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COMPANIES
CONTROLLED FOREIGN COMPANIES

DEDUCTIONS
PBOs: AUDIT CERTIFICATE PROVISIONS

GENERAL
REAL ESTATE INVESTMENT TRUSTS

TRADING STOCK
VALUATION FOR TAX AND IFRS

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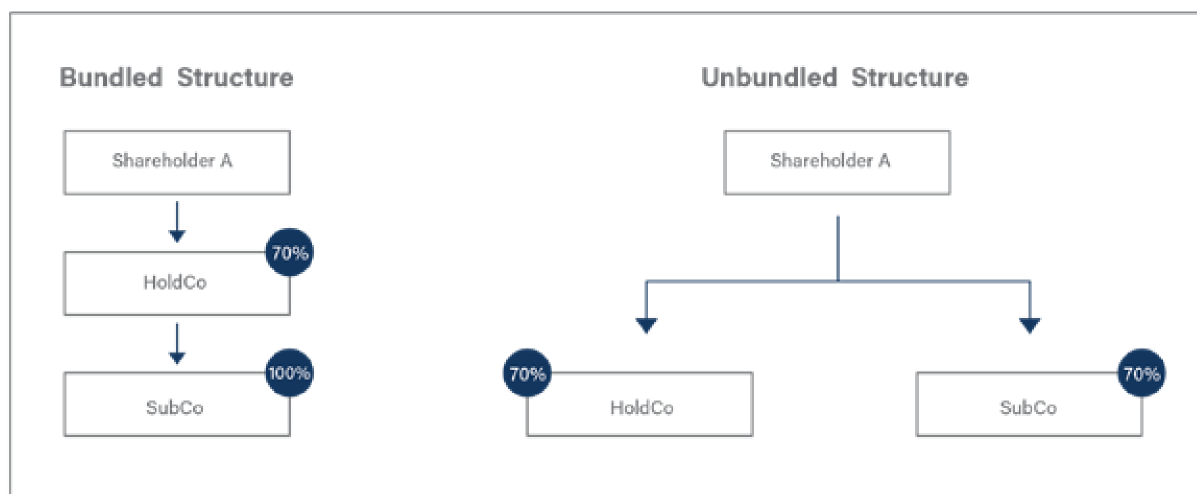
UNBUNDLING TRANSACTIONS: SARS RULING

Section 46 of the Income Tax Act, 1962 (the Act), provides tax relief where a company (the Unbundling Co) wishes to unbundle its shareholding in a subsidiary (the Unbundled Co), to the company's own shareholders. The Unbundling Co's shareholders' indirect shareholding in the Unbundled Co is converted to a direct shareholding, in proportion to their shareholding in the Unbundling Co.



Where an unbundling takes place outside the scope of section 46, as set out above, several tax consequences would ordinarily arise:

- Shareholder A would receive the shares in the subsidiary company (SubCo) as a dividend *in specie*, which may result in liability for dividends tax under Part VIII of Chapter II of the Act;
- The disposal of the shares in SubCo, would constitute a disposal under the Eighth Schedule to the Act, potentially resulting in a capital gain for the holding company (HoldCo); and
- Securities transfer tax (STT) would be payable on the transfer of all the shares under the Securities Transfer Tax Act, 2007.

On 24 May 2019, the South African Revenue Service (SARS) published Binding Class Ruling 066 (BCR 066). BCR 066 provides the income tax consequences and applicability of section 46 to the receipt of shares in a listed company by resident and non-resident shareholders, following an unbundling of that company by its listed parent company. It is binding only on the parties to the ruling.

The ruling dealt, among other things, with the following aspects of section 46:

- The definition of "unbundling transaction" in section 46(1)*(a)*; and the anti-avoidance provisions in section 46(3)*(a)*(v).

FACTS

The applicant in BCR 066 was a listed company with both listed and unlisted shares. A new company (NewCo) was to be formed and its single class of shares listed prior to the proposed unbundling. The shareholders in the applicant would upon the unbundling receive one NewCo share for each listed share they held in the applicant. In line with the participation rights attached to unlisted shares in the applicant, holders of these unlisted shares would receive one NewCo share for every five unlisted shares held in the applicant. In addition, some of the non-resident shareholders in the applicant were not able to accept transfer of ownership of the unbundled shares to them, due to being "restricted overseas shareholders" in their jurisdiction.

BCR 066 explains that because of the distribution of unbundled shares to the applicant's shareholders holding unlisted shares, it could result in such shareholders holding fractional entitlements. It was proposed that, rather than transferring these fractional entitlements, they be rounded down to a whole number and the aggregated excess fractions to which a shareholder would otherwise have been entitled will not be transferred to the shareholder but will instead be sold on behalf of the shareholder.

A similar mechanism was proposed in relation to the non-resident shareholders who could not accept transfer of the NewCo shares, with the NewCo shares being sold on their behalf and the proceeds paid to them upon completion of the transaction.

RULING AND DISCUSSION

Ordinarily, under section 46, shareholders of the Unbundling Co will receive transfer of a proportionate number of equity shares in the Unbundled Co. SARS decided on the facts of the ruling that, despite the shares being sold on behalf of the two types of shareholders, rather than the shares themselves being transferred, the transaction still fell within the definition of "unbundling transaction" in section 46(1)*(a)*. It is possible that SARS accepted this due to the specific facts of BCR 066. For example, in BCR 066, it is stated that the board resolution authorising and detailing the unbundling transaction provided that the entitlement to the NewCo shares would vest in the non-resident and unlisted shareholders and that ownership would transfer upon the unbundling.

Section 46(3)*(a)*(v) neutralises the tax value discrepancies which would occur where an indirect shareholding is unbundled into a direct shareholding. Essentially, it provides that the tax values – market value and expenditure as defined – of the unbundled shares, must be redetermined with reference to the market values of the unbundled and unbundling shares, at the end of the day that the distribution takes place.

> "BCR 066 is a good illustration of the underlying principles of the roll-over relief provided by section 46."

In BCR 066, SARS ruled that section 46(3)*(a)*(v) applied to both the holders of fractional entitlements and non-resident shareholders. This meant that the proportionate adjustment of the expenditure and market value of the shares to be sold on behalf of the above-mentioned shareholders would be calculated at the record date. This would determine the amount they would be entitled to, following the sale of the NewCo shares on their behalf.

BCR 066 is a good illustration of the underlying principles of the roll-over relief provided by section 46. To facilitate the restructuring of interests held within a group of companies, the indirect shareholding in a company can be unbundled to the shareholders of a parent company, without adverse tax consequences or significant economic distortion.

Cliffe Dekker Hofmeyr

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding class ruling* only applies to *SARS and the class referred to in the ruling*, and is published for general information. It does not constitute a practice prevailing. A third party may not rely on a class binding ruling under any circumstances. In addition, published binding class rulings may not be cited in any dispute with SARS, other than a dispute involving the class identified therein.

Act sections:

- Income Tax Act 58 of 1962: Section 46; Chapter II Part VIII (sections 64D–64N); Eighth Schedule;
- Securities Transfer Tax Act 25 of 2007.

Other documents:

- Binding Class Ruling 66.

Tags: tax relief; shareholding; unbundling transaction; anti-avoidance provisions; roll-over relief.

CONTROLLED FOREIGN COMPANIES

The various changes to the so-called debt waiver provisions in section 19 of the Income Tax Act, 1962 (the Act), and paragraph 12A of the Eighth Schedule to the Act affected in terms of the Taxation Laws Amendment Acts of 2017 and 2018 have come and gone. It is understood that the amendments to the debt waiver provisions as contained in the Act, are now in its final form. However, the tax implications for controlled foreign companies (CFCs) in relation to debt capitalisations may be different despite the various amendments to section 19 and paragraph 12A. This is the case in the context of a capitalisation of debt owing by one CFC to another CFC that is a shareholder of the first CFC.

BACKGROUND

A CFC is a foreign company in which more than 50% of the participation rights/voting rights are held/exercisable (directly or indirectly) by South African residents who are not headquarter companies. A wholly-owned foreign subsidiary of that CFC will also automatically be a CFC due to the proviso (ii) to paragraph *(a)* of the "controlled foreign company" definition in section 9D of the Act.

If there is a CFC, the effect is as follows: the "net income" of a CFC, as determined in accordance with section 9D(2A), is included in the taxable income of resident shareholders which hold 10% or more of the voting rights/participation rights in that CFC, in proportion to the shareholding held in the CFC, and taxed at the corporate income tax rate, unless certain exclusions apply.

In determining the "net income" of a CFC, section 9D(2A) provides that:

> "... the "net income" of a controlled foreign company in respect of a foreign tax year is an amount equal to the taxable income of that company *determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer*, and as if that company had been a resident for purposes of the definition of "gross income", sections 7(8), 10(1)*(h)*, 25B, 28 and paragraphs 2(1)*(a)*, 24, 70, 71, 72 and 80 of the Eighth Schedule:" (*emphasis added*)

The aforementioned means that the tax calculation, from a South African perspective, must be performed on the CFCs as if they were taxpayers in South Africa. When determining such net income, the CFCs are also treated as residents for purposes of certain provisions of the Act applicable only to "residents". As a result, section 19 and paragraph 12A will apply to CFCs to determine their "net income" for attribution purposes.

Hence, where one CFC capitalises its shareholder loan to its subsidiary (where that subsidiary is also a CFC), section 19 and paragraph 12A will apply if a debt benefit arises, ie, if the face value of the debt so capitalised exceeds the market value of the shares received in the other CFC. Moreover the exclusion for capitalisations between group companies (section 19(7)*(e)* and paragraph 12A(6)*(f)*) will not apply for purposes of section 19 and paragraph 12A, as the reference to "group of companies" is to the definition contained in section 41 of the Act and not the definition contained in section 1(1) of the Act (ie, it excludes foreign companies, and consequently CFCs, from the equation).

