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UNCOVERING TAX EVASION

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CONTENTS

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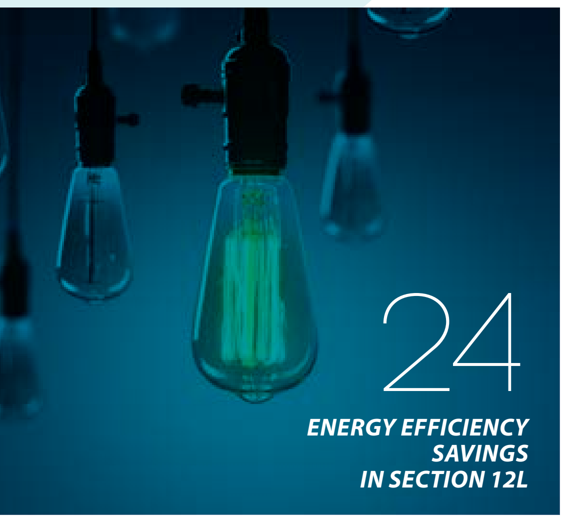
2hrs 45 mins CPD in this issue

FEATURES

TAX & CORRUPTION



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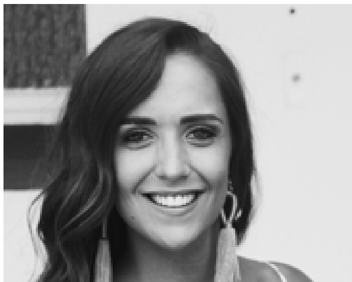

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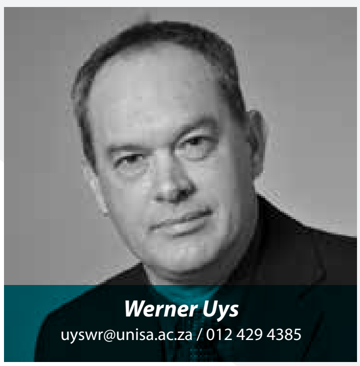

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DO WEALTHY INDIVIDUALS STILL USE SHELL COMPANIES?

This article will guide you through the contorted labyrinths of corrupt money flows, mail box companies, friendly jurisdictions, Dutch Sandwiches and layering.

▶ **BARBARA CURSON,** batier@icon.co.za

The Panama Papers exposed the opaque world that hid ill-gotten gains, assisted corporations and wealthy individuals to avoid taxes, and demonstrated the contorted labyrinths of corrupt money flows. Other prominent leaks followed. The general fallout obscured the legitimate reasons for using so-called shell companies in commercial transactions.

Shell companies, trusts, foundations and partnerships with limited liability features

Shell companies typically have no physical presence (no office, employees or business activity), apart from an address, and exist only on paper. Physical presence is often depicted by a brass plate on a wall of a building. They are also known as front companies or "mail box" companies.

Trusts and limited liability partnerships have the same features. There are many different kinds of trusts, including, discretionary trusts, blind trusts (the trustees are given a "letter of wishes" by the settlor), charitable trusts, trusts with protectors and purpose trusts.

Shell companies

Characteristics of shell companies include:

- They do not disclose the identity of the beneficial owner.
- They are generally formed in offshore tax friendly jurisdictions, which may be termed offshore financial centres (OFCs).
- They do not conduct any business activities in the jurisdiction in which they are incorporated, other than in a pass-through capacity.
- They may have bank accounts, hold passive investments or be the registered owners of intellectual property, property, art works or ships.
- They are used by criminals to launder money or facilitate the receipt or payment of bribes.
- They can be used by individuals for legitimate reasons (e.g., to protect wealth from estate duties, costly divorces, creditors and criminals) or illegitimate reasons (e.g., tax abuse and money laundering).

Shelf companies

A "shell" could include a shelf company. This is a company that has previously been active but has wrapped up its business activities and is lying dormant. Alternatively a shelf company is a registered company that is inactive but is kept "alive" by annually filing paperwork. The company can then later be sold as an "aged" company.

The importance of the jurisdiction

The "friendly" jurisdictions generally have the following common denominators:

- They enable easy registration of shell companies (or any other vehicle that is to be used for the required purpose).
- They are tax friendly, in other words they offer tax relief, for example, where companies that do not carry on business in the jurisdiction pay tax at a lower rate.
- They offer anonymity of the beneficial owner. This is ensured by strict banking and corporate secrecy laws which prohibit the disclosure of any information regarding beneficial ownership. These laws may severely restrict the information that can be shared under a treaty. Some jurisdictions also allow bearer shares, nominee shareholders and nominee directors.
- They often offer specialist financial skills and expertise, lower tax rates to offshore entities, and generally have a wide treaty network.

- Many do not require audited financial statements, nor a financial year-end.
- Some allow notional expense deductions or have special residence rules.

There is no consensus as to what these jurisdictions should be called. However, when dealing with tax avoidance, tax abuse or criminal activities, we should call a spade a spade. Islands have typically been in the firing line and are called tax havens, but they should not receive all the blame.

The US has its own internal tax-friendly jurisdictions that allow for the easy incorporation of shell companies, such as Delaware, Nevada and Wyoming. Further, the US tick-the-box regime facilitates many tax avoidance structures such as the Dutch-Sandwich and other elaborate partnership type structures. The tick-the-box regime allows a US holding to decide whether a partnership should be treated as a company (and therefore consolidated) or as a partnership. A partnership is see-through, that is, partners are taxed in their own capacity.

Money laundering is said to take place in gambling jurisdictions such as Miami, Nevada and Arizona.

The methods used

The methods used to obfuscate transaction flows, whether for legitimate or illegitimate reasons, include:

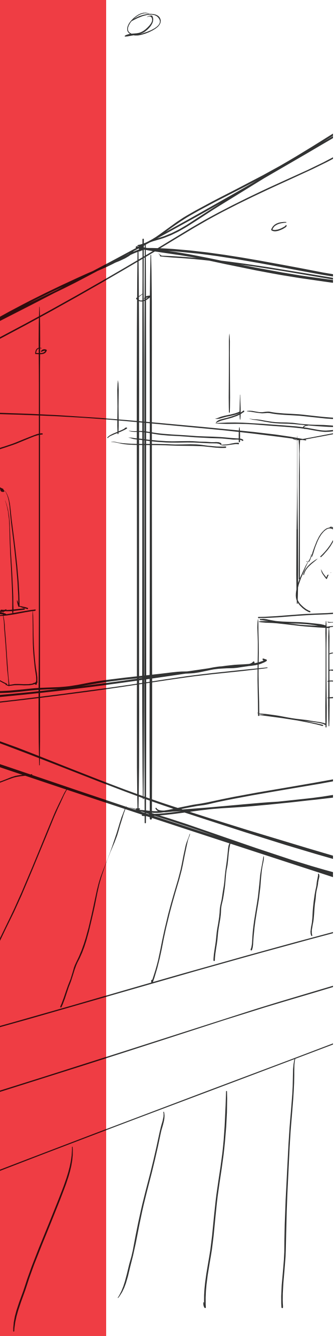
- Hiding international transactions in a complex web of “layering”, using multiple shell companies and trusts that own other entities.
- Power of attorney agreements that allow use of bank accounts by persons not connected to the entity that opened the bank account. The bank accounts can be accessed through the use of credit or debit cards.

What are the structures that an individual could use to transfer funds gained from lucrative contracts?

Example 1

A is a software developer living in South Africa. A establishes a blind trust in an offshore low-tax jurisdiction which offers stringent secrecy provisions. A develops software for the trust. The trust owns the intellectual property in the software. The trust receives all the royalty payments, which are taxed at a low rate. The trust transfers the money received from the royalty payments to a bank account in another low-tax jurisdiction. A holds a power of attorney over the bank account and is issued with a credit card. This is a legitimate business, but A is hiding his or her income.

“Global corruption watchdogs (Financial Action Task Force and the International Consortium of Investigative Journalists) continue to expose the money-laundering methods used by criminals, thereby raising awareness.”



Example 2

A provides professional services in South Africa and offshore. A establishes a partnership in Delaware. Fees for the offshore services are paid into the Delaware partnership. The partnership transfers the funds to a bank account in Panama, registered in the name of a foundation. A foundation is similar to a trust and the beneficiary is not disclosed. The partnership is see-through, A is not a resident of the US and the fees do not originate in the US. A is not taxed on the income in the US. Now that FATCA has been implemented, A can provide the services through a shell company registered in Jersey.

Example 3

A develops a patent in South Africa. However, the patent is not registered in South Africa, it is registered in a shell company in Switzerland. Even if A had previously registered the patent in South Africa, there is a view that a patent (unlike a trademark) does not have to be ceded. It can be registered in many different jurisdictions without being ceded or assigned from South Africa.

Example 4

A (Pty) Ltd invests funds in an unrelated trust or company, B. B on-lends the funds to the shareholder of A, or to an associate of A, at a low interest rate.

Example 5

Bribes or proceeds of corruption can be laundered in South Africa, invested in an offshore centre, passed through multiple layers of shell companies in various offshore jurisdictions – including a blind trust – and reinvested in South Africa as a "foreign investment".

What can be done to curtail tax abuse and illicit financial flows?

Identifying beneficial owners is a key tool in tackling tax abuse, money laundering, illicit financial flows and the financing of terrorism.

An updated international database of the structures used to hide assets and income and the enabling laws and regulations per jurisdiction can be maintained. This database can be shared under the necessary exchange of information agreements.

The OECD facilitates discussions and sharing of the best practice legislation to counter abuse.

The United States introduced the Foreign Account Tax Compliance Act (FATCA) in response to its 2008 global fraud. This was initially one sided, but many jurisdictions have entered into intergovernmental exchange of information agreements with the US.

The OECD initiated the Common Reporting Standard (CRS), which has been co-opted by over 100 jurisdictions. This has resulted in banks, insurance companies, collective investment vehicles and funds sharing information and financial data without the account holders' permission. The US has declined to participate in the CRS. Different languages, legislation and accounting reporting standards can impact the quality and understanding of the data.

Measures to fine the enablers of tax avoidance – the bankers, accountants and lawyers – can be introduced.

Recent exposés such as the money-laundering scandal involving the Danish bank (Danske Bank) and the alleged contract fraud and bribery offences committed by Deme (the Brussels-based dredging giant) demonstrate that money laundering and tax abuse take place in first world economies as well.

CRS is not fool proof, and it can be sidestepped. The passing of personal data under FATCA will be tested in the UK. A US-born British citizen is crowdfunding a judicial review of the action by Her Majesty's Revenue & Customs in handing over her personal data to the US on the grounds that this puts her at risk of hacking. It can also be argued that HMRC's action contravenes the EU data protection regulations.

Global corruption watchdogs (Financial Action Task Force and the International Consortium of Investigative Journalists) continue to expose the money-laundering methods used by criminals, thereby raising awareness.

Tenderpreneurship
Where did the (tax) money go?

▶ **MATT JOHNSTON,** matt.johnston@outa.co.za

A look at the impact of tenderpreneurship on tax revenues and Government services.

If the contract is above board, what's the (tax) problem?

Procurement in the public sector is the most lucrative avenue of organised tax abuse in South Africa. A strong suit of laws (such as the Public Finance Management Act, Preferential Procurement Policy Framework Act, Broad-Based Black Economic Empowerment Act and Municipal Finance Management Act) define the parameters of lawful public procurement. Yet we know that these parameters are increasingly often being circumvented or purposefully misinterpreted. Hence, we enthusiastically await the Public Procurement Bill – due to be tabled in Parliament soon.

One opposed to the bothersome red tape of bureaucracy may ask – so what? Why does it matter when irregular expenditure is incurred openly and honestly if the job gets done? Well, the problem is that tax money is not spent by a government void of partisan politics, accountability and patronage. The State exists primarily for the purpose of delivering public services – which justifies taxation and the expense thereof. In the current system, the State is constituted by deployed members of whatever political party is in power at any given point in time.

Yet, until recently, no legislation providing for the transparency of political party finances existed in South Africa. OUTA participated in the formulation of the Funding of Political Parties Act in 2018 precisely because we understand that the legislation governing public procurement, or the utilisation of tax money, does not necessarily determine the real outcome of public sector tenders. Instead, we find that subcontractors and general service providers are increasingly often awarded public contracts based on their connectedness with and charitability to powerful political leaders and their parties.

The notion of a culture of noncompliance is being thrown around a lot these days. In 2019, the Auditor-General of South Africa revealed the shocking financial state of municipalities as well as state-owned entities. These reports highlight an alarming trend of noncompliance with basic accounting standards as well as increasing fruitless, wasteful and irregular expenditure. This means that crucial organs of state that deliver basic public services are increasingly spending tax money outside the rule of law.

In a nutshell, the laws mentioned earlier do not exist solely to ensure that we get maximum value for money in public sector expenditure. They are also necessary to keep the discretionary power of accounting and executive authorities of all spheres of government in check. So, for us, the core problem is that even though tenderpreneurship may be "above board" and get the job done – it is still illegal and therefore those responsible for it are criminals that undermine the social contract between taxpayers and the State.

If the contract is not above board, how can the income be declared?

SARS' website indicates that a provisional taxpayer is defined in paragraph 1 of the Fourth Schedule to the Income Tax Act, i.e., any natural person who derives income, other than remuneration or an allowance or advance as mentioned in section 8(1) or who derives remuneration from an employer who is not registered for employees' tax.

Some exclusions to the definition are approved public benefit organisations, body corporates, share block companies and so on. Regarding provisional tax, the onus is on the taxpayer to determine whether he or she is liable. That is a serious responsibility. Individuals directly or indirectly undertaking tenderpreneurship refrain from operating transparently as natural persons (for obvious reasons). Instead, we see that persons involved in illicit public procurement – especially those who are known to be acquainted with powerful political leaders – operate behind the veil of corporate juristic persons.

According to an article penned by Dassah and published in 2018, titled *Effectiveness of South Africa's Legislative and Institutional Architecture to Combat Public Sector Corruption:* "Tenderpreneurship involves collusion among government employees, politically-connected people, family members and friends of politicians to flout supply chain management procedures in order to win government tenders for which they are often not the most qualified."

The paragraph from which this excerpt was taken is preceded by a section on state capture and followed by a section that outlines the existing anti-corruption statutory framework in South Africa. The framework is remarkably extensive, but evidently ineffectively implemented. In 2015, National Treasury published a document titled 'Public Sector Supply Chain Management [SCM] Review'. The foreword states: "The negative effects of inefficient public sector SCM, particularly in the procurement phase of the chain, are well documented. Suppliers charge excessive prices; goods and services contracted for and delivered are of poor quality and unreliable; and there is corruption and waste."

The intricacies of tenderpreneurship and how the profits are shifted are beyond the scope of this article. However, it is worth noting some lessons that are being learnt from ongoing state capture exposés. Ill-gotten gains are processed in a manner that makes them largely invisible to the taxman.

We are currently learning exactly how international banking and corporate channels were exploited by state capture culprits to mobilise the proceeds of grand-scale tenderpreneurship without a trace. Naturally, unlawful profits are hidden from SARS as far as possible. Large sums of money have been shifted from the likes of Eskom and PRASA to contracting companies and natural persons through major South African and global banks. Such movements effectively eliminate the necessity for organised criminals to launder money and fraudulently declare it.

Was the full amount of tax on these funds paid?
South Africa is infamous for public sector corruption and inadequate service delivery. It is important to recognise that taxpayers of all sorts do their utmost to avoid paying tax for various reasons. Regressive increases in taxation rates such as the recent Value Added Tax (VAT) hike and unjustifiable increases to the basic cost of living nudge consumers and businesses to minimise their dues to Caesar.

However, high-net-worth individuals have the resources at their disposal to craft formal avenues of tax exemption that effectively reduce their contribution to the fiscus. Here we find the distinction between tax evasion and tax avoidance. The latter may be unethical, but the former is illegal. One of the reasons for National Treasury's persistent overestimation of year-on-year tax revenue is the fact that individuals involved in big chunks of taxable business at the intersection of the private and public sectors refrain from duly paying tax.

To the end of detecting and remedying tax evasion, certain financial forensic or investigative mechanisms are necessary. In South Africa, SARS is entirely responsible for the collection of tax revenue and its Commissioner is solely accountable to the President. Its internal units geared to perform such functions were purposefully de-capacitated by political powers to ensure that organised tenderpreneurship went unnoticed – voilà: tax free loot.

It is safe to assume that a vast magnitude of tax revenue has been lost due to the proliferation of illicit public-private partnerships. What is more disturbing is the real context in which this has taken place – a nation where youth unemployment and socioeconomic inequality is almost the highest in the world. Educational and health care outcomes are also among the worst to be found anywhere around the globe. This means that every shred of taxpayers' money available to government has to be spent optimally.

A consistent recommendation made by experts regarding the administration of tax to ensure compliance and morality is greater access to information. Parliamentary oversight of SARS itself is crippled by laws that prioritise the confidentiality of individual taxpayer information over the public interest. This needs to change. As it stands, the macroeconomic impact of persistent corruption, tax evasion and financial maladministration is such that progressive targeted expenditure may soon be crowded out by ever growing debt-servicing costs. Therefore, the public interest must be prioritised immediately by appropriate legislation that provides for quick and cooperative forensic financial investigations into individual and commercial tax affairs – especially those of politically connected persons and companies.

THE ILLICIT CIGARETTE TRADE: BREACHING THE FISCAL GAP

FRANCOIS VAN DER MERWE, zf@tobaccosa.co.za

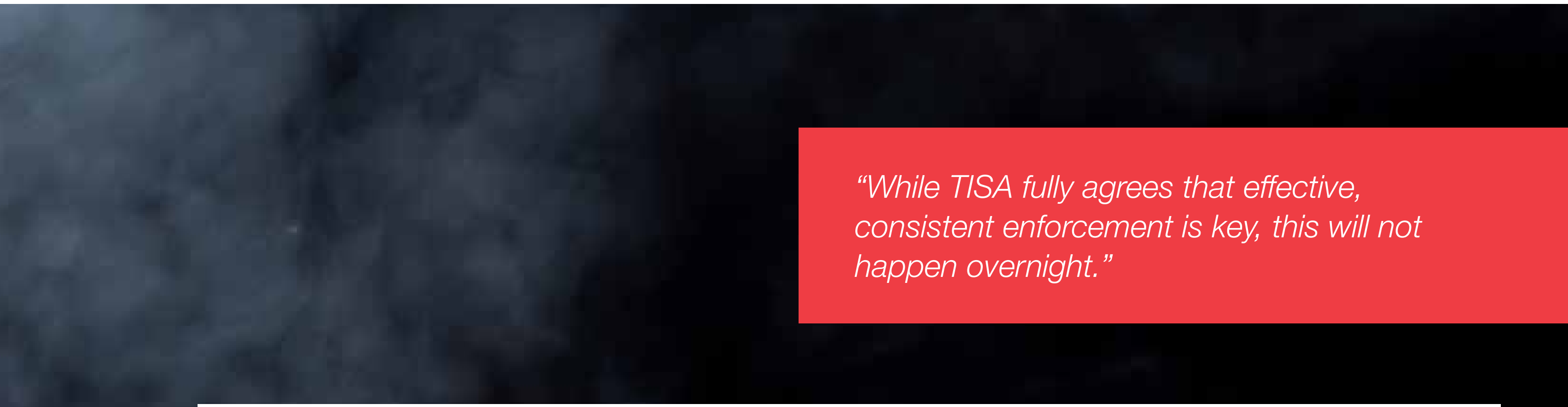
In our article the Chair of the Tobacco Institute of Southern Africa argues that holding excise rates on tobacco at current levels would increase tax revenues collected. Find out why.

It is estimated that South Africans smoke between 31 billion and 35 billion cigarettes per year. Taxes are currently only collected on an estimated 17 to 19 billion cigarettes, which leaves a gap of at least 12 billion sticks, costing the fiscus more than R11 billion this year alone.

Revenue lost

More than R50 billion in tax revenue has been lost to the illicit cigarette trade since 2010. This conservative loss is purely based on excise and VAT on excise, and does not take into consideration any associated taxes payable such as company or personal taxes that have also been evaded. R50 billion lost, which could have been used to fund much-needed infrastructure and services in South Africa.

The minimum collectable tax on a packet of 20 cigarettes is currently R19.16, of which R16.66 is excise tax and R2.50 is VAT on the excise tax. A sizeable number of cigarettes are available in the market for well below minimum collectable tax. This also severely compromises the government's health agenda due to the market being flooded with cheap, non-duty-paid cigarettes.



"While TISA fully agrees that effective, consistent enforcement is key, this will not happen overnight."

An honesty-based system?

Currently in South Africa, a "duty at source" system applies. This entails cigarette manufacturers having to declare their total production for the payment of taxes. It is therefore an honesty-based system which is open to abuse. While cross-border smuggling does occur, the main source of illicit cigarettes sold in South Africa is locally manufactured, non-duty-paid cigarettes.

The effect on legal manufacturers

Legal manufacturers' market shares are negatively affected by the illicit trade, which results in reduced demand for local tobacco leaf, and consequent job losses on farms and for legal manufacturers. Volumes of the Tobacco Institute of Southern Africa's (TISA's) manufacturer members declined by more than 22% in the past three years while total consumption grew during this time. Local tobacco farmers producing for the cigarette industry had to reduce production by 15% in the past two years due to the shrinking of the legal manufacturing industry. If left unabated, the illicit trade may lead to the demise of the primary tobacco industry in South Africa, which includes new farmers in deep rural areas where tobacco is planted as an anchor crop, along with food crops to ensure food security.

