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CAPITAL GAINS TAX
PERSONAL RIGHTS

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Mr KG Karro (Chairman), Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Ms MC Foster, Prof DA Tickle, Ms D Hurworth.

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PERSONAL RIGHTS

Personal rights play an important role in the determination of capital gains and losses. They may comprise assets in their own right for CGT purposes and play a role in establishing proceeds and base cost. Unfortunately, they impose a layer of complexity on the Eighth Schedule which cannot be avoided.

WHAT IS IT?

A personal right (*jus in personam*) is a right in or against a particular person or group of persons. Personal rights are of two types:

- *jus in personam ad rem acquirendam*, a right to claim delivery of a thing; and
- *jus in personam ad faciendum*, a right to claim performance or an act.

Put differently, a personal right is a right against another person for performance of an obligation under which the counterparty must do or refrain from doing something.

Examples of personal rights include an heir's right to claim an inheritance, a beneficiary's right to require the trustee to administer the trust in accordance with the trust deed, a claim for damages and a creditor's right to require a debtor to settle a debt.

In contrast, a real right (*jus in rem*) is a right in a thing, which is enforceable against all persons. It is the badge of ownership (see *National Stadium SA (Pty) Ltd v Firstrand Bank Ltd* [2011]). Examples include corporeal things such as motor vehicles, plant and machinery as well as registered real rights, such as a registered lease of at least ten years (see paragraph *(b)* of the definition of "immovable property" in section 102(1) of the Deeds Registries Act, 1937), a registered usufruct over immovable property, servitudes and a life right in a retirement village (see section 4A of the Housing Development Schemes for Retired Persons Act, 1988).

IS A PERSONAL RIGHT AN ASSET FOR CGT PURPOSES?

The answer to this question is yes. The definition of "asset" in paragraph 1 of the Eighth Schedule to the Income Tax Act, 1962 (the Act), includes "property of whatever nature, whether movable or immoveable, corporeal or incorporeal … and a right or interest of whatever nature to or in such property".

In *CIR v Estate CP Crewe & another*, [1943], in relation to the determination of estate duties, Watermeyer CJ said the following:

> "One would expect that when the estate of a person is described as consisting of property, what is meant by property is all rights vested in him which have a pecuniary or economic value. Such rights can conveniently be referred to as proprietary rights and they include *jura in rem*, real rights such as rights of ownership in both immovable and movable property, and also *jura in personam* such as debts and rights of action."

In 2004 Prof Julie Cassidy, then with Deakin University, Australia, compared the Australian CGT provisions with those of South Africa and questioned whether personal rights were assets for CGT purposes primarily on the basis that they were not capable of transmission (Julie Cassidy "Capital gains tax in South Africa: Lessons from Australia?" 2004 SA Merc LJ 164). Professor Gerrie Swart (then with Unisa) responded to her criticism in 2005, pointing out that the Eighth Schedule was replete with examples of personal rights being recognised for CGT purposes, among them financial instruments, options and debt claims (Gerard Swart "Interpreting Some Core Concepts Governing the Taxation of Capital Gains" 2005 SA Merc LJ 1).

It would be surprising if personal rights were not assets for CGT purposes, especially given the numerous references to them in the Eighth Schedule, such as paragraphs 56 (disposal by creditor of debt owed by connected person), 58 (exercise of option), 59 (compensation for personal injury, illness or defamation), 64A (awards in terms of land restitution programmes and land reform measures), among others.

The question whether a personal right was an asset arose in an unreported case (Case 13798/13931/14294, Gauteng Tax Court, 17 September 2019) in which the appellant (Massmart Holdings Ltd), a holding company, sought to claim capital losses incurred in the 2007 to 2013 years of assessment by its employee share incentive scheme trust.

On instruction from the appellant, the trust would grant selected employees options to acquire shares in that company at a strike price. When an employee exercised an option to acquire the shares, the appellant would purchase the shares on the trust's behalf at market value and debit the trust's loan account, as the trust did not have a bank account. When the employee paid the appellant, the appellant would credit the trust's loan account with the strike price and the shares would be given to the employee. Usually there would be a shortfall in the trust because the strike price would be less than the price paid by the trust. Under the trust deed, the appellant was liable for the shortfall and would credit the trust's loan account and debit "share expense cost" on its balance sheet with the amount for which it was liable. That meant the expense did not go through the income statement but directly against retained income (70 (March/April 2021) *The Taxpayer* (at 63)). Since the trust had recovered the shortfall from Massmart, its base cost in the shares was reduced under paragraph 20(3)*(b)* of the Eighth Schedule, with the result that it did not suffer any capital losses.