Therefore, in these circumstances, the CFCs will have "net income" for purposes of section 9D(2A). Yet, section 9D(9) states, *inter alia*, that . . .

> "(9) . . . in determining the net income of a controlled foreign company in terms of subsection (2A), there must *not* be taken into account any amount which—
>
> . . .
>
> *(f*A) is attributable to...
>
> . . .
>
> (iv) *the reduction or discharge* by any other controlled foreign company of a debt owed by that company to that other controlled foreign company *for no consideration or for consideration less than the amount by which the face value of the debt has been so reduced or discharged*,
>
> where that controlled foreign company and that other controlled foreign company form part of the same *group of companies*;..." (*emphasis added*)

"The CFC rules are complex enough on their own; it would therefore be unduly burdensome for taxpayers to concern themselves with two sets of 'debt waiver' rules for CFCs."

Interestingly, even though section 19 and paragraph 12A have undergone significant changes, it seems that section 9D(9) has not "kept up with the times", ie, it still uses the old language for the debt waiver rules which applied before the 2017 and 2018 amendments. Also, the tests to determine whether there was a "debt benefit" for purposes of section 19 and paragraph 12A differ substantially from those that apply to debt waivers. A "debt benefit" may therefore not be a "reduction or discharge" as contemplated in terms of the inter-CFC exemption provided for in section 9D(9)*(f*A)(iv).

Is it therefore intended that CFCs forming part of the same "group of companies" (section 1(1) of the Act's definition in this case) are exempt from the debt benefit rules given that more specific sections override more general sections? Or are taxpayers with potential CFC net income required to perform separate tests and market valuations that will inform which of these sections will apply or not? In some instances, it may give rise to some unintended consequences given the lack of alignment with the final wording of section 19 and paragraph 12A.

Given the uncertainty, National Treasury should consider aligning the wording used in section 9D(9) to eliminate any uncertainty or unintended tax consequences. The CFC rules are complex enough on their own; it would therefore be unduly burdensome for taxpayers to concern themselves with two sets of "debt waiver" rules for CFCs.

ENSafrica

Act sections:

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "group of companies"), 7(8), 9D(1) (proviso (ii) of paragraph ***(a)*** of the definition of "controlled foreign company", (2A) & (9), 10(1)***(h)***, 19, 25B, 28 & 41; paragraphs 2(1)***(a)***, 12A, 24, 70, 71, 72 and 80 of 12A of the Eighth Schedule;
- Taxation Laws Amendment Act 17 of 2017;
- Taxation Laws Amendment Act 23 of 2018.

Tags: debt waiver provisions; debt capitalisations; headquarter companies; foreign subsidiary; taxable income; debt waiver rules; market valuations.

PBOs: AUDIT CERTIFICATE PROVISIONS

When charitable organisations ask members of the public for donations, they often promise donors that the donation will be tax deductible and that they will issue the donor with a so-called "section 18A receipt". Section 18A of the Income Tax Act, 1962 (the Act), states that the entities referred to in that section, including certain public benefit organisations (PBOs), can issue receipts to donors which will entitle such donors to a tax deduction.

The entities that can issue a section 18A receipt are, amongst others:

- entities that are approved PBOs in terms of section 30 of the Act and which conduct public benefit activities (PBAs) listed in Part II of the Ninth Schedule to the Act (Activities PBOs);
- entities that are approved PBOs in terms of section 30 and which donate funds or assets to, amongst others, Activities PBOs that conduct activities listed in Part II (Conduit PBOs);
- entities that are approved as being tax-exempt in terms of section 10(1)*(cA)* of the Act; and
- the United Nations entities referred to in section 18A(1)*(bA)*, such as UNICEF.

Section 18A(2B) states that entities issuing section 18A receipts must obtain and retain an audit certificate confirming that all donations received or accrued in a particular year of assessment in respect of which donation receipts were issued, were used in the manner prescribed by the Act. On 21 June 2019, SARS issued Interpretation Note 112 (IN 112), which provides insight regarding

the provisions pertaining to audit certificates in section 18A(2B) and section 18A(2C). IN 112 expressly states that there is uncertainty as to how to comply with the audit certificate requirement. In this article, we discuss the audit certificate requirement in section 18A and what IN 112 states regarding its application to PBOs.

WHAT IS THE RATIONALE FOR THE AUDIT CERTIFICATE REQUIREMENT?

IN 112 explains that Part I of the Ninth Schedule lists the activities that are recognised as PBAs for purposes of section 30(1). Only some of the activities listed in Part I also appear in Part II. Section 18A(2A) provides that section 18A receipts can only be issued to a donor –

- by an Activities PBO, to the extent that the donation will be utilised in carrying on activities contemplated in Part II; and
- by a Conduit PBO, to the extent that the Conduit PBO provides the donated funds to an Activities PBO, institution, board or body, which will utilise the funds solely in carrying on activities contemplated in Part II. (A Conduit PBO must also comply with the requirement to distribute a certain amount of donations received, as stated in section 18A(2A)*(b)*).

As it is possible for an entity to conduct PBAs listed in Part I and Part II, but only issue section 18A receipts to donors for donations used in carrying on PBAs listed in Part II, section 18A(2B) was introduced as a control measure to ensure that section 18A receipts were issued only when permitted. This is a reasonable measure, as a section 18A receipt entitles the donor to claim a tax deduction that has a real cost to the fiscus, because the donee is normally not subject to tax on the donation received.

WHAT IS AN AUDIT CERTIFICATE?

IN 112 states that an audit certificate in the context of section 18A can be defined as a physical document, for example, a form, declaration or letter, that provides an opinion on the use of donations for which an approved organisation or department issued section 18A receipts.

WHO IS REQUIRED TO OBTAIN AND RETAIN AN AUDIT CERTIFICATE?

In the case of PBOs, only the following two types of PBOs need to obtain and retain audit certificates:

- an Activities PBO that conducts PBAs listed in both Part I and Part II; and
- a Conduit PBO that provides funds to Activities PBOs, or institutions, boards or bodies carrying on PBAs listed in Part I and Part II.

FROM WHOM MUST AN AUDIT CERTIFICATE BE OBTAINED AND WHEN WILL THE CERTIFICATE BE ACCEPTABLE?

IN 112 states that although the Act does not specify from whom an audit certificate must be obtained, SARS recommends that the person issuing the audit certificate must be independent of the PBO, suitably qualified and that appropriate work must have been performed to enable that person to express the opinion in the audit certificate. Strictly interpreted, confirmation regarding the use of all donations for which section 18A receipts were issued, would require detailed testing of every cash flow in respect of which a section 18A receipt was issued. However, IN 112 further states that control and system testing, representative sampling of section 18A receipts or a combination thereof may constitute appropriate work in the specific case and form the basis of expressing the required opinion.

"In 112 states that an audit certificate in the context of section 18A can be defined as a physical document, for example, a form, declaration or letter, that provides an opinion on the use of donations for which an approved organisation or department issued section 18A receipts"

Whether a person is suitably qualified involves a consideration of the person's qualifications and experience, taking into account, for example, the person's accounting, audit and tax knowledge and experience. For example, where a PBO is a non-profit company that is required to be audited or independently reviewed under the Companies Act, 2008 (the Companies Act), it can obtain an audit certificate from the independent auditor or independent reviewer appointed in terms of the Companies Act and any applicable regulations to it.

CONTENT OF AN AUDIT CERTIFICATE

In the case of an Activities PBO, the audit certificate must express an opinion confirming that all donations for which section 18A receipts were issued were used solely for PBAs listed in Part II. In the case of a Conduit PBO, the audit certificate must express an opinion confirming that the donations for which section 18A receipts were issued were used solely to provide funds to any PBOs, institutions, boards or bodies that use those funds solely in carrying on PBAs listed in Part II. In the case of a Conduit PBO, the audit certificate must also state that all donations received were

distributed as required under section 18A(2A)*(b)*(i). In addition to the prescribed opinion that must be issued in each case, IN 112 states that the audit certificate should at a minimum contain the following detail:

- The name and address of the approved PBO;
- The reference number issued to the approved PBO by SARS for purposes of section 18A;
- The taxpayer reference number of the PBO;
- The year of assessment to which the audit certificate applies;
- Full name, signature and designation of the person responsible for issuing the audit certificate;
- Details of the section 18A receipts issued by the PBO, for example the number of section 18A receipts issued and the total rand value of the donations for which section 18A receipts were issued;
- The date on which the certificate was issued;
- A statement addressing the following:
    - » A description of the work performed that formed the basis for the opinion reached, for example, the extent of the personal examination of the books of account and of the documents from which the books of account were written up;
    - » Whether the entries in those books and documents disclose the true nature of the transactions in so far as may be ascertained by that examination, and how the linkage between the funds for which a section 18A receipt was issued and the application of those funds to carry on PBAs in Part II was tested;
    - » Details of the local or international standards and regulations, if applicable, under which the audit was conducted; and
    - » Express confirmation that, in the opinion of the person issuing the audit certificate, sufficient and appropriate audit evidence was obtained to provide a basis for the opinion.

SUBMISSION OF AN AUDIT CERTIFICATE

It is not necessary for a PBO to submit the audit certificate to SARS with its annual income tax return. It only needs to be provided to SARS, upon request. However, IN 112 states that one must consider section 18A(5) and section 18A(5B), which stipulate various adverse consequences if SARS has reasonable grounds for believing that a section 18A receipt was issued in contravention of the Act. Failure to submit an audit certificate may be one of the facts giving SARS reasonable grounds for invoking section 18A(5) and section 18A(5B).