Enforcement issues

Limping from a period of utter destruction and demise due to state capture, it will take time for government agencies such as SARS to regain optimal functionality. Audit and enforcement capacities have to be rebuilt and strengthened, amongst others. The new Commissioner of SARS Mr Edward Kieswetter is gallantly leading the road to recovery for SARS, but he has an enormous task on his hands.

While operational improvements are taking place within SARS, short term solutions are required to arrest the losses to the fiscus.

Production counters on cigarette machines are urgently required to ensure correct volumes are recorded in real time so tax payments can be verified rather than relying on manufacturers submitting volumes of production.

Excise rates as a part of the problem?

TISA recently presented to the Standing and Select Committees on Finance in Parliament and proposed holding excise rates at current levels for at least three years, or until the illicit trade is drastically reduced. One of the reasons for this request is that an increase in excise taxes only benefits the illicit operators: their profit margins are increased by the non-payment of taxes. National Treasury differed from this view, noting that it is not an excise policy issue but rather an enforcement issue, which they believed was being addressed. While TISA fully agrees that effective, consistent enforcement is key, this will not happen overnight. In the meantime, the state coffers are leaking billions and TISA is firmly of the view that not increasing taxes further would actually lead to increased tax collections by the State.

A second, related matter is the current excise duty level on cigarettes. National Treasury's targeted incidence approach is set at 40% of the most popular brand within a tobacco product category. National Treasury acknowledged in Parliament that the rate for cigarettes has crept to 43.3% of the most popular price class.

TISA believes that correcting the excise rate level of cigarettes together with an excise rate freeze for a period of at least three years, while enforcement capacity is being strengthened, will lead to SARS actually collecting more revenue in the form of taxes.

Decisive action needed

There is no silver bullet, no single action that can solve the illicit trade in tobacco products. Effective coordination and collaboration amongst law enforcement agencies such as SARS, the South African Police Service and the National Prosecuting Authority are required to combat the scourge and bring perpetrators to book. Neither Government nor the tobacco sector can win the war against illicit traders on their own, but as a collective, through public-private partnerships, decisive action can be taken. This includes capacity building and raising public awareness.

LIFESTYLE AUDITS
The ultimate tool in controlling tax evasion?

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In light of ongoing reports about individuals and companies receiving improper financial benefits, on which the tax due is not paid, our article takes a close look at one of the tools proposed to combat tax evasion.

During the 2018 state of the nation address, President Cyril Ramaphosa called for lifestyle audits on all top Government officials and members of cabinet, including himself. He stated, "It is time that we implement our resolutions on the conducts, also on matters such as lifestyle audits of all the people who occupy positions of responsibility".

A task team – comprising the Anti-Corruption Task Team, Auditor General, Financial Intelligence Centre, Presidency, Public Service Commission, South African Police Service, South African Revenue Service and other entities – was assembled in order to design and develop a vigorous lifestyle audit framework. An effort was made to have the framework completed by the end of October 2018. Unfortunately to date, we have not seen the framework and hence lifestyle audits in this setting have not commenced.

Eskom recently conducted lifestyle audits on 365 senior employees as part of their clean-up operations. High risk cases were handed over to the Special Investigating Unit in order to pursue criminal or civil proceedings, based on wrongdoing such as conflict of business interests and procurement breaches. Eskom reported that these violations amounted to R1.3 billion for the 2019 financial year.

KPMG also adopted a policy of doing integrity checks and lifestyle audits on their employees. According to their CEO Ignatius Sehoole, "One of the lessons KPMG has learnt in the aftermath of suffering major reputational damage is to check whether employees are living beyond their means [as] it seems that, when people get away with things, they start getting greedy and want more and more".

Defining lifestyle "audits"

The term "lifestyle audit" might technically be incorrect due to the meaning of the word "audit". The general definition of an audit "…to inspect… by an independent body" seems to fit the term, but the general purpose of an audit is to provide assurance. The International Standards on Auditing, ISA 200, outlines the purpose of a financial statement audit as being to enhance the degree of confidence of intended users of the financial statements. This objective is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The term "lifestyle analysis" is therefore a more suitable term, as will be seen from the definition below.

A lifestyle analysis is a quantifying process of income and expenses that is utilised to determine the living standard of an individual. By quantifying

"The execution of a lifestyle analysis is usually not as simple as it seems, due to the amount of data needed and the time needed to complete such an analysis."

living expenses, periodic comparisons can be drawn between the individual's expenditures and known income sources. Discrepancies may be attributed to concealed or illicit sources of income.

The analysis may take one or more of the following forms:

- Analysis of bank statements and flow of funds
- In-depth verifications
- Asset declaration statements
- Actual field surveillance

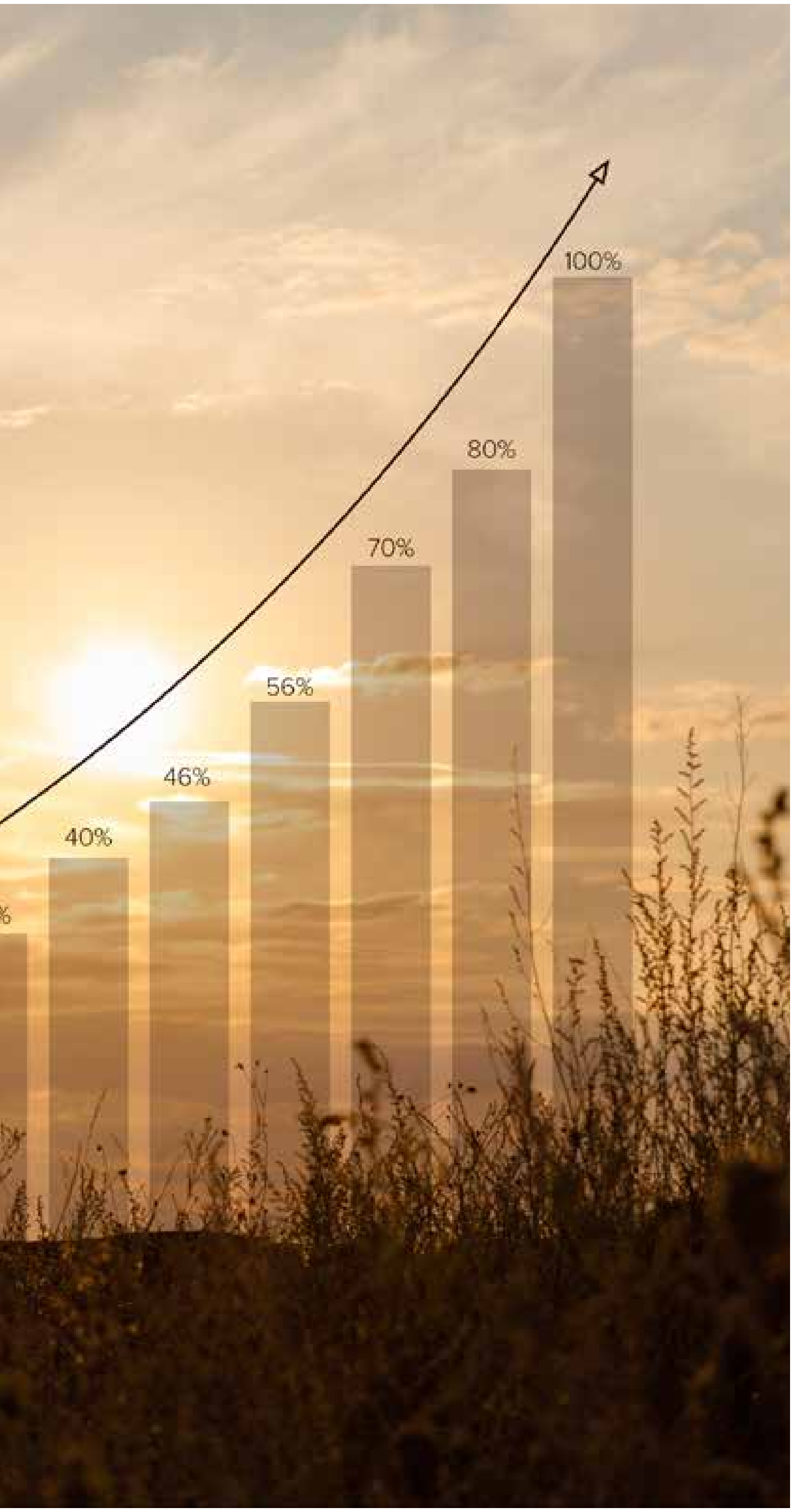
These are all aimed at determining whether or not a person's living standard is appropriate to their disclosed income and expenses.

Although a lifestyle analysis can contribute to the detection of unexplained income or possible proceeds of crime, the findings of a lifestyle analysis must be approached with caution. There may be a reasonable explanation for someone's excessive lifestyle such as inheritances, winnings or financial support received from a wealthy family member or partner.

When conducting a lifestyle analysis, access to a great quantity of essential personal data is needed. Sources of information include:

- Statements of assets and liabilities at the start and end of a period
- Tax returns
- Bank statements
- Companies and Intellectual Property Commission (CIPC) information
- External data from networks such as newspapers, wealth-ranking lists, suspicious activity reports and social media
- Original documents and vouchers for expenditure and for other assets accumulated

The execution of a lifestyle analysis is an expensive and time-consuming process. When performing a lifestyle analysis one also needs to consider whether the information-gathering process is legal and whether the data is sufficient, reliable and valid.



In SARS's *Strategic Plan 2016/17–2020/21*, one of the key initiatives is to conduct targeted compliance interventions in high-risk areas. Such targeted compliance interventions may typically include lifestyle analyses of taxpayers in order to combat tax evasion.

Combating tax evasion

Section 40 of the Tax Administration Act gives SARS the authority to conduct audits to ensure that a taxpayer has declared all income and to validate the deductions claimed. High-net-worth individuals are more likely to be audited due to the perception that they are more likely to understate their income, as established by SARS. High-net-worth individuals are also finding better ways to avoid paying their share of taxes. In a survey conducted by the Organisation for Economic Co-Operation and Development (OECD) nine countries (including the United States of America, United Kingdom, Australia and Japan) responded that indirect methods, which include lifestyle analyses, are used by their revenue bodies to detect and calculate undisclosed income.

It is important to understand that the term "lifestyle analysis" comprises a process and does not refer to a specific method. The methodology used in conducting a lifestyle analysis will derive from the objective and specific method most applicable to a specific case.

Methods

Various lifestyle analysis methods can be applied to identify and calculate the undisclosed income of individuals and companies. These methods differ in efficiency depending on the financial data that is available to the investigator and the nature of the individual's activities. The most accepted methods for individuals are discussed below.

Cash-T method

The cash-T method involves a comparison of the cash received by an individual and the cash spent by using a T-account format. The cash received items are listed in the T-account on the debit (left) side while the cash spent items are listed on the credit (right) side. The amount by which the cash received exceeds the known amount of cash spent (excluding lifestyle expenses) should be compared with the estimated lifestyle expenses of the individual and their dependants in order to detect and calculate undisclosed income.

The cash-T account calculation

Cash received	Cash spent
Gross receipts	Business expenses (excluding non-cash items)
Gross rents	Loan payments
Cash on hand/ in bank (at beginning)	Purchase of assets
Loans received	Cash on hand/ in bank (at year-end)
TOTAL CASH SPENT - TOTAL CASH RECEIVED = UNIDENTIFIED INCOME	

Bank deposits and cash expenditures method
This method aims to reconstruct an individual's income rather than estimating it by means of adjustments. It relies on the theory that when an individual receives an amount in income, they can only spend it or deposit it into a bank account. This means that the individual's gross income must be equal to the sum of all deposits made into his or her bank accounts, together with all cash expenses paid by the taxpayer. This method is used by various revenue bodies to detect and calculate undisclosed income.

Bank deposits and cash expenditures calculation

Total deposits (including business and personal accounts)	R2 000 000
Add: Cash expenditure (cash payments for business, capital and private expenses)	R500 000
Add: Increase in cash on hand	R100 000
Less: Non-taxable receipts (e.g., VAT, transfers between accounts, loans)	(R400 000)
GROSS RECEIPTS AS CORRECTED	**R2 200 000**
Less: Gross receipts as per declaration	(R1 800 000)
UNDERSTATED INCOME	**R400 000**

Source and application of funds method
The source and application of funds method identifies and calculates undisclosed income by relying on the theory that the amount by which all known application of funds (outflow of funds) exceeds all known sources of funds (inflow of funds) represents undisclosed income. The application of funds represents all outflows, e.g., all purchases including assets purchased, liabilities settled, business expenses and personal lifestyle expenses. The sources of funds reflect all inflows received by the individual, including business income, salaries, assets sold and liabilities incurred.

This method is closely related to the cash-T method, but differs in that it uses changes in assets and liabilities together with expenses and income, while the cash-T method focuses on cash expenditures only. The source and application of funds method is more time consuming than the cash-T and bank deposits method. However, it is the preferred method when in a tax audit it appears that the taxpayer's living expenses and wealth could not be sustained by the gross income declared.

Source and application of funds calculation

Sources of funds	Application of funds
Sale of assets	Purchase of assets
Declared income	Deductible expenditure
Non-taxable income	Non-deductible expenditure
Increase in reserves	Personal living expenses
Non-taxable capital gains	Tax
APPLICATION OF FUNDS - SOURCES OF FUNDS = UNDISCLOSED INCOME	

Net worth method
This method identifies and quantifies undisclosed income by comparing the change in an individual's net worth (end of year minus beginning of year) to the amount of income, adjusted for living expenses and income. The method is based on the theory that the difference in an individual's net worth can only be funded by the individual's adjusted income, i.e., income less expenses. The difference between the change in net worth and the adjusted income represents undisclosed income. This is a popular method with various revenue bodies across the world.

Net worth method calculation

Assets (current period)	R2 500 000
Less: Liabilities (current period)	(R1 000 000)
Equals: Net worth (current period)	R1 500 000
Less: Net worth (previous period) [Assets (previous period) - Liabilities (previous period)]	(R600 000)
Equals: Increase / (Decrease) in net worth	R900 000
Add: Personal and domestic expenditure	R300 000
Equals: Total increase in net worth	R1 200 000
Less: Income from known sources	(R800 000)
***EQUALS:* UNEXPLAINED INCREASE / INCOME FROM UNKNOWN SOURCES / INCOME POSSIBLY NOT DECLARED**	**R400 000**

Detecting irregularities

The execution of a lifestyle analysis is usually not as simple as it seems, due to the amount of data needed and the time needed to complete such an analysis. It does, however, provide good illustrations of the flow of money and can be used to detect irregularities on declared income. As for the lifestyle analyses (audits) on public officials raised by the President two years ago, we will have to wait and see if a proper framework is developed in order to effectively conduct these lifestyle analyses.

DIGGING DEEPER WITH FORENSIC AUDITING

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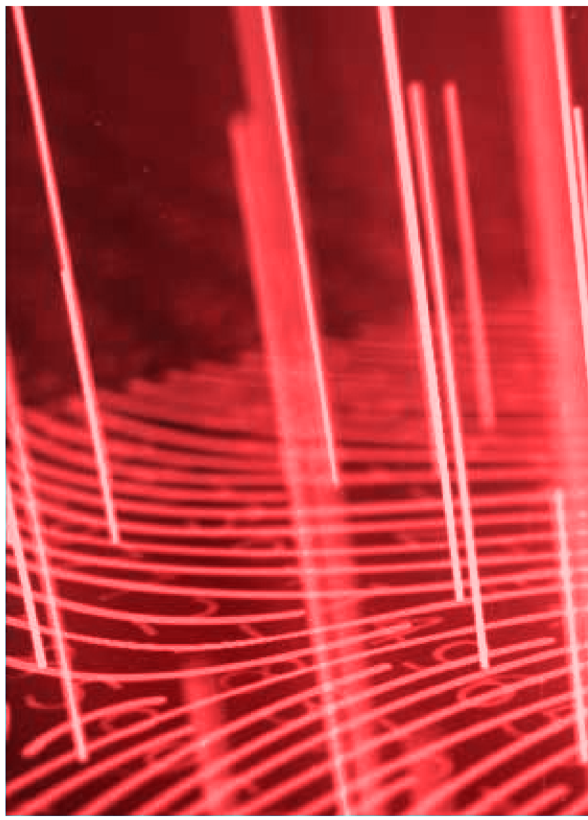
We examine the role that forensic auditors play in investigating fraud and tax evasion.



What does a forensic auditor do?

The legendary gangster Al Capone was never caught for the crimes that made him so famous. He was, however, caught out for cheating on his taxes by an accountant, or for that matter, a forensic auditor. If bookkeeping brought down Al Capone, it makes sense to use a forensic auditor when all else fails.

The question is asked: what does a forensic auditor do? Before answering this question, we must firstly determine who the forensic auditor is. A forensic auditor can be described as a person with exceptional background in the accounting sciences with sufficient knowledge of the law to ensure the conviction of alleged perpetrators for the type of crimes identified through their investigation, based on the evidence of their testimony in court. In simple terms, forensic auditors perform investigative work, such as the examination of financial documents or statements, in order to detect fraud (ACFE Manual, 2014).

As the investigation of fraud and other economic crimes is often very complex and involves facts and evidence of a wide-ranging nature, forensic auditors should do more than just an audit. They must be able to identify arrangements tailored outside the normal commercial transactions range.

A case in point is *S v Meyer and Others* [2017] ZAGPJHC 286. The matter dealt with various pieces of legislation such as the Prevention of Organised Crime Act, and the Financial Intelligence Centre Act, as well as cheque swaps (negotiable instruments), privileged documents (legal professional privilege), prolonging a case without good cause (Criminal Procedure Act), admissibility of data messages and cyber fraud (Electronic Communications and Transactions Act), unlawful VAT claims (VAT Act) and money laundering. The testimony of the SARS forensic investigator (expert witness) was of considerable importance as the court dealt with it at great length. Therefore, aside from assessing financial evidence for transgressions or misconduct, the forensic auditor must also offer support to the legal team during court proceedings.

As a forensic team (a multi-disciplinary team approach is preferable) normally consists of experts such as a legal advisor, IT specialist and forensic auditor, a forensic audit or investigation can be a costly exercise. It is not uncommon for a forensic auditor or legal specialist to head up an investigation.

Forensic auditors also act as expert witnesses in court proceedings. The cost of a forensic audit can be substantial (see *L obo K v L* [2017] ZAECPEHC 26 where a forensic auditor's services were required in divorce proceedings).

A forensic auditor's role may also include receiving allegations, initial planning or mandate to investigate, preliminary investigation, assessment, preliminary reporting, field work, final assessment and reporting (Unisa Programme in Forensic and Investigative Auditing, 2018). Some or all of these could be applicable in various fields of the law, such as determining tax evasion.

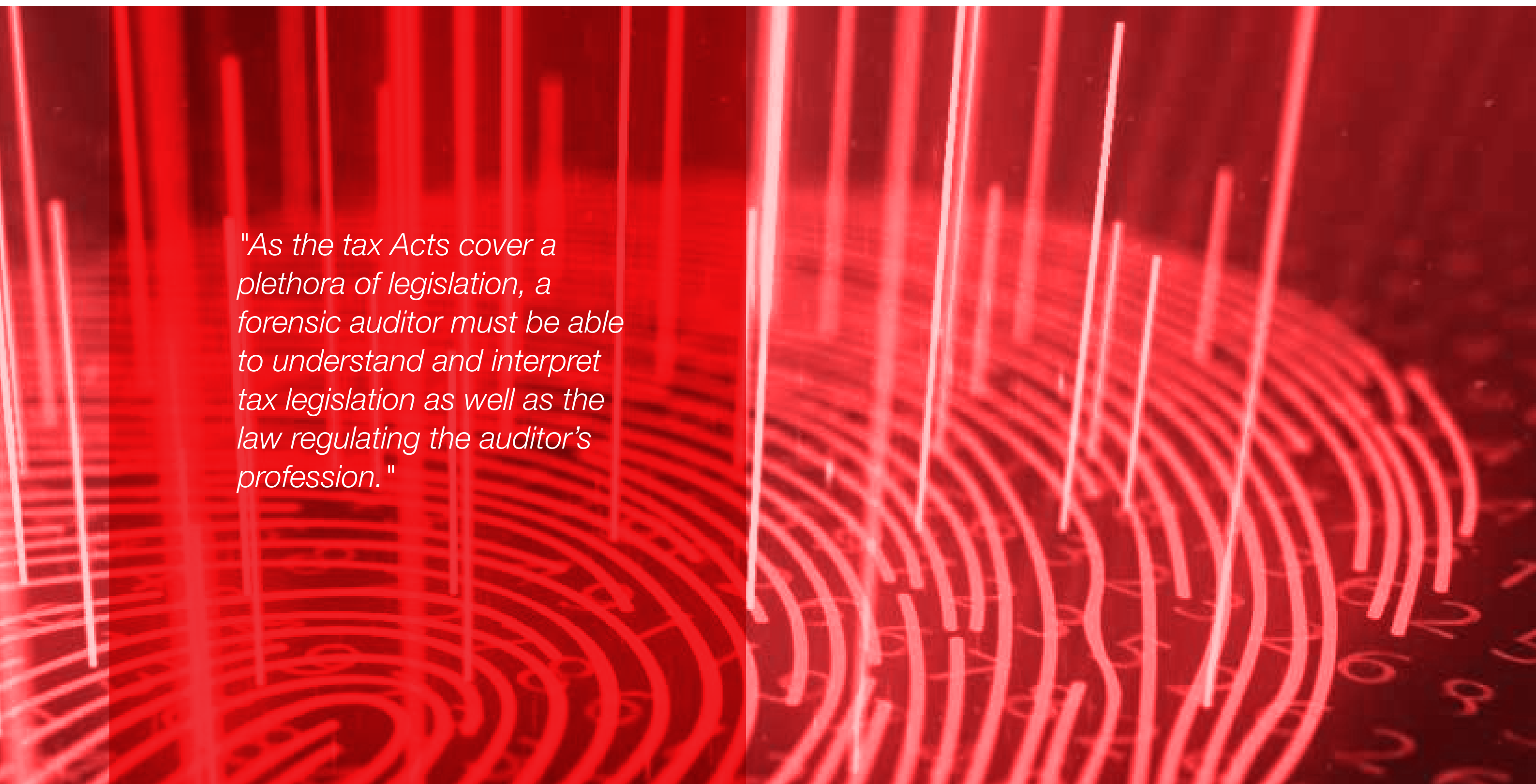
How is this applied to tax evasion?

