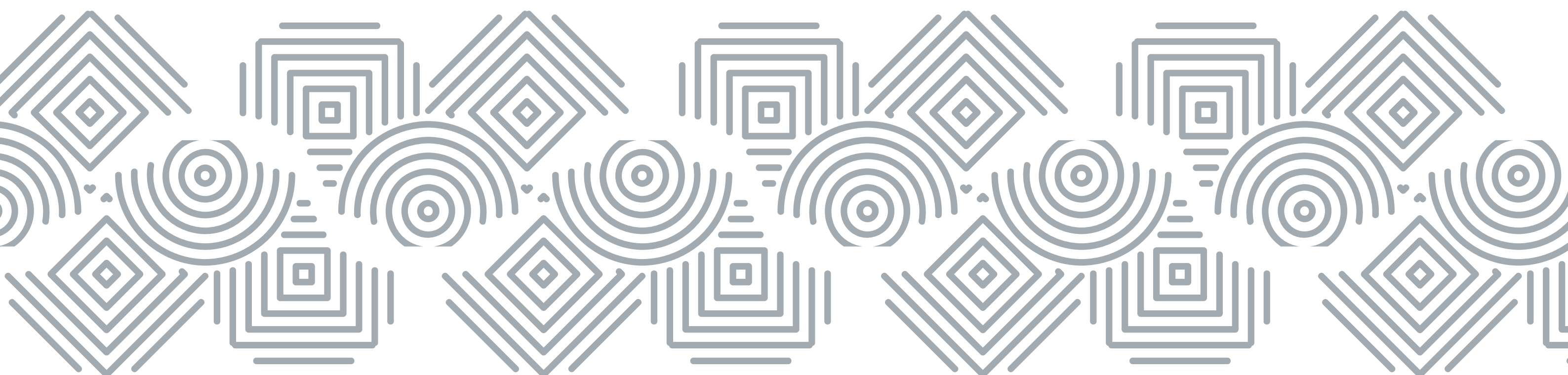
It was widely welcomed when SARS issued the 'Discussion Paper on APAs' to solicit comments from the public regarding the introduction of an APA mechanism in South Africa by 18 December 2020. This was followed by the release of SARS' 'Proposed Model for Establishing an APA Programme in South Africa' and 'Release of Draft Legislation' for comment by 31 January 2022. SARS was commended on maintaining the momentum of putting an APA process in place and it will be encouraging to shortly see further developments regarding the draft legislation.

SARS has indicated that it intends to start with bilateral APAs, as SARS will then have the opportunity to interact with tax authorities who are experienced in running an APA system, which will be a valuable source of information and upskilling.

It should also be pointed out that a bilateral APA programme is a specific focus point in the OECD's peer review reports on the effectiveness of the dispute resolution mechanisms available per country. It is vital for South Africa not to be regarded as falling too far behind its peers in offering dispute avoidance mechanisms. As SARS mentioned in the initial Discussion Paper on APAs, Egypt, Nigeria, Tanzania and Uganda already had APA legislation in place at the time.

Lessons from the OECD on bilateral APAs

The OECD Forum on Tax Administrations has recently issued the 'Bilateral Advance Pricing Arrangement Manual' with insightful content to guide tax administrations and taxpayers in increasing the efficiency of the bilateral APA process. It mentions that various tax policymakers, tax administrations and other stakeholders 'overwhelmingly' agree that APAs are an effective tool to achieve tax certainty but that the process has to be improved.



It is noted that taxpayers prefer the bilateral APA process to Mutual Agreement Procedure (MAP) engagements, i.e. where competent authorities aim to resolve existing tax disputes. Taxpayers are of the view that APAs are much more collaborative; more reasonable tax positions are achieved through them than by way of MAP proceedings.

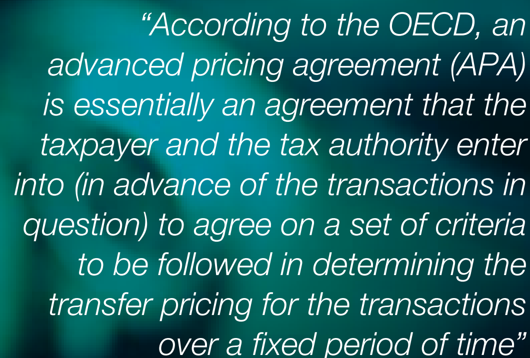
The following areas are identified by countries that have been involved in bilateral APAs for many years as aspects to be addressed in improving the effectiveness of bilateral APAs:

- bilateral APAs may take too long to be concluded and delays are specifically caused by different APA processes being followed in the separate tax jurisdictions—sometimes the APA process even takes longer than the period for which the APA was initially sought, which means that advance tax certainty was not truly achieved;
- at times the different tax authorities do not have access to the same information in a similar form and at the same time, which may lead to 'information asymmetries' occurring between the tax authorities and as a result, to the one administration potentially being in a better position to negotiate;
- there should be more transparency between the tax administrations and taxpayers throughout all key aspects of the bilateral APA process; and
- the bilateral APA process may require extensive resources from both taxpayers and the tax authorities—realistic expectations must be set for competent authorities and taxpayers at each stage of the bilateral APA process with regards to the resources needed and expected timelines to conclude the agreement.

The 'Bilateral Advance Pricing Arrangement Manual' then proceeds to suggest 29 'Best Practices' to be implemented to reduce the time taken to conclude the APAs, to improve the use of resources and to improve transparency.

The 'Best Practices' include, amongst others, that each bilateral APA should be concluded on its own merits by way of a principled approach, meaning that the tax positions proposed should be based on the applicable domestic and international tax law. Further, taxpayers should be in a position to submit their tax returns based on the positions taken in the bilateral APA application; Published guidelines and rules on the APA process must be clear and technology should be used more efficiently in sharing information electronically.

The jurisdictions should aim for the bilateral APA to be concluded within 30 months from the receipt of the completed application (to be reduced to 24 months once the process is up and running); and the bilateral APA should generally be for a minimum of five years which is the maximum period in terms of SARS' draft legislation. Although South Africa is presently implementing a



"According to the OECD, an advanced pricing agreement (APA) is essentially an agreement that the taxpayer and the tax authority enter into (in advance of the transactions in question) to agree on a set of criteria to be followed in determining the transfer pricing for the transactions over a fixed period of time"

bilateral APA programme for the first time, it would be very useful to leverage the extensive research performed by the OECD Form on Tax Administrations on the requirements of an effective APA programme to ensure that we have a system aligned with international best practices.

Way forward for APAs in South Africa

Although South Africa will not be the first African country to implement APAs, South Africa is well-positioned to become a leader in Africa in APA processing, given the transfer pricing skills available locally, by potentially leveraging from existing electronic platforms (e.g. as used for the administration of the existing Advance Tax Ruling regime) and South Africa's extensive tax treaty network.

We fully agree with SARS' statement in the Proposed Model for Establishing an APA Programme in South Africa that *"establishing an APA unit is foundational in advancing the SARS' strategic agenda and restoring the organisation to world-class status"*.

THE HEAVY TAX BURDEN

OF AFRICAN CROSS-BORDER FLOWS

LUTANDO MVOVO, Executive Head: International Tax, Vodacom

Multinational enterprises (MNEs) investing or providing services in Africa are subject to high rates of withholding taxes. These withholding taxes commonly apply to a wide range of payments to non-residents such as dividends, royalties, and interest. In addition, these taxes could apply to payments for rental, technical, managerial, consulting, or professional services, irrespective of whether these services are physically provided in that country or not.

These withholding taxes can exceed the arm's length profit of the parent company as imposed on gross amounts. They generally range from 10–30% of the gross amount. In some countries, a single flat tax rate applies to all the payments mentioned above; in others, different types of payment are taxed at different rates.

African tax authorities often justify imposing high rates of withholding taxes on the basis that foreign MNEs charge inflated fees and royalties to extract excessive profits from Africa. Therefore, withholding taxes seek to protect their tax base from the risk of erosion and to discourage foreign MNEs from importing services; instead, they seek to encourage MNEs to develop expertise locally.

These justifications are not correct because high withholding rates do not only penalise those cases where excessive fees or royalties have been charged, but also cases where the fees or royalties charged by the non-resident are reasonable. They are therefore very inadequate substitutes for proper transfer pricing procedures. Further, it is common for tax authorities in Africa to deny deductions concerning payments to non-residents.

In addition to the high withholding tax rates, African countries do not currently have a large tax treaty network. Further, African countries have restrictive central bank regulations. All the above-mentioned factors create a heavy tax burden for multinational enterprises investing or providing services in Africa.

Non-adherence to tax treaties concerning taxation of services

Some African countries are notorious for not adhering to tax treaty provisions, leading to taxpayers suffering double taxation. This is specifically common where a tax treaty does not contain an article dealing with technical fees. These countries apply domestic withholding taxes on technical services to residents of the other treaty partners. Kenya and Tanzania are amongst the countries that have adopted this unconventional approach to the interpretation of tax treaties. Both the Kenya Revenue Service (KRS) and the Tanzania Revenue Authority (TRA) have adopted a position that in the absence of a specific article in the tax treaty dealing with technical services fees (including technical, managerial, and professional fees), the other income article in the tax treaty gives them the right to tax payment of technical service fees.

This interpretation is contrary to the business profits article (Article 7) rule that income from services is exclusively taxable by the residence state unless the enterprise conducted business through a permanent establishment. In the absence of a permanent establishment, a withholding tax should not apply.

This approach has not gone without being challenged by taxpayers. For example, Kilombero Sugar Company Ltd (Kilombero), a Tanzanian tax resident company that entered into an agreement for the provision of operational and technical services with a South African tax resident company, namely Illovo Project Services Ltd (Illovo), challenged the TRA's approach. Pursuant to the agreement, Illovo provided operational and technical services to Kilombero and, in return, Kilombero paid fees of $30 000 per month to Illovo.

The TRA demanded the payment of withholding tax concerning the fees paid by Kilombero to Illovo. After unsuccessful appeals to the Tax Revenue Appeals Board and Tax Tribunal, Kilombero appealed to the Court of Appeal. The Court of Appeal held that as the service fee was an item that did not feature anywhere in the tax treaty, the other income article was the relevant article. It held that the costs incurred by Illovo and reimbursed by Kilombero would be taxable in Tanzania as per Article 21 of the tax treaty. It concluded that, in terms of the tax treaty, service fees by a South African entity for the provision of professional services to a Tanzanian entity do not form part of business profits as provided for under Article 7 of the tax treaty. This treaty is not taxable in Tanzania but falls under Article 21 of the tax treaty; therefore, it is subject to withholding tax at the rate of 15%.

The Kilombero decision was recently confirmed by the same Court of Appeal in the case of *Mlimani Holdings Limited v Commissioner General Civil Appeal* (No. 265 of 2021). The Court of Appeal took the same view and held that the payment did not amount to business profit envisaged under Article 7 of the tax treaty between South Africa and Tanzania; rather, it amounted to a payment that was subject to withholding tax on technical fees at the rate of 15% in Tanzania.

In Kenya, the KRS's interpretation which, as discussed above, is similar to the TRA's interpretation, was successfully challenged by the taxpayer. Unlike the Court of Appeal in Tanzania, the Tax Appeals Tribunal (TAT) in Kenya in the case of *McKinsey v Kenya Revenue Authority* came to a different conclusion and held that where a tax treaty did not contain a separate article dealing with management or professional fees, income concerning management or professional services were business profits; therefore, this income was not subject to withholding tax at the rate of 20% in Kenya. I understand that the KRS is appealing this decision.

Central bank rules applicable to cross-border payments

Most African countries have rules that require approval of payments to non-residents by the Central Bank. These payments include royalties and fees paid to non-residents. This is done by way of a formal application to the Central bank requesting approval for such royalties and service fees. The application needs to be accompanied by a copy of the agreement between the resident and the non-resident.

Tax treaty override through domestic limitation on benefits

Some African countries have introduced domestic limitation of liability provisions in their income tax acts that seek to deny tax treaty applications if certain shareholding thresholds are not met. For example, Kenya and Tanzania have an anti-treaty shopping provision in their tax legislation which states that reduced rates or exemptions under the tax treaties are not available to a resident of a contracting state where 50% of the underlying ownership is held by persons that are not resident in the other contracting state.

Limitation of the deductibility of service fees and royalties

While most African countries generally allow for the deduction of services fees and royalties, some African countries have rules limiting the deductibility of fees and royalties paid to related foreign entities. For example, in Nigeria, fees for management services, commercial and industrial know-how, and other similar services, are not deductible in computing trading profits, except where prior approval of the agreement giving rise to such management fees, has been obtained from the Minister of Finance. Similarly, all expenses that are incurred for the purpose of earning management fees are not tax deductible.

In Cameroon, headquarter expenses relating to operations in Cameroon, including remuneration paid for certain services rendered to Cameroonian companies are deductible up to 2.5% of taxable profits (before deduction of such expenses); 5% of sales in the case of approved engineering consultancy offices, and 1% of turnover in the case of construction companies. In Zimbabwe, general administration and management fees between any associated companies in excess of 1% of total allowable deductions will be non-deductible. Any disallowed (excess) interest expense, general administration and management fees are treated as a deemed dividend and taxed as such. Tax treaty rates in respect of dividends do not apply to such a dividend.

In some countries, the deduction of expenses from group transactions is subject to filing the transfer pricing documentation and meeting the transfer pricing arm's length requirement, while some have rules that deny a deduction if the service performed is locally available.