RETENTION OF AN AUDIT CERTIFICATE

Generally speaking, the audit certificate must be kept and retained for five years from the date of submission of the income tax return for the year of assessment to which it relates. However, there are circumstances in which it may have to be retained for a longer period. IN 112 lists the following two examples:

- Where an income tax return for a particular year of assessment is not submitted as required, the audit certificate must be retained indefinitely until the obligation to submit a return has been complied with. Once a return has been submitted, the audit certificate must be retained for five years from the date of submission; or
- If a person has been notified of or is aware of an audit or investigation by SARS regarding donations received or accrued, the issue of section 18A receipts or the usage of those donations, the audit certificate must be retained until the audit or investigation is concluded or the applicable five-year period has elapsed, whichever is the later.

COMMENT

The publication of IN 112 and the clarity it provides regarding audit certificates must be welcomed. Pursuant to the issue of IN 112, a Conduit PBO or Activities PBO that has been approved for purposes of section 18A, now knows with greater certainty how to comply with the audit certificate requirement in section 18A. It is also possible that SARS will more strictly monitor compliance with section 18A and the requirements pertaining to audit certificates. PBOs approved for purposes of section 18A should therefore ensure that they comply with the provisions regarding audit certificates to avoid SARS from invoking the provisions of section 18A(5) or section 18A(5A). In terms of these provisions, SARS can order that any donation is deemed to be taxable income of the PBO in a specific year of assessment, or that section 18A receipts issued after a certain date are invalid.

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: Sections 10(1)*(cA)*, 18A, 30; Part I and Part II of the Ninth Schedule to the Act;
- Companies Act 71 of 2008.

Other documents:

- Interpretation Note 112.

Tags: audit certificate; donated funds; tax deduction; audit evidence.

DEBT RELIEF PART II

The previous article on debt relief, published in Issue 17 of Tax Chronicles Monthly, focused on the legislation: the general application of the provisions and recent amendments. To recap: the provisions apply when a taxpayer obtains a "debt benefit" in consequence of a concession or compromise in respect of a debt. Cancellation, waiver, redemption and debt to equity conversions all are actions that may give rise to a debt benefit.

The tax treatment of the debt benefit depends on how the initial debt was applied.

TRADING STOCK – SECTION 19(3), (4) AND (5)

The tax treatment of a debt that was used to acquire trading stock will depend on whether the stock is still "held and not disposed of". A taxpayer is entitled to a deduction in terms of section 11*(a)* of the Income Tax Act, 1962 (the Act), in respect of the cost of trading stock acquired. So much of the stock that is still held at the end of the tax year is included in his taxable income as closing stock. This amount is carried forward to the subsequent tax year as opening stock and taken into account as a deduction. (Section 22(1) and (2) of the Act.)

"Generally speaking, the audit certificate must be kept and retained for five years from the date of submission of the income tax return for the year of assessment to which it relates."

If the trading stock is still held and not disposed of at the time the debt benefit arises, section 19(3) of the Act provides that the amount taken into account in terms of section 11*(a)* or 22(1) or (2) must be reduced by the amount of the debt benefit. In certain circumstances, the amount of the debt reduction may exceed the amount taken into account for purposes of section 22(3). This would for instance be the case where the taxpayer had opted to reduce the value of the trading stock as a result of a decrease in market value. In terms of section 19(4) any excess amount of the debt benefit will, for purposes of section 8(4)*(a)* of the Act, be deemed to be an amount that has been recovered or recouped and will be included in the taxpayer's income.

In the instance where the taxpayer has already disposed of the trading stock when the debt is reduced, he would be deemed to have recovered or recouped any amount that had been allowed as a deduction in respect of the acquisition of the trading stock.

GOODS AND SERVICES – SECTION 19(5)

Subsection 19(5) applies to all other expenses, as well as stock no longer held (see above). To the extent that the taxpayer had been granted an allowance or deduction in respect of the expense, the amount of the debt reduction will be deemed to be an amount that has been recovered or recouped for purposes of section 8(4)*(a)* and will be included in his income.

ALLOWANCE ASSETS – SECTION 19(6) AND PARAGRAPH 12A(3)

Allowance assets are strange creatures, forever crossing the capital/revenue divide. Accordingly, it is necessary to consider the implications for both capital gains tax (CGT) and income tax if the debt used to fund the acquisition of an allowance asset is reduced.

If the taxpayer still owns the asset when the debt is reduced, the starting point is paragraph 12A(3) of the Eighth Schedule to the Act. The aim of this provision is to reduce the base cost of the asset by the amount of the debt reduction. Section 19(6) then applies and any excess amount of the debt reduction, to the extent that it exceeds the base cost of the asset, is applied to deductions or allowances granted in respect of the asset. These amounts are deemed to have been recovered or recouped for purposes of section 8(4)*(a)* and are thus included in income.

The interaction between paragraph 12A, dealing with CGT, and section 19, dealing with income tax, can be demonstrated in the following example:

In Year 1, Mr A buys a machine for R1 000 000 on credit. He is entitled to a wear-and-tear allowance of R200 000 per annum. At the end of Year 2 his machine has an adjusted base cost of R600 000. He runs into financial difficulties and the creditor waives R750 000 of the R1 million loan. In Year 3 he decides to sell the machine for R800 000. His liability for tax is calculated as follows:

		Adjusted base cost:
Acquisition – Year 1	1 000 000,00	
Wear and tear – Year 1	-200 000,00	800 000,00
Wear and tear – Year 2	-200 000,00	600 000,00
Wear and tear – Year 3	-200 000,00	400 000,00
Debt reduction (Year 2) – R750 000:		
Adjusted base cost of R600 000 reduced to zero		
Recoupment – s 19A		**150 000,00**
Disposal – Year 3:		
Proceeds	800 000,00	
Less s 8(4)*(a)* recoupment	-450 000,00	R600 000 allowances less R150 000 included in Year 2

Adjusted proceeds	350 000,00	
Less base cost	0,00	
Capital gain		**350 000,00**
Recoupment – s 8(4)*(a)* recoupment		**450 000,00**

Mr A sells the machine in Year 2, while the waiver giving rise to the R750 000 debt benefit occurs in Year 3. Prior to the amendments, only the accumulated wear-and-tear allowance of R400 000 would have been deemed to be an amount recovered or recouped for purposes of section 8(4)*(a)*. Furthermore, since there is no longer an asset in respect of which paragraph 12A(3) can apply, the amount of the debt reduction can only be set off against his assessed capital loss. If no such loss exists, no further adjustments would have been necessary.

As from 1 January 2019, this anomaly has been addressed. Paragraph 12A(4) now provides that where a debt benefit arises in respect of an asset that had been disposed of in a previous year of assessment, the "absolute difference" between the capital gain or loss in respect of that disposal and the amount that would have been determined had the debt benefit been taken into account in the year of the disposal, must be treated as a capital gain in the year in which the debt benefit arises.

Prior to the amendments, the tax consequences for Mr A would have been...as follows:

		Adjusted base cost:
Acquisition – Year 1	1 000 000,00	
Wear and tear – Year 1	-200 000,00	800 000,00
Wear and tear – Year 2	-200 000,00	600 000,00
Wear and tear – Year 3	-200 000,00	400 000,00
Disposal – Year 2:		
Proceeds	800 000,00	
Less s 8(4)*(a)* recoupment	-400 000,00	
Adjusted proceeds	400 000,00	
Less base cost:	0,00	
Purchase price	1 000 000,00	
Less allowances	-400 000,00	
Adjusted base cost	-600 000,00	
Capital loss	**-200 000,00**	
Debt reduction in Year 3 – R750 000:		
No recoupment of allowances, already fully recouped in Year 2		
Assessed capital loss of R200 000 reduced to zero		

"When a taxpayer incurs an expense, whether to purchase stock or pay rent or buy a machine or fixed property, certain tax consequences arise."

Had the debt benefit occurred in the same year, the capital gain would have been calculated...as follows:

Proceeds	800 000,00
Less section 19 recoupment	-150 000,00
Less section 8(4)*(a)* recoupment	-250 000,00
Adjusted proceeds	400 000,00
Less base cost	0,00
Capital gain would have been	400 000,00

The absolute difference between this gain and the loss incurred by Mr A in Year 2 is R600 000. This amount must be taken into account as a capital gain. However, paragraph 8 of the Eighth Schedule to the Act provides that the gain must be set off against the capital loss of R200 000 carried forward from Year 2. He therefore has a net capital gain of R400 000.

NON-ALLOWANCE ASSETS – PARAGRAPH 12A(3) AND (4)

It is much simpler to account for the reduction of a debt used to fund the acquisition of a non-allowance asset (an asset in respect of which no deduction or allowance is granted in terms of the Act). If the asset is still held by the taxpayer at the time of the reduction, paragraph 12A(3) provides that the base cost of the asset must be reduced by the amount of the reduction. As mentioned above, the base cost can only be reduced to zero and the provision cannot create a negative base cost. Any excess must, in terms of subparagraph (4), be applied to reduce the taxpayer's assessed capital loss. If he has no assessed capital loss, no further adjustments need to be made for tax purposes.

If the taxpayer no longer holds the asset, subparagraph (4) applies in the manner explained above, except that there would be no recoupment of allowances.