Legislative framework

As the tax Acts cover a plethora of legislation, a forensic auditor must be able to understand and interpret tax legislation as well as the law regulating the auditor's profession. For instance, in terms of section 45(1) of the Auditing Profession Act, an auditor has a duty to report on irregularities found during an audit. The section stipulates that an auditor must report to the audit profession's Regulatory Board when believing that an irregularity occurred, such as tax evasion. Knowledge of the tax statutes and especially case law is therefore essential. Section 223 of the Tax Administration Act determines that if a taxpayer intentionally evades tax, an understatement penalty of up to 200% can be imposed. The forensic auditor's report could thus have crippling financial implications for a noncompliant taxpayer. Below are some key elements of tax evasion the forensic auditor should consider in advance.

Avoidance vs evasion

Avoidance of tax must not be confused with evasion of tax. While tax evasion typically involves fraud, dishonesty, deception, misrepresentation and non-disclosure, tax avoidance on the other hand assumes some legal arrangement or transaction which



"As the tax Acts cover a plethora of legislation, a forensic auditor must be able to understand and interpret tax legislation as well as the law regulating the auditor's profession."

would not render the taxpayer liable for tax (Goldswain, 2012). Currently, the Commissioner for SARS needs no unique powers to counter tax evasion, which amounts to fraud against the fiscus. If discovered, this could result in substantial understatement penalties for the disobeying taxpayer. Forensic auditors should therefore understand that tax avoidance, in contrast, signifies the application of legal (distinct from illegal) measures in order to lessen the amount of tax payable by the taxpayer. Legal measures employed in commercial transactions to avoid paying unnecessary taxes would also not qualify as reportable irregularities. At times this may be challenging and, when uncertain, auditors should obtain legal advice to confirm whether tax evasion has occurred.

An example of tax evasion is found in *ITC 1658*, 61 SATC 231. The taxpayer company's sole shareholder, who was also a director, annually travelled abroad during the holiday season. The director classified his travels for trade purposes while in fact, they were extended trips to support his love affair with his future wife. The taxpayer included in his travel itinerary many places where, historically, he had conducted no business. It was clear to the court that the director, acting on behalf of the company, had failed to discharge the burden of proof previously imposed on him by section 82 of the Income Tax Act (now section 102 of the Tax Administration Act). This was required to show that the Commissioner's decision in disallowing the travelling claims as a deduction was wrong. It may be assumed that the forensic auditor in this case applied his or her knowledge of classifying travelling expenses in order to identify misrepresentations by the taxpayer in claiming deductions for overseas travelling expenses.

Avoidance vs planning

Another area where a forensic auditor requires expertise is in distinguishing between tax avoidance and tax planning. There is no recognised distinction in legislation. Tax avoidance constitutes an aggressive form of tax planning by exploiting ambiguities in the tax laws to their maximum. Transactions tailored for tax planning may involve elements of abnormality, unexplainable business purposes or questionable legal substance. If proven, a successful application by the Commissioner for SARS of sections 80A-L of the Income Tax Act can be filed.

This is illustrated in the *Steinhoff* probe by PwC, where the manipulation of a set of financials, such as the addition of inflated values to properties, went beyond the normal range of commercial transactions (Fin24, 2019). The PwC forensic probe focused on accounting irregularities, accumulated some 3 000 pages of

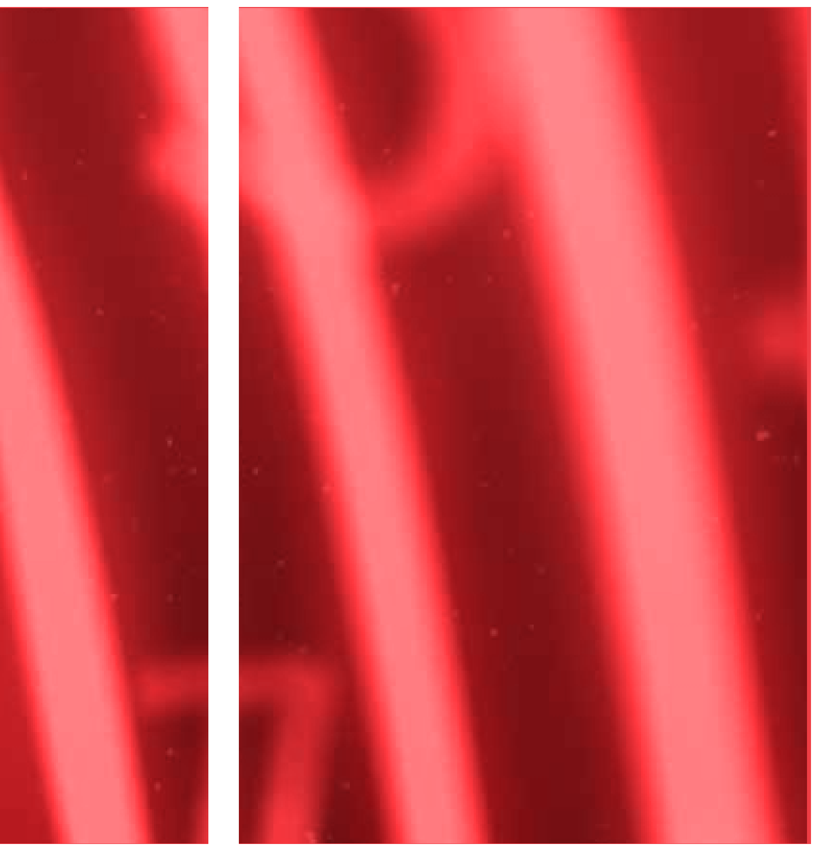
analysed evidence and took almost 15 months to complete and the matter is yet to be concluded. The lesson learned from *Steinhoff* is that a forensic auditor's work will always be multi–disciplinary, it has little regard for time constraints and requires spur-of-the-moment decision making which could have dire consequences for the party involved. It is the task of a forensic auditor to provide an expert opinion based on facts, not an opinion which favours the client (Fitzhugh, 2019).

"Forensic auditors … are best equipped to identify questionable business rationale and accounting treatment leading to tax evasion."

Are there enough forensic auditors to go around?

Taking account of the vast territory to be covered, are there enough forensic auditors? This question can be answered by quoting the number of members of the professional bodies for forensic examiners or practitioners, which may run into tens of thousands. Such an answer will, however, be misleading in the context of this article.

The more relevant question would be: Is there legislation that requires forensic auditors to investigate and testify on tax evasion? And the answer is: No, although forensic auditors, who also have competencies such as in-depth knowledge of tax legislation combined with business and accounting knowledge, are best equipped to identify questionable business rationale and accounting treatment leading to tax evasion.



Should the role of forensic auditors to detect and investigate tax evasion be legislated, professional bodies such as the Association of Certified Fraud Examiners (ACFE) and the Institute of Commercial Forensic Practitioners (ICFP) will be able to provide names of members that possess the required competencies. These members can be contracted by the tax authorities or by taxpayers to detect and investigate instances of tax evasion.

These forensic auditors can, as in the case of Al Capone, perform lifestyle audits on individual entrepreneurs as well as senior staff in companies and state entities, to detect tax evasion by non-declaration of income and assets. Tax evasion by companies may be more difficult to identify but analysing the calculation of all the different types of taxes for which a company is liable may raise red flags leading to further investigation. For example, revenue declared for income tax versus for VAT can reveal the skimming of income when the intention was to reduce the VAT liability. Similarly, expenses reported as deductible for income tax but not for VAT may point the forensic auditor to more red flags.

In conclusion, the role of the forensic auditor to help detect tax fraud should be supported and developed to help narrow down the vast territory to be covered.

CORPORATE TAX CHALLENGES

IMPROVING EFFICIENCY THROUGH AUTOMATION

Michael Mncube, Tax Product Manager at CaseWare Africa, a division of Adapt IT, elaborates on corporate tax challenges and how automation can improve efficiency.

The Income Tax Act requires all businesses liable to taxation to register with SARS as taxpayers. This comes with income tax return submissions which must be done 12 months after the tax year-end. In addition to annual income tax returns, every company is required to submit provisional tax returns.

The Challenges

Timelines

Timelines are unquestionably important in the whole process of tax return submissions. All tax practitioners concur that taxes and timelines go hand in hand. Missing such deadlines incurs additional penalties coupled with interest. All of these add up to additional costs on clients' bills. Time definitely costs money in the tax world.

Given that legislation allows for companies to select their own year-end dates, there is a high probability that a single tax practitioner will have a portfolio of clients with different year-end dates. For a single tax client, the tax practitioner needs to be cognisant of four dates: the first; second; and possibly, the third provisional tax, as well as the annual income tax return due dates. Imagine having a large portfolio of tax clients and all with different tax year-ends – now that is a nightmare guaranteed to keep a tax practitioner awake at night.

Provisional taxes

Provisional tax is not a separate tax from income tax but a method of paying the income tax liability in advance, to ensure that taxpayers do not have huge tax debts on assessment. This is done through the submission of an IRP6 Provisional Tax Return. Provisional tax allows the tax liability to be spread over the relevant year of assessment. Taxpayers are required to pay at least two amounts, based on estimated taxable income, in advance, during the year of assessment. A third payment is optional after the end of the tax year, but before the issuing of the assessment by SARS. On assessment the provisional payments will be off-set against the liability for normal tax for the applicable year of assessment. Issues normally arise when estimating taxable income, as when this is incorrectly done it might result in penalties being imposed by SARS.

Corporate income taxes

Corporate income tax is a tax imposed on companies resident in the Republic of South Africa (i.e. incorporated under the laws of, or effectively managed in, South Africa and that derive income from within or outside the Republic). Non-resident companies that operate through a branch or that have a permanent establishment in South Africa are subject to tax on all income from a source within the Republic. Payment of such taxes is through the submission of an ITR14 income tax return. This return comes with its challenges.

If gross income as disclosed on the first page of the ITR14 tax return does not agree with the aggregate total revenue and total other income, as disclosed in the income statement section, the ITR14 will not print or cannot be submitted.

Getting the right number in the right box of the ITR14 tax return is a challenge and consumes a bit of time. Take gross income for instance, which comes from three different fields in the Statement of Comprehensive Income (Income Statement) namely adding Revenue to Investment and Other Income.

For the Asset section of the ITR14 tax return, splitting the non-current assets section is also a hassle. The numbers are not disclosed on the same page of the Statement of Financial Position (Balance Sheet): this must be unpacked from both the face of the balance sheet and the property, plant and equipment note.

These processes are daunting and time consuming. Getting this wrong poses a risk for tax practitioners as there might be reviews or audits imposed by SARS, meaning further time investment and costs to the taxpayers.

Penalties and interests

Earlier this year SARS announced the implementation of administrative penalties on companies that do not comply with the requirement of submitting their tax returns. The penalties range from R250 to R16 000 per month that non-compliance continues, depending on a company's assessed loss or taxable income.

With the possibility of penalties, there is now a more stringent requirement to stick to tax return submission deadlines in order to avoid such penalties and interest.

The solution

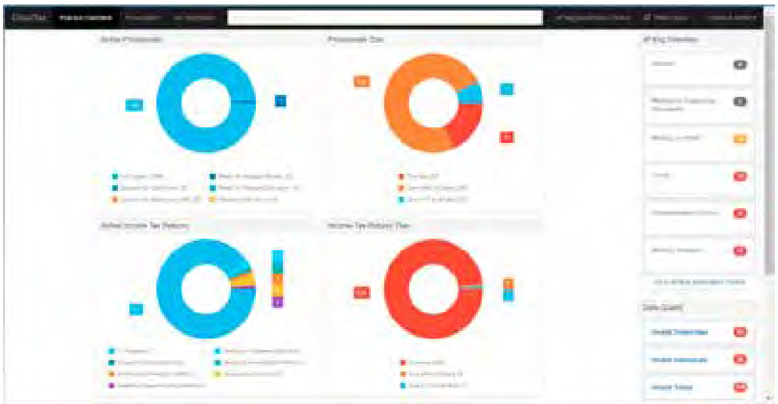
Automating your business practices will save you both time and money. Your administrative time will be reduced. Automation can avoid costly mistakes and disputes with SARS by 'getting it right the first time'.

With automation, tax practitioners will position themselves as strategic advisers. They will move into advisory roles and away from the traditional administrative role. One of the ways technology can create efficiencies is when tax practitioners make use of automated systems to submit their income tax returns.

Automated tax software solutions, such as CloudTax offered by Adapt IT – CaseWare Africa, can automate the income tax submission process. This process is usually done manually by tax practitioners and takes a lot of time.

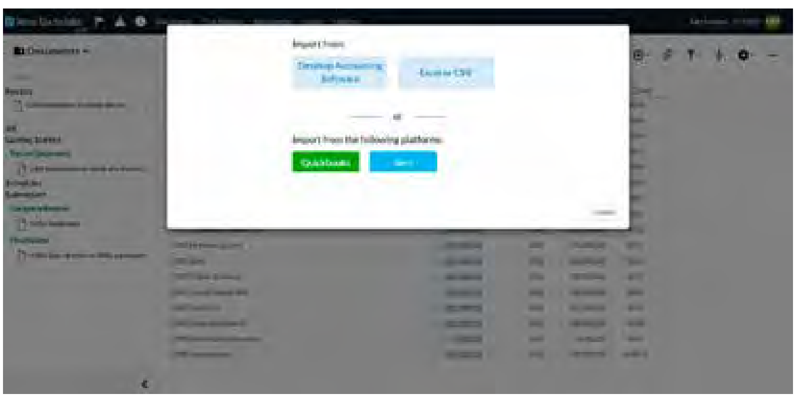
CloudTax is an automated cloud software that allows tax practitioners to store historical tax returns in the cloud, synchronise SARS correspondences and letters, track the work done by multiple professionals on a company's returns, and create provisional tax returns 60 days before a deadline imposed by the tax authority.

Keeping a manual diary of deadlines is a thing of the past – CloudTax notifies you of all tax deadlines (income tax and provisional tax) 60 days before due dates and keeps track of such until returns are submitted through a single dashboard.



The aim with CloudTax is to save tax practitioners time and ultimately money, over and above minimising errors – if not actually eliminating them completely.

CloudTax comes with an ITR14 tax return solution, the Corporate Tax Product which has automated integration with SARS synching. Populating the ITR14 has never been this easy. Using the solution puts the right number in the right box. The ITR14 is pre-populated through automated integration with CaseWare Working Papers. CloudTax also incorporates flexible integration with Xero, QuickBooks and Excel. Through automation, completing the ITR14 has been reduced to only seven simple steps.



THE CARBON TAX: WHERE ARE WE NOW?

15 minutes CPD

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Six months into its inception, what has been the impact of the carbon tax and what can we expect from it in 2020?

In its bid to tackle climate change, the South African Government has thrown most of its weight behind setting a price on carbon emissions. This will start with an initial marginal carbon tax rate of R120 per ton of CO_2q (carbon dioxide equivalent) applied to direct emissions that exceed a tax-free threshold. Annual tax rates will increase by CPI plus 2% during the first phase of implementation.

Overview

The primary objective of the carbon tax is for emitters in South Africa to change their behaviour and thereby assist the country to meet its climate commitments under the 2015 Paris Climate Agreement.

To allow businesses to adapt and transition to low-carbon alternatives in the first phase of the carbon tax (2019-2022), various tax-free allowances, including capped offset allowances, are applicable to a maximum of 90% or 95% of total emissions emitted, depending on how such emissions are categorised. The required categorisation of greenhouse gas (GHG) emissions into three categories makes the calculation of a company's liability highly complex. The categories are energy, process and fugitive, and each category receives a different tax treatment in accordance with the Act.

At the time of writing this article, two regulations that would define eligibility of emitters for the tax-free allowances are still in draft form, with an expected finalisation date of the first quarter in 2020. These are:

- Z-factor regulations that define emission benchmarks for sectors and sub-sectors. When an emitter achieves such a benchmark, 5% could be added to the company's basic tax-free threshold of 60% that is awarded to most sectors.
- Trade exposure regulations that identify trade exposed sectors. A sector could be awarded up to 10% incrementally. Trade exposure eligibility would need to be reviewed by National Treasury on a regular basis in accordance with fairly complex calculations and trade data.

The tax-free allowances that are clear thus far are:

- 5% allowance if an emitter participates in the voluntary carbon budget system orchestrated by the Department of Environment, Forestry and Fisheries.
- 10% allowance for process and fugitive emissions.
- 60% basic tax-free threshold awarded to most emitters. There are sectors which qualify for a higher allowance in this regard (e.g. aviation)) and the waste sector is fully exempt, i.e. a 100% tax-free threshold is awarded.
- Offset allowances for defined projects can reduce the tax liability by between 5% and 10%, depending on the category of emissions. A taxpayer may also purchase these offsets in the open market.

The fact that regulations referenced in the Carbon Tax Act are not yet promulgated places emitters in an extremely awkward situation, as they are not in a position to accurately determine their tax liability for statutory and financial reporting purposes.

Is the carbon tax achieving its stated aims?

The fact that tax-free thresholds are provided for sounds pretty noble and accommodating. However, the opposite is in fact the case when an energy intensive and coal dependent industry like iron and steel is considered. The tax liability – even if most tax-free allowances are obtained or achieved – will still be totally disproportionate compared to earnings potential, and hence unfair.

Changing behaviour?

The iron and steel industry depends on coal as a reductant, with no alternative technologies being available to convert iron ore to steel. Scrap-based iron and steel production may have better GHG emission attributes, but the reality is that only 30% of the world's steel can be produced via this route due to scrap availability globally. Consideration should also be given to the fact that scrap has its origins from iron ore based production. The objective of the tax to change behaviour is thus not at all realistic and the question needs to be asked whether it is not just a concept that was introduced to raise revenue.

Unfair competition?

Carbon tax revenue will also not be ring-fenced – a request from business that was not entertained to date. Other countries that introduced a carbon tax, for example in the European Union, exempted some sectors such as iron and steel and cement or awarded free emission allocations. This was to prevent a migration to jurisdictions where carbon tax is not levied. To date, National

"Industry's pleas are not based on denialism, but rather on the future of South Africa's manufacturing sector."

Treasury has not acknowledged this approach and they maintain that adequate provision is made via the tax-free allowances.

In the South African context carbon intensive products like steel compete with imported material from countries where no price is being levied on carbon. This is a serious threat to the competitiveness of local industries – on top of having to deal with high regulated costs such as electricity and transport.

An iron ore based manufacturer could reduce its tax liability by using higher quality imported coals, but should local job opportunities be compromised? Carbon tax also ignores the GHG footprint emissions associated with such imports, which may increase due to shipping.

The expectation is that, where possible, emitters will attempt to pass their tax liability on to the consumer. Here the question is whether the consumer is spoilt for choice. In most cases not. Hence the question about fairness can be raised again.

Industry in general has been accused of being denialists but the above arguments should be considered. There is a need to realise that the future of the South African economy is at stake if the whole carbon pricing concept is not implemented delicately. Especially energy or carbon intensive industries that are not sunset industries need further assistance and support. Steel and cement, for instance, may become crucial products when adaptation measures need to be implemented. However, such manufacturing facilities may not be present in South Africa in future if aggressive carbon pricing policies are continued: imports from jurisdictions with no carbon pricing will become far more feasible.

To make things worse, the Department of Environment, Forestry and Fisheries has published a Climate Change Bill that would formalise the concept of carbon budgets. Alignment with the carbon tax has not been successful to date – can South Africa afford two mitigation instruments regulated by two different pieces of legislation?

Other considerations to be taken further

From the above it can be concluded that the global playing field is not level and hence trade could become distorted. Do we really wish to promote cheap commodity imports whilst our local manufacturing industry is suffering from high carbon prices? In order to accommodate local emitters, the possibility of border tax adjustments has been raised with National Treasury for products like steel. These are seen as too cumbersome, which might be true. However, the consequences of this burden not being tackled could well be disastrous.