"While most African countries generally allow for the deduction of service fees and royalties, some African countries have rules limiting the deductibility of fees and royalties paid to related foreign entities"

Concluding thoughts

While there are good opportunities for growth, investing in Africa is not for the fainthearted. It is common for global tax practices and tax treaties to be completely ignored or misinterpreted. This generally gives rise to tax uncertainty and double taxation. The resolution of disputes relating to cross-border payments is often difficult to resolve; when they are resolved, the process leading to the resolution is often unreasonably long. Even where a tax treaty exists between countries, the mutual agreement procedure (MAP) article only requires competent authorities to endeavour to resolve the double taxation cases. It is important to note that all African countries that signed the base erosion and profit shifting (BEPS) Multilateral Instrument opted out of the mandatory binding arbitration. This leaves the taxpayer who has relied on the tax treaty without any solution or relief to double taxation.

THE LONGSTANDING LACK OF AFRICAN 'COMPARABLES'

15 minutes

THABISO MOHOKARE, Senior Manager - Transfer Pricing and International Tax, Liberty

According to the 2022 African Economic Outlook released by the African Development Bank, despite the recent pandemic-induced contraction of 1.6% in 2020, Africa's average annual gross domestic product (GDP) grew by an estimated 6.9% in 2021; the reasoning behind why a lot of investors still consider Africa as a destination for future growth and opportunities.

Multinational enterprise activities frequently represent a very significant proportion of African countries' tax base. On average, close to 20% of tax revenues arise from corporates compared to the 8–10% for developed countries. A lot of the countries in Africa collect only about 15% of their GDP in taxes versus the 40% that is being collected by European, North American, and Asian countries.

According to the United Nations' Conference on Trade and Development report on Africa in 2020, every year about $88.6 billion—equivalent to 3.7% of Africa's GDP—leaves the continent as illicit capital flight. It is believed that over 60 per cent of all illicit outflows of tax in Africa are a result of transfer pricing. It remains unclear how much of this is in the form of tax evasion, however, it is not unreasonable to estimate that the lost revenue is equivalent to multiple global bilateral development aid and more than the national income of several poor countries combined. This is money foregone that could have been spent on healthcare, education, and infrastructure, not to mention the lost lives that could have been saved.

Aggressive transfer pricing practices by multinational enterprises (MNEs)have been seen to pose huge risks to the tax base in many developing economies as they are particularly vulnerable, owing to the fact that the corporate tax revenues account for a larger share of their income. One of the biggest concerns of developing economies in implementing transfer pricing law concerns the lack of or challenges inherent in obtaining 'comparables', that is, data relating to transactions entered into between independent parties used in the application of the arm's length principle.

Both the Organisation for Economic Co-operation and Development (OECD) and non-OECD countries have expressed concerns relating to the quality and availability of reliable data on transactions entered into, between third parties that can be used when performing comparability analyses for transfer pricing purposes.

Addressing the issue of lack of 'comparables'

The challenge faced by developing economies, which causes a lack of comparability, comes from the financial costs relating to acquiring access to databases used in accessing such 'comparables'. Often, when comparable data exist, the datasets display differences when compared to the actual transactions which would be under review. In these cases, developing countries would often need to use this imperfect data; they sometimes rely on foreign markets for comparable information.

Databases relied on in transfer pricing analyses tend to focus on developed economies and may not always apply to the markets in developing economies. The ‚United Nations' Practical Transfer Pricing Manual for Developing Countries, states that "developing economies tend to have fewer organised players in any given sector than in developed countries, making it difficult to obtain proper comparable data."

A toolkit has been developed in response to an application by the Development Working Group of the G20 to assist tax administrators in developing countries. This toolkit aims at addressing the challenges that relate to the difficulties associated with the lack of comparable data in developing economies. It does this by setting rules and practices that are more predictable for business which discuss an acceptable estimation of the arm's length price that can be determined by using the available data. It also continuous to state that available data may then be improved by extending the criteria for data selection and by performing comparability adjustments. Although safe harbours can be regarded as inappropriate in the case of high-risk and complex-related party transactions, the potential for developing safe harbours or prescriptive approaches is also discussed.

African revenue authorities starting to reject purely Pan-European comparability

Another major challenge in developing economies is that the revenue authorities do not have adequate transfer pricing capacity to address many of the approaches recommended in the toolkit, which require a lot of theoretical and practical experience in order to apply. Therefore, this, means that although the toolkit can be very helpful, it would not accomplish the anticipated outcome in cases where revenue authorities do not have the capacity and skills to implement it. In such cases, it would therefore be important for revenue authorities to publish clear and consistent guidance relating to the acceptable approaches available to taxpayers to ensure compliance when there is a lack of suitable comparability. This will assist in facilitating compliance and in reducing controversy.

Using non-domestic 'comparables' should not lead to taxpayers being penalised for non-compliance.

"A toolkit has been developed in response to an application by the Development Working Group of the G20 to assist tax administrators in developing countries"

It is important to note that both domestic and non-domestic 'comparables' need to be evaluated based on specific facts and circumstances of the case; revenue authorities cannot reject 'comparables' automatically purely based on the fact that they originate from a different jurisdiction.

Unexpected loss-making entities can be excluded from being improperly benchmarked

The existence of certain economic conditions, a business strategy, or high risk can cause companies to incur recurring losses for over 3–5 years. Loss-making 'comparables' are generally rejected, except when taxpayers prove that they are comparable.

It is normal for independent companies to occasionally incur losses, however, it would not be expected that such losses would continue for an extended period of time. The rejection of 'comparables' due to consistent loss is common, especially during unusual economic conditions. However, the OECD guidelines do not have specific guidance regarding the exclusion or inclusion of such loss-making 'comparables'.

Guidance on the, Transfer Pricing Implications of the COVID-19 Pandemic has been published to provide much-needed clarification and support to taxpayers and tax administrations as they evaluate the application of transfer pricing rules for the period impacted by COVID-19. The guidance represents the consensus view of the 137 members of the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS).

Conclusion

Although challenges relating to the implementation of transfer pricing regulations and the arm's length principle in developing countries exist, the benefits are likely outweigh the perceived risks. The OECD and various stakeholders have already done work through a wide range of actions in addressing these challenges.

Solid transfer pricing regulations have the potential to increase and attract foreign direct investments and increase the much-needed tax revenues needed in developing economies.

The importance of Africa's participation in the BEPS initiatives and the inclusion of unique challenges faced by Africa to ensure that the negative effects of BEPS are kept to a minimum, cannot be over-emphasised.

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THE STATE OF TRANSFER PRICING CAPACITY IN AFRICAN REVENUE AUTHORITIES AND ITS IMPACT ON BUSINESS

DISEBO MAKHETHA, Senior Manager: Transfer Pricing Services & **ELLAINE RABOROKO,** Transfer Pricing Manager at SNG

Africa is a continent that continues to show potential for economic growth and business opportunities. Representing the world's largest free trade area with a 1.2 billion-person market mainly consisting of young people, any business would be keen to explore the opportunity. Notably, the continent has made strides in streamlining processes perceived as barriers to business; similarly, revenue authorities are responding to the call.

Growth in developing economies is largely attributable to key industries such as agriculture, retail, mining, banking and, most recently, technology. Many multinational enterprises operating in such industries continuously seek opportunities to participate in various jurisdictions, including Africa. With the increase in cross-border activity comes complexities of determining profits attributable to specific jurisdictions.

Developing countries are exposed to potential profit-shifting arrangements conducted by multinational enterprises. Transfer pricing is critical in addressing the exposure as it requires multinational enterprises to ensure that the conditions of their intercompany transactions do not differ from those agreed to by independent enterprises for comparable activities performed by multinational enterprises. Certain African countries do not have effective transfer pricing regimes in place to mitigate this potential exposure and often rely on anti-avoidance rules that do not adequately address the exposure. According to the Organisation for Economic Cooperation and Development (OECD, 2015), challenges such as lack of administrative, technical and auditing capacity to conduct effective audits exist in countries with a fully effective transfer pricing regime.

Implementation of the capacity building programmes in Africa

In efforts to conduct effective and efficient audits, African revenue authorities are ramping up their transfer pricing capacity with the support of foreign experts. Over the years, developing African countries such as Botswana, Ethiopia, Ghana, Kenya and Zambia were part of the Transfer Pricing Programme of the Task Force on Tax and Development. The OECD (2015) developed this task force together with other partners in efforts to support developing countries in strengthening and implementing their transfer pricing.

In Kenya, the programmes were mainly focused on capacity building through a training programme on advanced transfer pricing issues. The training programme was specifically tailored to Kenya's needs and to the auditors' level of knowledge. Successes of the programme include increased skill and capacity for the Kenyan Revenue Authority. An OECD report indicated that there was an increase in the number of audit cases completed that yielded, true to the objective of the programme, a significant increase in revenue collected from transfer pricing cases. Further to the above, the Kenyan revenue authority has set up an international tax office focusing on international transactions.

Apart from realising similar tax revenue successes, the Zambian Revenue Authority improved transfer pricing legislation in 2018 following assistance from the programme. This trend is expected to continue in other countries for the foreseeable future.

Building capacity in South Africa

Revenue authorities are clearly benefiting from implementing these capacity-building programmes; this makes the initiatives more attractive to other revenue authorities. South Africa is no exception. The South African Revenue Service (SARS) continues to build capacity in the transfer pricing unit to improve the administration of transfer pricing in South Africa. More recently, SARS also opened discussions concerning the Advance Pricing Arrangements programme.

The purpose of the recently released discussion paper titled 'Proposed Model for Establishing an Advance Pricing Agreement Programme and Release of the Draft Legislation' (SARS, 2021) was to introduce the advance pricing agreement programme in South Africa and provide a model draft legislative framework for the advance pricing agreement unit and associated processes at a high level. It is evident from the introduction of such a programme that SARS will be required to intensify capacity for the success of the advance pricing agreement unit.

In this discussion paper, SARS recognises that the establishment of the unit will require resources and time. This is particularly challenging considering the scarcity of transfer pricing experts in South Africa and the fact that the existing transfer pricing unit requires additional resources for audits.

Another added challenge specific to South Africa is the allocated time for audits as per the tax administration act. The challenge to grow capacity within the transfer pricing space is globally ongoing for revenue authorities and taxpayers.

Measures taken by taxpayers to ensure readiness

Our experience across Africa confirms the increase in transfer pricing audit capacity in many countries and further illustrates a clear market focus in relation to the audits. For example, in Kenya, there has been an increase in transfer pricing audits on taxpayers participating in the pharmaceutical industry and limited risk structures within manufacturing and distribution industries.

Similarly, Nigeria—one of the biggest economies in Africa—has seen an increase in industry focused audits mainly addressing 'cost-plus' structures.

During transfer pricing audits, the assessment or decision made by the revenue authority is as a result of the revenue authority not being in agreement with the classification of these entities or the basis on which the comparability analysis is performed. Revenue authorities are often required to perform various tasks to gain an understanding of transfer pricing methodologies adopted in line with the functional analyses presented in the taxpayer's documentation. Most informative are the functional analysis interviews conducted by revenue authorities with individuals in various departments in the taxpayers' business. The facts presented in the interviews are compared to extensive supporting information collected as part of the audit on the taxpayers' transfer pricing conclusion as outlined in the relevant documentation.

Increased transfer pricing audit capacity not only improves revenue collection efforts in-country, but also improves the overall taxpayer experience throughout the audit. Audits provide an educational platform for revenue authorities and taxpayers alike. Taxpayers should take the opportunity to provide clarity in their business and adopt transfer pricing methodologies in a transparent manner.

Taxpayers are noticing the change in climate globally and adjusting accordingly. In efforts to prepare for potential audits as a result of the capacity-building initiatives, taxpayers have been seeking expert advice on transfer pricing issues. These measures are taken to ensure compliance with local transfer pricing regulations, tighten transfer pricing policies and ensure that sufficient transfer pricing documentation is in place during such audits.

Conclusion

The building of administrative capacity in transfer pricing units by African revenue authorities remains an interesting and exciting space for the continent and those who operate businesses in it. Increase in capacity not only improves revenue collection, but also improves the taxpayers' overall experience throughout the audit.

With transfer pricing being one of the largest tax issues globally, it is important for taxpayers who transact with related cross-border entities to ensure that the transfer pricing methodologies adopted in such transactions are accurate and supported by adequate documentation.

15 minutes

SARS EMBRACES THE CONCEPT

'ADVANCE PRICING AGREEMENT'

▶ **CARRYN ALEXANDER,** Partner and Tax Specialist, Webber Wentzel

After many years of reluctance, SARS has finally issued a discussion document indicating the time has come for South African advanced pricing agreements (APAs). This article explores likely implementation, along with the status of APA updates from other African countries.

South Africa is missing an opportunity to enhance foreign investment by dragging its heels on implementing an Advance Pricing Agreement programme.

Following the recommendation of the Organization of Economic Co-operation and Development (OECD) in its Base Erosion Profit Shifting (BEPS) report, several countries have endorsed and adopted various types of advance pricing agreement (APA) programmes.

Although South Africa is a member of the G20 and the OECD/G20's BEPS Project and has largely adopted the OECD/G20's transfer pricing recommendations and guidelines into its legislation, South Africa has yet to implement APAs. Other member countries that have similar transfer pricing legislation have endorsed and implemented an APA programme. In addition, other countries on the African continent such as Liberia, Morocco, Nigeria, Tanzania, and Uganda, have APA legislation in place, with several more African countries offering similar arrangements. Whereas South Africa is a leading country on the African continent and a gateway for foreign investment

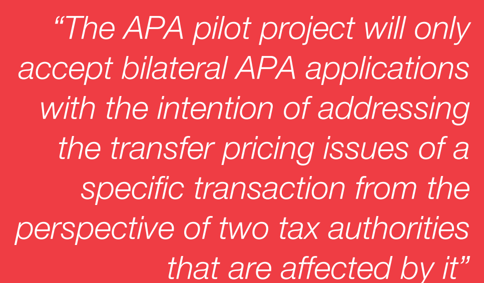
into Africa, it has admittedly fallen behind. Unsurprisingly, SARS' Discussion Paper on APAs (2020), as well as its Proposed Model (2021), including a draft legislative framework for establishing an APA programme in South Africa, have received a warm welcome.