IN CONCLUSION

When a taxpayer incurs an expense, whether to purchase stock or pay rent or buy a machine or fixed property, certain tax consequences arise. He may be entitled to an outright deduction or an allowance for income tax purposes, or he will have an asset with a base cost that he can deduct from proceeds for CGT purposes should he dispose of his asset. The debt benefit provisions effectively reverse or neutralise the tax consequences of transactions entered into which were funded by way of debt or borrowings. In practice, the application of the provisions may prove problematic because it is not always possible to specify for which purpose borrowed funds were applied. Many businesses are funded by both borrowings and earnings and do not necessarily keep a record of which funds are used to finance which expense. These provisions make it essential to keep accurate records of the purpose for which borrowed funds have been applied.

Unik Professional Services

Editorial comment: See also article 0142 in Issue 17 (December 2019) – "Debt Relief Part I".

Act sections:

- Income Tax Act 58 of 1962: Sections 8(4)*(a)*, 11*(a)*, 19(3), (4), (5) & (6), & 22(1) & (2); Eighth Schedule: Paragraph 12A(3) & (4)..

Tags: debt benefit; debt reduction; non-allowance asset.

REAL ESTATE INVESTMENT TRUSTS

The 2019 Taxation Laws Amendment Bill (TLAB) proposes key amendments to the taxation of real estate investment trusts (REITs). In particular, the proposed amendments provide clarification of the definition of "rental income" in respect of foreign exchange differences and also clarify the interaction between the corporate reorganisation rules and REITs.

CLARIFICATION OF THE DEFINITION OF "RENTAL INCOME" IN THE REIT TAX REGIME

The dedicated taxation regime provided for in the Income Tax Act, 1962 (the Act), relating to REITs, makes provision for a flow-through principle in respect of income and capital gains to be taxed solely in the hands of the investor of the REIT and not in the hands of the REIT itself. In turn, a REIT may claim distributions to its investors as a deduction against its income. This deduction may only be claimed if a distribution is considered a "qualifying distribution", which, amongst others, requires more than 75 per cent of the gross income of a REIT to consist of "rental income".

The term "rental income" is defined in section 25BB(1) of the Act to mean various amounts received and/or accrued to a REIT, including most importantly an amount received and/or accrued in respect of the use of immovable property (ie rental income).

Given South Africa's stagnating economy and the desire for South African REITs to diversify their investments, many South African REITs have invested (and continue to invest) in real estate outside of South Africa. Given these investments, many REITs enter into foreign exchange derivative contracts for purposes of hedging themselves against fluctuations in the highly volatile South African rand.

" Given these investments, many REITS enter into foreign exchange derivative contracts for purposes of hedging themselves against fluctuations in the highly volatile South African rand."

National Treasury has, however, identified that unrealised foreign exchange gains arising from the foreign exchange derivative contracts of a REIT do not qualify as "rental income" of a REIT, even though they are incurred solely for the earning of such "rental income". Instead, such gains/losses are, in terms of paragraph *(n)* of the definition of "gross income" in section 1(1), read with section 24I(3) of the Act, taken into account in determining the taxable income of such REIT.

In order to address this anomaly, clause 32 of the TLAB substitutes the definition of "rental income" in section 25BB(1) to include any foreign exchange gains arising in respect of an "exchange item" relating to the "rental income" of a REIT (or its subsidiary). Clause 32 of the TLAB thus contemplates one new insertion under the definition of "rental income" namely an "exchange gain" (EG) which will be incorporated into the formula to calculate "rental income" for any REIT's relevant year of assessment.

CLARIFICATION OF THE INTERACTION BETWEEN THE CORPORATE REORGANISATION RULES AND REIT TAX REGIME

National Treasury has further identified an issue regarding the interaction of the anti-avoidance measures contained in the corporate reorganisation rules and the provisions of section 25BB(5).

The Explanatory Memorandum on the Draft TLAB, 2019 (the Memorandum), states that in certain instances, if immovable property is disposed of by a REIT within 18 months after the implementation of the relevant corporate reorganisation, the anti-avoidance measures contained in the corporate reorganisation rules require that the rolled over capital gain in respect of such immovable property be added to the taxable capital gain of the REIT for the year of assessment in which the disposal of the immovable property takes place. On the other hand, section 25BB(5) provides for a capital gains tax exemption in respect of disposals of certain immovable property by a REIT. The anti-avoidance measures contained in the corporate reorganisation rules, when read with the provisions of section 25BB(5), create a discrepancy given that in general, corporate reorganisation rules override the provisions for the taxation of REITs in section 25BB.

National Treasury thus proposes that in order to ensure that the REIT rules are aligned with the corporate reorganisation rules, amendments should be made in the tax legislation so that corporate reorganisation rules do not give rise to capital gains tax on disposal of assets within 18 months after their acquisition by a REIT under a corporate reorganisation rule.

CONCLUSION

The issues identified by SARS regarding REITs and the proposed amendments aimed at clarifying the issues are likely to be welcomed in the real estate industry.

Cliffe Dekker Hofmeyr

Act sections:

- Taxation Laws Amendment Bill 18 of 2019: Clause 32;
- Income Tax Act 58 of 1962: Sections 1(1) (paragraph *(n)* of the definition of "gross income"), 24I(3), & 25BB(1) (definition of "rental income") & (5).

Other documents:

- Explanatory Memorandum on the draft Taxation Laws Amendment Bill, 2019;
- Draft Taxation Laws Amendment Bill, 2019: Clause 31.

Tags: rental income; immovable property; taxable income; exchange gain; exchange loss; anti-avoidance measures.

WITHDRAWALS FROM FUNDS UPON EMIGRATION

Prior to the change in tax legislation effective from 1 March 2020, South African tax residents who are employed outside of South Africa were (subject to certain criteria) exempt from South African tax on their foreign remuneration. From 1 March 2020 the maximum exemption from tax has been limited to the first R1 million of their foreign remuneration. However, the potential impact of a double taxation agreement between South Africa and the country where the person is employed needs to be taken into consideration. Persons considering formal emigration need to be aware of the implications that these steps have on being able to withdraw lump sums from retirement annuity funds, pension preservation funds and provident preservation funds.

> "Amendments effective from 1 March 2017 were made to the Income Tax Act to allow for transfers of amounts between, or within, retirements funds of the same employer so as not to create a taxable fringe benefit."

A member of a retirement annuity fund is entitled to receive the full value of the after tax lump sum benefit from the retirement annuity fund if the member emigrates from South Africa, and such emigration is recognised by the South African Reserve Bank (the SARB) for the purposes of exchange control. Expatriates are also allowed to withdraw the full value of after tax lump sums from their retirement annuity funds when they leave South Africa at the expiry of the work visas that were granted in terms of the Immigration Act, 2002.

As from 1 March 2019 the above concession has been extended to members of pension preservation and provident preservation funds if the members emigrate from South Africa and such emigration is recognised by the SARB for the purposes of exchange control or upon repatriation on expiry of their work visas. Prior to 1 March 2019 only members of retirement annuity funds were able to access and withdraw the full value of their after tax retirement benefits upon emigration or repatriation on expiry of the work visa, while members belonging to pension preservation funds or provident preservation funds were not permitted to do so.

Transfers of actuarial surplus between retirement funds

Contributions made by an employer-owned retirement fund into another employer-owned retirement fund for the benefit of the employees, previously created a taxable fringe benefit in the hands of employees.

Transfers of actuarial surpluses between, or within retirement funds of the same employer previously triggered fringe benefits in the hands of employees. The transfers were deemed to be a contribution by the fund for the benefit of employees and regarded as a taxable benefit in the employees' hands. Amendments effective from 1 March 2017 were made to the Income Tax Act to allow for transfers of amounts between, or within, retirements funds of the same employer so as not to create a taxable fringe benefit.

PKF

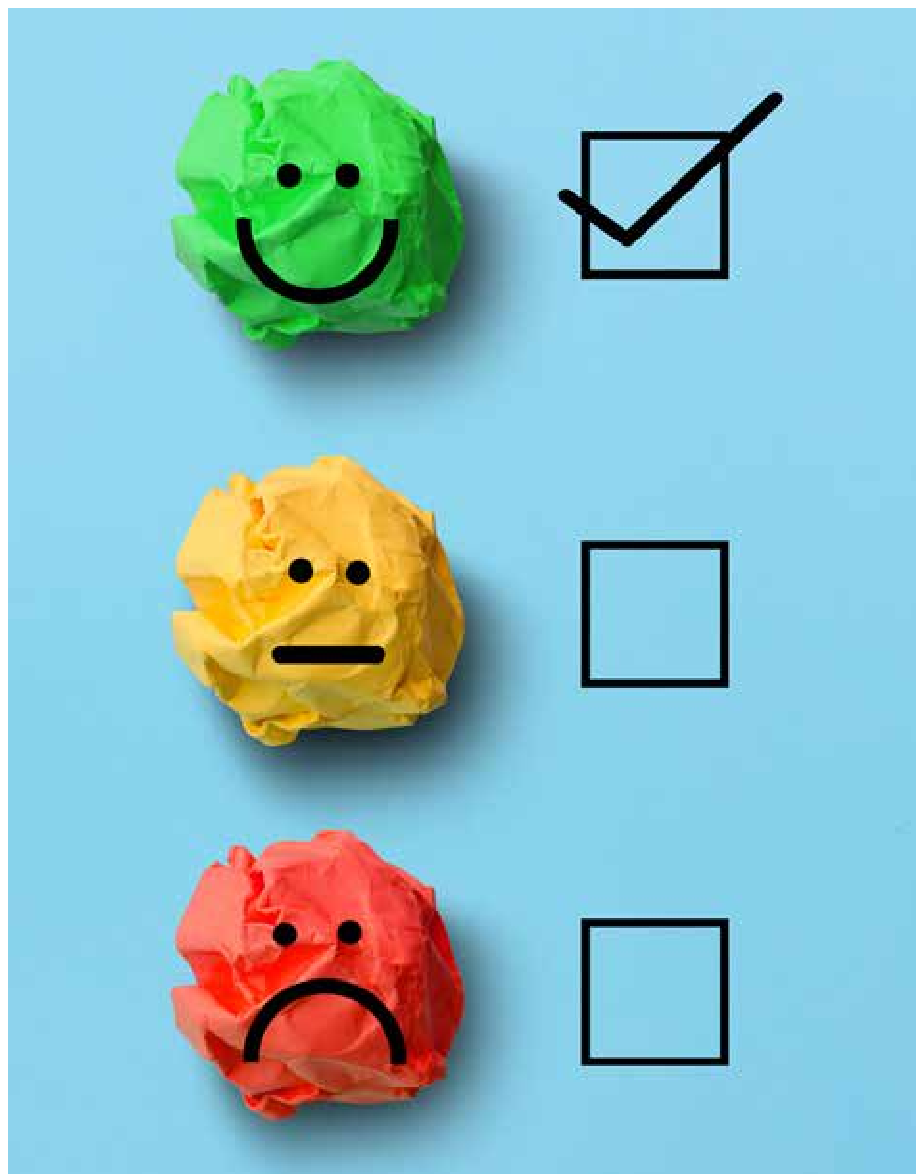
Act sections:

- Immigration Act 13 of 2002.