Globally, industries like iron and steel face the challenge of developing carbon neutral technologies by 2050. Financial support from European authorities for this is generous. In South Africa such support is lacking and any tax breaks re energy efficiency (e.g. section 12L of the Income Tax Act) are simply not enough. Tax breaks are also of no immediate benefit when companies have significant assessed losses and where profits are small to non-existent – a reality within our economy. Tax breaks should rather be incorporated into the Carbon Tax Act and not the Income Tax Act.

How much tax revenue is being generated?

There is still some uncertainty about the total carbon tax revenue that SARS will collect, but the table below reflects some figures as published by COVA.

Eskom, Sasol and ArcelorMittal are the top three direct emitters of GHGs in South Africa with the magnitude differing significantly from first to third place. These sectors will bear the brunt of the carbon tax from a financial perspective.

Carbon tax liability in South Africa

Year	Total Tax Liability	Tax Liability Excluding Eskom	Tax Liability Excluding Eskom and Sasol
2019	R 8 billion	R 2.4 billion	R 863 million
2020	R 14 billion	R 4.38 billion	R 1.569 billion
2021	R 15.7 billion	R 4.64 billion	R 1.663 billion

Source: Carbon Offsets and Carbon Tax presentation made by COVA, 12 September 2019.

Conclusions

The stated purpose of the carbon tax is to change behaviour and affect positive change from a climate perspective - a concept that is agreed with. The reality is that this is not always possible. Where relevant new technologies are not available or where other unintended consequences like the import of higher quality raw materials or industry migration to other jurisdictions may occur, more support and understanding is required from government. For the iron and steel industry, the tax is an additional punitive measure and many other manufacturing industries will concur.

What is now being called for is a constructive debate across all spheres of government and business. Legislators cannot ignore the effect that carbon pricing policies may or will have on struggling energy intensive sectors, for instance iron and steel. Industry's pleas are not based on denialism, but rather on the future of South Africa's manufacturing sector.

THE FUTURE OF THE 12L INCOME TAX ALLOWANCE ON ENERGY EFFICIENCY SAVINGS

▶ **HEMAMALINI MOODLEY,** hemamalini.moodley@sasol.com

Our article reviews the rationale for incentivising energy efficiency and the interaction between the section 12L allowance and the relatively new carbon tax.

The Paris Agreement was adopted on 12 December 2015 at the 21st session of the Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC CoP21). The Agreement is a comprehensive framework which will guide international efforts to limit greenhouse gas emissions and to meet all the associated challenges posed by climate change. It signals a change in pace towards low carbon development from 2020 onwards through commitments of countries to ambitious national plans. This outcome recognises that climate change represents an urgent threat to human societies and the planet, requiring the widest possible cooperation by all countries and other stakeholders.

Global commitments to mitigate climate change

Seventy-seven countries committed to cut greenhouse gas emissions to net zero by 2050, while 70 countries announced they will either boost their national action plans by 2020 or have started the process of doing so. On transitioning from brown to green energy, Michael Bloomberg committed to increase the funding and geographic spread of his coal phase-out efforts to 30 countries. Already, his work has helped to close 297 out of 530 coal plants in the US.

The United Nations Climate Change Summit held in September 2019 delivered critical platforms for improving energy efficiency and reducing the growing energy needs for cooling. The “Three Percent Club” coalition is working to drive a 3% annual global increase in energy efficiency and the Cool Coalition is setting ambitious national cooling targets for its members with the potential to deliver up to 1 degree on the pathway to a 2050 net zero-carbon world.

What does this mean for South Africa?

The main objective of the Paris Agreement on Climate Change is to limit the global temperature increase to well below 2 degrees Celsius, while pursuing efforts to limit the increase to 1.5 degrees. The recognition of the 1.5 degree target is of central importance to South Africa as an African and developing country that is highly vulnerable to climate change.

Under the Paris Agreement on Climate Change, to which South Africa is a party, governments committed to significantly reduce their carbon emissions by phasing out fossil fuels – without doubt a challenging task for South Africa, given that 90% of energy is still produced from coal.

In anticipation of transitioning to a lower-carbon economy and supporting the global call on climate change, legislation in the form of section 12L of the Income Tax Act came into effect from 1 November 2013. The intent and purpose of section 12L was to incentivise taxpayers to make upfront investments relating to energy efficiency savings despite the perceived long pay-back periods. The section 12L incentive was an appropriate mechanism to encourage such behaviour, given the contribution that energy efficiency savings can make towards a reduction in the demand for energy (especially electricity), thereby resulting in the reduction of CO_2 emissions (knowing the fossil fuel intensive nature of energy production in SA).

Section 12L(1) states that a taxpayer can qualify for a deduction from income of an amount in respect of energy efficiency savings by that person in respect of that year of assessment ending before 1 January 2020. The amount of the deduction must be calculated at 95 cents per kilowatt hour or kilowatt hour equivalent of energy efficiency savings. The energy efficiency savings are determined by an accredited measurement and verification professional using a standardised baseline methodology. The energy efficiency savings certificate, which is issued by South African National Energy Development Institute, is a prerequisite for the allowance. SARS has acknowledged that the process to claim a section 12L energy efficiency saving is highly technical and very complex. SARS has since issued Interpretation Note 95 to provide guidance to taxpayers around the interpretation, process and application of the said legislation.

The Minister of Finance, Mr Tito Mboweni, announced in his Budget Speech on 20 February 2019 that the section 12L energy efficiency tax incentive, which was due to expire by 31 December 2019, will be extended to years of assessment ending before 1 January 2023 to encourage additional investment in energy efficiency. The change in legislation was confirmed by the Taxation Laws Amendment Bill 18 of 2019, introduced in Parliament on 30 October 2019.

Energy efficiency incentive versus carbon emissions deterrent

Recent studies (https://www.iea.org/weo2019/) have shown a distinct rise in African energy consumption, so much so that by 2040 Africa's demand for energy is likely to exceed that of both India and China. Africa's infrastructure development, unfortunately, is not set to follow the same path, although the energy implications of African urbanisation trends are still profound. The expected growth in population in Africa's hottest regions also means that up to half a billion additional people would need air conditioners or other cooling services by 2040.

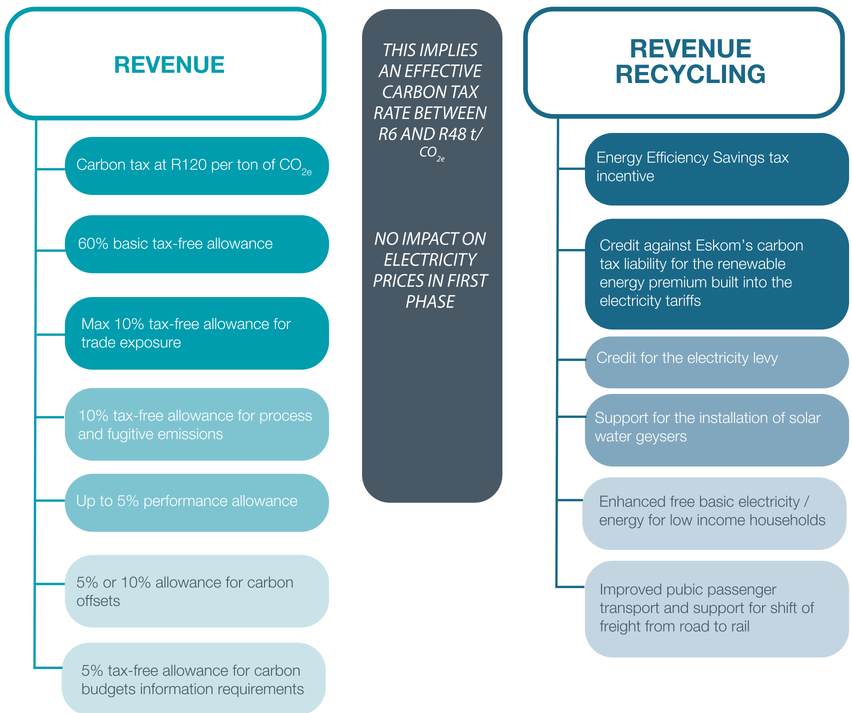
However, the announcement to extend the section 12L energy efficiency savings until 31 December 2022 coincided with the introduction of the carbon tax. The carbon tax is effective from 1 June 2019 and is established by the Carbon Tax Act 15 of 2019 (read with the Customs and Excise Act 91 of 1964). It gives effect to the polluter-pays principle, prices greenhouse gas emissions and aims to ensure that businesses and households take these costs into account in their production, consumption and investment decisions.

The tax will not only force emitters to reduce emissions but also ensures South Africa meets its commitments under the 2015 Paris Climate Agreement. Since there was commitment by legislators to review the tax after three years, at this stage the design and framework therefore entitles qualifying emitters specific allowances until 31 December 2022.

The National Treasury's rationale for the design and implementation of the carbon tax was to act as a deterrent so that emitters of greenhouse gases (GHGs) change their behaviour and start the process of reducing emissions and transitioning to a lower-carbon economy. This has been confirmed by National Treasury in the suite of related policy and discussion documents, wherein it is stated that the purpose of the carbon tax is not to generate revenue for the fiscus. The carbon tax needs to be bolstered by well-designed implementation mechanisms that reduce overall complexity while ensuring that the objective of such an economic instrument is rendered effective. Currently, this remains a challenge.

The first phase of the Carbon Tax Act runs from 2019 to 2022, at which point the tax would likely be aligned with the carbon budget process of the Department of Environment, Forestry and Fisheries. While the framework legislation was promulgated, requisite subordinate legislation (regulations pertaining to carbon offsets, trade exposure and performance benchmarks) is still outstanding. The carbon tax is R120 per ton carbon dioxide equivalent, escalating at CPI + 2%, less the allowances allocated for the sectors that a company falls into. This regime (tax rate, allowances and escalation) is fixed until 2022. However, we are not able to determine potential liability beyond 2022 as the nature of the budget regime still needs to be determined. These allowances significantly reduce the effective tax liability per ton to between R12 to R24 (see Figure below), with different categories of emissions having different prices within this range.

Overview of the Carbon Tax Act design (Source: National Treasury 2018)



Finally, companies can claim further reductions in their tax liability through the purchase of offsets up to a value of between 5% and 10% of their total emissions.

A mechanism to drive change

Given that 90% of South Africa's energy is still produced from coal, the incentive to transition to a lower-carbon economy is marred by the following:

- The impact of potential job losses in the affected sectors
- The political and socio-economic factors
- The infancy of the renewable energy sector
- The significant upfront investment with longer pay-back periods
- A volatile economy with lowered GDP growth forecast for South Africa and government's spending priorities

The alignment of the carbon tax introduction to the extension of the section 12L energy efficiency allowance, although to incentivise, begs the question whether tax can effectively drive social behaviour.

I am of the view that the section 12L tax incentive is a positive mechanism to influence the changes required for South Africa to meet its commitments under the Paris Agreement on Climate Change. The qualification period should be extended to beyond 31 December 2022 to see the true benefit of this legislation.

EXPAT TAX:

SARS ISSUES DRAFT INTERPRETATION NOTE 16

15 minutes CPD

▶ **JEAN DU TOIT,** jean@taxconsulting.co.za

In light of a new draft of SARS Interpretation Note 16, our article looks at the vexed question of the partial exemption of remuneration earned abroad by South African employees.

As South African expatriates are now aware, as of 1 March 2020 the amendment to section 10(1)(o)(ii) of the Income Tax Act will bring considerable change to the expatriate landscape. Previously, where expatriates satisfied the requirements of the exemption, it was possible for their remuneration to be wholly exempt from tax in South Africa. From 1 March 2020, the exemption will be capped at R1 million per annum.

In March 2019 National Treasury and SARS held a special workshop to address queries raised around the amendment by various stakeholders. At the time, there appeared to be many aspects that had not yet been ironed out. Since then, on 7 October 2019, SARS issued a Q&A document and a draft of the update (Issue 3) of Interpretation Note 16 (Draft Issue 3) to clarify certain aspects pertaining to the amendment.

As the underlying requirements of the exemption have not been affected by the amendment, Draft Issue 3 largely mirrors Issue 2 of Interpretation Note 16. There are, however, some useful additions that clarify items that will be affected by the amendment. These will be canvassed in the paragraphs that follow.

Rationale for amendment

As a first point, the draft of Issue 3 provides justification for the amendment. In line with the Explanatory Memorandum to the Bill that introduced the exemption back in 2000, it is outlined that the exemption was introduced to prevent double taxation between South Africa and the expatriate's host country. However, as it creates opportunities for "double non-taxation" where the host country imposes little or no tax, the exemption is not used for the purpose at which it is directed. Hence, it was decided to impose a R1 million threshold.

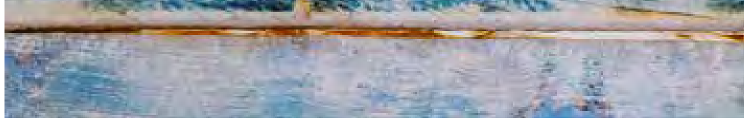
Remuneration

The exemption requires that the taxpayer must earn a specific type of remuneration by a specified means. The term "remuneration" in this context has a narrower meaning than that assigned to it under the Fourth Schedule to the Act.

Draft Issue 3 does not bring about any changes in this regard, but it is important to highlight allowances and fringe benefits at this juncture. Expatriates' remuneration packages may likely differ from that of ordinary employees. They are afforded certain benefits and allowances to enable them to operate in their host country. This may include accommodation, special medical aid cover, travel allowances and transport services, international school fees, security upgrades or other security related expenses and hardship subsidies.

Expatriates must take note that whilst these "benefits" are perhaps provided out of necessity, they are fully taxable under the Seventh Schedule to the Income Tax Act and their cash equivalent values count towards the R1 million threshold.

This has been a sore point for employees and employers alike, as there is a perception that it is unfair to tax expatriates on benefits in terms of domestic legislation, where the benefits are afforded pursuant to the circumstances in the host country. This may consume a large chunk of the R1 million threshold, and more expatriates may be affected by the amendment than anticipated.



"Certain jurisdictions such as the United Arab Emirates do not impose taxes on income, but there are high indirect taxes and levies, which will not qualify for the tax credit."

Double taxation

Draft Issue 3 acknowledges that a double tax situation may arise in respect of the portion of the remuneration earned over and above R1 million. This will be the case where a tax treaty does not provide a sole taxing right to one country or if there is no double tax treaty between South Africa and the host country.

Draft Issue 3 confirms that South Africa will provide double tax relief under section 6quat of the Income Tax Act. This form of relief is a foreign tax rebate that may be claimed on assessment when the taxpayer submits their income tax return.

The fact that employers may still withhold employees' tax in South Africa, together with the fact that the rebate may only be claimed upon assessment can be problematic from a cash flow perspective.

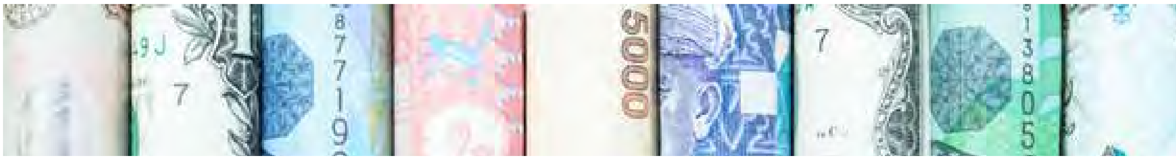
It is also important to be cognisant of the requirements of section 6quat. Section 6quat only applies in respect of *"taxes on income proved to be payable to any sphere of government of any country other than the Republic".*

This raises an interesting question: whilst section 6quat merely requires that the foreign tax be "proved to be payable", how does one do this if the tax has not yet in fact been paid? If the tax has not yet been paid, then the taxpayer may have some difficulty in shifting the burden of proof. Certain self-assessment taxes do not require assessment from the revenue authorities and the only proof the individual would have of taxes paid would be their foreign tax return. In addition, differing tax years cause complexity in calculating the credits available.

As a further point, section 6quat only applies to taxes on income. Certain jurisdictions, such as the United Arab Emirates, do not impose taxes on income but there are high indirect taxes and levies, which will not qualify for the tax credit. Similarly, social security or other high consumption taxes will not fall within the ambit of section 6quat either.

Hardship directives

Draft Issue 3 recognises the potential cash flow problem and confirms that employers may at their discretion apply to SARS for a directive to vary the basis on which employees' tax is withheld, as envisaged under paragraph 10 of the Fourth Schedule.



Gains under section 8C

One important aspect that is clarified in Draft Issue 3 is how the amendment will impact on gains that vest under section 8C of the Income Tax Act after 1 March 2020. Proviso (C) to section 10(1)(o)(ii) holds that where remuneration accrues in one year of assessment in respect of services rendered over multiple years of assessment, such remuneration is deemed to have accrued evenly over the period that those services were rendered.

Practically, this means that the gain derived from an equity instrument in terms of section 8C will be spread across the years during which the underlying services were rendered, or the "sourcing period" as it is referred to in Interpretation Note 16. SARS determines the gain by obtaining the ratio of work days outside the Republic during this period over the total work days during the same sourcing period, multiplied by the section 8C gain.

This poses the question of whether the R1 million threshold will be taken into account in respect of sourcing periods prior to 1 March 2020? In other words, will the gain be apportioned so that the portion that relates to earlier periods is entirely exempt? Arguably, the portion of the sourcing period that falls after 1 March 2020 must be subject to the threshold, but the balance should not be.

In terms of draft Issue 3, SARS follows a different application: SARS will calculate the gain in terms of the above formula and cap it at R1 million, even if the sourcing period predominantly pertains to periods pre-dating the effective date of the amendment.

This means that where vesting occurs after 1 March 2020 and it results in a substantial gain that was "sourced" during pre-amendment periods, the taxpayer will have a much larger tax liability than they may have anticipated.

Employees' tax

Draft Issue 3 further clarifies items around disclosure from an employer perspective. An employer that is satisfied that the exemption under section 10(1)(o)(ii) applies should disclose the salary income to the extent that the remuneration is exempt under the foreign income source code indicating the amount from which no employees' tax was withheld. If the remuneration exceeds R1 million and becomes subject to normal tax, the excess remuneration should be disclosed as a separate line item under the same foreign source code indicating the amount from which employees' tax was withheld.

Outstanding issues

Whilst SARS has issued the Q&A document and Draft Issue 3, which covers the salient aspects of the amendment, most certainly not every eventuality has been covered. It is also quite likely that some issues will only be picked up once the amendment kicks in and once employees, employers and SARS have to apply it in practice. Stakeholders that identified these items were invited to share their comments with SARS by 13 December 2019.

BUYING AND SELLING SHARES POST 2019

15 minutes CPD

Our article examines the impact of recent legislative changes on share buy-backs and dividend dilution transactions.

▶ **STEPHAN ZAAIMAN,** szaaiman@renmere.co.za

The 2017 budget speech signalled a number of changes which had a significant impact on the broader South African mergers and acquisitions industry in the period that followed. Apart from announcing an increase in various tax rates, the 2017 budget speech proposals included a renewed focus on share buy-back transactions. This focus culminated in sweeping changes to the manner in which share disposals are taxed and remained in place throughout the subsequent and current legislative amendment cycles.

A brief history of share buy-back transactions and changes to the legislative landscape

By the time that the finance minister delivered his speech on 22 February 2017, the share buy-back had evolved into a relatively standard exit mechanism within the South African market. For corporate sellers faced with a 22.4% effective CGT rate upon the sale of shares, the allure of a tax exempt dividend would often prove irresistible. A typical share buy-back transaction would involve a purchaser subscribing for new shares in the target company and the target company utilising the subscription proceeds to repurchase the shares held by the seller. Broadly speaking, the transaction would achieve the same commercial outcome as a normal sale of shares. However, whereas a sale would result in tax in the hands of the selling company, the buy-back proceeds (if properly implemented) would yield a tax exempt "dividend" in the hands of a South African tax resident corporate seller. In the era preceding the 2017 amendments, taxpayers and their advisers drew some comfort from the fact that SARS and National Treasury had been aware of these structures for a number of years (many of them having been reported as reportable arrangements over the years). The only legislative intervention occurred in 2012 through the promulgation of a somewhat toothless set of specific avoidance provisions in the form of section 22B of the Income Tax Act and paragraph 43A of the Eighth Schedule to that Act.

The 2012 version of section 22B and paragraph 43 only affected a very limited subset of debt-funded buy-backs. (Note the two sections mirror each other with the only distinction being that section 22B applies to shares held on revenue account and paragraph 43A applies to shares held on capital account.) However, the 2017 proposals sought to target a much broader spectrum of buy-back arrangements. To this end, the revised provisions brought exempt dividends within the taxable sphere where the selling shareholder is a company which holds a "qualifying interest" in the target company. A qualifying interest is defined as 50% or more of the equity shares or voting rights in the company or 20% or more of the equity shares or voting rights where there is no majority, if this interest is held within 18 months of disposing of such shares, and where the selling company received dividends exceeding 15% of the market value of such shares within 18 months of or as part of the disposal of such shares.

In broad terms, the 2017 changes meant that significant corporate shareholders who sell their shares in a target company (assuming the shares are held on capital account) could be subject to an effective CGT rate of roughly 19% (i.e., 85% x 22.4%) on buy-back proceeds and pre-transaction dividends. Given that the effective tax rate in a "taxable" buy-back could still be slightly better than the rate applicable to ordinary sale proceeds and given that holders of smaller stakes could still escape the impact of section 22B or paragraph 43A in some instances, the buy-back mechanism remains useful beyond the 2017 amendments.