The appellant argued that it acquired an asset in the form of a claim for performance against the trust. This personal right comprised the right to require the trustees to make offers to the employees and deliver the shares upon exercise of the options. The base cost of the right was equal to the amount of the shortfall and, when the right was disposed of through performance, there would be no proceeds, resulting in a capital loss. Adams J dismissed the appeal, noting that a personal right was not an "asset" as defined in paragraph 1 of the Eighth Schedule.

On appeal in *Massmart Holdings Ltd v C: SARS* [2021], the Supreme Court of Appeal (SCA) found in favour of SARS, on the following grounds:

- The evidence of the three witnesses appeared to bolster SARS' argument that the notion that the so-called right constituted an asset was illusory and an *ex post facto* reconstruction to establish a basis by Massmart for a claim for capital gains.
- Even if it were accepted that the right to require the trustees to grant the options was an asset, the expenditure in respect of that asset was incurred after the asset was disposed of and hence did not qualify to be added to the base cost under paragraph 4*(a)* of the Eighth Schedule.
- Since the loans to the trust were unpaid, they comprised an asset for Massmart, so it had not incurred any loss. Instead, Massmart had sought to account for the trust's losses in its books.

Unfortunately, the court's reasoning in dismissing the appeal is unsatisfactory in a number of respects.

Firstly, the court should not have relied on the opinion of witnesses to determine a question of law, namely whether a personal right to claim performance was an asset for CGT purposes.

Secondly, the court's statement that the expenditure on the personal right could not give rise to a capital loss because it was incurred after the asset was disposed of is incorrect. The appellant sought to use paragraph 4*(b)* and not paragraph 4*(a)*. Paragraph 4*(b)* specifically permits a capital loss to be claimed in respect of expenditure incurred after an asset has been disposed of.

Thirdly, the court was wrong to conclude that the loans were unpaid and therefore no loss had been incurred by Massmart. The unpaid loans related to the small stock of shares held by the trust at year end, not to the amounts claimed by Massmart in making good the trust's losses.

Despite the court misdirecting itself on these issues, it would have been difficult to persuade it that the personal right to require performance from the trustees was an asset with pecuniary value related to the R1 billion that the company had spent over the period in making good the trust's losses. Massmart's argument was that the loans did not give rise to capital losses in the trust because the trust acquired a counter claim against Massmart in respect of the losses. In Massmart, the debit loan arising on the acquisition of the shares less the amount paid by the employee was set off against the credit loan arising from the counter claim. The fact is that Massmart incurred expenditure when it became indebted to the trust in respect of the losses. The court therefore did not address the identity of the true asset, if any, to which this expenditure related.

Massmart was unable to claim the expenditure under section 11*(a)* of the Act. since it related to the employees of its subsidiaries and was not incurred in the production of income. The problem could easily have been avoided if Massmart had simply recovered the cost from its subsidiaries, which in turn could have claimed it under section 11*(a)* as an employment-related expense.

The case raises the issue of how expenditure incurred by a holding company on behalf of its subsidiaries should be dealt with. If it can be proven that the expenditure was incurred in enhancing the value of the shares in the subsidiaries, the expenditure may qualify to be added to the base cost of the shares under paragraph 20(1)*(e)*. In the United States case of *Eskimo Pie Corp v Commissioner of Internal Revenue* (4 TC 669 (1945)), the court stated the following (at 676):

> "Payments made by a stockholder of a corporation for the purpose of protecting his interest therein must be regarded as additional cost of his stock and such sums may not be deducted as ordinary and necessary expenses."

The Internal Revenue Service (IRS) has treated the payment of bonuses to employees of subsidiaries by the holding company as a capital contribution to the subsidiaries and a constructive deduction by the subsidiaries. (See Rev. Rul. 84–68.) However, this treatment would be impermissible in South Africa, since the subsidiaries would not be regarded as having actually incurred an expense. Section 40CA does not deal with capital contributions, only with the issue of shares in exchange for an asset.

"Personal rights play an essential role in determining capital gains and losses and the tax court was clearly wrong to conclude that all personal rights are not assets for CGT purposes."

CONCLUSION

Personal rights play an essential role in determining capital gains and losses and the tax court was clearly wrong to conclude that all personal rights are not assets for CGT purposes. It is a pity that the SCA did not address the question whether a personal right to require performance is an asset. Despite the court's prevarication on the issue, it would probably be going too far to conclude that all such personal rights have pecuniary value and comprise property and hence assets for CGT purposes. In any situation involving CGT, it is important to identify the true asset.

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Duncan McAllister

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 11*(a)* & 40CA; Eighth Schedule: Paragraphs 1 (definition of "asset"), 4*(a)* & *(b)*, 20(1)*(e)* & (3)*(b)*, 56, 58, 59, 64A;
- Deeds Registries Act 47 of 1937: Section 102(1) (definition of "immovable property", paragraph *(b)*);
- Housing Development Schemes for Retired Persons Act 65 of 1988: Section 4A.