Tags: taxable income; double taxation agreement; exchange control; taxable fringe benefit.

REVIEW OF SARS ASSESSMENT OR DECISION

In terms of South African tax law, where a taxpayer wishes to object or appeal against an assessment issued by or decision made by the South African Revenue Service (SARS), it must do so in the manner prescribed in the Tax Administration Act, 2011 (the TAA). Where a dispute is not resolved pursuant to an objection lodged by a taxpayer, the taxpayer can appeal the decision to the tax court.



But what happens if the taxpayer wants to review an assessment or decision before the High Court, where the objection and appeal process is still ongoing?

In *Gold Kid Trading CC v The Commissioner for the South African Revenue Services*, 2018, the South Gauteng High Court was asked to consider, among other things, the application of section 98 of the TAA to exhaust internal remedies, as provided for in section 7(2) of the Promotion of Administration of Justice Act, 2000 (PAJA).

In this case, Gold Kid sought to review and set aside the decision of SARS to reverse the value-added tax (VAT) assessments in terms of which refunds were due to Gold Kid in respect of the tax periods 2014/08 – 2015/03 (Disputed Period) and the interest on refunds for other tax periods.

FACTS

Gold Kid is in the business of, among other things, exporting and selling gold offshore. As the supply of gold in terms of section 11 of the Value-Added Tax Act, 1991 (the VAT Act), to foreign purchasers is subject to VAT at the zero rate where the requirements of section 11 have been met, the price paid by the foreign purchasers would then be the purchase price plus VAT at 0% (the judgment states that the foreign buyers were exempted from paying VAT).

Up until 2016, SARS had paid the refunds pursuant to the submission of VAT returns by Gold Kid. In 2016, this seemed to be no different and SARS raised an assessment concerning the December 2015 VAT period reflecting a refund due to Gold Kid of approximately R70 million.

Subsequent to the assessment, however, SARS commenced with an audit and as a result delayed in paying the refund. Gold Kid pursued litigious avenues by way of an urgent application to compel SARS to pay in accordance with section 190(1) of the TAA. The application was unopposed, and the court found in Gold Kid's favour. SARS then paid the amount as per the order.

In 2017, SARS withdrew the assessment by way of an additional assessment issued 17 March 2017 which resulted in an amount owing by Gold Kid to SARS. SARS opted to disallow the VAT refund claimed by Gold Kid in its VAT returns for the Disputed Period on the basis that it was not satisfied that the suppliers which Gold Kid had listed in its supporting documentation to the VAT returns existed.

Gold Kid objected to the additional assessment and subsequently took the matter on appeal to the tax court. Concurrently, Gold Kid decided to take the matter on review to the High Court, which is the matter discussed here.

RELEVANT LEGAL FRAMEWORK

In considering the matter, the High Court had to consider, among other things, the following provisions:

Section 98 of the TAA, which provides for the withdrawal of assessments by SARS. The section states that:

> "(1) SARS may, despite the fact that no objection has been lodged or appeal noted, withdraw an assessment which –
>
> *(a)* was issued to the incorrect taxpayer;
>
> *(b)* was issued in respect of the incorrect tax period; or
>
> *(c)* was issued as a result of an incorrect payment allocation.
>
> (2) An assessment withdrawn under this section is regarded not to have been issued, . . ."

Section 117 of the TAA, which provides for the jurisdiction of the tax court, states the following:

> "(1) The tax court for purposes of this Chapter has jurisdiction over tax appeals lodged under section 107.
>
> (2) The place where an appeal is heard is determined by the 'rules.'
>
> (3) The court may hear and decide an interlocutory application or an application in a procedural matter relating to a dispute under this Chapter provided for in the 'rules.'"

Section 190(1) and (2) of the TAA, which provides for refunds of excess payments, states:

> "(1) SARS must pay a refund if a person is entitled to a refund, including interest thereon under section 188(3)*(a)*, of –
>
> *(a)* an amount properly refundable under a tax Act and if so reflected in an assessment; or
>
> *(b)* the amount erroneously paid in respect of an assessment in excess of the amount payable in terms of the assessment.
>
> (2) SARS need not authorise a refund as referred to in subsection (1) until such time that a verification, inspection or audit of the refund in accordance with Chapter 5 has been finalised."

The court also considered section 7(2) of PAJA, which provides that "…no court or tribunal shall review an administrative action in terms of this Act unless any internal remedy provided for in any other law has first been exhausted."

JUDGMENT

Grounds of review

Gold Kid instituted the review for the setting aside of the additional assessment on the grounds that SARS' decision to raise the additional assessment was not rationally connected to the purpose for which the decision was taken and that such decision was unreasonable. Furthermore, that SARS had failed to consider the relevant information from the suppliers which SARS was not satisfied were in existence. Gold Kid also alleged that as a result of the order obtained pursuant to the urgent application SARS had lost its right to audit it for the periods in dispute.

"The High Court found that SARS' right to continue the audit would turn on the interpretation of the order obtained in 2016"

The High Court found that SARS' right to continue the audit would turn on the interpretation of the order obtained in 2016. The High Court in this instance highlighted that the court in the urgent application merely dealt with section 45 of the VAT Act as well as section 190(1)*(a)* of the TAA, which obliged SARS to pay Gold Kid in respect of the assessment issued by themselves as well as interest provided for by way of section 45 of the VAT Act. SARS did not dispute this, but maintained that it did not restrain it from exercising its powers in terms of section 98 of the TAA. The High Court in this instance agreed with SARS' arguments.

Res judicata

Gold Kid raised the issue of *res judicata* in this instance, but the High Court, although it did not comment on the principles which are already well-established in our law, found that due to the fact that the court review application had not dealt with the merits of the assessments and facts in the matter such argument of *res judicata* could not be sustained herein.

Exhaustion of internal remedies

The issue of jurisdiction was raised and section 117 of the TAA, as well as section 7 of PAJA, was considered. The High Court held that when one considers sections 107 and 129(2) of the TAA, it appears that the tax court does not have the power to consider whether an assessment made by SARS is reviewable on the grounds of review listed in PAJA. The High Court held that the powers afforded to the tax court do not oust the powers of the High Court to hear review applications related to the exercise of power by SARS. That said, the High Court ultimately conceded that although it had the jurisdiction to hear the matter before it, Gold Kid had failed to exhaust the internal remedies afforded to it in terms of the TAA, as directed by section 7 of PAJA.

High Court's findings

It remained undisputed that SARS was entitled to withdraw the earlier assessment it had made in terms of section 98 of the TAA on the basis that SARS was not satisfied that Gold Kid's suppliers were in existence.

The High Court, however, ultimately found that Gold Kid had failed to exhaust the internal remedies provided for in respect of the TAA and that no reason existed as to why Gold Kid should not have exhausted the internal remedies before considering a review.

The merits of the review application were therefore not considered, and Gold Kid was ordered to exhaust the internal remedies afforded to them in terms of the TAA first.

COMMENT

The judgment suggests that even though a tax court cannot consider whether an assessment should be set aside in terms of the grounds of review in PAJA, a taxpayer must first exhaust the dispute resolution process provided for in terms of the TAA. In stating that it is not necessary to consider the merits of the review application "at this stage", the High Court's judgment seems to suggest that the merits of the review application, based on grounds of review in PAJA, can be heard once the dispute resolution process in terms of the TAA has been concluded.

Cliffe Dekker Hofmeyr

Act sections:

- Tax Administration Act 28 of 2011: Sections 98, 107, 117, 129(2), 188(1) & (3), 190(1) & (2); chapter 5;
- Promotion of Administrative Justice Act 3 of 2000: Section 7;
- Value-Added Tax Act 89 of 1991: Sections 11 & 45.

Cases:

- *Gold Kid Trading CC v The Commissioner for the South African Revenue Services* (2016/31842) [2018] ZAGPJHC 710 (19 July 2018).

Tags: exhaust internal remedies; additional assessment; review application; dispute resolution process.

VALUATION FOR TAX AND IFRS

On 27 September 2019 the Supreme Court of Appeal (SCA) delivered its judgment in CSARS v Atlas Copco South Africa (Pty) Ltd. In doing so the court drew heavily on its 2018 judgment in CSARS v Volkswagen SA (Pty) Ltd. As was the case in Volkswagen, central to the issues in Atlas Copco were the effects of international financial reporting standards (IFRS) on the provisions of section 22 of the Income Tax Act, 1962 (the Act), dealing with the valuation of trading stock.