However, SARS has indicated that an APA programme will only be prioritised once the practice of profit shifting has successfully been curtailed and SARS' transfer pricing skills and expertise, including capacity constraints, have been addressed. SARS estimates that it will take a further three to four years for an APA programme to be successfully implemented in South Africa.

The release of a draft enabling legislation for an APA programme is a step in the right direction, but SARS' lack of urgency regarding implementation is disconcerting in view of the potential opportunities for foreign direct investment in the country and economic growth.

The importance of an APA programme for South Africa

Due to an increase in globalisation, transfer pricing plays a critical role in international trade. For South Africa as a developing country and in the current global economic climate, attracting foreign direct investment is crucial. Business leaders consider regulatory uncertainties and risks that may arise in the country where they conduct business to be key (Whitford, 2010). SARS and the South African government need to strike a balance between protecting South Africa's tax bases through activities that counter transfer pricing manipulation and profit shifting, while mitigating regulatory uncertainties and risks if they are to enhance foreign direct investment and cross-border trade (Beebeejaun, 2018; Blumenthal, 2017).



"The APA pilot project will only accept bilateral APA applications with the intention of addressing the transfer pricing issues of a specific transaction from the perspective of two tax authorities that are affected by it"

APAs can be used to reduce or even eliminate regulatory uncertainty associated with multinational enterprises' determination of transfer prices that meet the arm's length standard set out in the OECD Guidelines (Kortebusch, 2014), thereby reducing the risk of entities being audited and assessed with an additional tax liability (Whitford, 2010). APAs' role in dispute prevention could potentially enhance SARS' efficiency in combating BEPS because less time will be needed to monitor compliance through audits (Davis Tax Committee, 2014; Kerschner & Stiastny, 2013).

Also, with heightened global attention on multinational enterprises' tax footprint and how 'moral' an entity is, APAs have been a driving force for corporate governance. On the one hand, APAs improve governance for a multinational as far as tax administration is concerned, as tax compliance demonstrates a multinational's willingness to comply with tax laws and to voluntarily meet their tax obligations (Kerschner & Stiastny, 2013). On the other hand, APAs guarantee that the tax authority receives a fair portion of the profits from multinationals' intra-group transactions, allowing the tax authority to reallocate its resources to other tax compliance issues (Mqina, 2022).

Proposed implementation process

According to the implementation process outlined in the Proposed Model, SARS intends to implement the APA programme in phases, starting with an APA pilot project as soon as the legislative framework is in place. The APA pilot project will only accept bilateral APA applications with the intention of addressing the transfer pricing issues of a specific transaction from the perspective of two tax authorities that are affected by it.

This proposal has attracted some public criticism. Bilateral and multilateral APAs are guaranteed to give multinationals a higher degree of certainty than unilateral APAs — bilateral and multilateral APAs reduce the risk of a transaction being challenged by one revenue authority where it is accepted by another revenue authority. However, since these types of APAs require the involvement of two or more countries in the negotiation process, they are, on the one hand, correspondingly more difficult to establish; consequently resulting in a prolonged and onerous process (Joubert, 2021). A unilateral APA, on the other hand, would be a simpler and more logical starting point because it would mirror the process of applying for and obtaining an advance tax ruling, which is already well established in South Africa (Joubert, 2021).

Moreover, a unilateral APA would help with strategically progressing existing transfer pricing disputes that are currently in the alternative dispute resolution phase (or heading there); in settlement negotiations between the parties and finalising lengthy and costly transfer pricing disputes; and in providing much-needed perspective clarity on open years of assessment for taxpayers (Miller & Chong, 2022).

The Davis Tax Committee recommended the implementation of an APA programme in South Africa but also pointed out that the availability of qualified resources must be ensured (Davis Tax Committee, 2014; SARS, 2020). SARS admits that the chief impediment to establishing a successful APA programme in South Arica is the scarcity of transfer pricing expertise in the country, which will require additional time and resources to develop (SARS, 2020). However, this excuse has been criticized on the basis that, while reaching an APA with taxpayers may be time-consuming and resource-intensive, SARS' capacity constraints should be fleeting as APAs will allow tension to move away from lengthy transfer pricing tax disputes (Joubert, 2021).

The Davis Tax Committee also highlighted that since taxpayers requesting APAs will be required to pay an APA application fee, the cost of ensuring that SARS has the relevant qualified resources through the appointment of external specialist consultants should be mostly covered (Davis Tax Committee, 2014). In the long run, there should be a significant and organic skills transfer while SARS' personnel work together with these skilled external specialist consultants (Joubert, 2021).

The status of APA programmes in other African countries

As noted by SARS Nigeria, Tanzania and Uganda are among the comparable countries in Africa that have APA legislation in place. Tanzania and Uganda

have already implemented their APA system. Liberia has introduced an APA programme and Morocco has implemented an APA system, which is outlined in the Moroccan Local Tax Code (CGI).

While these African countries have made a concerted effort to adopt the OECD Guidelines and have put measures and incentives in place for incorporating and entering into APAs, implementation is still a challenge. This is because they lack bargaining power in negotiations with developed countries and because their revenue authorities lack capacity, expertise, and resources to effectively monitor multinationals' compliance with stipulated regulations and guidelines (Natalie, 2020; Blumenthal, 2017).

The African APA landscape remains underdeveloped. However, as Africa continues to grow and become more integrated into the global economy (PwC, 2016), especially against a backdrop of the global energy crisis, a focus on achieving net zero by 2050 and the rich renewable energy sources on the continent (Ferroukhi & Onuoha et al., 2022), African governments' desire to enhance investment and to protect their tax base should influence the positive development of APA systems.

In its Discussion Paper (2020), SARS admits that tax certainty is one of the fundamental requirements for foreign direct investment. Dispute prevention through the use of APAs could potentially raise SARS' credibility (Deloitte, 2018) and make it more efficient in combating BEPS, thereby protecting and increasing South Africa's revenue. The incorporation and implementation of an APA programme in South Africa is not only possible but also imperative.

CUSTOMS: CROSS BOARDER TRADE

PROGRESS REPORT

ON THE AfCFTA

MARK ALEXANDER GOODGER, Chief Executive at Global Maritime Legal Solutions (Pty) Ltd

As part of its mandate, the African Continental Free Trade Area (AfCFTA) agreement is to eliminate trade barriers and boost intra-Africa trade. Its specific objective is to advance trade in value-added production across all service sectors of the African Economy.

To reduce the landed cost of goods traded internationally across borders, global traders should be consistently aware of the proliferation of international trade agreements that afford preferences to the importer or buyer in such transactions.

Naturally, both seller or exporter and buyer or importer should be aware of the benefits that can be secured via the preferential duty structures. In order to achieve such benefits, however, it requires that the trading parties be conversant with annexes to the AfCFTA or any such trade agreement. In particular, the annex that governs compliance in accordance with the Rules of Origin. The annexes are generally found under the Protocol on Trade in Goods.

Tax consultants and practitioners, who impart compliance guidance regarding trade agreements and specifically Rules of Origin to both importers and exporters, should be fully conversant with the technical criteria in Annex 2, namely governing Rules of Origin of the AfCFTA and such rules in trade agreements that may be relevant to the trade of their clients.

Customs duties in the African context are fiscal and protective measures for locally produced goods against similar imported goods and a way of encouraging local production. In the context of trade arrangements, preferential rules of origin replace customs duty as a protective measure on imports. With the increase in free trade agreements, customs authorities are expected to implement the rules according to the relevant annexes. This provision places the obligation on each of the parties to take the necessary steps for the implementation of the administrative arrangements and the application of preferential rules of origin such as the AfCFTA, in the performance of their control and duty collection duties.

Origin and all the related technical criteria for customs declaration compliance is often one of the least understood areas in global trade. The Protocol for Trade in Goods of the AfCFTA commences with Annex 1, which deals with the Schedule in Tariff Concessions. The detail that each member country is prepared to offer by way of preferences appears in this annex.

Since 1994, South Africa has entered into several negotiations for free or preferential trade agreements to be concluded, thus liberalising customs duties and eliminating non-tariff barriers to trade. South Africa initially entered into Generalised System of Preferences (GSP) from the European Community (EC), Norway, and Switzerland, followed by the signing of free trade agreements between the EC and the Southern African Development Community (SADC). This was followed by the African Growth and Opportunity Act (AGOA) arrangement offered by the United States of America (USA) to sub-Saharan African countries; the GSPs extended by Russia and Turkey; and lately, the implementation of the Free Trade Agreement between the European Free Trade Association (EFTA) and the Southern African Customs Union (SACU) as well as the AfCFTA.

As related to the customs technical criteria regarding Origin we should have an awareness of reciprocal and non-reciprocal criteria in trade agreements.

a) Reciprocal criteria

The reciprocal tariff treatment of goods refers to trade agreements or international commercial treaties in which two or more nations grant trade concessions that are equally advantageous to one another. It usually refers to treaties dealing with tariffs, for example, one nation may grant another a special schedule of tariff concessions in return for equivalent advantages. Originally, reciprocal agreements involved bilateral tariff reductions that were not to be extended to third countries.

b) African Continental Free Trade Area

Part IV of the General Agreement on Tariffs and Trade (GATT) includes provisions on the concept of non-reciprocal preferential treatment for developing countries—when developed countries grant trade concessions to developing countries. They should not expect developing countries to make matching offers in return.

The World Trade Organization (WTO) agreements contain special provisions that give developing countries special rights, and that give developed countries the possibility to treat developing countries more favourably than other WTO Members. GSPs are extended under the auspices of the United Nations Conference on Trade and Development. An example is the AGOA agreement for trade with the USA to promote African exports to the USA.

There are complex criteria when dealing with the origin and the attainment of a preference in duties. The origin may be broadly defined as the rules to define the economic identity of a product. One will encounter the following criteria and one will need to diligently study and interpret legal provisions as may be specifically related to the AfCFTA when all is hopefully concluded and agreed upon.

i. General requirements: this criterion prescribes either a general rule or a product-specific rule of compliance, e.g. an *ad valorem* rule of approximately 25% or a manufacturing process on non-originating materials that must be complied with.

> *"Some AfCFTA member states have observed that they will need the rules of origin completed before finalising the tariff offers, as there is a link between the rules of origin and the tariff offers"*

ii. Wholly obtained products: this criterion indicates a list of products that may qualify as being wholly obtained, e.g. products that are generally available in the territories of the parties.

iii. Cumulation: this criterion provides for sharing resources and giving recognition to substantial manufacturing processes conducted in each other's territories, e.g. wholly obtained or manufactured products obtained in the territories of the other party are considered as originating when used in the manufacturing process of another party.

iv. Value tolerance: this criterion provides for a limit to deviations from local inputs that may be allowed from the agreed usage, e.g. should a rule prohibit the use of a specific raw material obtained from a third country, derogation is made to the rule to the extent indicated.

v. Sufficiently worked or processed: this criterion provides for what is considered to be substantial manufacturing or processing, i.e. manufacturing or processing ensuring that substantive value is added to a product in order to qualify as originating, and

vi. Not sufficiently worked or processed: this criterion provides for what is considered not to be sufficiently worked or processed and for what does not qualify for preferential treatment, e.g. minimal processes such as screwdriver jobs, diluting, mixing, etc.

vii. Unit of qualification: this criterion refers to the quantification of inputs and final products as imported to be considered separately. See the examples below.

(a) Separation of materials regulates that an accounting system be used where, for purposes of determining origin, products cannot be separated;

(b) Treatment of mixtures relates to the mixture of non-originating products with originating products;

(c) Accessories, spare parts, and tools provide for the inclusion of these goods into the goods with which they are imported and invoiced together, and exceptions;

(d) Packing and packing materials for retail sale clarify where such products are considered as originating together with the packed product;

(e) Containers and packing materials for shipment clarify where such products are considered as originating together with the packed product;

(f) Sets provide for instances where sets comprising originating and non-originating goods may be considered as originating from;

(g) Neutral elements refer to those products that are consumed in the manufacturing process such as fuel, water, and glue, which are normally considered to be originating; and

(h) Derogations that would provide for deviations from the agreed rules of origin in the case of specific countries by agreement between the parties.

In seeking out intra-Africa trade opportunities, one should be highly familiar with the above in terms of customs compliances beyond the normal requirements of providing certificates of origin, what to do for replacements, substitutions, copies, amendments and the like.

As stated by AfreximBank (Jan 2021), *"Schedules of Tariff Concessions and Rules of Origin are the cornerstone for liberalisation of trade in goods and establishment of a continental free trade area"*. On the one hand, Tariff Concessions identify which products will be liberalised and determine the period of phasing out tariff barriers. On the other hand, Rules of Origin are used to determine a product's eligibility for preferential tariffs under a free trade agreement and have major implications for the extent of trade under the agreement and the growth of regional value chains. Therefore, tariff concessions and rules of origin go hand in hand in negotiations and in practice. These negotiations are not yet complete and a constant vigil needs to be exercised to keep track of these developments under the AfCFTA, to eventually see what opportunities may exist for trade on various products between respective African member states.