Dividend dilution transactions and the latest legislative amendments

A slight variation to the share buy-back exists in the dividend dilution structure. Being a somewhat more subtle relative of the share buy-back structure, this mechanism largely escaped the impact of the 2017 amendments to section 22B and paragraph 43A. Instead of buying back shares a target company could, where the circumstances allowed, declare a dividend on temporary loan account, thus reducing the equity value attributable to the shares in the company. The new investing shareholder would then subscribe for new shares in the company and the subscription proceeds would be applied to settle the temporary loan account. Given that no disposal occurred, the provisions of section 22B and paragraph 43A would not apply to the dividend (at least not where the relevant shareholders retained their shareholding).

However, the 2019 legislative amendment cycle brought further proposed changes to section 22B and paragraph 43A which seek to bring the aforementioned dividend dilution structures within the taxable sphere. Based on the amendments proposed in the 2019 Taxation Laws Amendment Bill (expected to be promulgated in its current form), the amended section 22B and paragraph 43A will now include a special deeming provision. The deeming will be triggered where a company issues shares to another person and the transaction results in a reduction of the "effective interest" of the corporate shareholder. The amendment is deemed to have come into operation on 20 February 2019 and applies to a reduction of an "effective interest" that occurs on or after that date. Where applicable, the corporate shareholder would be deemed to dispose of its shareholding in the target company for purposes of section 22B and paragraph 43A. As is the case with share buy-back transactions, the effective tax rate in a "taxable" dividend dilution structure could still be slightly better than the tax rate applicable to ordinary sale proceeds and holders of smaller stakes could still escape the impact of section 22B and paragraph 43A. Dividend dilution structures will therefore likely remain useful beyond the latest proposed amendments.

The practical impact of changes to the taxation of share buy-back and dividend dilution structures

Sellers who can choose the level of their exit: Implications for the South African founder class

Going forward, sellers who have flexibility will generally steer towards a disposal of their shareholding above the corporate level where possible. For example, an individual who holds shares in a holding company that holds shares in an operating company would prefer 18% CGT on the disposal of the shares in the holding company rather than suffer CGT in the holding company as well as dividends tax when the proceeds are distributed as a dividend. Members of the business founder class, i.e., the entrepreneurial individuals who establish and build businesses, typically fall in this category. To these taxpayers, the most significant impact of the legislative amendments is likely their diminished ability to defer tax upon exit. Previously, for example, the holding company could have exited via an exempt buy-back, could have reinvested the pre-tax proceeds and only attracted dividends tax when the proceeds were distributed beyond the corporate level. The tax deferral which could previously be achieved by these sellers in buy-back and dividend dilution structures was most pronounced where the proceeds were reinvested locally. The legislative amendments may therefore have an unintended impact on the investment decisions of the South African founder class in the longer run. Prior to the amendments, the prospect of a pre-tax reinvestment would have been a compelling incentive to redeploy exit proceeds locally where the alternative option was an after-tax investment abroad.

Sellers who cannot choose the level of their exit: Implications for corporate sellers

Sellers who do not have the ability to divest above the corporate level are most severely affected by the aforementioned amendments. These sellers include corporates disposing of subsidiaries, incorporated co-investment vehicles such as captive and semi-captive private equity and listed companies. For these taxpayers, the changes may well impact the viability of an exit and the timing of their divestment. The amendments may furthermore have resulted in an uneven playground for incorporated and tax transparent investment funds. Careful planning could still yield tax efficient outcomes for this group of taxpayers. However, the risk exists that the legislative amendments could ultimately prove to have a negative impact on liquidity within the local market.

Legislative complexity

The most recent legislative amendment cycles have brought about various changes which have had a significant impact on the available exit mechanisms and related tax implications applicable to the disposal of shares. Although careful planning and proper implementation could still yield good results in appropriate circumstances, share sale transactions are subject to increasing legislative complexity. A level of risk exists that the recent amendments could ultimately have negative commercial and economic implications within the local market.

45 minutes CPD

INCLUSION OF DEEMED DISPOSALS IN THE DIVIDEND STRIPPING RULES COULD BE BAD NEWS FOR EMPOWERMENT TRANSACTIONS

▶ **LESLEY BOSMAN,** Lesley.Bosman@kpmg.co.za

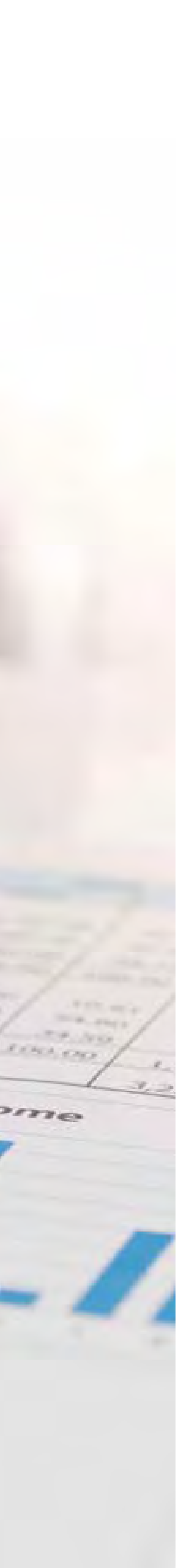
Weighing the need to prevent abusive dividend stripping against the requirements of empowerment transactions can become a delicate balancing act. Our article provides some facts and examples.

The Taxation Laws Amendment Bill introduced in Parliament on 30 October 2019 will upon promulgation introduce deemed disposals into the "dividend stripping provisions" set out in the Income Tax Act. The new deemed disposal provisions could trigger additional tax consequences for shareholders who dilute their effective interest in a resident company as a result of a share issue to third parties where, prior to the share issue, that shareholder extracted value from the company via a tax exempt dividend. The amendments are effective from 20 February 2019, being the date of the budget speech in which the tax proposal was first announced.

The amendments could have a significant impact on the implementation of transactions seeking to restructure shareholdings in resident companies. Empowerment transactions are common drivers of these type of transactions so it is important to unpack the impact of the amendments on such arrangements.

It has long been a fundamental tenet of tax law that where an intended commercial arrangement can be entered into in more than one manner, one of which results in less tax being payable than the other, the taxpayer is permitted to structure the arrangement in the more tax efficient manner. This principle of course envisages tax legislation that clearly permits the more tax efficient route.

The ongoing endeavours of taxpayers and their advisors to identify the most tax efficient manner of implementing a particular commercial arrangement requires continuous vigilance by National Treasury and results in regular amendments to tax legislation to protect the fiscus. Changing the rules governing "dividend stripping" or disguised sales as National Treasury often calls them is a prime example of this.



"Extracting historical profits could result in extraordinary dividends and possibly a deemed disposal that would be taxable under the proposed dividend stripping provisions."

Dividend stripping explained

Dividend stripping transactions are best explained by using a simple example. In order to understand why these transactions (although "tax efficient") can be construed as potentially eroding the tax base, it is worth touching on a couple of key tax concepts which have driven these transactions:

1. The disposal of shares triggers tax – For purposes of the example we will assume that capital gains tax will be triggered. In the case of a shareholder who is a company, the effective tax rate is 22.4%.
2. Local dividends paid to resident companies are exempt from both income tax and dividends withholding tax if certain requirements are met. Foreign dividends may also be exempt from tax in certain instances.
3. The consideration received by a shareholder on the buy-back of shares by a resident company is seen as a distribution, most often in the form of a dividend.
4. Any dividend that is received as consideration for the disposal of the shares is excluded from the proceeds used to determine any capital gains tax liability.

Now for the example:
Let's assume a company – SACo – had one shareholder, a resident company – Company A. Company A founded SACo and had a nominal tax base cost for the shares in SACo. Currently, SACo has a value of R100 million. The parties want to enter into an empowerment transaction in terms of which 30% of the shares in SACo will ultimately be held by empowerment partners.

Company A could simply dispose of the shares in SACo to the empowerment partners for a market related consideration of R30 million (ignoring any discounts that are common in transactions of this nature). Structuring the transaction on this basis would, however, result in a capital gains tax liability for Company A of R6.72 million.

Alternatively, prior to the introduction of the divided stripping provisions in current enacted form, introducing empowerment partners could have been structured in a manner that required Company A to pay no capital gains tax. Rather than acquiring shares from Company A, the empowerment partners could utilise the R30 million to subscribe for shares in SACo. SACo would then utilise the cash proceeds to buy back 30% of the shares held by Company A. As a result of the tax principles outlined above, Company A would receive the R30 million as a tax-exempt dividend which is excluded from capital gains tax proceeds. No proceeds, no capital gain. The most tax-efficient manner in which to structure the transaction is clear.

Under the buy-back scenario set out above, Company A has extracted R30 million of value from SACo by means of a tax-exempt dividend as part of a transaction in terms of which 30% of the shares in SACo have effectively been sold. From a tax perspective the shares have been sold for nil proceeds. This is dividend stripping in its most obvious form.

As a further alternative, SACo could have declared a significant dividend to Company A ahead of the empowerment transaction, thereby reducing the market value of SACo. As a result of the lower market value, the empowerment partners would pay less to acquire 30% of the shares from Company A and Company A would realise a reduced capital gain on disposal of the shares. This could also be seen as dividend stripping: Company A has been compensated partly through a tax-exempt dividend and partly through taxable proceeds on disposal of the shares. The result for Company A would be a capital gains tax liability lower than R6.72 million but not quite nil.

Currently enacted anti-avoidance rules

Because the Income Tax Act provisions regulating dividend stripping transactions were largely ineffectual, in 2017 National Treasury introduced new legislative provisions intended to curb the dividend stripping transactions outlined above. The relevant provisions are contained in section 22B and paragraph 43A of the Eighth Schedule to the Income Tax Act. The dividend stripping provisions in current enacted form are subject to certain exclusions, most important of which is in respect of the corporate roll-over relief provisions. The provisions target transactions with the following key features:

1. A company that holds a "qualifying interest" in another company – essentially a test of whether the shareholder exercises some control over the company. For purposes of the provisions, this requirement will be met if:

- in the case of an unlisted company, the shareholder holds 50% or more of the equity shares or voting rights; or
- in the case of an unlisted company where there is no majority shareholder, the shareholder holds 20% of the equity shares or voting rights; or
- in the case of a listed company, the shareholder holds 10% or more of the equity shares or voting rights.

The qualifying interest can exist on the date of the disposal event or at any time within the 18 months preceding the disposal of the shares.

2. The company must have received an "extraordinary dividend" being:

- in the case of any share other than a preference share, a dividend that exceeds 15% of the market value of the shares on either the date on which the dividend is declared or on the date of the disposal event, whichever is greater; or
- in the case of preference shares, dividends in excess of any dividends that would be payable based on a 15% annual coupon rate.

3. The extraordinary dividend must be exempt from both income tax and dividends withholding tax. The extraordinary dividend could be a foreign dividend, provided these requirements are met.
4. Within 18 months of receiving the extraordinary dividend or as part of the transaction in respect of which the dividend is paid, there is a disposal of all or part of the shares in respect of which the dividend was received.

Where these requirements are met, the extraordinary dividend is included in either capital gains tax proceeds or taxed as revenue.

Whilst going some way to address the impact of dividend stripping transactions for the fiscus, the provisions in their current form do still allow for a small advantage over the outright sale of shares. Under the provisions only amounts in excess of the extraordinary dividends are taxed, so it is possible to extract an amount equivalent to the extraordinary dividend in a tax neutral manner, for example as part of a share buy-back.

The need for change

This remaining advantage offered by the current provisions appears to have been insufficient for some taxpayers. These taxpayers sought to circumvent the dividend stripping provisions by structuring transactions in a manner that did not require a disposal of the shares in respect of which the extraordinary shares were received. Alternatively, they structured transactions in a manner which deferred that disposal for a period of 18 months. This objective was achieved by simply diluting the effective interest of the existing shareholder in the target company (TargetCo) through TargetCo issuing shares to the new party.

Back to our example:

In the example used previously, SACo would declare a dividend of R30 million to Company A and would then issue sufficient shares to the empowerment partner, for a consideration of R30 million, so as to enable the empowerment partner to hold 30% of the shares. As there is no disposal by Company A, there would be no tax event for Company A.

Proposed amendments

It is precisely the type of transaction described above that National Treasury is targeting with the proposed amendment. Whilst the budget speech indicated that further anti-avoidance provisions would be introduced to target transactions in which shareholdings were reduced to negligible percentages, the proposed amendment does not contain any minimum percentage reduction in effective interest.

In terms of the proposed amendments, a company that holds a qualifying interest and that receives a tax-exempt extraordinary dividend will be subject to the dividend stripping provisions:

- if the shares in respect of which the dividends were declared are disposed of; or
- if the effective interest of that shareholder in the equity shares of the target company is reduced as a result of the issue of new shares.

The dilution in effective interest through the issue of new shares will trigger a deemed disposal for purposes of the dividend stripping provisions. The percentage of shares which will be subject to the deemed disposal is based on the percentage by which the effective interest is reduced. For example, a 30% reduction in effective interest would trigger a deemed disposal of 30% of the shares.

No tax base cost may be attributed to the shares deemed to be disposed of. However, should the shareholder subsequently dispose of the shares under circumstances where the dividend stripping provisions are still applicable, any portion of the extraordinary dividend which was taxed under the deeming provisions will not be taxed on the actual disposal of those shares. In addition, tax losses on the actual disposal of the shares, which may otherwise be disallowed, may be recognised to the extent of any extraordinary dividends already taxed under these provisions.

For purposes of determining the effective interest of a shareholder, shares which convert into equity shares will be treated as equity shares.

Finally, effective from 30 October 2019 dividends declared pursuant to liquidation transactions or unbundling transactions as contemplated in the corporate roll-over relief provisions will be excluded from the ambit of extraordinary dividends. The corporate roll-over relief provisions allow for the tax neutral transfer of assets.

Criticism of the proposed amendments

Criticism of the proposed amendments has been swift. Taxpayers who placed reliance on the budget speech references to negligible percentages and proceeded with transactions in which the dilution was muted may well feel aggrieved. Ideally, given the proposed effective date of 20 February 2019, the first draft of the amendments should have accompanied the release of the budget speech documents. The first draft of the proposed amendment was, however, only released for comment on 10 June 2019.

Taxpayers may also feel aggrieved by their inability to allocate any tax base cost to the portion of shares subject to the deemed disposal. National Treasury is quick to point out that the amendments target avoidance behaviour and that the lack of parity with outright disposals of shares is intentional.

Most importantly, however, critics are reminded of the fact that not all share subscriptions will trigger a deemed disposal by existing shareholders. The requirements that the shareholder hold a qualifying interest, that an extraordinary dividend is declared and that the dividend is tax exempt remain in place. All of these elements must be present within the 18 months prior to the issue of shares.

Impact on empowerment transactions

Empowerment transactions can be structured on a myriad of different bases. Clearly the issue of shares to an empowerment partner in the absence of any extraordinary dividend having been declared would not be problematic. However, it often happens that in anticipation of an empowerment transaction the target company or group is restructured. The restructuring may be driven by a number of objectives. Existing shareholders may want to extract historical profits from the company, either to limit the participation by the empowerment partners in these profits or to reduce the value of the company in order to reduce the cost of entry for the empowerment partner. Subsidiaries or parts of the business where empowerment credentials are not required may be unbundled for the same reasons. Extracting historical profits, even if well intentioned, could result in extraordinary dividends and possibly a deemed disposal that would be taxable under the proposed dividend stripping provisions. Nevertheless, the exclusion of liquidation transactions and unbundling transactions from the ambit of extraordinary dividends should go some way in enabling companies to restructure non-empowerment sensitive shareholdings ahead of the empowerment transactions.

The proposed amendments could also impact notional vendor funded schemes which are a popular method of introducing empowerment shareholders without the need for the empowerment partner to raise funding. In terms of these schemes the empowerment shareholder is issued with, say, A ordinary shares for a nominal consideration. Based on an agreed formula, the A ordinary shares transform or are converted to shares with the same rights as the ordinary shares. (The formula is driven by elements such as the growth in value of the ordinary shares in the company as well as dividends declared to such shareholders.) Even where these A ordinary shares are not regarded as equity shares at the time of issue, they would convert into equity shares and would thus be taken into consideration when determining whether there has been a dilution in effective interest. It is however worth repeating that this dilution will only trigger the dividend stripping provisions where an extraordinary dividend was declared in the 18 months preceding the implementation of the scheme.

Whilst it is conceivable that some companies may, as a matter of course, declare dividends in excess of 15% of the market value of the company, such occurrences are likely to be rare. The impact of the proposed amendments is far more likely to catch the very transactions at which they are targeted. These are transactions where a shareholder with control over the target company extracts significant value out of the target company via a tax free dividend in anticipation of a change in shareholding percentage.

CORPORATE TAX RATES, BEPS AND SA'S CFC CHANGES

15 minutes CPD

OSMAN MOLLAGEE, osman.mollagee@pwc.com

Our article looks at BEPS, regional variations in income tax rates, changes to the controlled foreign company regime and the interaction between global taxes and politics.

With the 2020s poised to (maybe) see the most roaring changes to the international tax landscape in a hundred years, the one base erosion and profit shifting (BEPS) theme that has been thrust ominously into the spotlight is "coherence". Now that visible strides have been made towards increased disclosure and transparency, and towards greater regard for economic and human substance, the proverbial elephant remains that different countries have different (often vastly different) tax rules and rates in relation to cross-border activities.

Mismatches in tax bases and rates will continue to put pressure on the objective of coherence. Whilst there are still substantial differences in corporate tax rates, it is also interesting to see that, in general, the rates continue to fall. The Tax Foundation's review (taxfoundation.org) of 208 jurisdictions in 2018 found that over the last 40 years (since 1980) the global average of corporate tax rates fell from 38.8% to 23.0% —a drop of 41%. The OECD (stats.oecd.org) reports that the 2019 average rate for its 36 member-countries is 23.5%. Notwithstanding the general downward trend, the question of differences remains critical. Not only are there big differences (as there have always been) when looking at individual states but the regional variations are also hard to ignore. Africa's average corporate income tax rate is almost 29% whilst Europe's is under 20%.

Impact of BEPS

Market-based taxation

Most of the OECD's BEPS Actions are in advanced stages of implementation and the remaining gaps continue to be identified more clearly. It now remains to be seen what impact the proposed new market-based taxing right will have. We call it the new "market-based" taxing mechanism because many taxpayers simply switch off when we use the OECD's more official label – "Pillar 1 of the actions to address the Tax Challenges arising from the Digitalisation of the Economy", with many still under the impression that Pillar 1 is only about very highly digitalised organisations like Google, Netflix and Uber.
In summary, the new market-based taxing right will allocate a portion of the global tax base to countries where consumers are. Will this sales-based allocation to consumer jurisdictions really bolster coherence on the question of tax base? Will it finally address the decades-old debate on the residence-bias in the international tax system? Are the two questions one and the same?

In principle, the addition of a market-based taxing right to the international tax landscape should find approval from tax policy pragmatists. Whilst the source and residence bases of taxation reward a country for supporting the business activities of a multinational enterprise, the market basis rewards a country for providing consumers.

However, as the dust settles to reveal likely net winners and losers, the tension remains more on political coherence. That is, the question of whether Pillar 1 will see the light of day may not depend on whether it is a fair and workable solution that advances the BEPS agenda, but rather on how it will impact the ultimate tax collections of the more powerful countries in the world.

Pillar 2 seems less fuss?

The OECD's Pillar 2 proposals might in fact be more palatable and, ultimately, more effective.

One element of Pillar 2 is to some degree already part of South Africa's existing tax law. For example, South Africa does not offer foreign branches any exemptions, but rather taxes them in full — subject to our foreign tax credit regime. Imagine the same principles were applied to controlled foreign companies (CFCs), or that we have some hybrid where a different version of the so-called CFC high-tax exemption became an over-arching test. The 2020 amendment to our foreign remuneration exemption (in section 10(1)(o)(ii) of SA's Income Tax Act), is also a case in point.

- The other aspect of Pillar 2 would equally be easily implementable in SA. This would mean denying deduction for a payment if that amount is not subject to tax in another country (in the hands of the foreign recipient). South Africa's sections 23I and 23M (of the Income Tax Act) already have the building blocks of such deduction-denials, albeit largely dependent on whether South Africa will tax the recipient — but the principle is well-understood.

That said, from a BEPS standpoint, the discussion inevitably returns to the point of coherence. There is no point in only a handful of countries implementing Pillar 2, since that would simply increase the scope for mismatches and arbitrage.

SA's CFC rules

The two recent amendments to South Africa's CFC regime are arguably aligned with the BEPS agenda discussed above (although it is not clear whether this is deliberate). These changes are contained in the Taxation Laws Amendment Act, 2019, and come into effect in 2020, namely:

1. Reducing the threshold for the so-called high-tax exemption (HTE)
2. Targeting indirect diversionary transactions

HTE threshold

The HTE is essentially about exempting controlled foreign companies that are in any event subject to a sufficiently high level of non-South African tax. Previously, the threshold (i.e. acceptable level of foreign tax) was 75% of the equivalent South African tax that would hypothetically have been paid, whereas that threshold is now reduced to 67.5%.