The taxpayer is a member of the Atlas Copco Group, with its parent company in Sweden. In terms of group policy, its main business is to sell or lease, and subsequently service, machinery and equipment, including spare parts and consumables, imported mainly from Sweden and used in the mining and related industries. Group policy, known as the Finance Controlling and Accounting Manual (FAM), required the taxpayer to write down the value of its trading stock by 50% if it had not sold in the preceding 12 months and by 100% if it had not sold in the preceding 24 months.

The taxpayer duly applied this policy and reflected the resulting values in its tax returns for the 2008 and 2009 years of assessment. SARS took the view that this policy did not comply with the provisions of section 22(1)*(a)*, which provides for the carrying value to be reduced to the extent that it had been diminished by reason of "damage, deterioration, change of fashion, decrease in market value or for any other reason satisfactory to the Commissioner". In the first appeal, the tax court had identified what it called the crisp legal dispute between the parties as being "whether the nett realisable value ('*NRV*') of the Atlas Copco SA's closing stock, calculated in accordance with IAS2, IFRS, South African Statements of Generally Accepted Accounting Practice ('SA GAAP') and the policy, may and should, where it is lower than the cost price of such trading stock, be accepted as representing the value of 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 tax court found that the policy led to a "sensible and businesslike result" and was a "just and reasonable basis" for valuing the taxpayer's stock as contemplated in section 22(1)*(a)*. In doing so it had followed the decision of the tax court in *Volkswagen*, but without the benefit of knowing that the SCA had subsequently reversed this decision.

On appeal by SARS, the SCA noted that section 22(1)*(a)* is concerned with the value of a taxpayer's trading stock at year end. SARS has the power to allow a deduction in the four circumstances

specified in the section: damage, deterioration, change of fashion, and decrease in market value or for any other reason satisfactory to the Commissioner. As it had done in *Volkswagen*, the court observed that this provision is couched in the past tense; in other words, the diminution in value must have already occurred. The exercise was thus one of looking back at what had happened during the past year of assessment.

The taxpayer's case was that the reference to market value in section 22(1)*(a)* is the same as NRV as employed in the accounting statements. However, the SCA traversed its decision in *Volkswagen*, summarising the five "important observations" made by Wallis JA:

(a) whilst annual financial statements prepared in accordance with a group's accounting handbook serve a valuable purpose in providing a true picture of the company's financial affairs, they are not necessarily equally applicable to the determination of the taxpayer's tax liability;

(b) although there is some scope for overlap, not all the elements of accounting standards relate to the same matters as the section;

(c) the determination of NRV is based on an assessment of future market conditions. It is forward looking, which has the result that future expenditure is taken into account and becomes deductible in a prior year;

(d) whether NRV reflects a diminution of value of trading stock for purposes of section 22(1)*(a)* depends, not on its acceptance as part of GAAP, but on its conformity to the requirements for diminution in value as determined on a proper interpretation of the section; and

(e) the fiscus is concerned with the valuation of trading stock, the question being whether trading stock as a whole had suffered a diminution in value. [This remark had raised some unease in tax circles, suggesting as it did that section 22(1)*(a)* does not call for an item by item consideration of the value of trading stock].

Accordingly, found the court, the tax court in the present matter had erred as had the tax court in *Volkswagen*.

Atlas Copco, by its own admission in evidence, had not considered whether there had been a diminution by reason of any of the criteria mentioned in section 22(1)*(a)*. It had merely applied the group's policy on aging without regard to any other factor. This purely time-based approach was not entirely consonant with the requirements of section 22(1)*(a)*. It was an arbitrary, fixed and rigid company policy and "did not present the most reliable evidence available at the time in respect of any diminution in value". The taxpayer's auditor testified that they had identified only three product lines that had been sold below cost during the year, and these at between 24% and 26% below cost. As the court commented, this is a far cry from the application of 50% or 100% in terms of the policy. In fact, the auditor conceded that the group policy was "a very aggressive policy".

As the court stated, this evidence indicated that the taxpayer's approach to the valuation of its trading stock was flawed and ordinarily this would have been dispositive of the appeal. However, it was necessary to deal with each of the six categories that made up the taxpayer's trading stock.

Slow moving and overstock categories. The taxpayer asserted that it operated in the mining sector and had to meet orders at relatively short notice. For this reason it had surplus stocks of various items from time to time. The FAM policy was applied to these items, not because they had deteriorated, but because they had been on hand for longer than the group's 12-month or 24-month policy. There was no indication of any diminution in these items; it was "at best an unmotivated guesstimate" as to whether there would in future be demand for them.

Goods in transit. These were goods that for whatever reason had to be returned to the Swedish parent company. On the evidence of the taxpayer's witness, the taxpayer relied on an unsubstantiated estimate of the value of these stocks.

Demonstration items. Although the taxpayer's witness conceded that these ought to have been recorded in a fixed asset register, they were kept as part of inventory and valued for tax purposes at 50% of cost, save for items that could not be located; these were reduced by 100%. The evidence suggests a less than satisfactory treatment of these items.

Dynapac stock. This consisted of road construction heavy equipment and spare parts. This had been acquired in October 2008, a mere two and a half months before the financial year end. Under the "enormous pressure" of year end preparations, the taxpayer had simply followed Dynapac's valuation policy and written assets off by 100%. There was no evidence that the diminution conditions of section 22(1)*(a)* had been considered, let alone applied.

Standard cost items. These comprised items acquired from the parent company, only to be notified by the latter later during the tax year of a price increase or decrease. The taxpayer was unable to tender any satisfactory evidence as to the value of the stock at year end.

It was apparent to the court that the taxpayer's approach in respect of all the stock categories was that, because it held thousands of items of stock at year end, it was not feasible to value each item individually. The tax court had accepted this explanation in support of the proposition that the legislature could not have intended that a trader should assess every item of closing stock in these circumstances. The SCA found that this acceptance was misplaced. SARS had never contended that the taxpayer had to assess each item individually. SARS had accepted that the practice of sampling is a well-recognised method of dealing with high volume trading stock. However, this was not what the taxpayer had done in the present matter.

For all the reasons given, the decision of the tax court could not stand. The appeal was upheld with costs, including two counsel.

The taxpayer had also appealed against SARS' imposition of interest under section 89*quat* of the Act for underestimating provisional tax based on the taxpayer's estimate of taxable income. The court found no warrant for remitting this interest.

The SCA has now twice within a year confirmed that the application of accounting standards to valuing trading stock, without reference to the four circumstances in section 22(1)*(a)*, is not acceptable for tax purposes. Unfortunately, however, the court did not clarify the aspect of the *Volkswagen* judgment that has caused the unease in tax circles, and which appears in (e) above. In fact, all the court did was to refer without comment to the statement of Wallis JA at [46]: "However, I can see no reason for the Commissioner to accept that Volkswagen's trading stock had diminished in value on the basis of a calculation where Volkswagen took advantage of the 'swings', where the NRV was lower than cost price, but disregarded the "roundabouts", where the reverse was true. For tax purposes the question was whether Volkswagen's trading stock as a whole had suffered a diminution in value". With the utmost respect, if by "roundabouts" the learned judge was referring to increases in the NRV of some items of trading stock, these are irrelevant for purposes of section 22(1)*(a)*. The section is clear: if the value of an item of trading stock has fallen below its cost price, in consequence of one or more of the circumstances contemplated in section 22(1)*(a)*, its carrying value for tax purposes is the lower figure. If the NRV of the item has increased above cost, its carrying value is the cost price.

However, the court in *Atlas Copco* accepted SARS' statement that sampling is a well-recognised, and by implication acceptable, method of dealing with high volume trading stock. The wider implication is that blanket valuation methods are not acceptable; if trading stock is not high-volume, an item by item, or at least by groups of stock of similar nature and value, approach is required.

It seems that the uncertainty surrounding Wallis JA's remarks have concerned SARS as well. In the Taxation Laws Amendment Bill, 2019, published on 30 October 2019, the following amendment appears in respect of section 22(1)*(a)*:

> "**24.** (1) Section 22 of the Income Tax Act, 1962, is hereby amended by the addition in subsection (1) to paragraph *(a)* of the following proviso:

"It seems that the uncertainty surrounding Wallis JA's remarks have concerned SARS as well."

> ': Provided that for the purposes of this subsection—
>
> (i) the amount of trading stock must be taken into account in determining taxable income by including such amount in gross income; and
>
> (ii) in determining any diminution in the value of trading stock, no account must be taken of the fact that the value of some items of trading stock held and not disposed of by the taxpayer may exceed their cost price; and'.
>
> (2) Subsection (1) comes into operation on 1 January 2020 and applies in respect of years of assessment commencing on or after that date."

By introducing this additional proviso, SARS aims to eliminate any doubt that the reference to "roundabouts" in [46] of the *Volkswagen* judgment does not mean that increases in NRV of items of trading stock should be taken into account in determining the value of closing stock for purposes of section 22(1)*(a)*. Only diminutions in the value below cost price, the "swings" mentioned in [46], may be taken into account, provided they are caused by one of the four criteria listed in section 22(1)*(a)*.

Prof Peter Surtees

Act sections:

- Income Tax Act 58 of 1962: Sections 22 & 89*quat*;
- Taxation Laws Amendment Bill 18 of 2019.

Other documents:

- International Financial Reporting Standards (IFRS);
- South African Statements of Generally Accepted Accounting Practice (SA GAAP);
- IAS 2.

Cases:

- *CSARS v Atlas Copco South Africa (Pty) Ltd* (834/2018) [2019] ZASCA 124;
- *CSARS v Volkswagen SA (Pty) Ltd* (1028/2017 [2018] ZASCA 116.