Other documents

- Julie Cassidy "Capital gains tax in South Africa: Lessons from Australia?" 2004 SA Merc LJ 164;
- Gerard Swart "Interpreting Some Core Concepts Governing the Taxation of Capital Gains" 2005 SA Merc LJ 1;
- 70 (March/April 2021) *The Taxpayer* [at 63];
- Revenue Ruling 84–68 (a public decree issued by the IRS).

Cases

- *National Stadium SA (Pty) Ltd v Firstrand Bank Ltd* [2011] 3 All SA 29 (SCA) [at 39];
- *CIR v Estate CP Crewe & another* [1943] AD 656, 12 SATC 344 [at 352];
- Case 13798/13931/14294, Gauteng Tax Court, 17 September 2019 (unreported);
- *Massmart Holdings Ltd v C:SARS* [2021] 83 SATC 333 (SCA);
- *Eskimo Pie Corp v Commissioner of Internal Revenue* 4 TC 669 (1945) [at 676].

Tags: personal right (*jus in personam*); corporeal things; connected person; capital contribution.

EXTENSION OF THE FIRST PHASE

EXTENSION OF THE FIRST PHASE

When the carbon tax came into effect in 2019, it was announced that the first phase of the tax would come to an end on 31 December 2022. In principle, it is contemplated that the transition from the first phase to the second phase will result in a broadening of the carbon tax base, an increase in the annual carbon tax rate and a reduction in the allowances for which taxpayers could qualify to reduce their carbon tax liability. Of course, all of this must be seen in the context of South Africa's obligations under the Paris Agreement to reduce its carbon emissions, also read with its commitment made under its revised Nationally Determined Contribution, which was submitted to the UNFCCC in 2021.

"In the 2022 Budget Speech, it was announced that the first phase of the carbon tax will be extended by three years from 1 January 2023 to 31 December 2025."

In the 2022 Budget Speech, it was announced that the first phase of the carbon tax will be extended by three years from 1 January 2023 to 31 December 2025. As such, the transitional support measures afforded to companies in the first phase, such as significant tax-free allowances and revenue recycling measures, will continue over this period, alongside other adjustments. The main proposals in this regard include:

- Extending the energy-efficiency-savings tax incentive from 1 January 2023 to 31 December 2025. This incentive is contained in section 12L of the Income Tax Act, 1962.
- Extending the electricity price neutrality commitment until 31 December 2025. The electricity-related deduction will be limited to the carbon tax liability of fuel combustion emissions of electricity generators and will not be offset against the total carbon tax liability.
- Adjusting the threshold for the maximum trade exposure allowance upwards from 1 January 2023. Updated sectors and allowances will be published for public consultation.
- Penalising emissions exceeding mandatory carbon budgets. The mandatory carbon budgeting system comes into effect on 1 January 2023, at which time the carbon budget allowance of 5% will fall away. To address concerns about double penalties for companies subject to the carbon tax and carbon budgets, it is proposed that a higher carbon tax rate of R640 per tonne CO2e will apply to greenhouse gas emissions exceeding the carbon budget. These amendments will be legislated once the Climate Change Bill, 2022, is enacted.

The Climate Change Bill, 2022, was introduced in the National Assembly on 18 February 2022. In anticipation of the Bill coming into law, persons who may be liable for carbon tax should carefully consider the provisions of this Bill dealing with the carbon budget and ensure that they comply with the carbon budget provisions once in effect. The proposed penalty rate of R640 per tonne CO2e for carbon budget offenders is substantially higher than the current rate of R144 per tonne CO2e and compliance with the carbon budget provisions is crucial, especially if the proposed penalty rate comes into effect.

PROPOSAL REGARDING THE RENEWABLE ENERGY PREMIUM AND CARBON SEQUESTRATION DEDUCTIONS

In terms of section 6(2) of the Carbon Tax Act, 2019 (the Carbon Tax Act), taxpayers generating electricity can claim a tax deduction for electricity generation levy payments and additional renewable electricity purchases. These provisions were amended in 2021 to allow taxpayers entering into power purchase agreements in certain contexts to also claim the premium and qualify for the benefit.

It is now proposed that section 6(2) of the Carbon Tax Act be amended to clarify that taxpayers would qualify for a deduction if they generate electricity from fossil fuel and conduct fuel combustion activities under IPCC codes 1A1 (energy industries) and 1A2 (manufacturing industries and construction). Hopefully, the proposed amendment will result in more taxpayers being able to use the premium to reduce their carbon tax liability.

In relation to the issue of carbon sequestration, it is proposed to limit the deduction for forestry management and harvested wood product sequestration activities to only those activities within the operational control of the taxpayer conducting paper and pulp activities. This follows amendments made in 2021 to expand the scope of the carbon sequestration deduction to include emissions sequestered in harvested wood products for the paper and pulp activities under IPCC code 1A2d (referred to in the Schedule 2 to the Carbon Tax Act).