Naturally, the correct classification of goods under the Harmonized System (HS) Codes is key to correctly establishing the opportunity for duty preferences. Negotiations on the final rules of origin are also not yet concluded. Some AfCFTA member states have observed that they will need the rules of origin completed before finalising the tariff offers, as there is a link between the rules of origin and the tariff offers.

The AfCFTA outlines Tariff Elimination Modalities (the methodology of committing to tariff preferences), which determine the mechanism and criteria for trade liberalisation. African countries are committed to removing tariff barriers on 90% of all tariff lines (of traded goods) over five years for non-least developed countries (LDCs) and over ten years for LDCs. Consequently, all member states are, strictly speaking, committed to making at least 90% of all products quoted in the HS available. The remaining 10% of goods are further divided into 7% representing 'sensitive products' (LDCs as determined by the AUC), which are to be liberalised over a period of ten and thirteen years for LDCs and non-LDCs respectively, whereas 3% of goods are excluded from tariff liberalisation altogether. The Republic of South Africa (RSA), for example, will have a view on the automotive sector. With great expectations, the AfCFTA entered into force on 30 May 2019. The African Union (AU) Assembly then decided that, instead of commencing trade under the AfCFTA in July 2020, trade would commence on 1 January 2021. Unfortunately, owing to various reasons and mainly because negotiations had not yet been concluded, limited trade has transpired since that milestone. We will shortly deal with an update on the trade that has taken place. Although the AfCFTA is driven by its member states, the Secretariat functions as the coordinating body for all its activities.

The Secretariat is the administrative organ mandated to coordinate the implementation of the AfCFTA. To date, guided trade has taken place between Rwanda, Cameroon and Ghana. A constant watch for further developments should be on the Secretariat. Understanding the application of the fundamentals of the rules and the schedules of concessions will be important in seeking future opportunities for intra-Africa trade under the AfCFTA; the existing RECs remain the foundation blocks until such time.

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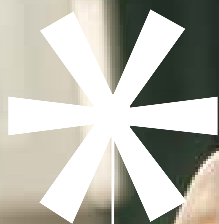

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SOUTH AFRICA FREE TRADE: TALKING FORWARD BUT GOING BACKWARD

▸ **ANNEKE JANSEN VAN VUUREN,** Trade Analyst in Economics at XA Global Trade Advisors(Pty) Ltd

Whereas South Africa has made much of the desire for free trade in Africa, local policy on the ground seems contrary to this intention. Many would argue that direct tariffs and hidden trade barriers are increasing. This article explores the veracity of South African trade policy.

In common with most small economies, South Africa is dependent on global trade. Our home market is small and barely growing, making it difficult for most businesses to grow to any substantial degree if they focus only on the domestic market. This is not to say that the domestic market is unimportant, but without global markets, we don't have an economy.

Trade contributes over 50% to our gross domestic product (GDP), so how we relate to our trading partners is indeed very important. Of course, trade is a two-way thing, so trading also means allowing imports into the country. Our take on trade has shifted quite dramatically; we have developed a rather counterproductive view. Minister Patel has announced that we import too much at 25% of our GDP, comparing unfavourably with China at 14%, India at 16%, Brazil at 10%, the United States (US) at 12%, and the European Union (EU) at 14%. This, however, misses the difference in size between South Africa and the other economies on the list. If we got our imports down to 15% of our economy, we would have a very small economy indeed. Small, closed economies are very difficult to grow.

The global economy has seen decades of exceptional growth because of ever-freer trade, yet we have not seen anything even close to the average growth levels of other economies. Free trade is a trade policy where imports and exports can move across international borders without being restricted by trade barriers. These trade barriers include import duties and non-tariff barriers such as quotas, bribes at the border, and poorly maintained infrastructure.

While direct tariffs and hidden trade barriers are increasing and hindering South Africa's ability to trade, our attitude towards trade can be seen as a greater trade barrier to overcome. Trade policies are not implemented in the same way in which they are initially approached and talked about. Adding to the trade complexity is our government's quite explicit view that imports are bad and exports are good. This view is confirmed by our approach to localisation and designation (government procurement rules around local content).

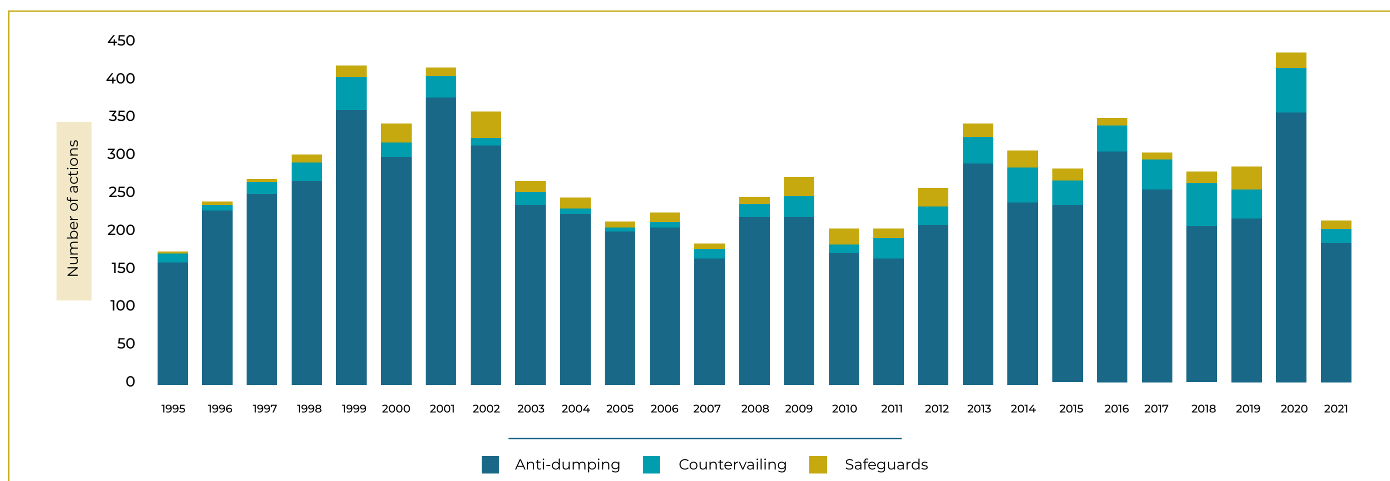
South Africa wants a win-win, no-compromise situation where we can produce more products locally and grow our exports without relying on imports, but this assumes we can produce the inputs as competitively as the imported equivalent. If we cannot, then we levy a duty on the imports to increase their cost to match our local costs. This works fine for as long as we trade behind our trade barrier (import duties), but it becomes far more difficult when we try to export.

When we move outside our protective barriers, the only thing which matters is our competitiveness. But producing more of most things is difficult, given our high inflation, petrol prices, the impact of the Ukraine-Russia situation, load-shedding, and decreasing production capacity.

Protectionist actions

from the free trade towards more protectionism, both globally and in South Africa. According to the World Trade Organization (WTO), in 2020, the number of anti-dumping, countervailing (anti-subsidy), and safeguard actions globally increased to 427, compared to 280 in 2019 and 208 in 2021. Such a high number of protectionist actions were last seen in 1999 and in 2001. South Africa reported the initiation of 13 anti-dumping actions in 2021 in comparison to four actions in 2020.

"Trade policies are not implemented in the same way in which they are initially approached and talked about. Adding to the trade complexity is our government's quite explicit view that imports are bad and exports are good"



Source: World Trade Organization

Not only has South Africa been taking more protectionist actions, but we have also been taking longer to act on these actions. In 'XA Global Trade Advisors' Open Cases Report', it was found that duty increase, reduction, and rebate investigations are meant to be completed within four to six months, depending on the conditions. These investigations are taking closer to two years to be completed. So, we talk about protecting our local industries but then we take forever to act. We speak of reducing duties on raw materials but drag our heels.

South Africa collects approximately R55 billion per annum in customs duties. However, roughly R1.25 billion in duties has been lost due to delays in finalising the protective actions on time, whereas approximately R2 billion has been collected on goods where there are no domestic industries and no local production. Think of how this money could have been spent to further trade and increase employment and investment.

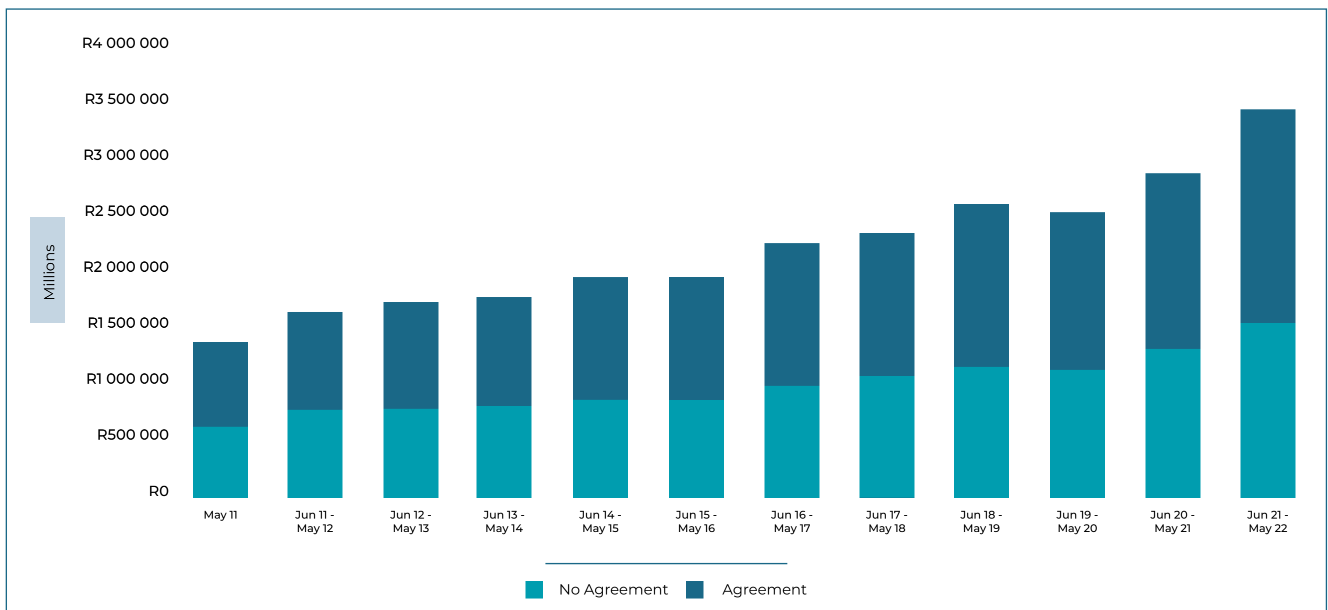
Underutilisation of trade agreements

Like many other countries, South Africa takes years to negotiate trade agreements with other regions and countries. But what happens when the negotiations are done? Trade agreements are left on a shelf to collect dust. There is a disconnection between the departments negotiating the trade agreements and the departments that are supposed to promote them to the public sector. This is not a problem unique to South Africa. How many companies in South Africa that import and/or export really know what preferential duties they have when trading with certain countries?

When we look at 12 years' worth of trade patterns, from June 2010 to May 2022, an average of 45% of South Africa's trade balance is still traded without the benefit of trade agreements.

Most of what we export are either minerals, cars, or some agricultural products. Most minerals attract no duty and so trade agreements tend not to affect this trade. Twenty per cent of our exports go to the EU, but this only accounts for 0.5% of their imports, yet this is the most important trade agreement we have. The EU is an enormous market which is largely untapped.

We have preferential access to the United States of America (USA), the world's largest market, by way of the African Growth and Opportunity Act (AGOA). AGOA is a US Trade Act that gives South Africa and other African countries preferential access to the USA. According to Minister Ebrahim Patel in 2019, sub-Saharan Africa was only using 748 or 40% of the 1,835 tariff lines under AGOA. He further stated that we needed to identify the challenges and increase the utilisation of AGOA preferences to deepen trade and investment relationships between Africa and the USA. However, three years later and South Africa's pattern of trade with the US has not changed much. This is not to say that some individual companies or sectors have not utilised preferential access to the USA. A total number of



Source: SARS trade statistics

12,621 traders have exported to the USA between 2010 and 2021, 50% of the total exports were made up of six companies in the mining, automotive, and chemical sectors.

AGOA is set to come to an end in 2025. This gives us three years to either continue trading as we have until now or to use the remaining time to try and utilise the opportunity we were given. We are not sure whether AGOA would be renegotiated with South Africa by the end of 2025 or what our benefits would look like. But is South Africa willing to spend another 25 years underutilising its preferential access to one of the largest economies in the world?

Putting all our eggs in one basket

Ask any trader about the African Continental Free Trade Area (AfCFTA) and with great excitement, they will tell you about the opportunities for trading in Africa. The AfCFTA seeks to establish a single market for goods and services by reducing tariffs and connecting the entire African continent.

According to the World Bank, *"The AfCFTA agreement will create the largest free trade area in the world measured by the number of countries participating. The pact connects 1.3 billion people across 55 countries with a combined gross domestic product (GDP) valued at US$3.4 trillion. It has the potential to lift 30 million people out of extreme poverty."* (The World Bank - The African Continental Free Trade Area: Economic and Distributional Effects).

However, the reality is that we are a long way from the AfCFTA benefits being realised and achieved. Whereas we talk about creating a single market, we also take direct actions to make trade from the rest of Africa with us difficult. We lost sugar volume when we implemented the Health Promotion Levy (and excise duty on sugary drinks) but then we expect to make up this volume by getting Eswatini to export less sugar to us. Ditto for clothing, to protect our clothing sector, we have created large barriers to clothing produced in Lesotho and Eswatini. While all of this is happening, we are trying to get a continent-wide agreement over the line. There is no AfCFTA if South Africa blocks imports from the continent.