Tags: international financial reporting standards (IFRS); diminution of value; by its own admission; valuation policy.

SARS PRACTICE NOTE

South Africa's transfer pricing guidance, as contained in the South African Revenue Service's (SARS') Practice Note 7 (PN 7), is the oldest on the continent – on 6 August 2019 it was 20 years old. This article gives an overview of PN 7 and its importance for transfer pricing in South Africa as well as some other interesting facts.

BACKGROUND

South Africa, like many other countries on the continent and abroad, has transfer pricing legislation in place. Section 31 of the Income Tax Act, 1962 (the Act), was introduced in 1995. Until 2012 only marginal amendments were made to the section. With effect from years of assessment commencing on or after 1 April 2012 the most extensive amendments were made to the section in order to align the South African transfer pricing regime with the updated Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) of the Organisation for Economic Cooperation and Development (the OECD). Thereafter, further smaller amendments to the section followed.

PN 7, in its initial form, was published by SARS on 6 August 1999. The Practice Note was based, *inter alia*, on material published by the Inland Revenue Department of New Zealand. The Note includes 21 Chapters and two Annexures and it is still, to date, applicable notwithstanding the various changes made since to South African legislation and international guidance.

Although South Africa is not a member of the OECD, PN 7 makes reference to the OECD Guidelines in some paragraphs and it acknowledges the OECD Guidelines.

An interesting fact is that Namibia's Practice Note 2 on transfer pricing, which came into effect on 5 September 2006, is based not only on the OECD Guidelines, but also the South African PN 7 and the wording is partly the same as that of PN 7.

"More recently, since 2001, SARS has been issuing Interpretation Notes and existing Practice Notes have been withdrawn or replaced by Interpretation Notes."

THE STATUS OF PRACTICE NOTE 7

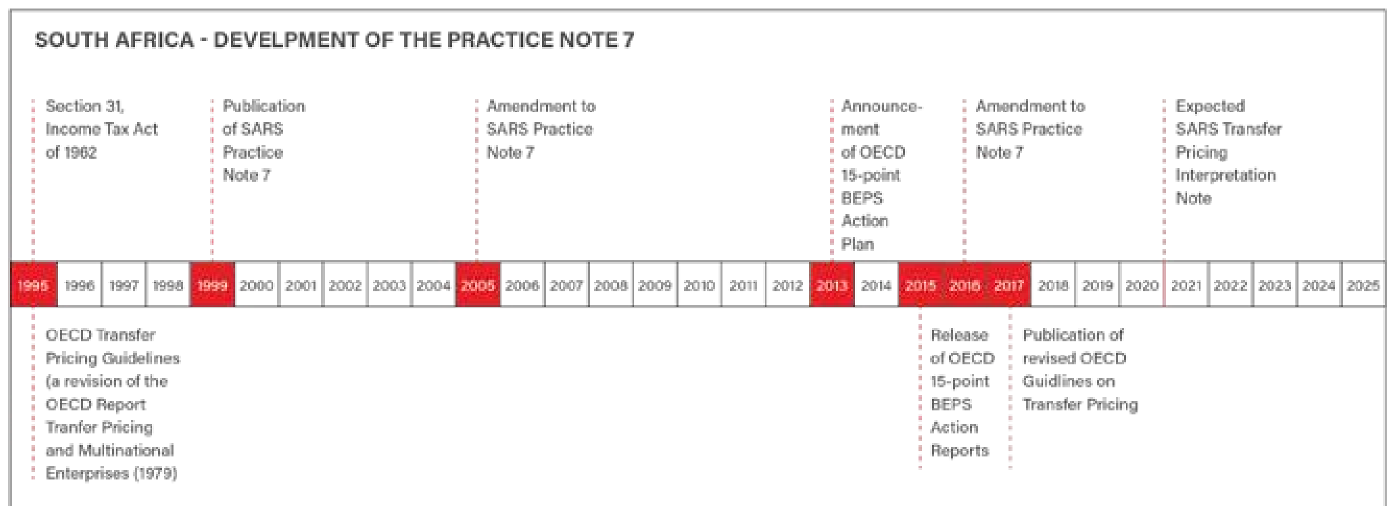
PN 7 provides guidance on transfer pricing from a South African perspective. As mentioned above, PN 7 was issued by SARS and thus reflects SARS' view. More recently, since 2001, SARS has been issuing Interpretation Notes and existing Practice Notes have been withdrawn or replaced by Interpretation Notes.

However, the question arises whether PN 7 constitutes a "practice generally prevailing" and whether it has a binding effect on taxpayers and/or SARS. The courts have not decided this in respect of PN 7 specifically, but in a judgment in *Marshall and Others v Commissioner for the South African Revenue Service*, 2018, although the application for leave to appeal was refused, the court set out its view on the status of Interpretation Notes when interpreting tax legislation. In terms of the law, section 5(1) of the Tax Administration Act, 2011 (the TAA), defines the term "practice generally prevailing" to be a practice set out in an official publication regarding the application or interpretation of a tax Act. Further to this, the term "official publication" is defined in section 1 of the TAA to be "… a binding general ruling, interpretation note, *practice note* or public notice issued by a senior SARS official or the Commissioner" *(own emphasis)*. Therefore, PN 7 could be considered to be a practice generally prevailing. However, section 5(2) provides exemptions regarding when the practice generally prevailing ceases to be such, unless it is a binding general ruling, which PN 7 is not. Paragraph *(a)* of section 5(2) states that, for example, where the tax Act which is the subject of the official publication is repealed or amended to an extent material to the practice, the practice generally prevailing ceases to exist from the date the repeal or amendment becomes effective. This raises the further question as to whether the amendments to section 31, which are the transfer pricing provisions, were material enough to the practice (as set out in PN 7), in order to cease it being a practice generally prevailing. While SARS has been working on a draft for a new interpretation note on transfer pricing, the existing PN 7 is still relied on by both SARS and taxpayers.

Interestingly, SARS Practice Note 2 (PN 2), which deals with the determination of taxable income where financial assistance has been granted by a non-resident to a resident of South Africa, ie it contains guidance regarding thin capitalisation from a South African perspective, should have been withdrawn because the old section 31(2), which dealt with thin capitalisation, was deleted when the section was amended in 2012. However, although not applied in practice, this Practice Note is still on the SARS website.

CHANGES TO PRACTICE NOTE 7 OVER THE YEARS

CHRONICALS OF EVENT RELATING TO THE DEVELOPMENT OF TRANSFER PRICING LEGISLATION IN SOUTH AFRICA



While section 31 was amended over time, only two changes, in the form of addenda, occurred in respect of PN 7 over the past 20 years. One addendum was published in 2005 (29 September 2005) and another addendum followed in 2016 with effect for years of assessment commencing on or after 1 October 2016.

The purpose of the 2005 addendum was to clarify that, although SARS recommends the preparation of transfer pricing documentation for South Africa, there was then not a statutory transfer pricing documentation requirement.

The 2016 addendum replaced the transfer pricing documentation requirements as set out in both the original PN 7, ie paragraph 10 of PN 7, and the 2005 Addendum, with the transfer pricing documentation retention (record keeping) rules as set out in Notice 1334 of *Government Gazette* 40375. As these transfer pricing documentation retention rules were issued in terms of the TAA (section 29), they will override PN 7 to the extent applicable.

THE INFLUENCE OF THE OECD BASE EROSION AND PROFIT SHIFTING INITIATIVE

The OECD's Base Erosion and Profit Shifting (BEPS) initiative resulted in a 15-point Action Plan and each of the 15 action points concerned a specific international tax topic. BEPS Actions 8 to 10 and Action 13 dealt specifically with transfer pricing. Action 13 only focused on transfer pricing documentation and Chapter V of the OECD Guidelines, which sets out the OECD's guidance on transfer pricing documentation, was replaced, in the 2017 edition, with the contents of the BEPS Action 13 report. The various aspects addressed in Actions 8 to 10, for example relating to intellectual property, financial assistance, financial transactions, low value-adding intra-group services, the Profit Split Method, etc, were also incorporated, to the extent that the various BEPS projects were already completed and approved within the OECD, in the 2017 version of the OECD Guidelines.

As PN 7 dates back to the time prior to the 2017 OECD Guidelines and even further to before the prior update, ie the 2010 OECD Guidelines, it is not aligned to the guidance set out in these two versions, except, of course, for the transfer pricing documentation update in 2016.

However, because PN 7 was designed partially based on the OECD Guidelines, as at the time, and there is, in paragraph 3.2.1 of the Practice Note, reference specifically to the OECD Guidelines as an important influential document, in practice, the guidance in the more recent updates is followed by South Africa. For example, while PN 7 still includes a reference to the hierarchy of the transfer pricing methods focusing on the CUP method as the most suitable method in paragraphs 9.3.1 and 9.3.4, practice follows the broader "best method" approach, which was introduced in terms of the 2010 OECD Guidelines. Also, the consequences of a primary transfer pricing adjustment, namely a secondary adjustment, have changed with the repeal of Secondary Tax on Companies (STC) in 2012.

CONTENT OF PRACTICE NOTE 7

PN 7 addresses a wide array of topics relating to transfer pricing and it sets out some good guidance regarding how certain aspects thereof should be dealt with, from a South African transfer pricing perspective.

The contents of PN 7 are summarised as follows:

Definition and terminology (Paragraph 1)

This paragraph sets out various definitions of terms, including for example the definition of "connected person" as set out in the Act. However, some of these definitions have been updated in the legislation, but not in the Practice Note.

Introduction (Paragraph 2)

The introduction describes what the term transfer pricing means and it makes reference to section 31 (as it read in 1999) and the arm's length principle.