It would be inappropriate to categorically say that countries with a headline corporate tax rate in excess of 18.9% (i.e. 67.5% x 28%) —such as the UK's 19%— would automatically be "safe", although it does have some indicative value to look at it that way. With corporate tax rates around the world falling, this is a welcome amendment.

This amendment is in the further proviso to section 9D(2A) of the Income Tax Act. It comes into effect for tax years ending on or after 1 January 2020.

Indirect diversionary income

One of the main exemptions from CFC imputation is the foreign business establishment exemption. Simplistically put, it exempts CFCs that have a suitable level of physical business substance outside South Africa. However, one of the concerns with this exemption is that taxpayers might be tempted to divert other income to these exempt CFCs — hence anti-diversionary rules to disqualify certain types of income from the foreign business establishment exemption. At present, there are eight categories of diversionary income, all listed in section 9D(2A)(a).

The latest amendments relate to three categories of diversionary income, namely where the CFC earns income from:

- Selling goods to any SA-resident connected person
- On-selling goods that were purchased from any SA-resident connected person
- Rendering services to any SA-resident connected person

The addition of the phrase “directly or indirectly” into these rules is intended to target (as the words suggest) indirect relationships between CFCs and their SA-resident connected persons. For example, if CFC-1 sells goods to CFC-2 and CFC-2 on-sells those goods to any SA-resident connected person, then the previous rules would only have targeted the profits of CFC-2. Against that, the new amendments will ensure that the profits of CFC-1 are also caught. Furthermore, it seems that if CFC-1 sells goods to an unrelated third party (whether SA-resident or not) who then on-sells those goods to a SA-resident connected person in relation to CFC-1, then the profits of CFC-1 could arguably also be caught under the amended rules.

The amendments in question are in respect of subparagraphs (i), (iA) and (ii) of section 9D(9A)(a). The changes come into effect upon promulgation of the Amendment Act (which had not yet happened at the date of writing this article). Importantly, this means that there will be a debate around whether the changes take effect at the start of a CFC’s foreign tax year or rather on a specified date (so that different transactions in the same foreign tax year might be treated differently).

Coherence

Whilst the thinking behind these amendments seems clear, the question of global coherence continues to stand out. If some countries continue to strengthen and refine their CFC rules but others become more lenient, the mismatches will continue to present uneven playing fields to multinational enterprises.

Global tax and politics

This article is about the global tax system, not global politics. However, it does seem that now — more than ever before — the direction of the international tax system will be determined by the extent to which coherence prevails at the political level.

South Africa’s tax policy-makers are faced with the challenging task of constantly seeking the delicate balance between protecting our tax base, not creating obstacles to economic growth and contributing to global coherence. Although there is clearly room for improvement, recent legislative amendments suggest that we could do worse. However, perhaps the biggest stress-point at the moment is that South Africa’s corporate tax rate is on the wrong side of the global average.

KILLING THE ARM'S LENGTH PRINCIPLE SOFTLY

15 minutes CPD

▶ **OKKIE KELLERMAN,** okkie@gpjkellerman.com

Our article looks at the "Unified Approach" proposed by the OECD in Pillar One of BEPS. The author also proposes an alternative approach that does not involve killing off the long established arm's length principle.

At the 2013 International Fiscal Association Congress in Copenhagen, which took place just after the launch of the BEPS Action Plan by the Organisation for Economic Co-operation and Development (OECD), delegates voted that the arm's length principle will remain the only way to apply transfer pricing and that the profit split method will in time be the most widely used transfer pricing method. They clearly did not know about the OECD's Pillar One proposals – a way of killing the arm's length principle softly.

Toward a "Unified Approach"?

The "Unified Approach" introduced by the OECD in 2019 is the OECD's most recent attempt to find international consensus on the taxation of the digital economy. However, the Pillar One proposals through the "Unified Approach" have, in my view, several defects. The most important of these is the apparent abandonment of the arm's length principle. There is a view out there that the Pillar One proposals go dead against the accepted transfer pricing principles which have now been applied by multinational enterprises and revenue authorities with success over many years.

Taxing digital MNEs

Key to the Pillar One proposals is the allocation of taxing rights between multiple jurisdictions using a formula to apportion entrepreneurial profits earned by an MNE in one jurisdiction to the various market jurisdictions in which the multinational enterprise operates. Pillar One attempts to redefine "value creation" for digital businesses and creates a new way of taxing the "value creation" within this sector.

Multinational enterprises operating in the digital economy are perceived to be more difficult to tax than any other operations despite their heavy reliance on the use of intangibles, data, and network. These digital multinational enterprises seem to include Google, Amazon, Apple, Facebook and Microsoft.

Digital sales and services taxes

As a first stab at the profits of these digital multinational enterprises, several governments have either introduced or proposed a digital sales/services tax. Market jurisdictions, where the users and consumers of digital multinational enterprises are located, must now decide to introduce their own digital sales/services tax or support the Pillar One proposals. Most African and other developing jurisdictions seem to support the OECD Pillar One proposals – easier to implement without the need to create local rules for applying the arm's length principle. An easy way out, I fear!

A formula-based mechanism

The "Unified Approach" proposes a formula-based mechanism that will allow market jurisdictions to allocate the following three pieces of an MNE group's global profits to be taxed in the market jurisdiction:

- The first amount will be a portion of the digital multinational enterprise's deemed non-routine global profits, using a prescribed formula, to be divided amongst all the market jurisdictions in which the multinational enterprise operates.
- Local marketing and distribution subsidiaries in market jurisdictions will also be required to allocate fixed remunerations which reflect an assumed baseline activity.
- An additional amount over and above this minimum income can also be added in situations where the arm's length principle amount is in excess of the fixed minimum return.

> *“The belief that the 'Unified Approach' retains the ALP and merely complements it with a formula-based solution is totally misplaced.”*

Going beyond digital

It is important to note that the proposals under Pillar One no longer only apply to digital multinational enterprises but are intended to include all “consumer-facing” businesses. In other words, the Pillar One proposals now go much wider than just the digital economy, something that was never expected to be the intention of Pillar One.

The aim of BEPS Action 1 was always the taxation of profits generated within the digital economy. However, under the “Unified Approach” multinational enterprises can now be taxed on the profits of almost all businesses, including all marketing and distribution activities in market jurisdictions. Broadening the scope means that the proposals are no longer about “taxing the digital economy”.

A less radical approach?

The introduction of the “Unified Approach” ignores all existing international tax concepts and transfer pricing rules which should rather be broadened to also tax the income of multinational enterprises operating in the digital economy.

Could the solution to taxing the profits of digital multinational enterprises not be found in amending Article 5 (Permanent Establishment) of the Model Tax Convention on Income and Capital, 2017 (Model Convention) so as to create a virtual permanent establishment when remote digital business activities meet certain nexus requirements? These requirements could include a minimum level of country-specific digital investment and the size of the local user base in the market jurisdiction.

Determining taxable profits

The transfer pricing rules set out in Article 7 (Business Profits) of the Model Convention can then be used to determine the taxable profits of the virtual permanent establishment created under article 5. This profit allocation can be based on value creation: looking at where the significant people functions are located. Seeing that digital activities are generally carried out from remote locations this could impact on the amount of profits allocated to the permanent establishment.

Allocating profit

The answer to the question of how to allocate profit to the permanent establishment may be found in applying the profit split method and a “DEMPE like analysis” developed specifically for the digital economy. Both the application of the profit split method and developing a functions, risks and assets analysis for the digital economy will require significant guidance from the OECD. If this was done successfully for intellectual property, why not for the profits of the digital economy?

By doing this the OECD will use the current transfer pricing rules and other international tax concepts effectively to deal with the digital economy without the need for the formalistic approach of the “Unified Approach”.

Using current rules

The “Unified Approach” represents a clear and present danger to the arm’s length principle: it not only relies on a new nexus rule but it also creates an allocation mechanism based on formulary apportionment methods. Does this not spell the death of the arm’s length principle by replacing it with a formulary apportionment?

A view expressed broadly is that the introduction of the “Unified Approach” will have detrimental consequences for both the arm’s length principle and the international tax system as we know it. The belief that the “Unified Approach” retains the arm’s length principle and merely complements it with a formula-based solution is totally misplaced.

The current international tax rules and the arm’s length principle are indeed robust and flexible enough to deal with the profits of multinationals operating in the digital economy and we do not need the “Unified Approach”.

SECTION 72 OF THE VAT ACT: THE "JOKER IN THE PACK"

▶ **SEELAN MOONSAMY,** smoonsamy@ENSafrica.com

Our article takes a look at what the fuss around section 72 of the VAT Act and SARS' discretionary power is about.

15 minutes CPD

The term "joker in the pack" is loosely used to describe someone or something that is different from other things or people in a situation and does not seem to fit in, or may cause problems. In some ways, the pre-amended version of section 72 of the Value-Added Tax Act was this so-called joker in the pack. In order to understand the analogy, it is instructive to consider the purpose of section 72 and the concerns raised with its reach and application, and then navigate to the changes that were introduced to rein in section 72.

Purpose of section 72

The aim or purpose of section 72 was, simply, to empower SARS to make an arrangement or decision (a "ruling") to overcome difficulties, anomalies or incongruities ("hardship") experienced by a vendor. The hardship would arise in conducting its business on one hand and complying with a specific provision of the VAT Act, on the other. Section 72 empowered SARS to make a ruling to assist the vendor in overcoming such hardship, on condition that the ruling made by SARS did not have the effect of substantially increasing or reducing the ultimate liability for tax that was leviable in terms of the VAT Act (contained in the proviso to section 72).

In upshot, as long as the proviso to section 72 remained intact, SARS had a discretionary power embodied in section 72 to issue a ruling to aid the vendor in overcoming such hardship, as to:

- the manner in which a specific section in the VAT Act would be applied or
- the calculation or payment of tax or
- the application of any zero rated provision or exemption provision in the VAT Act.

Was amending section 72 necessary?

In order to address this question, one needs to contextualise the disquiet that section 72 caused for the National Treasury and SARS, ultimately leading to it being overhauled.

At first glance, it is perceptible that the VAT Act contains certain mandatory language. For example, section 20(1) states that a vendor "must" issue a tax invoice; a supply of goods under section 11(1) "shall" be charged with tax at the rate of zero per cent; and so forth. Section 72 empowered SARS to "sidestep" this mandatory language, in instances where the vendor experienced hardship in complying with a specific section in the VAT Act, as long as the ruling by SARS did not violate the proviso to section 72. There was also some consternation amongst tax practitioners (and SARS officials) that since section 72 rulings were, in the main, vendor specific, and were not published (even in sanitised form), this created a fiefdom. It gave a few officials in SARS VAT Legal and Policy the power to, as some would argue, create a secret body of VAT law.

Hence, I have often referred to section 72 as being the proverbial "joker in the pack".

It is also understood that other comparable VAT regimes do not have a discretionary provision akin to section 72, so in a sense section 72 was unique to the South African VAT Act. Further, VAT laws are of general application and should not afford preferential treatment to a specific vendor or class of vendors. Lastly, a plethora of section 72 ruling applications were made to overcome mere administrative difficulties faced by a vendor in complying with the provisions of the VAT Act.

Changes made to section 72

The changes ushered in by the Taxation Laws Amendment Bill, 2019 (introduced in Parliament on 30 October 2019), have cut a swathe through the reach and application of section 72.

- The hardship that a vendor encounters needs to be similar to the hardship which has arisen or will arise for any other vendor or class of vendors of the same kind or who makes similar supplies of goods or services. This removes the preferential treatment that a vendor enjoyed and makes section 72 applicable to a larger number of vendors.
- SARS can no longer make a ruling (i.e., a decision, as reference to an arrangement was deleted) regarding the application of the zero rate or providing an exemption from tax. The rationale is that a decision to zero rate a supply of goods or services or to provide for a supply of goods or services to be exempt from tax resides with Parliament, in conjunction with the Minister of Finance. It is enshrined in our law that only a "money Bill" may impose "national taxes, levies, duties or surcharges" (section 77(1)(b) of the Constitution of South Africa), and it follows that SARS should not be given any discretion in this regard, as it becomes a constitutional issue.
- The proviso to section 72 was strengthened in that the ruling must not have the effect of (substantially) reducing or increasing the (ultimate) liability for tax levied under the VAT Act. Stated differently, the words "substantially" and "ultimately" were deleted to achieve this objective.
- The proviso to section 72 is buttressed by adding an alternative layer as item (ii). More specifically, the ruling cannot be contrary to the construct and policy intent of the VAT Act as a whole, or with reference to any specific provision contained therein.
- SARS may publish by public notice a list of transactions or matters in respect of which a ruling under section 72 may be declined.

The effective date for the amended section 72 is 21 July 2019, and it applies to ruling applications made on or after that date. National Treasury and SARS have provided certain transitional rules for section 72 that deal with "existing" section 72 rulings.

Rulings issued in respect of applications made before 21 July 2019 and that expire before 31 December 2021 may be reconfirmed by SARS on application by the vendor (where such reconfirmation application is made not later than two months prior to the expiry of the existing ruling, or in exceptional circumstances, such other date acceptable to SARS). The ruling will be considered in terms of the pre-amended section 72 and may not extend beyond 31 December 2021.

"New" section 72 rulings that were issued by SARS before 21 July 2019 and that cease to be effective after 31 December 2021, or where no expiry period is stated, automatically expire on 31 December 2021.

"Section 72 empowered SARS to 'sidestep' this mandatory language, in instances where the vendor experienced hardship in complying with a specific section in the VAT Act."

Is this high noon for section 72 ruling applications?

It is patently obvious that the reach and application of the so-called "joker in the pack" has been reined in.

It appears as though a vendor can no longer approach SARS for a ruling under section 72, notwithstanding the fact that the vendor may experience hardship in the conduct of its business and in applying the provisions of the VAT Act. The vendor is required to do some homework and approach SARS in conjunction with another vendor or a class of vendors that are experiencing or are likely to experience similar hardship. This may lead to issues of confidentiality and a general lack of desire to share proprietary information with competitors. Further, with the Fourth Industrial Revolution disrupting almost every business sector and also creating new business models, if first-movers share information with other players this may pose a threat to their competitive advantage.

If a vendor fails to drum up support (as discussed), the only other avenue to address the hardship that the vendor is facing is for the vendor to lobby National Treasury and SARS to change the VAT law. This is a drawn out process and may be somewhat counterintuitive. A law change should not be made to cater for a specific hardship faced by a vendor, i.e. tax laws should be of general application.

The proviso to section 72 (under item (i)) states that a ruling must not have the effect of reducing or increasing the liability for tax levied under the VAT Act. It is arguable that a negligible reduction or increase in the VAT liability would dissuade SARS from issuing a ruling in terms of section 72.

Lastly, the no-rulings list that SARS is in the process of compiling would give an indication of transactions or matters that SARS may refuse to consider in terms of section 72. This would inevitably lead to a reduction in the number of ruling applications being made to SARS, depending on the ambit of the rulings list.

Only time will tell if section 72 of the VAT Act will require a rethink in the foreseeable future.

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VAT REFUNDS A FRAUDSTER'S LOTTO

15 minutes CPD

What do fixed property, precious metals, agriculture and tax invoices have in common? Read all about past and present ways of using VAT to defraud the tax system, disadvantage other taxpayers and add to the misery of would-be beneficiaries of government services.

▶ **RODNEY GOVENDER,** rodney.govender@pwc.com

VAT systems implemented worldwide expose the fiscus to significant risk due to the VAT's inherent feature of allowing the VAT incurred by registered vendors to be set off against the VAT charged. The key risk is fraudulent transactions resulting in undue VAT refunds. The South African VAT system, just like many other VAT systems, has over the years had to deal with fraudulent transactions.

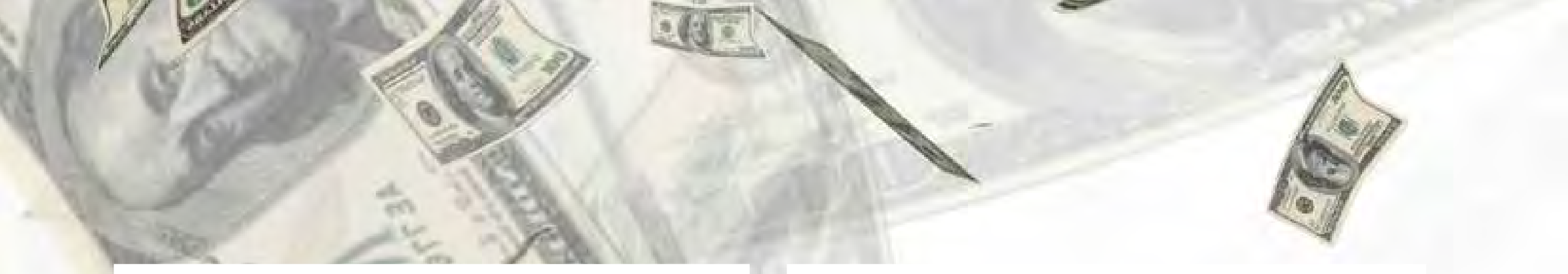
Fixed property fraud

The earliest type of fraud detected was regarding the sale of fixed property. This fraud was perpetrated soon after VAT was introduced in 1991. This scheme was simplistic in its nature, designed to work within the scope of the prevailing VAT legislation. It entailed the actual sale of fixed property by a non-VAT registered person to a registered VAT vendor. The fixed property would be sold at an inflated value (well in excess of the open market value) and "paid" through a deceptive movement of payment (i.e., round tripping or loan accounts). In terms of the prevailing legislation, the VAT vendor was entitled to a notional input tax deduction on the acquisition of the fixed property, calculated by applying the tax fraction to the selling price. In many of these cases, the notional input tax deduction exceeded the open market value of the properties. A very clever approach to property investment as you could acquire property, and have it financed by the taxpaying citizens of South Africa. This was however very short-lived. SARS immediately reacted to these types of transactions and successfully won the matter in court. Changes to the VAT Act were also effected to ensure that the risk was eliminated.

Precious metal fraud

The following major fraudulent activity occurred within the mining sector. The sale of jewellery by a non-vendor to a vendor created opportunities, including fraudulent input tax deductions and legitimising illegally obtained "zama zama" gold into the formal economy. Further to this, gold coins were acquired at the zero rate (correctly so) and "sold" as second-hand goods by non-VAT registered persons to VAT vendors. In these circumstances, the VAT vendor would qualify for a notional input tax deduction on the acquisition of gold coins initially acquired at the zero rate. At face value, these transactions were not suspicious and the value and quantity attributable to such transactions were not in question. What was however suspicious were the motives, frequency and value of such transactions by non-vendor sellers. The VAT benefit was obviously very lucrative as it involved continuous and regular trade of a valuable commodity. SARS tried through its enforcement actions to minimise the fraud but could not eliminate it.

SARS also attempted to amend the law by excluding precious metals from the definition of second-hand goods. However, this amendment had a negative impact on legitimate trade in the second-hand goods industry and required SARS to refine its exclusion of precious metals. In this regard, SARS excluded, amongst others, gold coins from the definition of second-hand goods. It would be interesting to see whether the legislative amendments have had the desired effect of combating the fraud.



Fraud in agriculture

The agricultural sector enjoys certain benefits under the VAT system in that VAT registered farmers can acquire certain goods used for farming purposes at the zero rate. Unlike the previous types of fraud, this scheme involves two VAT vendors. The fraud is disguised in the form of fictitious or inflated transactions illustrated as follows. This illustration is based on the example provided in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2014.

- Farmer A (VAT vendor) acquires goods from Vendor 1 at the zero rate. Before Vendor 1 can deliver the goods, Farmer A cancels the transaction.
- Farmer A, based on the cancelled order with Vendor 1, issues a tax invoice to Farmer B (a VAT vendor) zero rating the supply.
- Farmer B thereafter invoices Farmer A for the same amount but adds VAT at the standard rate. There is, however, no movement of goods.
- The result is that Farmer A deducts the VAT charged by Farmer B as input tax. The refund paid to Farmer A is thereafter shared with Farmer B. Farmer B also never remits to SARS the VAT charged on the supply to Farmer A.

The Taxation Laws Amendment Act contained the repeal of Part A in Schedule 2 to the VAT Act. This Part was the provision that allowed farmers or farming activities to acquire certain goods used for farming purposes at the zero rate. However, this will only come into effect on a date determined by the Minister by notice in the *Gazette*, which notice may not be published earlier than 12 months after the promulgation of this Act. To date, this has not occurred which is presumably due to the pressure from the farming community and stakeholders. It remains to be seen whether this fraud is still being perpetrated.

Tax invoice fraud

The most common fraud involves the deduction of input tax based on fictitious invoices, resulting in a refund being claimed. Modern technology enables the reproduction of tax invoices. This makes it difficult for tax authorities to detect without further investigation being performed. There have, however, been successful criminal prosecutions. It is obvious that this type of fraud cannot be prevented through legislative changes and SARS enforcement action is the only means of detection.

Complete reliance therefore should not be placed on the face value of an invoice when fraud is suspected. The authenticity and validity of the fraudulent transaction can be determined through the use of purchase orders, supplier statements, goods received notes and proof of payment. The ultimate test would inevitably involve the verification of the transaction with the supplier. SARS does implement verification on selected transactions but perhaps this could be expanded.