Without trade, we have no economy. No number of political speeches can change this. We cannot sit back and wait for free trade with the rest of Africa to get us out of the mess in which we are. We need to start utilising the opportunities we have better. Where our trade policies are concerned, South Africa cannot keep talking forward but moving backwards.

SECURING SUPPLY CHAINS UNDER THE AUTHORISED ECONOMIC OPERATOR PROGRAMME

BIANCA ROMANS, Manager, Customs and Global Trade at EY Cova

The Authorised Economic Operator (AEO) programme is effectively a public-private partnership between SARS and companies that are involved in the international movement of goods. SARS accreditation results in a freer movement of goods in terms of administration. This article explores the current benefits and challenges based on practical experience.

Moving goods across borders and adherence to official rules and formalities can be a daunting task for traders, to such an extent that there is a multitude of specialists who make their living from forwarding freight and similar activities.

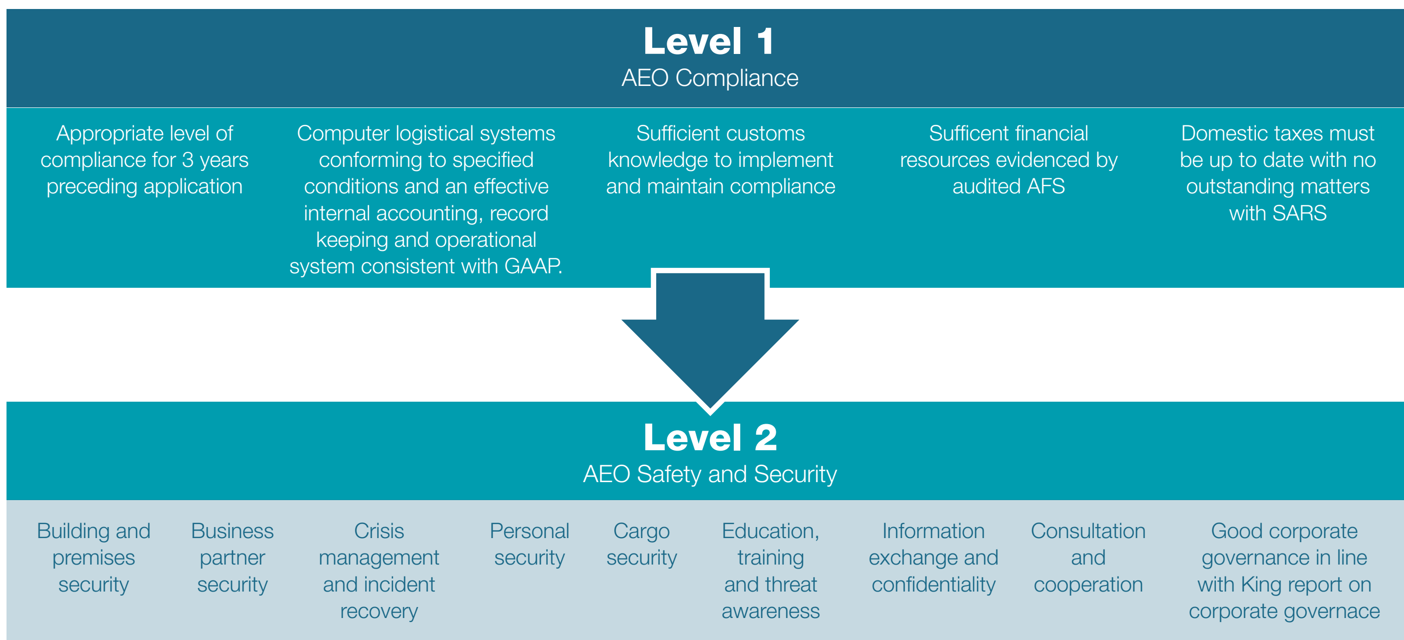
However, some help is at hand in the import and export supply chain in South Africa in the form of the AEO programme of the South African Revenue Service. This programme comprises a framework of standards to secure and facilitate trade. In 2005, the World Customs Organisation (WCO) identified the need to enhance international supply chain security and facilitate the movement of legitimate goods, out of which the AEO programme was born. SARS, as South Africa's administrator of customs, has taken charge of this framework and it is now part of our domestic legislation.

"There is a requirement for a nominated individual to take a Customs Knowledge Test. This is part of the accreditation requirement and it is intended to show SARS that your operation is sufficiently knowledgeable to be trustworthy and accredited"

SARS piloted a local accreditation programme which was aligned with the compliance requirements of an Authorised Economic Operator (AEO) between 2009 and 2016. This programme was known as the 'Preferred Trader Programme'. The SARS Preferred Trader Compliance programme was designed to be equivalent to the European Union (EU) AEO Compliance model.

On 23 July 2021, changes to customs legislation were made to expand the participation of importers and exporters within the supply chain in the SARS AEO Programme. A key point of difference between the preferred trader programme and AEO is that AEO is open to all role players within the supply chain and it is not limited to importers and exporters. With support from the World Customs Organization (WCO), the Border Management Agency (BMA) and the World Bank (WB), SARS is taking the necessary steps towards its goal for 2025, which relates to the Single Government Organisation AEO Programme. This programme derives from the WCO's SAFE Framework of Standards which was adopted in 2005 to secure and facilitate global trade that would act as a deterrent to international terrorism, secure revenue collections and promote trade facilitation internationally.

The criteria for qualification of each level are presented below:



Application for AEO

An AEO self-assessment on the SARS website needs to be completed in order to apply and to determine if you qualify. Following your completed application, a SARS client relationship manager will contact you to run through the requirements. If the relevant requirements are met, an application is completed using the DA186 form.

There is a requirement for a nominated individual to take a Customs knowledge test. This is part of the accreditation requirement and it is intended to show SARS that your operation is sufficiently knowledgeable to be trustworthy and accredited.

SARS will then commence its verification process or audit and, if all is in order, it should then agree that you can be accredited. If not, it will suggest a compliance improvement programme. This will lay out what needs to be done within the applicant's business.

There are two levels of accredited client status provided:

- Level 1 – Authorised Economic Operator (Compliance).
- Level 2 – Authorised Economic Operator (Security) with associated facilitations.

Given that the two levels require different levels of effort to achieve acceptance from SARS, it follows that the benefits are linked to the level achieved.

The benefits of AEO

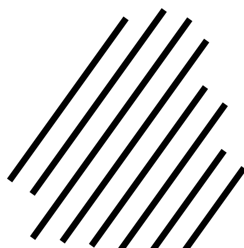
The AEO programme is designed to facilitate trade and ease the administrative burden. This should mean fewer inspections; less onerous documentation requirements; expedited crossing of borders for your goods; reduced time and cost to move your goods; and overall supply chain efficiency with fewer stops, inspections, and delays.

South Africa's AEO programme is recognised by other customs authorities through Mutual Recognition Agreements (MRAs). Therefore, as an AEO, you should expect the same benefits in those countries that have implemented the AEO programme and with which South Africa has an MRA.

The benefits for each level include:

AEO Level 1 Benefits (AEO Compliance)
A designated Client relationship manager
Reduction in amount of security required as per the Act
Fewer documentary and compliance inspections
Expedited tariff and value determinations
Non-intrusive techniques when goods are stopped
Expediting inspections
Inspection of goods at client's premises on appointment
Authorised to make use of a unique SARS logo identifying holder of AEO status
Recognised by other Customs Authorities as Level 1 accreditation through mutual recognition agreements (MRAs)
Coordination of interventions to mitigate risk pertaining to holder's goods by officers from other governments agencies

AEO Level 2 Benefits (AEO Security)
A designated Client relationship manager
Reduction in amount of security required as per the Act
Fewer documentary and compliance inspections
Expedited tariff and value determinations
Non-intrusive techniques when goods are stopped
Expediting inspections
Inspection of goods at client's premises on appointment
Authorised to make use of a unique SARS logo identifying holder of AEO status
Recognised by other Customs Authorities as Level 2 accreditation through mutual recognition agreements (MRAs)
Coordination of interventions to mitigate risk pertaining to holder's goods by officers from other governments agencies
Exemption from customs supervision upon submission of an application by holder (subject to Commissioner's approval)
Prioritising for special or extra attendance where holder is not exempted from supervision. No charges imposed if attendance is provided during hours
Expedited processing of refunds and drawbacks
Provisions for targeted training sessions
Provisions of trade statistics on a quarterly basis
Extension of validity of license issued under section 60
Reduced cyclical compliance audits
Fewer documentary and physical inspections for compliance and supply chain security risk
Exemption from security payment



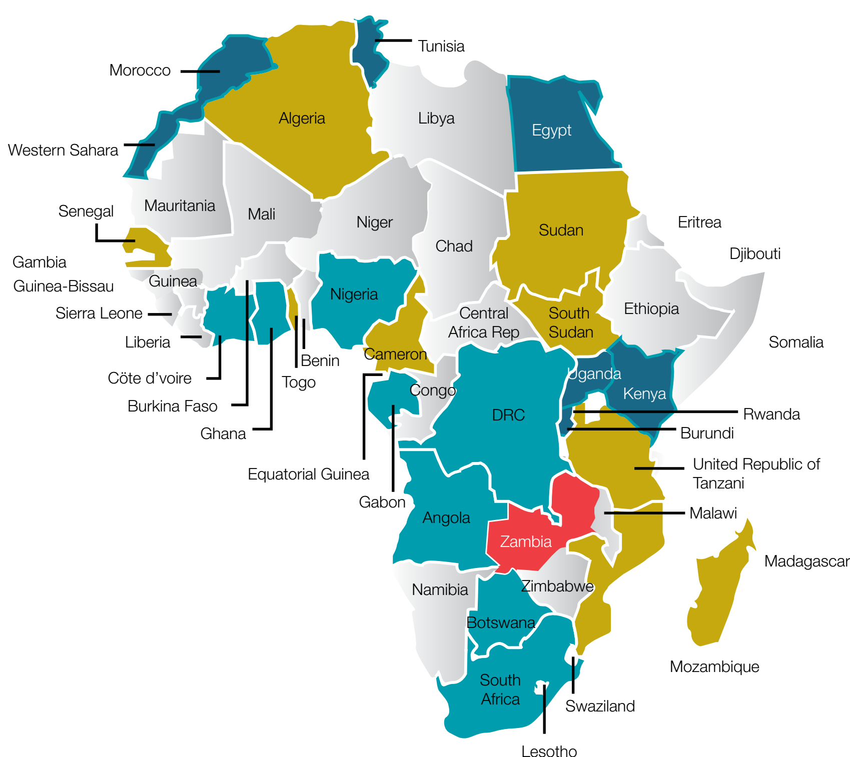
The challenges of AEO

Despite all the benefits available, there are still concerns among traders. For example, businesses have raised concerns about the audit process to achieve accreditation as SARS may detect deficiencies and non-compliance; a concern is that traders will be penalised. SARS has said, however, that it will not apply such penalties and interest; rather, it will assist clients in rectifying any non-compliance.

Another challenge is tangible access to the benefits that are stated as being available before going through the time and effort required to join the programme. Historically, the benefits have not been recognised by accredited traders.

Admittedly, the process of accreditation is administratively onerous. However, it is a once-off process and it will ensure that business procedures and systems are adequately geared to maintain compliance with the Customs and Excise Act.

Meanwhile, if the AEO is adopted by more and more African countries, this will facilitate the development of the African Continental Free Trade Area (AfCFTA). The AEO or equivalent customs programmes are being implemented in 31 out of 55 African countries.



Customs Programme status in Africa

- 8 AEO Operational
- 10 AEO under -development
- 12 Customs compliance programme operational
- 1 Customs compliance programme under development

Source: WCO AEO Compendium 2020

Globally, the application of AEO is also on the rise: 97 countries are operational, 20 counties are developing the programme, and 37 countries have implemented compliance programmes. In addition, 91 MRAs have been concluded between countries and 78 are under negotiation.

To conclude, there is a real benefit in securing the full supply chain by signing up for the AEO programme. The benefits clearly outweigh the administrative burden and will strengthen the supply chain for the future. This is a public-private partnership model which requires buy-in from the private sector for success.

SARS IS UNDERTAKING AN ACTIVE EFFORT to train and support SMME traders

CARRIDINE BROOKS, Director at ITX Advisory Services (Pty) Ltd

The article explores this effort's viability to ease custom's administrative burden while improving compliance.

The Small, Medium, and Micro Enterprise (SMME) segment is seen as the lifeblood of most economies and this is no different for the South African economy. It is estimated that SMMEs contribute between 50% and 60% of employment and approximately 34% of the country's gross domestic product (GDP).

Globally, many SMMEs ceased trading during and after COVID-19, which resulted in a significant increase in unemployment. The impact was so great that global bodies such as the World Customs Organisation (WCO) shifted their focus to coordinating efforts in order to facilitate trade, given the challenges that SMMEs face with internationalising trade and accessing valuable information. This was echoed by the WCO Secretariat in his note to WCO members in June 2020, where he called on WCO members to revise their support to SMMEs and to remove barriers that would stifle trade, including inter alia ease of licensing, registration, and accessing information that would aid in making customs processes transparent and predictable.

"The survey responses and target group sessions resulted in SARS launching a dedicated web page for SMMEs on Customs and Excise, namely the 'Small Business Traders and Travellers page' "

SARS and other government agencies have heeded this call and have intensified their efforts to stimulate growth for SMMEs by removing barriers and red tape that would stifle trade and ultimately hamper efforts toward economic recovery. It has been noted that, in practice, one of the main concerns of small business traders is to have access to Customs and Excise legislation that has been written in layman's terms; this would ensure understanding of the legislation and consequently compliance with the legislation.