The Commissioner's approach to the Practice Note (Paragraph 3)

This paragraph states that it is the intention of PN 7 to serve as guidance rather than being prescriptive, and it confirms that the approach should be to consider each case on its individual basis and, importantly, to take the taxpayer's business strategies and commercial judgement into consideration. It furthermore clarifies the status of the OECD Guidelines.

Section 31 of the Act (Paragraph 4)

In this paragraph, the transfer pricing legislation and its background, as it was then, ie in 1999, is clarified. It should be noted that significant amendments have been made to the legislation since then.

Financial transactions (Paragraph 5)

It is clarified that financial transactions constitute services in terms of section 31, and reference is also made to PN 2 on Thin capitalisation, which, although not yet officially repealed, would not apply because the subsection of section 31 to which PN 2 applies, has been deleted.

Tax treaties (Paragraph 6)

Reference is made to article 7 (Business profits) and Article 9 (Associated enterprises) of the OECD Model Tax Convention and SARS confirms the view that there is no inconsistency between tax treaties and domestic law regarding the application of the arm's length principle. Further, it is stated that the Practice Note should also apply to determine the arm's length consideration for income tax purposes of cross-border transactions conducted in certain cases where these transactions are not entered into between two legal entities (eg between a head office and its branch in South Africa), in the application of tax treaties with South Africa.

The arm's length principle (Paragraph 7)

This paragraph provides guidance in respect of the arm's length principle and its application.

Principles of comparability (Paragraph 8)

The paragraph dealing with the principle of comparability is important and detailed. Guidance is provided regarding basic principles of comparability, the characteristics of the property or services, functions undertaken, economic circumstances and business strategies and how these may impact on comparability.

Acceptable methods for determining an arm's length price (Paragraph 9)

This paragraph addresses the principles to be applied when selecting a transfer pricing method to benchmark a transaction. In addition, it discusses the OECD transfer pricing methods (Comparable Uncontrolled Price (CUP), Resale Price, Cost Plus, Transactional Net Margin and Profit Split). It should be noted that reference here is still made to the hierarchy of the transfer pricing method, which was an approach followed until a change in the 2010 OECD Guidelines. Since then, the focus is on the best (suitable) transfer pricing method, although it is accepted that if the CUP method is equally suitable as another method, then the CUP method would be considered most reliable.

Documentation (Paragraph 10)

This paragraph sets out the South African transfer pricing documentation requirements. However, as mentioned above, these were replaced in their entirety with the transfer pricing documentation retention rules in terms of Notice 1334 of *Government Gazett*e 40375 with effect from 1 October 2016.

Practical considerations (Paragraph 11)

This paragraph is detailed and addresses several practical transfer pricing areas such as, for example, guidance on the determination of an arm's length range, losses incurred by a member of a multinational group, arrangements common between group companies, the use of hindsight, safe harbours and more.

The Commissioner's approach to transfer pricing reviews, audits and investigations (Paragraph 12)

Here SARS confirms the intention to apply the guidance set out in PN 7 and, in addition, provides further guidance on matters not discussed in the prior paragraphs.

Interest and penalties (Paragraph 13)

This paragraph refers to the interest and penalty sections, which used to be included in the Act at the time, but can now be found in the TAA, ie sections 187, 188 and 189 regarding interest, and sections 222 and 223 regarding any understatement penalty.

Secondary tax on companies (STC) (Paragraph 14)

Secondary tax on companies was repealed with the introduction of dividend withholding tax in 2012. This paragraph is therefore not relevant anymore. The principle, however, ie that a transfer pricing adjustment (Primary Adjustment) triggers a "Secondary Adjustment" and that this results in deemed dividend tax, remains and is now based on section 31(3)*(b)*(i), together with section 64E, etc.

Burden of proof (Paragraph 15)

This paragraph in PN 7 confirms that the burden of proof to transact at arm's length is with the taxpayer. However, it still states that the Commissioner has a discretion with regard to making a transfer pricing adjustment. This discretion was removed with the 2012 amendment to section 31.

Advance pricing agreements (Paragraph 16)

It is confirmed that SARS does not entertain advance pricing agreements.

Intangible property (Paragraph 17)

This paragraph refers to Chapter VI of the OECD Guidelines, which provides detailed guidance on the transfer pricing treatment of intangible property. It should be noted, however, that Chapter VI has been significantly updated since 1999, most recently with the content of the BEPS Actions 8 to 10 Report, which introduced the new DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) Functions concept to determine the correct allocation of profits in a value chain.

Intra-group services (Paragraph 18)

This paragraph refers to Chapter VII of the OECD Guidelines, which contains detailed guidance on the transfer pricing treatment of services transactions. There have been further changes to this Chapter over time.

Cost contribution arrangements (Paragraph 19)

The term "cost contribution arrangement" is defined in Chapter VIII (8.4) as "… a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants." PN 7 refers to the detailed guidance in Chapter VIII of the OECD Guidelines, which was also recently updated.

Effective date (Paragraph 20)

Although published in 1999 only, PN 7 is effective from the date from which section 31 has been applied, ie in respect of goods or services supplied on or after 19 July 1995.

Conclusion (Paragraph 21)

The conclusion reiterates that a taxpayer should adhere to the arm's length principle and prepare suitable documentation to demonstrate this. If a taxpayer does not give adequate consideration to transfer pricing this will result in increased scrutiny from SARS and an increased risk of a transfer pricing adjustment. Furthermore, this paragraph provides a summary of the broad guidelines suggested by SARS.

Annexure A: Characteristics of a functional analysis

Annexure A sets out guidance regarding what should be included in a functional analysis.

ANNEXURE B: THE FOUR-STEP APPROACH

Annexure B provides guidance in respect of the four-step approach relating to each of the four steps:

1. Understanding the cross-border dealings between connected parties in the context of the business;
2. Selecting the transfer pricing method or methods;
3. Applying the transfer pricing method or methods; and
4. Arriving at the arm's length amount and introducing processes to support the chosen method.

The four-step approach is addressed in paragraph 11.18 of the Practice Note and based on the four-step approach designed by the Australian Taxation Office and was considered a useful tool by SARS at the time.

"The 2016 addendum, which provided some well needed clarity on transfer pricing documentation requirements, was a good step in the right direction."

ADDENDUM: SUBMISSION OF TRANSFER PRICING POLICY DOCUMENT

As indicated above, the purpose of the 2005 addendum was to clarify that at the time there was no statutory requirement for a taxpayer to prepare transfer pricing documentation, but to also clarify that not preparing transfer pricing documentation would create a certain risk for a taxpayer.

APPLICATION OF PRACTICE NOTE 7

As noted above, section 31 only applies to the supply of goods and/or services supplied on or after 19 July 1995. In line with this, PN 7 also applies to goods and/or services supplied on or after that date. However, PN 7 was only published in August 1999, ie four years after the legislation was put in place and became effective.

The latest addendum, regarding transfer pricing documentation requirements, is effective for years of assessment commencing on or after 1 October 2016.

Although the transfer pricing legislation has been updated over the years and several paragraphs of PN 7 are therefore not applicable in that the legislation they refer to does not exist anymore, there are still valid paragraphs and by replacing the existing transfer pricing documentation regulations with the new regulations from 2016 SARS has confirmed that it still applies PN 7, to the extent it is relevant.

THE FUTURE OF PRACTICE NOTE 7

For many years, since 2012, there has been talk of an update of PN 7 or new guidance. It is understood that SARS has been working on an Interpretation Note, which would replace PN 7 eventually. However, attempting to address and, to the extent possible and desired, include the work by the OECD since the BEPS Action Plan has been difficult due to the various work-streams within OECD Working Part 6.

The 2016 addendum, which provided some well needed clarity on transfer pricing documentation requirements, was a good step in the right direction.

It is now widely expected that an Interpretation Note on Transfer Pricing will be published during 2020.

Taxpayers involved in cross-border connected persons transactions should look out for the new guidance and, once published, review it, particularly in respect of deviations from the OECD Guidelines.

FINAL WORDS

Transfer pricing has been a hot topic across the world. Recent developments in South Africa and Africa have also brought it closer to home. The potential financial and reputational implications of non-compliance with transfer pricing legislation are severe and taxpayers are aware of this. However, being able to comply with transfer pricing requirements is based on consistent and unambiguous guidance. PN 7 has been helpful, but as time passes and transfer pricing legislation and processes are modernised, it is important that related guidance is available and, more importantly, kept current.

Christian Wiesener

Act sections:

- Income Tax Act 58 of 1962: Sections 31 & 64E;
- Tax Administration Act 28 of 2011: Sections 1 (definition of "official publication"), 5(1) & (2), 29, 187, 188, 189, 222 & 223.

Other documents:

- Practice Note 2 (on Thin Capitalisation) (South Africa);
- Practice Note 7 (South Africa);
- Practice Note 2 (on Transfer Pricing) (Namibia);
- Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Organisation for Economic Cooperation and Development) – Chapters VI (includes BEPS Actions 8 to 10 Report), VII & VIII;
- The OECD's Base Erosion and Profit Shifting (BEPS) initiative (this resulted in a 15 Action Plan)
    - BEPS Actions 8 to 10 Report (it introduced the new DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) Functions concept, and now forms part of Chapter VI of OECD Transfer Pricing Guidelines);
- *Government Gazette* 40375 (Notice 1334) – transfer pricing documentation retention (record keeping) rules;
- Interpretation Note on Transfer Pricing (expected to be published during 2020).

Cases:

- *Marshall and Others v Commissioner for the South African Revenue Service* (CCT208/17) [2018] ZACC 11.

Tags: practice generally prevailing; taxable income; transfer pricing methods; arm's length principle; tax treaties; domestic law; intangible property