Electronic service fraud

Rules governing the supply of electronic services are relatively new in South Africa. It is essential that SARS evaluates whether there is a platform for fraud based on the design of the legislation. SARS has not provided any information on this possible new fraudulent activity, and I am of the view that this is most definitely the next area fraudsters will be looking to exploit.

By forcing non-residents to register for VAT, the electronic services regime provides a platform for alleged non-resident electronic service suppliers to charge VAT to SA customers without ever remitting the tax to SARS. A modus operandi similar to that employed in the agriculture scenario above is employed. The charges to the South African customer are inflated and the SA customer (a VAT vendor) then deducts the input tax. The non-resident is liable for the payment of output tax but never pays over such VAT to SARS. In light of this risk, consideration should also be given as to whether the new legislation has created a platform for money laundering under the guise of legitimate transactions benefitting both parties.

The biggest challenge for SARS in this type of fraud is auditing non-resident suppliers. SARS can invoke the international agreements it has at its disposal to recover the unpaid VAT, but it is accepted that this is a long drawn out process which in the end may yield no benefit and a significant tax loss for SARS. The question to be asked is therefore whether SARS and National Treasury have evaluated this risk.

One option to be considered to minimise non-payment of the output tax by non-residents is a withholding tax equivalent for VAT. This would involve requesting financial institutions or similar institutions (i.e. facilitators or platforms for payments to non-resident suppliers) to withhold 15% of payment amounts. However, this option requires significant collaboration between SARS and the mentioned institutions as well as well-defined rules. Many will view withholding of VAT from payments to non-resident suppliers as contrary to well-established VAT principles. Maybe protecting the fiscus from these fraudsters requires the application of unconventional rules.

It is recommended that SARS and National Treasury engage with other tax jurisdictions to learn about the different frauds being perpetrated and the enforcement strategies being adopted as a weapon to win the battle that is constantly being fought.

This article is not a full representation of all the different types of fraudulent transactions in the South African VAT arena but highlights those that forced or may yet require the VAT Act to be amended. In conclusion, VAT fraud is not unique to South Africa and cannot be completely eliminated.

TAX BOOKS for 2020

TAX LEGISLATION

SAIT Compendium of Tax Legislation 2020

JUTA LAW EDITORS

R1 100.00 // JUTA

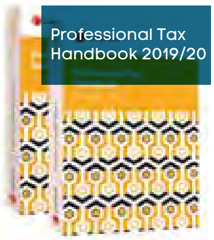
This tax legislative compendium incorporates all promulgated and proposed amendments relevant as at 1 January 2020, aided by Juta's Prelex and Pendlex. Related supplementary material has been incorporated online in Volume 2. The Tax in Practice aids allow readers to easily navigate content within the different tax Acts.

JUTA's Indirect Tax 2020

JUTA LAW EDITORS

R810.00 // JUTA

This annual subscription is a consolidated source of current indirect tax Acts and their relevant supplementary material as at 1 January 2020. Juta's Prelex and Pendlex present a comprehensive view of historic and proposed amendments of the legislation. Supplementary material to the indirect tax Acts is included.



Professional Tax Handbook 2019/20

LEXISNEXIS EDITORIAL STAFF

R1 092.50 // LEXISNEXIS

This set includes two comprehensive legislative handbooks which contain all the direct tax and VAT acts, regulations, practices and interpretation notes. Updated annually and includes pending amendments.

Income Tax Legislation 2020

LEXISNEXIS EDITORIAL STAFF

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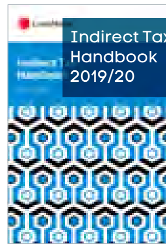
This book is a concise and handy reference to the consolidated Income Tax Act and Tax Administration Act. It incorporates the legislative amendments made during the current tax year, as well as pending amendments. Updated annually.



Indirect Tax Handbook 2019/20

LEXISNEXIS EDITORIAL STAFF

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This book comprises indirect tax acts, such as transfer duty and VAT, as well as tax administration. It also includes the related regulations, interpretation notes and practice notes. Updated annually and includes pending amendments.

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SILKE: South African Income Tax 2020

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R 1,034.76 // LEXISNEXIS

The objective of the authors and publishers of Silke: SA Income Tax is to provide a book that simplifies the understanding and application of tax legislation in a South African context for both students and general practitioners.

Tax Law: An Introduction

LEGWAILA, T (EDITOR); SURTEES, P; OGUTTU, A; MULLER, E; WILLIAMS, RC & LOUW, C

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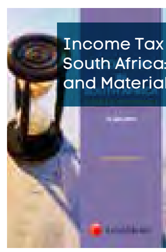
CASE BOOKS

Income Tax Cases and Materials

EMSLIE, T & DAVIS, D

R1 800 // THE TAXPAYER

This book offers students abbreviated cases supplemented by notes.



Income Tax in South Africa: Cases and Materials

WILLIAMS, RC

R 1,125.74 // LEXISNEXIS

The primary objective in this work has been to assist students of income tax, including those studying at post-graduate level, not just to understand each judicial decision in isolation, but to gain insight into underlying (often unarticulated) general principles, and to grasp the inter-relationship between the Income Tax Act and the principles of common law.

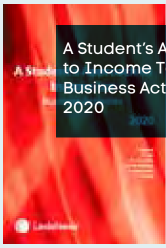
HANDBOOKS, GUIDES, INTRODUCTIONS AND STUDENT-SPECIFIC APPROACHES TO TAX LEGISLATION

South African Income Tax Guide 2020

DIVARIS, C; STEIN, ML

R569.25 // LEXISNEXIS

A concise and reliable guide to South African income tax law for the current tax year. All the taxes imposed by the Income Tax Act are dealt with, namely, income tax, capital gains tax, donations tax, the various withholding taxes, the turnover tax for micro businesses, employees' tax (PAYE) and provisional tax.



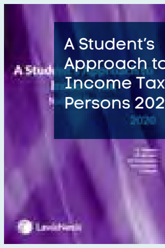
A Student's Approach to Income Tax: Business Activities 2020

BRUWER, L; CASS, SC; CUCCIOLILLO, D; KOEKEMOER, A; OOSTHUIZEN, A & STEDALL, C

R775.61 // LEXISNEXIS

* *Also available in Afrikaans*

This book was written with the specific purpose of combining in one concise volume the provisions of the Income Tax Act 58 of 1962 (the Act) as it applies to business activities. The provisions of the Act regarding natural persons are dealt with in a separate book, A Student's Approach to Income Tax: Natural Persons



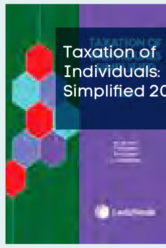
A Student's Approach to Income Tax: Natural Persons 2020

COETZEE, K; DE HART, KL; KOEKEMOER, A; OOSTHUIZEN, A & STEDALL, C

R756.69 // LEXISNEXIS

* *Also available in Afrikaans*

This book was written with the specific purpose of combining in one concise volume the provisions of the Income Tax Act 58 of 1962 (the Act) as it applies to individuals. The provisions of the Act regarding business activities are dealt with in a separate book, A Student's Approach to Income Tax: Business Activities.



Taxation of Individuals: Simplified 2020

DE HART, KL; SMULDERS, S; HAMEL, E & STEENKAMP; LA

R766.22 // LEXISNEXIS

The publication is aimed at an entry level of Taxation studies. The title is ideal for more practical and rudimentary tax courses.

LexisNexis Concise Guide to Capital Gains Tax 2020

CLEGG, D

R419.75 // LEXISNEXIS

Easy to understand guide to the complex subject of capital gains tax. Makes use of simple examples to illustrate and clarify key points. Starts with the basic principles and identifies frequently misunderstood areas, explains the law in clear, non-technical terms and cross-references every statement made through footnotes to the Act.

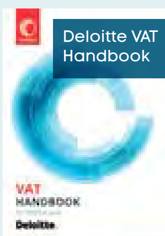
HANDBOOKS, GUIDES, INTRODUCTIONS AND STUDENT-SPECIFIC APPROACHES TO TAX LEGISLATION

Concise Guide to VAT 2020 25th Edition

CLEGG, D AND WIID, E

R424.50 // LEXISNEXIS

This is a quick and easy guide for finance and accounting practitioners,and is also simple enough for the uninitiated taxpayer to grasp the complexities of the VAT system. Fully cross-referenced to the VAT Act and extracts from the Act, as well as a detailed index, are included for additional reference and guidance.



Deloitte VAT Handbook

SILVER, M

R695.75 // LEXISNEXIS

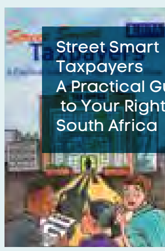
A comprehensive guide to the application of the provisions of the Value-Added Tax Act. It facilitates understanding of the mechanics of the VAT system. Also includes the VAT Act and regulations, as well as interpretation and practice notes, a list of private rulings, VAT forms and case law summaries.

Tax Administration 2nd edition

CROOME, B & OLIVIER, L

R1 354.00 // JUTA

This book sets out the rules of tax collection, showing how areas of law interrelate and noting best international practice. It provides clear and authoritative guidance on aspects such as the registration and submission of tax returns, assessments, requests for information, penalties and interest, privilege, reportable arrangements, dispute resolution, advance tax rulings and remedies.

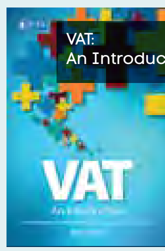


Street Smart Taxpayers A Practical Guide to Your Rights in South Africa

CROOME, B & CROOME, J

R460.00 // JUTA

This book explains the processes SARS must follow when working with taxpayers throughout the various stages of the tax process, and identifies the remedies available to taxpayers.



VAT: An Introduction

BOTES, M

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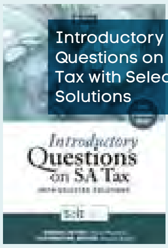
The book will help students understand the practical mechanics of the South African VAT system.

SAMPLE TAX PROBLEMS



Introductory Questions on SA Tax with Selected Solutions

PARSONS, S ET AL.

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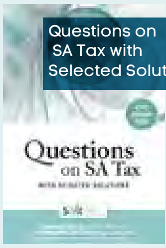

Questions on SA Tax with Selected Solutions

PARSONS, S ET AL.

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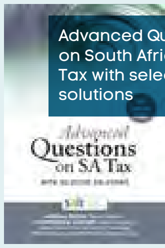
Questions on SA Tax 21st edition is the second publication in the *Questions on SA Tax* series designed to provide comprehensive tutorial coverage to taxation students. This book covers foundational topics and those typically dealt with in the study of tax at an undergraduate level.



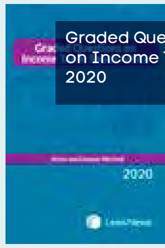
Advanced Questions on South African Tax with selected solutions

PARSONS, S ET AL.

R340.00

JUTA

Advanced Questions on SA Tax 5th edition is the third and final publication in the *Questions on SA Tax* series designed to provide comprehensive tutorial coverage to taxation students. This book covers advanced topics and integrated questions. Its complementary publications, *Introductory Questions on SA Tax* and *Questions on SA Tax*, cover foundational topics and those typically dealt with in the study of tax at an undergraduate level.



Graded Questions on Income Tax 2020

MITCHELL, K & MITCHELL, LD

R891.74 // LEXISNEXIS

The questions are based on the Income Tax Act 1962, the Tax Administration Act 2011, the Value-Added Tax Act 1991 and the Estate Duty Act 1955 incorporating amendments up to and including the Rates and Monetary Amounts and Amendment of the Revenue Laws Act.

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Q&A

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Q

SAIT

Our members posed questions around registering of PBOs, vesting of unrealised gains in trust beneficiaries, taxing UDZ allowance recoupments and calculating taxable gains in the case of depreciable assets. Here are some answers provided by our experts.

Q My client is a voluntary association that is not registered as a non-profit organisation. I have read that it is advisable for a voluntary association to register as an NPO and then as a PBO at SARS. Must all voluntary associations register as NPOs or can they continue as voluntary associations? Are there specific criteria that need to be met in order to be registered as a PBO at SARS?

The advice you obtained is not correct. SARS explains it as follows in their *Tax Exemption Guide for Public Benefit Organisations in South Africa* (Issue 5): "Registration as an NPO is not a condition for approval as a PBO since the registration as an NPO under the NPO Act is a voluntary registration lodged with the Directorate of NPOs."

See the following page where this is confirmed: http://www.dsd.gov.za/index.php/2-uncategorised/6-non-profit-organisations

We copied the following from the page:

> *"The Register of Nonprofit Organisations (NPOs) is a voluntary registration facility that enhances the credibility of the registered NPO as it reports to a public office. The NPO Directorate, as a public office, holds information about registered NPOs for the public to access. This thus, increases the transparency and accountability of the organisation beyond its immediate role-plays. This accountability and transparency improves the governance of an organisation as it is also expected that a registered NPO must comply with the requirements of the NPO Act. The NPO registration status is also a funding requirement for most donor and funding agencies. The national NPO registration facility therefore brings NPOs into a public system that allows for information about the sector to be gathered and made publicly available which in many ways increases the confidence of the public in the nonprofit sector.*
>
> *An NPO is defined, in terms of section 1 of the NPO Act, as a trust, company or other association of persons established for a public purpose and of which its income and property are not distributable to its members or office bearers except as reasonable compensation for services rendered."*

In most instances a non-profit organisation (NPO) is a company for tax purposes (see section 1(1) of the Income Tax Act). It must therefore register as a taxpayer.

From a tax point of view the following is relevant: In terms of section 1(1), and for purposes of the Income Tax Act, "company" includes any association (not being an association referred to in paragraph (a) or (f)) formed in the Republic to serve a specified purpose, beneficial to the public or a section of the public – see paragraph (d) of the definition of "company". In terms of the above a voluntary association may be a company.

Registration as a taxpayer, not as an NPO, is necessary before application for approval under section 30 is made. It is normal to do this simultaneously. The constitution of the association must be submitted when the application is made. SARS will only approve the association as a PBO if the constitution meets all the requirements in section 30.

As defined, in section 30(1) of the Act, "public benefit organisation" means *"any organisation—*

(a) which is—

- i. *a non-profit company as defined in section 1 of the Companies Act or a trust or an association of persons that has been incorporated, formed or established in the Republic; or*
- ii. *…*

(b) of which the sole or principal object is carrying on one or more public benefit activities, where—

- i. *all such activities are carried on in a non-profit manner and with an altruistic or philanthropic intent;*
- ii. *…"*

In order to qualify for exemption from normal tax under section 10(1)(cN) of the Income Tax Act, the public benefit organisation must be "approved by the Commissioner in terms of section 30(3)" of the Income Tax Act.

Q We have a trading trust with unrealised foreign exchange gains in the current tax year. The question has come up as to whether the Trust should distribute the unrealised gains to beneficiaries. It is a discretionary trust and the trust deed caters for the trustees distributing income to beneficiaries at their discretion.

I am of the view that the unrealised gains will not be regarded as being a receipt or accrual and hence should not be available for distribution.

Does paragraph (n) of the definition of "gross income" change this to potentially include the gains in income on application of section 24I?

It is accepted that the trust deed does not define the word "income". If it does, it is unlikely that the definition would include unrealised gains. From a tax point of view, section 24I is indeed relevant.

However, it is section 25B(1), read with section 25B(2), that deals with the tax consequences of the vesting of income. Section 25B(1) refers to an "amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust".

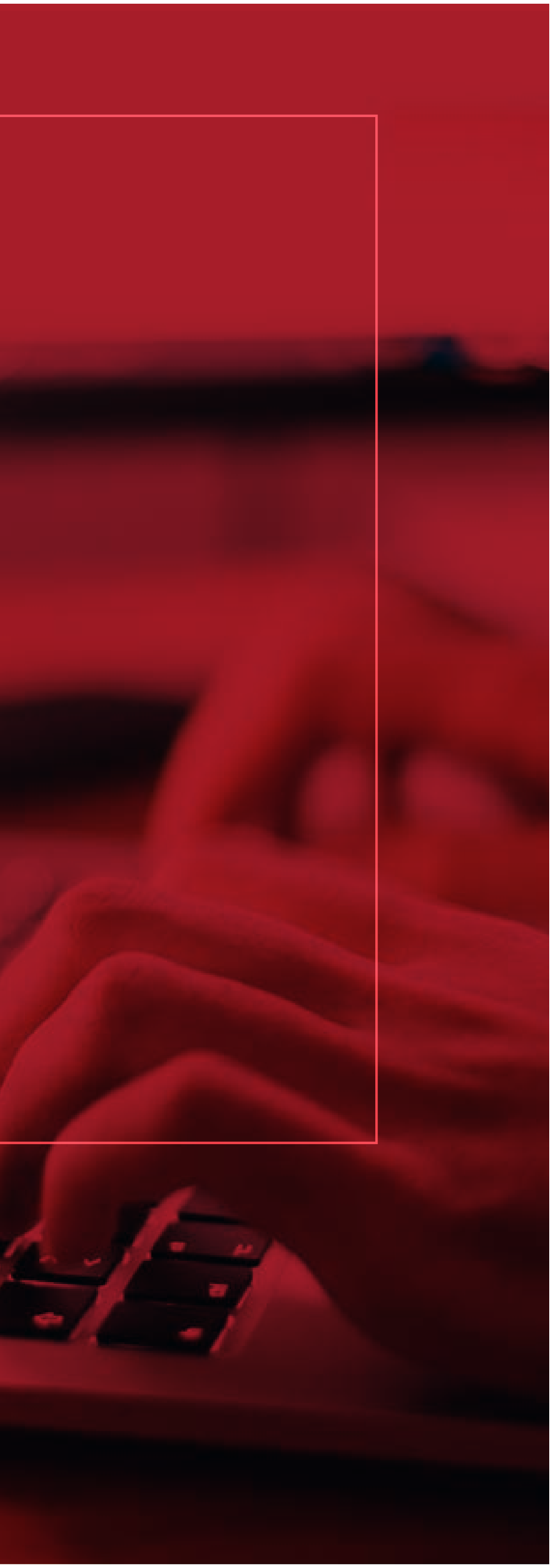
In terms of section 24I(3)(a), "… there shall be included in or deducted from the income, as the case may be, of that person any exchange difference in respect of an exchange item of or in relation to that person, subject to subsection (10A)…". It does not deem there to be a receipt or accrual by or to the trustees.

For the purposes of section 24I, " *'exchange difference' means the foreign exchange gain or foreign exchange loss in respect of an exchange item during any year of assessment determined by multiplying such exchange item by the difference between–*

(a) the ruling exchange rate on transaction date in respect of such exchange item during that year of assessment, and –

- i. *the ruling exchange rate at which such exchange item is realised during that year of assessment; or*
- ii. *the ruling exchange rate at which such exchange item is translated at the end of that year of assessment; or*

(b) the ruling exchange rate at which such exchange item was translated at the end of the immediately preceding year of assessment or at which it would have been translated had this section been applicable at the end of that immediately preceding year of assessment, and–



i. *the ruling exchange rate at which such exchange item is realised during that year of assessment; or*
ii. *the ruling exchange rate at which such exchange item is translated at the end of that year of assessment;"*

It is submitted that it would only be where an exchange item was realised during that year of assessment that there will be a receipt. Where the exchange item was not realised during the year of assessment of the trust there will, however, not be a receipt or an accrual. Section 25B would then not apply and the trustees cannot vest unrealised gain (for tax purposes).

Q Is the recoupment of the UDZ allowance taxable?

The taxpayer, a company, has an assessed loss of R2 million. This came about mainly via the allowance. Now there is a capital gain on the sale of a building of about R6 million. Normally 80% of the gain would be taxed at 28%. Can the tax loss be off set against 80% of the gain or does the recoupment wipe out the tax loss?

Normally recoupment of allowances is taxed as income. In this instance, we are not sure if this applies to the UDZ allowance.

Section 13quat of the Income Tax Act allows deductions in respect of the erection or improvement of buildings in urban development zones.

In terms of section 8(4)(a), of the Income Tax Act, "there shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, … whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment …"

The recoupment provisions of section 8(4)(a) therefore apply to deductions under section 13quat. SARS' *Guide to the Urban Development Zone (UDZ) Tax Allowance* (Issue 7), explains it as follows:

"The allowance will cease upon the sale of a building and the taxpayer will no longer qualify for any allowance from the year following the year of assessment in which the building was sold. All allowances that were previously deducted will then be subject to the recoupment provisions contained in section 8(4)(a). In addition, such taxpayer will be subject to taxation on any capital gain made on the disposal of the building."

The amount recouped will be included in gross income, as per paragraph (n) of the definition of gross income, and will consequently end up in the taxable income of the taxpayer for the year of assessment. The balance of the assessed loss can be deducted in arriving at the taxable income before the inclusion of the taxable capital gain (which is after the inclusion rate was applied).

Remember that the recoupment, as well as the section 13quat allowances, will reduce proceeds and base cost respectively.

Q My question relates to section 8(4)(a) and paragraph 66 of the Eighth Schedule and recoupments. I need to know how the calculation of the recoupment should be done.

When the recoupment is calculated on a depreciated asset is it correct to say (1) that the cost price will be the tax value (cost price less the depreciation) and (2) that the proceeds must be decreased by the wear and tear amount by which the asset was depreciated?

My problem is that most of the time there will then be a capital loss and, due to the capital loss, paragraph 66 may not be elected and therefore section 8(4)(e) is also not applicable.