Needless to say, many benefits flowing from a proper understanding of the law are lost and, as such, competitiveness is often lost. An example of this would be the lack of knowledge or awareness surrounding the mechanisms available that would enable SMMEs to leverage cash flow mechanisms such as deferments, rebates, or refunds that are available which, in this day and age, is crucial to the survival of an SMME.

Customs and Excise legislation is complex; it consists of an Act, 9 Schedules to the Act, and lastly, a set of rules known as the Customs and Excise Rules. Based on the legal framework for Customs, it is understandable that SMMEs often find themselves frustrated with the law and end up not complying with it, thus paying penalties and interest for non-compliance or missing benefits at its disposal due to the complexity in understanding the legislative provisions.

Apart from the license and registration requirements, trading within South Africa is further complicated as some goods are subject to import and/or export control measures. In such instances, SMME traders would be required to obtain import or export permits from the International Trade Administration Commission of South Africa (ITAC) or a letter of authority from the National Regulator for Compulsory Specifications (NRCS). These permits are almost always a prerequisite before the SMME can import or export into or from South Africa.

SARS initiatives

As part of South Africa's economic recovery programme, SARS initiated several engagements with SMME traders to obtain an understanding of the effectiveness of the Customs and Excise policies, processes, legislation, and incentives. These engagements, albeit initially in the form of surveys, were used as a foundation for further stakeholder engagement that would assist SARS in addressing specific SMMEs' informational needs. These sessions were followed with more focused target group sessions to unpack responses from the surveys.

The survey responses and target group sessions resulted in SARS launching a dedicated web page for SMMEs on Customs and Excise, namely the 'Small Business Traders and Travellers page'.

Since the launch of this web page in February 2022, SARS has more frequently been making information available on topics and events that would be of interest to SMMEs. Whereas the guidelines are not very detailed, they have been written in a more simplistic manner that would assist SMME traders in fulfilling their compliance obligations and hopefully in deterring them from non-compliant activities.

Other initiatives by SARS included specific awareness training to SMMEs through collaboration with the Small Enterprise Development Agency (SEDA) on 'Export Readiness', addressing some of the fundamentals of exporting.

One can only hope that there will be more roadshows or webinars on fundamentals and other considerations such as market access, basics on the rules of origin requirements, and specifically trading with countries that are part of the Southern African Development Community (SADC) and the European Union (EU), which are some of South Africa's biggest trading partners.

Like other Customs and Excise publications, SARS has published a frequently asked questions (FAQ) document that details questions often asked and short responses on where to find relevant information on the website or in the various sections of the Act. Although the responses in the FAQ do not solve all the informational needs of SMMEs, it is a step in the right direction as it links the FAQ with the specific requirements contained in the Act.

Other initiatives include more frequent webinars, workshops, and roadshows where information is shared with SMMEs such as the more recent RLA Onboarding Roadshow, where traders have been migrated to the SARS e-filing platform, as well as tariff determination clarification webinars.

Whereas the FAQs and published guidelines for SMMEs do not necessarily unpack every imaginable scenario, one must appreciate the coordinated efforts made by SARS to address the informational needs of SMME traders, including the provision of free training, that will aid in getting this segment of the economy to be more compliant and in ensuring that they have access to information in a simplified manner.

Hopefully, SARS will soon set up a dedicated mailbox for SMME traders, where specific questions or queries can be raised that will further enhance SARS' facilitation efforts in presenting valuable information to this segment.

Additional information that SARS will hopefully make available to traders quite soon, should be focussed on tariffs, rebates, refunds, and other benefits that will assist SMME traders in expanding their businesses and improving their cash flow. This will contribute meaningfully towards stimulating the economy and providing more employment creation opportunities for the youth.

DRAWBACKS AND REFUNDS:

THE CURRENT STATE OF PLAY

ALISON VAN DEN BERG, Director of Alison van den Berg Attorney Inc

Rebates, drawbacks, and refunds are key features in alleviating trade barriers, but these features pose a key risk to SARS. The article explores the current state of play.

There has lately been a lot of noise again about the SARS Customs and Excise divisions taking further steps to 'modernise' their operations. The modernisation we have seen over the past years includes automation of previously manual and paper systems such as declarations and registrations. It has come as no surprise then that SARS' latest ambition is to also have the refunds and drawbacks process automated. One hopes this will in fact contribute towards the stated motivation by SARS for modernisation, namely to facilitate legitimate trade.

The nature of the beast: pearl or swine?

Let's go back to the basics and consider the role and relevance of these mechanisms in the international trade environment, as well as whether they achieve their intended objective.

Different countries have differing trade policies. The debate on free trade vs. protectionism is an old one; it is well portrayed in this quote from Lalor's Cyclopaedia of Political Science:

"For more than two centuries, economists have steadfastly promoted free trade among nations as the best trade policy. Despite this intellectual barrage, many practical men and women of affairs continue to view the case for free trade skeptically, as an abstract argument made by ivory-tower economists with, at most, one foot on terra firma. *Such people* 'know' *that our vital industries must be protected from foreign competition . . . "*

The Cambridge English Dictionary defines a trade barrier as *"something such as an import tax or a limit on the amount of goods that can be imported, that makes international trade more difficult or expensive".*

The USA Trade Administration's Commercial Country Guide on South Africa notes that companies have cited protective tariffs as a barrier to trade in South

It stands to reason that the effectiveness of the rebates and refunds in facilitating legitimate trade are very important to ensuring continued interest of other countries in investing and trading with South Africa.

"SARS has at least promised to host webinars available on SARS TV on YouTube as training, and pilot participants will be selected and notified of their participation in due course"

SARS' external policy on refunds and drawbacks clarifies that refunds are paid in respect of duty or levy overpaid, or where goods are exported in the same condition as they are imported; whereas drawbacks are paid in respect of specified materials used in the manufacture, processing, packing, etc., of goods that are subsequently exported. SARS also publicly declares that it has an obligation to ensure that refunds or drawbacks due are paid out in the shortest time possible and to the correct person. Failure to live up to these obligations is the obvious potential risk faced by SARS in administering these mechanisms.

According to those in the know, 90% of refunds paid out by SARS are those in respect of destructions and fifth schedule items 521; 522.03; 536 and 537.

The applicant for refunds in terms of Schedule 5 has historically been and is still presently required, to complete and submit (to the enquiry counter at the relevant Customs office branch) the drawback or manual claims via submission of the DA 66 form together with all the supporting documents to prove that the refund or payment is due. This process has many detailed rules which, if not followed to the T, are queried or rejected—giving the applicant the proverbial runaround (i.e. it's a swine). For example, as per the SARS external policy guide:

- *"If an amended CCD is processed on an export declaration and the quantity or tariff heading is amended, such a declaration will only be accepted for drawback purposes if the goods were still under Customs control. If the goods have left South Africa and are readily not available for inspection the application will not be considered even if International Trade Administration Commission (ITAC) issues a retrospective permit(s).*

- *The Customs Procedure Code (CPC) and refund or drawback item must appear in the appropriate fields on the export declaration before the goods are exported, except where:*
  - (I) *The drawback item is amended or inserted or a CPC is amended when the goods are still under Customs control; or*
  - (II) *Exceptional circumstances as prescribed in Note 8 to Schedule 5 are approved by Legislative Policy: Customs and Excise.*
- *Two (2) copies of the first page of the DA 66 must be produced with each claim.*
- *The number allocated to the claim by Customs remains with the claim until it is finalised even if the claim is rejected on several occasions.*
- *Should a query be issued by SARS, no further claim(s) will be entertained unless the query has been finalised. All queries must be forwarded to the Branch Office.*
- *If any irregularities are found the claim is queried or rejected with reasons on page four (4) of the DA 66, and the applicant must acknowledge receipt thereof by signing the register."*

The list continues . . .

Let's go back to the most prolifically used 5th schedule refunds we spoke of before; one of these is refund item 536.00/00.00/03.00 and 04.00 as part of the Automotive Productive Development Programme (APDP). This refund can be claimed in respect of imported *"automotive components on which duty has been paid and which have been supplied to a vehicle manufacturer for use as original equipment components in the manufacture of specified vehicles as defined in Rebate Item 317.03 or 317.07 or which have been incorporated in original equipment components supplied to vehicle manufacturers provided".*

The previously mentioned USA Trade Administration's Commercial Country guide on South Africa, said this of our automotive industry: *"Under the South African Automotive Masterplan (SAAM) 2021-2035, the objective is to produce 1% of global vehicle production, or 1,4 million vehicles, per annum in South Africa by 2035 which will substantially improve the country's status and global vehicle production ranking.*

The automotive industry therefore represents an increasingly important strategic and catalytic role in the overall South African economy by impacting directly on many important economic policy goals, such as contribution to GDP, employment, skills development, economic linkages, technology, and innovation."

And critically, they add that *"Imports of automotive products into South Africa remain a function of the success of the APDP, domestic market demand, and currency movements. Under the APDP, the level of imports remains a function of the success of the program, as the benefits can only be used to rebate the import duties on vehicles and eligible automotive components that are imported."*

This is a direct example of how the pearl that is the APDP and its rebate or refund or drawback system, can become swine, if not effectively administered.

Automation of refunds: putting lipstick on a pig?

The proposed new automated system, using new forms, covers parts 1 to 5 of the Schedule 5 refunds (including part 3 in respect of motor vehicles) and some of those in Schedule 6 (part 1F being excise on mineral products and parts 3, 4, and 5 being in respect of other levies).

The system was scheduled to go live on 19 Sept 2022 and as such, the public was informed that the last day to submit manual refund and/or drawback claims for Customs was 15 Sept 2022. However, the system implementation date was delayed. According to the SARS letter to trade dated 12 September 2022, the delay was due to *"further enhancements to the system; to allow more time for trade testing; etc."* The future implementation date is to be advised in due course.

SARS has also advised that registered traders will only have to register a SARS eFiling profile (or activate customs and excise on their existing eFiling profile) in order to submit claims. In addition, SARS will have to have the applicant's updated and verified banking details on the system. The EWP process will remain manual (where applicable to the claim).

Unfortunately, the new system will not enable traders to view and track the progress of claims online. Instead, the client will only be able to track and locate the cases by contacting SARS' Contact Centre (using a case number).

SARS has at least promised to host webinars available on SARS TV on YouTube as training; pilot participants will be selected and notified of their participation in due course.

Regardless of how well-enhanced the automated system may turn out to be, the issues and risks faced by both industry and SARS remain the same. For example, in respect of destructions the question begs: Can the SARS system identify whether the goods being destroyed (for which a refund of duty is applied) are actually goods imported in the previous two years? Do SARS officials actually count or weigh the items when destroying the goods?

Applicants for refunds in terms of Item 536 are required to produce proof from a motor vehicle manufacturer that the relevant imported components or goods were received by them. Does the SARS system effectively ensure that the same quarterly report from such a manufacturer can only be used once by a refund applicant? If not, refunds are being and will be paid to those not entitled to them and the fiscus is losing revenue.

It remains crucial that for the effective facilitation of legitimate trade, the system for administering rebates, refunds, and drawbacks is effective and user-friendly. If this cannot be achieved and maintained, the mechanisms are not achieving their intended purpose.

TRENDS IN SARS CUSTOMS AUDIT AND CONTROVERSY MANAGEMENT

QUINTUS VAN DER MERWE, Partner, Head of Shipping & Logistics (including Customs) Wylie

SARS has increased its customs audit capacity as part of its overall recovery process. This article explores the latest trends in audit and dispute as well as the practical impact on import operations.

SARS plays an absolutely vital role in the well-being of South Africa. The South African Revenue Service Act 34 of 1997 states specifically that SARS is established to make provision for the efficient and effective administration of the revenue-collecting system of the Republic. There can be no doubt that their primary purpose is, therefore, the collection of revenue; this, after all, is the lifeblood for effective government operation and the funding of all infrastructure.

The Customs and Excise Act 91 of 1964 (the Act) provides for the levying of customs and excise duties, surcharges, fuel levies, road accident fund levies, air passenger tax, environmental levies, health promotion levies, as well as the prohibition and control of the importation, exportation, manufacture, and use of certain goods. The Schedules to the Act provide for all these duties, surcharges, and levies. The Schedules also provide for various rebates and refunds.

The customs audit process, both at the time of clearance and post-clearance, is an extremely useful tool used by SARS to ensure compliance. It also provides a way to ensure that rebates, refunds, customs and excise storage warehouses, customs and excise manufacturing warehouses and the like, are properly administered and controlled. The audit framework is multifaceted and complex.

SARS is given far-reaching powers in terms of the Act. Section 4 gives SARS vast investigative powers and sections 87, 88, and 107 give SARS the right to detain goods to ensure that they have been correctly dealt with and to seize the goods or to call for one times the value of the goods if the goods cannot readily be found. If the goods have been irregularly dealt with, as well as to have the goods declared forfeit to the state. All this is in addition to the penal provisions in the Act providing for penalties of up to three times the value of the goods and imprisonment.

However, audit teams do not simply operate to police and ensure compliance. There can be no doubt that areas of risk or potential contraventions are identified to hold audits in order to generate additional revenues for the Republic. In this regard, it is not only the duties, VAT, levies, surcharges and the like, which are then taken into account, but also penalties and forfeiture, even interest, which significantly increase the quantum of payments called for by SARS.

Commerce has often lamented the fact that SARS does not only target the criminal element but often innocent blue-chip companies trying to operate legally with the aim of reaching their revenue targets. The downside of a revenue-driven approach adopted by SARS is that SARS has far-reaching powers once a letter of demand has been issued. Any other entity, subsequent to the issuance of a letter of demand, would first have to issue a summons; then, after following the necessary legal process, obtain a judgment.

"The downside of the revenue-driven approach adopted by SARS is that SARS has far-reaching powers once a letter of demand has been an issue. Any other entity, subsequent to the issuance of a letter of demand, would first have to issue summons; then, after following the necessary legal process, obtain a judgment"

When SARS issues an entity with a letter to demand, the amount demanded is immediately deemed to be a debt to the State, which is due and payable unless the Commissioner has suspended it. The debt does not prescribe for 20 years and SARS has extensive powers to place liens over assets, to have the debt made a judgment, to take steps for the execution of the debt, to appoint banks and other debtors as third-party collection agents, requiring funds which should be paid to the creditor instead of being paid directly to SARS.

While it is possible to apply for suspension of the debt, it has become increasingly difficult to do so, with SARS requesting various financial and other documents in support of any suspension request. SARS, in recent times, has taken a more aggressive approach to secure debts, requesting either full payment or security for the full amount demanded.

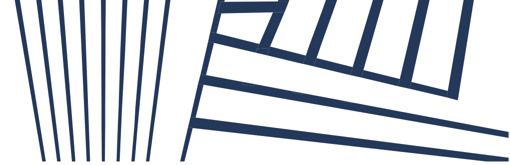
Controversy management is perhaps an unintended but appropriate pun. The Act provides in chapter XA for internal administrative appeal, alternative dispute resolution and dispute settlement. The Tax Administration Act 28 of 2011 also allows for an entity to approach SARS with a request to compromise an admitted debt. Taxpayers are obliged to follow internal remedies before approaching a Court for relief. This entails following an international administrative appeal process and possibly alternative dispute resolution, which is heard internally by a committee consisting of SARS officials. Post-state capture, it seems a trend that officers within SARS are reluctant to easily find in favour of taxpayers, no doubt to avoid criticism or coming under suspicion of favouritism or possibly worse.

Perhaps because they deal with so many cases where there is genuine tax evasion or wrongdoing, there is seemingly a tendency within SARS to view all taxpayers as offenders or wrongdoers. This is not meant to be a slight of SARS. The flip side of the coin is that SARS would argue that most taxpayers maintain that they are entirely innocent of any wrongdoing.

The difference is that SARS is a vast organisation with massive resources empowered by legislation that the Courts have described as draconian to ensure that SARS achieves its objectives. In short, SARS is given very sharp teeth and a very wide mouth.

Conversely, many businesses either do not have specific expertise in the area of law or many are unable to afford to engage the services of an auditing firm, a firm of attorneys or legal counsel. The reality is that many matters simply do not warrant protracted and expensive opposition, so many entities and individuals either choose not to pursue litigation against SARS or settle the matter prior to the date when the court is due to hear the matter.

Put differently; the cards are stacked in SARS' favour.



CASE LAW WRAP-UP

KIMENTHA PATHER, kimentha@taxconsulting.co.za
MONIQUE CARVALHO, monique@taxconsulting.co.za
RICHAN SCHWELLNUS, richan@taxconsulting.co.za

CSARS VS WIESE AND OTHERS (15065/17) [2022] ZAWCHC 188 (9 SEPTEMBER 2022)

Issue

The issue before the High Court in this matter was twofold: the first issue was determining the admissibility of a Defendant's transcript in an inquiry. The second issue was whether the capital gains tax and the secondary tax on companies are considered a 'tax debt' for purposes of section 183 of the Tax Administration Act, No. 28 of 2011 ('the TAA').

Facts

Tullow Oil plc and its subsidiaries ('the Tullow Group') undertook a restructuring of its African operations in January 2007; prior to this restructuring, Energy Africa Proprietary Limited ('the taxpayer') formed part of the Tullow Group.

Later that month, the taxpayer sold its shares and claims in Energy Africa Holdings (Pty) Ltd ('EAH') to Tullow Overseas Holdings BV ('TOH').

In November 2012, SARS ('the Plaintiff') issued a notice to the taxpayer in terms of section 80(J)(1) of the TAA, informing the taxpayer of its intent to effect adjustments to the taxpayer's 2007 assessment following an audit that was conducted by the Plaintiff.

The Plaintiff alleged that the taxpayer was in total liable for R940 million for capital gains tax and secondary tax on companies because the sale of shares and claims during that period of assessment had amounted to impermissible tax avoidance as defined in the Income Tax Act, No. 58 of 1962 ('the Act').

The Plaintiff granted the taxpayer two extensions in submitting a formal response to the audit finding and the Notice. Whereafter, the First Defendant instructed the Second Defendant to obtain the distribution of the loan claim against Titan Share Dealers (Pty) Ltd to Titan Premier Investments (Pty) Ltd and, subsequently, the sale of the taxpayer to Friedshelf (Pty) Ltd.

The taxpayer's attorney disputed the tax liability in totality on grounds being 'substance over form' and the alternative under the General Anti-Tax Avoidance Rules ('GAAR'). It must be noted that at all relevant times, the taxpayer's only asset was a loan claim against Titan Share Dealers (Pty) Ltd to the value of R216 million.

In April 2013, prior to the assessment being raised by the Plaintiff, the taxpayer disposed of its only asset by making a distribution to its sole shareholder, Elandspad. Thereafter, this was further distributed from Elandspad to its holding company, Titan Premier Investments (Pty) Ltd.

The taxpayer's attorney formally responded to the finalisation of the audit letter in September 2013, advising the Plaintiff that the taxpayer disputes any tax liability and that the taxpayer did not have any assets or cash to pay towards the tax liability. The taxpayer, after remaining dormant, was wound up in April 2016 by order of the High Court.

The taxpayer's case

According to the taxpayer, the transaction that took place in 2007 was not simulated and held that the deemed dividend provision contained in section 64C(2)(a) of the Income Tax Act did not apply.

The taxpayer further contended that the transactions under consideration did not constitute impermissible avoidance arrangements and that the sole purpose of the transaction was not to obtain a tax benefit; based on this, the Plaintiff was not obliged to rely on the provision of section 80B of the Act.

SARS' case

The Plaintiff stated that in terms of section 64C(2)(a) of the Act, the distributions are, in fact, deemed to be dividends declared by the companies and paid to its shareholder.

Outcome

The Court held that the capital gains tax and secondary tax on companies amounted to tax debts and are therefore tax due or payable, alternatively due by the taxpayer to SARS as envisaged by the amendments and in section 183 of the TAA.

Section 183 read with section 169 of the TAA states that where a tax debt is 'due and payable', it will not lead to two irreconcilable conclusions. Capital gains tax and secondary tax on companies for which the taxpayer was assessed were amounts that were already owed at the time of dissipation in April 2013.

The secondary tax on companies, which was payable on the deemed dividend, as assessed in August 2013, was due and payable by the end of the relevant dividend period, namely 28 February 2007.

Capital gains tax was payable at the end of the 2007 income tax year for the taxpayer, which was 30 September 2007.

The Court held that the Defendants who arranged for the declaration of the dividend *in specie* could be held liable in terms of section 183 of the TAA in the absence of an assessment at the time of the dissipation.

The Court ordered that the separated issues were decided in favour of SARS with costs (to include costs of two counsels).

Core Reasoning

The Court held that a 'tax debt' as contemplated in section 183 required SARS to issue an assessment before invoking section 183, or the term could be read in terms of section 169, which would allow SARS to issue a notice in anticipation of an adjusted assessment and thereafter determine the taxpayer's tax liability.

The provisions in terms of section 183 of the TAA provides as follows:

> *"Liability of person assisting in dissipation of assets – If a person knowingly assists in dissipating a taxpayer's assets in order to obstruct the collection of a tax debt, the person is jointly and severally liable with the taxpayer for the tax debt to the extent that the person's assistance reduces the assets available to pay the taxpayer's tax debt."*

The Court noted that section 183 was enacted by the Legislature for the purposes of holding a person(s) jointly and severally liable if the person assists in dissipating a taxpayer's assets in order to avoid the payment of tax.

Chapter 11 deals with the recovery of tax; section 183 in Part D of Chapter 11 deals with the liability and collection of tax debt from a party other than the taxpayer. In these instances, where the purpose and aim of the TAA are to hold a third party liable, the notice as issued by SARS on 16 November 2012, which included the notice in terms of 80J(1), is more than sufficient to fall within the true meaning of a 'tax debt' as contemplated in section 183.

Takeaway

SARS has a discretionary right to audit any transactions to verify the same. It is the taxpayer's duty to ensure that all transactions are carried out in a lawful manner; SARS is of the view that ignorance is no longer bliss.

AB VS THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE (TAX COURT CASE NO. 35476) [2022] (23 AUGUST 2022)

Issue

The issue before the Tax Court in this matter was whether it was correct to dismiss the point *in limine* raised by South African Revenue Service ('SARS') against AB (Pty) Ltd ('the taxpayer'), in a dispute in relation to the 2014–2017 tax years, under section 129(c) of the Tax Administration Act, No. 28 of 2011 (the 'TAA').

Facts

The taxpayer held a diverse range of shares in various companies, specifically Holding (Pty) Ltd ('Holding') for purposes of this article, which loaned money to one another.

The unaudited financial statements for the 2014 year of assessment reflected a loan account in the amount of R30 179 163.

The taxpayer claimed that the amounts reflected in the unaudited financial statements were incorrect by virtue of the fact that the amounts included interest on the borrowings payable by Holding to the financial institutions. As a result, the taxpayer effected an amendment thereto; the corrected value was R10 390 949.

SARS' initial review was sceptical of the authenticity of the taxpayer's version of events, followed by concern about how the error in the unaudited financial statements was not recognised for a period in excess of five (5) years.

Subsequently, SARS alleged that the taxpayer gave three different versions of the unaudited financial statements during the time and in between the objection and appeal process. These versions were followed by a fourth version which was submitted after the appeal had been lodged during 2019, when the Alternative Dispute Resolution proceedings took place.

Per the delayed submission of the fourth version, the corrected version of the unaudited financial statements, SARS was unable to investigate the material as part of the objection and appeal process. SARS therefore requested that the matter be referred back to it for examination and assessment purposes.

Practically, an examination and assessment request requires SARS to conduct a further audit of the companies in the taxpayers' group and other related companies for purposes of determining the taxpayers' liability.

The taxpayer's case

The taxpayer objected to the relief sought on the basis that it was not competent with the TAA. The taxpayer further maintained that the material that SARS would be required to consider was already before the court as part of the record forming the appeal.

Subsequently, the taxpayer's argument originated from its subjective interpretation of section 129; it is believed that the court can only give referral relief in terms of section 129(2)(c) after having heard the appellants' appeal. Since the appeal has not yet been heard, the court has no power to give effect to the relief sought; the taxpayer further argues that the decision by SARS is final in nature when making a new assessment.

SARS' case

SARS' contention was that the court does have the necessary power as provided for in terms of section 129(2)(c), read together with section 117(3) of the TAA; insofar as SARS does not intend trying to ascertain any form of final relief and any decision made by SARS is subject to appeal. Section 129, followed by section 117 of the TAA, would apply.

Outcome

The Tax Court found in favour of the appellant and the appeal was upheld with costs.

Core reasoning

Section 129 read with section 117 of the TAA, states as follows:

> *"129. Decision by tax court.— (1) The tax court, after hearing the 'appellant's appeal lodged under section 107 against an assessment or 'decision', must decide the matter on the basis that the burden of proof as described in section 102 is upon the taxpayer.*
>
> **(2)** In the case of an assessment or 'decision' under appeal or an application in a procedural matter referred to in section 117(3), the tax court may—
>
> …
>
> **(c)** refer the assessment back to SARS for further examination and assessment;"
>
> and;
>
> *"117. Jurisdiction of the tax court.—*
>
> …
>
> **(3)** The court may hear and decide an interlocutory application or an application in a procedural matter relating to a dispute under this Chapter as provided for in the 'rules'".

SARS argued that since it was not seeking final relief, only interim relief, which is subject to appeal, then section 129(2)(c) read together with section 117(3) applies.

However, per the taxpayer's argument, insofar as SARS makes a new assessment, the decision is final in nature; it is at this point that the nature of the relief sought by SARS was final in effect.

Accordingly, the taxpayer's argument was upheld and the court concluded that such relief sought by SARS is final in effect; therefore, the point *in limine* could not succeed under section 129(2)(c).

Subsequently and in addition to the above, the point *in limine* was further problematic on the basis that one cannot determine the dispute of facts based solely on the disputed record before the court.

Takeaway

The case demonstrates to us that insofar as SARS wishes to raise a new assessment through the application of a point *in limine*, such relief sought by SARS is regarded as being final in effect; therefore, the point *in limine* cannot succeed under section 129 of the Act.

MR TAXPAYER VS THE COMMISSIONER FOR THE SARS (TAX COURT CASE NO. 45628) [2022] (17 AUGUST 2022)

Issue

The core issue before the Tax Court was whether a payment in the amount of R60 million received by Mr Taxpayer ('the taxpayer') in consideration of a restraint of trade agreement, should be classified as revenue under the definition of 'gross income' under section 1(cB) of the Income Tax Act No. 58 of 1962 ('the Act').

Facts

The taxpayer met Mr A while the taxpayer was conducting research for his Master's degree in chemical engineering. Together, they established a profitable business, processing various precious metals from mining by-products ('the company'). Both men were directors and employees of the company. Regrettably, their relationship soured and the taxpayer was forced out of the company.