If there is a "capital loss" and the asset is a "depreciable asset", as defined in section 1(1) of the Income Tax Act, the taxpayer would be entitled to elect to make a section 11(o) deduction. You are correct that section 8(4)(e) would then not apply. The cost (of acquisition) will then exceed the sum of the amount received or accrued from the alienation, loss or destruction of that asset and the amount of any allowance or deduction allowed in respect of that asset in that year or any previous year of assessment or which was deemed to have been allowed in terms of section 12B(4B), 12C(4A), 12DA(4) or 37B(4) or taken into account in terms of section 11(e)(ix), as the case may be. No paragraph 66 election would be possible because the proceeds then would not exceed the base cost.

It is important to remember that the taxpayer can make an election where the capital gain is zero.

In calculating the proceeds one must indeed deduct any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain – see paragraph 35(2) of the Eighth Schedule.

The same applies to base cost. One must deduct from the expenditure, any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person – see paragraph 20(3)(a) of the Eighth Schedule.

If the asset is disposed of for less than its original cost, and the asset was fully depreciated, this would mean that both the amount of "proceeds" and the amount of the "base cost" will then be zero. An election under paragraph 66 would, however, still be available because the proceeds received or accrued from that disposal are equal to or exceed the base cost of that asset – see paragraph 66(1)(b) of the Eighth Schedule. The SARS CGT guide provides some good examples that relate to these scenarios.

BINDING RULINGS

▶ **JANA DE CLERK,** jana@taxconsulting.co.za, **JEREMIAH LEE MOODLEY,** jeremiah@taxconsulting.co.za & **JUALEEN OOSTHUIZEN,** jualeen@taxconsulting.co.za

Our binding private rulings provide answers to the following questions: Will the de-grouping charge apply in a transaction subsequent to a previous intra-group transaction? Is an operating company leasing and buying land in order to conduct blueberry farming engaged in an "impermissible trade" in immovable property? What are the income tax and donations tax implications when loans owing to a settlor by a trust are waived?

BINDING PRIVATE RULING 331

De-Grouping Charge

Issue

The transferee company in the proposed intra-group transaction was the transferor company in an earlier intra-group transaction. This ruling determines the applicability of the de-grouping charge.

The transaction

The applicant is a listed resident company and a wholly owned subsidiary of company B. Company A is a listed resident company. Company B is a resident company and a wholly owned subsidiary of company A. Company C is a resident company and a wholly owned subsidiary of company D and company D is a resident company and a wholly owned subsidiary of company A.

Company A is the holding company of a group of companies (the group). Prior to 27 June 2017, all the shares in the applicant and 57% of company C's shares were held by a third party, and the remaining 43% were held by the applicant.

During 27 June 2017, company D acquired all of company C's shares, with 57% of the shares being acquired at market value and 43% of the shares being acquired from the applicant through an intra-group transaction.

The contemplated disposal of the shares in company D out of the group for cash consideration at market value necessitates the proposed transaction.

In order to retain company C as part of the group, company D proposes to dispose of the shares held in company C at nominal value in favour of the applicant, which will result in the applicant no longer forming part of the same group as company D.

Ruling

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

- The proposed transaction will not result in section 45(4)(b) applying to the applicant in respect of the 43% portion of the shares in company C that will be re-acquired by the applicant from company D in terms of the second section 45 transaction.
- The proposed transaction will result in section 45(4)(b)(i) applying to the applicant in respect of the 57% portion of the shares in company C that will be acquired by the applicant from company D, to the extent to which the 57% portion of the shares in company C are assets of which the market value is greater than the base cost. Section 45(4)(b)(i) will not apply to the applicant to the extent to which the 57% portion of the shares in company C are assets of which the market value is less than the base cost.

BINDING PRIVATE RULING 333

Venture Capital Company – Investment in Farming Operations

Issue

The applicant approached SARS for a determination on whether an operating company will be considered to be carrying on an impermissible trade in respect of immovable property as contemplated in paragraph (a) of the definition of "impermissible trade" in section 12J(1) of the Income Tax Act.

Therefore, the issue relates to an interpretation and application of the definition of "impermissible trade" and whether the proposed transaction by the applicant falls within the ambit of same.

Facts

The applicant is a resident company approved under section 12J(5) as a "venture capital company" as defined in section 12J(1).

The applicant wishes to subscribe to shares held in an operating company that is also a resident company.

The operating company will undertake farming activities that consist of planting, growing, harvesting and distributing blueberries. To conduct these activities, the operating company will purchase or lease vacant immovable property upon which farming operations will take place. These include irrigation systems, cold rooms, fencing, netting and planting of blueberry bushes.

Ruling

SARS ruled that the farming of blueberries by the operating company will not constitute an impermissible trade for purposes of paragraph (a) of the definition of "impermissible trade" contained in section 12J(1) of the Income Tax Act.

SARS issued this ruling without it being subject to any additional conditions or assumptions. The ruling is valid for a period of five (5) years from 30 July 2019.

BINDING PRIVATE RULING 334

Waiver of loan claims by the settlor of a trust

Issue

This ruling determines the tax consequences of the waiver of loans owing to the settlor by a trust, in terms of the Income Tax Act.

Facts

The applicant is a resident individual and the settlor and beneficiary of a trust that was formed and registered in South Africa.

The applicant has made loans to the trust in excess of R30 million. These proceeds were used by the trust to acquire equity interest in a South African private company. The loans made by the applicant to the trust are unsecured, interest-free and have no repayment terms.

To date, donations tax has been paid in respect of the interest that the applicant should have received on the loans as prescribed by section 7C, read with Part V of Chapter II of the Income Tax Act.

On or after 31 July 2019, the applicant intends to waive some of the loans to the trust.

Conditions and assumptions

The ruling is valid for a period of three years from 31 May 2019 and is subject to the following additional condition and assumption: All donations made on or after 1 March 2018 must be taken into account to calculate the aggregate value of the donations for purposes of section 64(1)(a) of the Income Tax Act, to determine the applicable donations tax rate.

Ruling

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

The applicant

The waiver of the loan claims by the applicant will constitute a donation as contemplated in section 55 of the Income Tax Act and will be subject to donations tax under section 54 at the applicable donations tax rate.

In terms of section 64(1)(a), the applicable rate of the donations tax chargeable will be 20% on donations with an aggregate value not exceeding R30 million, and 25% on donations with an aggregate value exceeding R30 million.

The applicant will be disposing of a debt owed by the trust which is a connected person to the applicant. Any capital loss determined as a result of such disposal must therefore be disregarded by the applicant under paragraph 56(1) of the Eighth Schedule to the Income Tax Act.

However, to the extent that the R100 000 exemption under section 56(2)(b) is taken into account to determine the donations tax payable, the capital loss of R100 000 will not be disregarded under paragraph 56(1), and this loss will be subject to paragraph 39.

The trust

In the event that the debt is reduced by way of a donation under section 55, paragraph 12A(6)(b) specifically excludes the application of paragraph 12A to the debt benefit received by the trust.

However, to the extent that the R100 000 exemption under section 56(2)(b) is taken into account to determine the donations tax payable, paragraph 12A will find application and the amount of expenditure so incurred in respect of the acquired shares must, for purposes of paragraph 20, be reduced by the debt benefit (R100 000) in respect of that debt.

Case Law
Wrap-up

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The cases summarised here deal with the interaction between accounting policy and the Income Tax Act, the timing of a claim for the commercial building allowance and a decision by SARS to grant or withdraw condonation for late submission of a notice of appeal.

C:SARS V ATLAS COPCO SOUTH AFRICA (PTY) LTD
(834/2018) [2019] ZASCA 124

Issue
Whether the taxpayer's internal accounting policy, which allowed for the write-down of trading stock, was in compliance with the provisions of section 22(1)(a) of the Income Tax Act.

Facts
The taxpayer, Atlas Copco SA (Pty) Ltd, was in the business of the sale and leasing of machinery and equipment. The taxpayer implemented an accounting policy that required the taxpayer to write down the value of its closing stock: by 50% if such closing stock had not been sold in the preceding 12 months, and by 100% if it had not been sold in the preceding 24 months.

SARS took the view that the taxpayer's accounting policy and write-down of stock did not comply with the provisions of section 22(1)(a) of the Income Tax Act. SARS accordingly added back the deducted value to the closing stock, on the grounds that "there was no diminishing value at year end for deduction to be claimed as a result of damage, deterioration, change of fashion [or] decrease in the market value in respect of stock".

The Tax Court had previously identified the crux of the dispute between the parties as being *"whether the nett realisable value ('NRV') of Atlas Copco SA's closing stock, calculated in accordance with the IAS2, IFRPS, South African Statements of Generally Accepted Accounting Practice (SA GAAP) and their internal policy, may and should, where it is lower than the cost price of such trading stock, be accepted as representing the value of the trading stock held and not disposed of at the end of the relevant years for purposes of section 22 (1)(a) of the Income Tax Act".*

The taxpayer's case
The taxpayer's position, which found favour with the Tax Court, was that the reference to market value in section 22(1)(a) is the same as the NRV employed in the Statement of Generally Accepted Accounting Practice (AC 108) or International Standard 2 (IAS2). Its application provided a sensible and business-like result, which was both just and reasonable for valuing the taxpayer's stock.

SARS' case
SARS disagreed with the finding of the Tax Court and successfully lodged an appeal in the Supreme Court of Appeal. SARS submitted that they may only grant a just and reasonable allowance in respect of diminution in value of trading stock under section 22(1), in two circumstances:

1. Where an event has occurred in the tax year in question causing the value of the trading stock to diminish; or
2. Where it is known with reasonable certainty that an event will occur in the following tax year that will cause the value of the stock to diminish.

Outcome
The Supreme Court of Appeal found in SARS' favour on the basis that the taxpayer did not suggest that there had been a diminution by reason of damage, deterioration, change of fashion or decrease in the market value of the stock.

Core Reasoning
The taxpayer relied on their internal policy and NRV, which were diametrically opposed to the provisions of section 22(1)(a) for the following reasons:

1. The preparation of annual financial statements in accordance with a company's accounting policy is not equally applicable to the determination of liability to tax under the Income Tax Act.
2. The overlap in scope between the provisions of section 22(1)(a) and IAS2 is limited, and they are not identical as proposed by taxpayer.
3. The determination of NRV is based on an assessment of future market conditions. This is contrary to the two basic principles that underpin section 22(1)(a).
4. Whether NRV reflects a diminution of value of stock for the purposes of section 22(1)(a) depends not on its acceptance as part of GAAP but on its conformity with the proper interpretation of the section.

As Walllis JA outlined in the matter of *Commissioner for the South African Revenue Services v Volkswagen South Africa (Pty) Ltd* (1028/2017) [2018] and paraphrased at paragraph 10 of the present ruling: "Whilst annual financial statements prepared in accordance with a group's accounting handbook serve a valuable purpose in providing a true picture about the financial affairs of the company, they are <u>not necessarily equally applicable to the determination of liability to tax under the Act"</u> (own emphasis added).

Take-Away

The ruling places an obligation on companies to ensure that internal accounting policies not only comply with domestic and international accounting standards, but that they are in accordance with the necessary provisions of the Income Tax Act, so as to align the financial affairs of a company with their tax liabilities.

XYZ CC V C: SARS

IT14434

Issue

In this matter, the Tax Court was required to determine the circumstances under which the appellant is entitled to claim a commercial building allowance as provided for under section 13*quin* of the Income Tax Act.

Facts

The appellant is XYZ CC, a resident investment company taxpayer that owns an income-generating commercial property. During the periods of assessment from 2007 to 2012 the appellant effected certain capital improvements to the property and claimed an allowance in terms of section 13*quin*.

The appellant claimed a lump sum building allowance of R6 670 507 in the 2014 year of assessment, which was the aggregate amount calculated under section 13*quin* for the tax periods in question.

SARS issued an additional assessment whereby only R1 195 384 of the section 13*quin* allowance was allowed, despite the appellant claiming R6 670 507. The deduction was partially allowed because the appellant failed to claim the allowances timeously in the respective tax periods in question.

Taxpayer's case

The appellant relied on the wording of section 13*quin*, and contended that the wording allowed the appellant to claim the aggregate allowance in the 2014 year of assessment, where the appellant did not claim the allowance during the previous tax periods. The appellant was also of the view that there would be no prejudice to the fiscus if SARS allowed these deductions, as these amounts would be recouped by the respondent upon the sale of the property.

The primary argument put forward by the appellant was that section 13*quin*(3) was ambiguously worded and, as a result, the Court should interpret the provision in favour of the appellant in terms of the *contra fiscum* rule. The appellant also indicated that there was no deeming provision that explicitly provided that the appellant may not claim the allowance for previous years in the current year of assessment. If this was contrary to the legislator's intention, it would have been clearly stated in the provision.

SARS' case

Counsel for SARS submitted that the appellant had failed to tender any evidence to establish that section 13*quin*(3) is ambiguous and, therefore, could not invoke the *contra fiscum* rule.

As the appellant had declared its rental income during the tax periods, SARS contended that the appellant should have claimed the section 13*quin* allowance in those respective years. SARS also went further in asserting that it is impermissible for the appellant to claim a lump sum, as tax is an annual event and allowances should be claimed annually.

In terms of SARS' interpretation of section 13*quin*(3), if the allowance could not be claimed because the receipts and accruals of the taxpayer were not included in its taxable income, the allowance is nonetheless deemed to be claimed and allowed.

Outcome

The appeal was dismissed, and the appellant was liable to pay the tax debt raised by the additional assessment for the 2014 year of assessment.

Core Reasoning

The Court found that it is trite that section 13*quin* was introduced to provide for capital allowances in respect of commercial immoveable property that generates income.

The Court held that the provisions of section 13*quin*(3) are clear and plain, and specifically stated the following in paragraph 12 of the judgment: "…It is clear that if the receipts and accruals were not included in the income of the taxpayer during the previous year of assessment, any deduction which could have been allowed in terms of section 13*quin* during that year shall be deemed to have been allowed in that year."

The Court was further aligned with SARS's argument that tax is an annual event and allowances should accordingly be claimed in each year. The Court referred to the matter of *New Adventure Shelf 122 (Pty) Ltd v C: SARS* [2017] (5) SA 94 (SCA), wherein the Supreme Court of Appeal stated the following:

> *"…. This is in line with the general principle that income tax is an annual fiscal event so that, as was stated by Botha JA in Caltex Oil (SA) Ltd v Secretary for Inland Revenue 1975 (1) SA 665 (A) at 677H678A:*
>
> > *'…events which may have an effect upon a taxpayer's liability to normal tax are relevant only in determining his tax liability in respect of the fiscal year in which they occur, and cannot be relied upon to re-determine such liability in respect of a fiscal year in the past.'..."*

On these grounds, the Court held that the deeming provisions were inserted to prevent taxpayers from delaying the claiming of deductions and to avoid unnecessary cash flow problems. Consequently, a taxpayer cannot claim a lump sum allowance in respect of any preceding year of assessment.

Take-Away

The judgment places an onerous duty on taxpayers not to rest on their laurels in claiming the section 13*quin* allowance timeously where improvements to commercial buildings are concerned. The Court found that the wording of section 13*quin* is not ambiguous and that the claiming of an allowance is an annual tax event which requires that these amounts be claimed in the correct tax year. Failing this, the taxpayer will not have any further relief under section 13*quin*, consequently raising the tax liability of the taxpayer.

CM V C: SARS

(TAdm 0035/2019)

Issue

The issue in this matter was whether the taxpayer was entitled to file a notice of appeal or to seek default judgment as a consequence of SARS' failure to file a statement of grounds of assessment as contemplated in section 104(2) of the Tax Administration Act, on SARS' issuance of a notice of invalid objection.

Facts

The taxpayer disclosed taxable income of R356 919 on her 2014 income tax return and declared an amount of R142 901 673 received as a "gift from her companion abroad". In January 2015, SARS raised an original assessment in which it was accepted that the "donation" made to the taxpayer was not subject to tax. However, in February 2015, SARS initiated a process of interrogating the tax return, with special focus on the foreign "donation". In its draft audit findings, SARS expressed the view that the amount (in the region of R142.9 million) was not a gratuitous donation and was instead subject to income tax.

The taxpayer and SARS then entered into settlement negotiations and the taxpayer's legal team proposed the following terms of settlement to SARS:

- That, of the amount of R142.9 million, a sum of R110.3 million be treated as taxable income
- That the balance be treated as a foreign donation not subject to tax
- That SARS not raise penalties on the late payment of tax on the sum of R110.3 million
- That the funds which the taxpayer's foreign benefactor would pay to enable the taxpayer to meet the tax on the sum of R110.3 million be recognised as a foreign donation not subject to tax.

SARS subsequently approved the above settlement proposal and issued an agreed assessment in terms of section 95(3) of the Tax Administration Act. The taxpayer was thus liable for approximately R44 million. SARS, through their legal counsel, expressed their acceptance in a letter to the taxpayer on 18 February 2016.

SARS raised an additional assessment in accordance with the settlement, dated 17 February 2016. Upon the taxpayer's payment of the agreed upon tax liability, SARS discharged a preservation order against the taxpayer and the taxpayer filed notices of withdrawal in the action.

The taxpayer, without lodging a request for an extension of time, lodged a notice of objection via e-Filing in terms of rule 7(1)(b) of the Rules promulgated under section 103 of the Tax Administration Act to the additional assessment of 17 February 2016. This was done 31 months after the settlement proceedings had concluded.

The taxpayer's case

The taxpayer stated that the reason for challenging the additional assessment was that she had paid the amount in terms of the "pay now, argue later" rule, but that the amount did not qualify as taxable income in her hands.

Upon SARS' failure to respond appropriately to the taxpayer's notice delivered in terms of rule 56, the taxpayer argued that SARS had failed to respond to her notice of appeal, in terms of rule 31, by not delivering its grounds of assessment. Further reliance was placed on section 9 of the Tax Administration Act whereby the taxpayer argued that SARS did not have the authority to withdraw its condonation. The taxpayer argued that section 9 could only be invoked at the request of the taxpayer and presented the explanatory memorandum accompanying Act 13 of 2017 in support of her argument.

SARS' case

SARS had initially issued the taxpayer with a letter condoning the late submission of the objection, which stated that the dispute would be processed. However, upon further review, SARS placed this decision "under review" and subsequently withdrew its condonation to the taxpayer's late filing based on the following:

- No exceptional circumstances existed to allow an extension of more than 30 days.
- SARS disputed that the applicant only became aware of the assessment on 7 September 2018.
- The additional assessment was raised in terms of section 95(3) of the Tax Administration Act and was, therefore, not subject to objection or appeal.

SARS subsequently issued a notice of invalid objection to the taxpayer, arguing that the taxpayer failed to comply with the rules in section 95(3) as the assessment in question was not subject to objection or appeal in terms of that section. Furthermore, SARS stated that the taxpayer was not "entitled" to object to the assessment, placing reliance on rule 7 and section 104 of the Act. SARS argued that the correct remedy for the taxpayer to have followed, if she were aggrieved by the assessment, was to have the tax court resolve the dispute by making an application in terms of rule 52(2)(b).

Outcome

The taxpayer was unsuccessful in her claim. It was dismissed with costs based on the court's opinion that she did not satisfy the requirement that reasonable grounds existed for the delay in her objection to the assessment and furthermore had not shown that exceptional circumstances existed in order to be granted the condonation.

Core reasoning

The court accepted that, for a rule 56 application to be valid, it must have been preceded by a valid objection and valid notice of appeal. In this regard, the court considered the relevant sections of the Tax Administration Act and rules pertaining to the process of an appeal to the tax court, more especially paying attention to the "entitlement" of a taxpayer to object to an assessment.

The court paid regard to SARS' contention that the taxpayer was not "a taxpayer who may object" in terms of rule 7(1) read with section 104(3) of the Tax Administration Act. On this basis, even if the taxpayer had lodged an objection within 30 days of the additional assessment of 17 February 2016, SARS would still have regarded her objection as invalid and as such the taxpayer would not have a further right to file a new notice of objection in terms of rule 7(5).

The court considered the taxpayer's interpretation of section 9 and disagreed, stating that the wording of the provision, though clearly enacted for the benefit of taxpayers, also implicitly meant that the power to withdraw or amend decisions could, in the court's view, also be exercised with adverse effect to the taxpayer.

The court further held that the decision to grant condonation and the subsequent withdrawal of the condonation was one which SARS could in principle withdraw or amend *mero motu*. The court found that SARS' decision to withdraw the condonation was justified on the merits. The explanation proffered by the taxpayer was not candid and the lack of substance within her explanation, when conveyed to a SARS official unacquainted with the history of the matter, would present the taxpayer in a light of only recently becoming aware of the assessment. This, the court held, was untrue and on the facts showed that the opposite was indeed the case.

Take-away

This decision shows the importance of correctly applying the rules and sections of the Tax Administration Act. It also shows that, although many administrative powers are ascribed to SARS by the Tax Administration Act, a SARS official does not have an unfettered power to extend the period for objecting to an assessment and must also abide by the requirements laid out in the relevant sections of the Tax Administration Act and rules.

Looking back on 2019....

Budget Review Event

Mandela Day

Mandela Day

Tax Indaba

Heritage Day

Gender Based Violence Protest

Gender Based Violence Protest

Tax Student Conference

South African Institute of Tax Professionals

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