The taxpayer launched litigious proceedings against the company by the medium of AB Trust. However, before the trial date, a settlement agreement was concluded between parties, whereby the company would pay AB Trust R160 million. In addition, the settlement agreement contained a suspensive condition that the taxpayer would enter into a five-year restraint of trade agreement and that the company would pay him R60 million in consideration thereof.

Upon receipt of the payment of the R60 million, the taxpayer declared the amount to the South African Revenue Service ('SARS') as a capital gain and paid the amount of R8 million to SARS after receiving a somewhat suspect 'directive' from SARS confirming the same.

Thereafter, SARS was dissatisfied with the classification of the R60 million and adjusted it to fall within the ambit of section 1(cB) of the Act. Unhappy with this development, the taxpayer proceeded to file an objection which was subsequently disallowed by SARS. The taxpayer proceeded to file two appeals: one in connection with the amount received in consideration for the restraint of trade amount (R60 million) and the other for the share purchase agreement amount (R160 million). Shortly before the hearing date, SARS withdrew its opposition to the second appeal with the effect that only the issue of costs thereof had to be considered by the Tax Court.

The taxpayer's case

The taxpayer made several assertions in support of his appeal, which primarily revolved around a 'directive' that had been issued to him by a former SARS official, Mr C. The directive stated that SARS confirmed that the taxpayer had been paid an amount of R60 million which should be classified as a capital gain. The tax payable to SARS was stated therein as R8 million.

Mr C testified in court that he had not signed the document and that it would have been impossible for him to have issued the document, as he did not have access to the SARS system used to issue such directives or tax assessments. Mr C also conceded under cross-examination that the document in question was not a tax assessment.

Thereafter, a chartered accountant and tax practitioner who had assisted the taxpayer with the matter, Mr N, testified that he had advised the taxpayer to tender payment of R8 million to SARS upon perusal of the 'directive'. However, Mr N conceded that he was unsure whether the amount of R60 million should be classified as a capital gain or income and that the 'directive' had made no mention of a restraint of trade.

The taxpayer asserted that the restraint of trade agreement was linked with the objective of protecting the company's shares and not with his status of employment with the entity. Flowing from this, the restraint of trade agreement was an ancillary part of the settlement agreement; as such, the taxpayer contended that the R60 million payment should have been assessed as a capital gain.

Furthermore, the taxpayer made the submission that the company had terminated his employment some four and a half years prior to his receipt of the R60 million; thus, no causal link existed between his former employment with the company and the restraint of trade agreement.

SARS' case

SARS called the operational specialist auditor that performed an audit of the taxpayer's tax return, Mr E, who testified that he had addressed a letter to the taxpayer on 11 January 2018. Therein, he requested that the taxpayer furnish SARS with relevant information for the capital gains tax, as reflected in the taxpayer's tax return for the 2016 year of assessment.

SARS referred to a letter received from Mr N, in which it was clearly stated that the sum of R60 million arose from a restraint of trade agreement and that SARS had issued the taxpayer with a 'directive' confirming that the R60 million was capital in nature. SARS disputed the veracity of the purported 'directive' and referred to a June 2018 letter sent to the taxpayer which confirmed this position.

Outcome

The Tax Court found in favour of SARS and the first appeal was dismissed with costs. In the second appeal, costs were awarded on a punitive scale to the taxpayer.

Core reasoning

As a point of departure, the Tax Court examined two different types of restraint of trade agreements. The first type could be concluded between employees and employers, with the second type being entered into between sellers and purchasers of business entities.

The Tax Court held that the distinction between the two types of restraints is vital when tested against section 1(cB) of the Act. This section explicitly states that any amount received by or accrued to any natural person as consideration for any restraint of trade imposed, due to either employment or the holding of any office; alternatively, past or future employment or the holding of any office, would be classified as 'income'.

The Tax Court held that because a causal link existed between the restraint of trade agreement and both the taxpayer's employment contract and position as director of the company, the R60 million received by the taxpayer should be classified as 'gross income' as per section 1(1) of the Act.

Flowing from this determination, the Tax Court also ruled that it would be reasonable for SARS to levy both interest and an understatement penalty on the R60 million. This was adjudged to be reasonable as the taxpayer was assisted by a seasoned tax practitioner of 27 years' experience (Mr N) and relied on a 'directive' that, at face value, was neither a directive nor a tax assessment.

Takeaway

Taxpayers and tax practitioners should take care to perform due diligence checks on directives or tax assessments seemingly received from SARS to avoid adverse consequences. Furthermore, taxpayers and tax practitioners would do well to determine the type of restraint of trade agreements that they are dealing with and the correct tax treatment of these agreements.

BINDING RULINGS

COLLEEN KAUFMANN, colleen@taxconsulting.co.za
VIKARA KISTNASAMY, vikara@taxconsulting.co.za
KIVASHNA VEERASAMY, kivashna@taxconsulting.co.za

BINDING CLASS RULING: BCR 080
Tax implications for resident beneficiaries of a foreign pension trust (12 August 2022)

Issue

This Ruling determines the income tax, capital gains tax, and estate duty implications of resident beneficiaries of a foreign pension trust ('FPT').

Facts

The applicant is the founder of an FPT. The FPT is a non-resident pension scheme established under trust and constituted by way of a trust deed. The foreign pension trust has internal scheme rules and its proper law is not that of South Africa ('SA').

The applicant intends to offer a financial product which will be housed in the FPT and which is intended to be a pension scheme that will offer SA resident investors access to offshore hard currency retirement investment options with estate and succession planning benefits.

The scheme operates, according to the applicant, as follows:

- A SA resident will make a contribution of cash or assets, either on a once-off or on an *ad hoc* basis, to become a beneficiary of the FPT in order to receive retirement benefits subject to the trustees exercising their discretion in accordance with the scheme rules.
- A SA resident will be eligible to receive retirement benefits upon reaching the 'normal retirement date'. Prior to the normal retirement age, a SA resident will be eligible to receive:

    (i) 'discretionary distributions' of income or capital in the event of incapacity; and

    (ii) retirement benefits from the age of fifty years, subject to approval from the trustees of the FPT.

- The retirement benefits will be funded from the SA resident's initial capital contribution, the growth on that contribution, and any income earned due to the contribution.
- Any income earned prior to the SA resident reaching normal retirement age will only vest in the SA resident upon the trustees exercising their discretion in terms of the scheme rules.
- The FPT will not become obsolete if an investor changes their country of tax residence.
- The FPT will provide protection from creditors and will not form part of the investor's personal assets.
- The contributions and growth thereon will not at any time be encumbered by existing or potential liabilities of other investors.
- Investors will not have beneficial control of the contributions made to the FPT and any growth thereon.
- With respect to beneficiary nominations, an investor's assets may be passed to any nominated beneficiary or into a trust on the death of an investor.

Ruling

The ruling made in connection with the proposed transaction is as follows:

(a) The FPT is not a 'pension fund', 'provident fund' or 'retirement annuity fund' as defined in section 1(1) of the Income Tax Act, No. 28 of 1962 ('the Act').

(b) Section 11F will not apply in respect of contributions made by investors to the FPT.

(c) A contribution made by an investor will not constitute a 'donation' as defined in section 55. Sections 54 and 58(1) will not apply to investors in respect of contributions made to the FPT.

(d) An investor will, upon becoming a beneficiary/member of the FPT, acquire a personal right against the trustees of the FPT to administer the trust appropriately and a vested personal right to the income and capital of the FPT, subject to the time-based restrictions stipulated in the scheme rules.

(e) An investor's personal right to the income and capital of the FPT will have a base cost in accordance with paragraph 20(1) of the Eighth Schedule equal to the contribution made by the investor. Paragraph 81 of the Eighth Schedule will not apply in respect of the personal right of an investor mentioned in this paragraph as the right is not a contingent right but a vested right.

(f) Section 7(1) will apply to the investors of the FPT.

(g) When an investor dies prior to the normal retirement date, the vested personal right will constitute 'property' in terms of section 3 of the Estate Duty Act. The right will form part of the deceased investor's dutiable estate.

(h) When an investor dies prior to no the normal retirement date, they will be deemed to have disposed of their vested personal right before their death for market value in terms of section 9HA(1). Where the requirements of paragraph 54(b) of the Eighth Schedule are not satisfied, the market value of the right will be treated as proceeds for purposes of paragraph 35(1) of the Eighth Schedule.

(i) On the death of an investor after the normal retirement date, the right to an annuity will constitute 'property' as defined in paragraph (b) in section 3 of the Estate Duty Act. The right to an annuity will fall within the dutiable estate of the deceased investor.

(j) On the death of an investor after the normal retirement date, the investor will be deemed to have disposed of the right to an annuity for market value in terms of section 9HA(1). The investor will also be deemed to have disposed of their right to lump sum benefits for market value where the requirements of paragraph 54(b) of the Eighth Schedule are not satisfied.

(a) No ruling is made on the application of section 25B of the Act and paragraph 80 of the Eighth Schedule to the investors.

BINDING PRIVATE RULING: BPR 379 QUALIFYING PURPOSE (03 OCTOBER 2022)

Issue

This Ruling determines the tax consequences of a dividend declared by the issuer of a preference share which was issued for a qualifying purpose after the shares in an operating company financed by the preference share funding are disposed of by the shareholder in the operating company.

Facts

Company H contemplated investment in Company T, an operating company, and requested its subsidiary, the applicant, to provide financial assistance. The applicant raised the funding by issuing cumulative redeemable preference shares to the co-applicant and provided a loan to Company H. The preference shares are 'hybrid equity instruments' as defined in paragraph (c)(i) of that definition, in section 8E(1)of the Income Tax Act, No. 58 of 1962 ('the Act').

The preference share terms contain an 'enforcement right' as defined in section 8EA(1), and would have qualified as hybrid equity instruments as defined in paragraph (c)(i) of the definition of that term in section 8EA(1) of the Act. The ordinary shares in Company T have since been disposed of by Company H because of ongoing losses sustained in the market on the value of the shares.

It is proposed that a preference share dividend be declared by the applicant subsequent to the disposal of the ordinary shares in Company T.

Ruling

This Ruling is subject to the assumption that Company T is an 'operating company' as defined in section 8EA(1), at the time when the applicant declares the dividend.

The ruling made in connection with the proposed transaction is as follows:

(b) Any dividends paid by the applicant to the co-applicant on the preference shares, after the scale by Company H of the equity shares in Company T, will not be recharacterised as income under the provisions of either section 8E of 8EA of the Act in the hands of the co-applicant.

BINDING PRIVATE RULING: BPR 380 TRANSFER OF SHARES IN RESIDENT COMPANY TO NON-RESIDENT HOLDING COMPANY (04 OCTOBER 2022)

Issue

This Ruling determines the tax consequences of the transfer of ordinary and preference shares by a South African resident company (the applicant) to a non-resident, indirect subsidiary (Foreign Company) of the Applicant.

Facts

The applicant as the resident company, holds 90% of the ordinary shares in SA Holdco as the private holding company, which indirectly holds the ordinary shares of SA Opco. SA Opco as the operating company issued two classes of redeemable, non-participating, no par value preference shares to the applicant. Together, the ordinary shares in SA Holdco and the preference shares in SA Opco are referred to as the sale shares. The sale shares will be transferred to the Foreign Company for a price determined with reference to a market valuation done in January 2022.

The financial position of the operating company is weak and, as a result, the sale shares will be transferred for a significant discount, which will result in a capital loss for the applicant.

Conditions and assumptions

This Ruling is subject to the following additional conditions and assumptions:

(a) The applicant holds the sale shares on a capital account.

(b) The Foreign Company does not conduct any business in South Africa through a permanent establishment in South Africa.

(c) The effective rate of tax (taxes on income payable to all spheres of government) applicable in the country of residence of the Foreign Company is at least 18.225%.

(d) At all material times, the Foreign Company is the beneficial owner of the dividends in respect of the sale shares and complies with the evidentiary requirements under section 64G(3) of the Income Tax Act, No. 58 of 1962 ('the Act') to qualify for the reduced rate under the DTA referred to below.

Ruling

The ruling made in connection with the proposed transaction is as follows:

(e) (Subject to the application of paragraphs 38 and 39 of the Eighth Schedule to the Act, the applicant will be required to include any gains or losses realised on the transfer of the sale shares in the calculation of its net gains or losses for the relevant fiscal year.

(f) Under paragraph (d) of the first proviso to section 9D(2A) of the Act, the exemption under section 10(1)(k) of future dividend income received by the Foreign Company in respect of the sale shares from SA Holdco and SA Opco, will be limited and the dividend income must be attributed to the applicant in accordance with section 9D(2), subject to the application of the comparable tax exemption in the second proviso to section 9D(2A).

(g) On the basis that the Foreign Company will own at least 10% of the capital of SA Holdco and SA Opco, the reduced dividends tax rate of 5% will apply regarding dividends received by the Foreign Company in respect of the sale shares (Article II of the Protocol to the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion between South Africa and the United Kingdom).

(h) Under section 2 read with section 6(1) of the Security Transfer Tax Act, No. 25 of 2007 ('the STT Act'), Security Transfer Tax ('STT') will be payable upon the transfer of the sale shares on the taxable amount.

(i) SA Holdco, as the issuer of the ordinary shares, is liable for the STT on the transfer of these shares to the Foreign Company under section 6(2) of the STT Act but may recover that amount from the Foreign Company under section 7(2).

(j) SA Opco as the issuer of the preference shares, is liable for the STT on the transfer of these preference shares to the Foreign Company under section 6(2) of the STT Act but may recover that amount from the Foreign Company under section 7(2).

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