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 12L;
- Carbon Tax Act 15 of 2019: Section 6(2); Schedule 2;
- Climate Change Bill 9 of 2022.

Other documents

- Documents on Intergovernmental Panel on Climate Change (IPCC) category codes: 1A1 (energy industries), 1A2 (manufacturing industries and construction) & 1A2d (emissions sequestered in harvested wood products for the paper and pulp activities).

Tags: tax-free allowances; carbon sequestration deduction.

TAX INCENTIVES DISCONTINUED

Tax incentives are applied to encourage certain behaviours and activities by providing businesses and individuals with favourable tax treatment. The introduction of a tax incentive is generally based on a social, economic or environmental need that has been identified and can be alleviated by the actions or behaviours of taxpayers in exchange for a tax benefit.

Although tax incentives are introduced in order to remedy or improve a particular circumstance or behaviour, there are potential negative effects from these incentives that make them economically less desirable, including –

- the reduction of the tax base;
- increasingly complicated governing legislation;
- greater benefits to larger entities that can obtain specialised tax advice; and
- additional South African Revenue Service resources required to monitor and audit the incentives.

In order to mitigate these possible negative effects, tax incentive provisions often include a sunset clause that indicates a predetermined date on which the relevant incentive will cease to be in effect. In addition, these incentives are continually reviewed in order to determine their effectiveness and ascertain whether the desired outcome (1) has been achieved; and (2) outweighs any negative consequences arising from the incentive. These reviews often inform a decision by the National Treasury either to extend or discontinue a tax incentive.

Following the reviews undertaken during 2021, the Minister of Finance indicated that a number of corporate tax incentives provided for in the Income Tax Act, 1962, would not be renewed upon reaching their sunset dates. Further details in this regard are mentioned below:

- section 12DA, dealing with deductions in respect of rolling stock, ended on 28 February 2022;
- section 12F, dealing with deductions in respect of airport and port assets, ended on 28 February 2022;
- section 12O, providing for an exemption in respect of receipts and accruals from the exploitation rights of films in certain prescribed circumstances, lapsed on 31 December 2021; and
- section 13*sept*, dealing with deductions in respect of the sale of low-cost residential units on loan account, ended on 28 February 2022.

Notably, although the research and development (R&D) tax incentive, provided for in section 11D of the Act, is intended to come to an end on 30 September 2022, a discussion document and an online survey reviewing the R&D tax incentive were published on 15 December 2021 and workshops will be held with interested parties in 2022 in order to ascertain its effectiveness. On the basis that the public consultation process for reviewing the R&D tax incentive is still ongoing, it was proposed in the 2022 Budget Speech that the sunset clause for the R&D tax incentive be extended until 31 December 2023 in order to create certainty for taxpayers.

Taxpayers who have benefited from the tax incentives that have been discontinued should take note of the dates on which the relevant incentives ceased to be in effect in order to ensure that they do not erroneously rely on the relevant provisions going forward. Whether the R&D tax incentive will be extended beyond 31 December 2023 remains to be seen and will likely depend on the outcome of the public consultation process.

Louise Kotze

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962 (extension or discontinuance of sunset clauses in respect of provisions dealing with corporate tax incentives): Sections 11D, 12DA, 12F, 12O & 13*sept*.

Tags: tax incentives; research and development (R&D) tax incentive.

INCENTIVES ENHANCED AND TIGHTENED

One of the greatest challenges faced by South Africa is the high unemployment rate, which especially impacts the youth. High levels of unemployment have a profound impact on the socio-economic fabric of South Africa as a society. Chapter 4 of the 2022 Budget Review states that youth unemployment in South Africa was at 56,2% for 20- to 29-year-olds in the third quarter of 2021. Even by emerging market economy standards, that figure is staggeringly high.

Given the high unemployment rates in South Africa, Government introduced the employment tax incentive (ETI) in January 2014 as one of the tools to try to increase employment. The Preamble to the Employment Tax Incentive Act, 2013 (the ETI Act), sets out the key reasons why it was introduced:

> *"Since the unemployment rate in the Republic is of concern to government;*
>
> *And since government recognises the need to share the costs of expanding job opportunities with the private sector;*
>
> *And since government wishes to support employment growth by focusing on labour market activation, especially in relation to young work seekers;*
>
> *And since government is desirous of instituting an employment tax incentive,"*

Notwithstanding some of the negative publicity around certain ETI arrangements since 2020, positive developments have also been seen in the latest statistics referred to by the National Treasury, which reflect modest positive effects on growth rates of youth employment in firms claiming the ETI, coupled with some of the anticipated significant negative effects not materialising.

ETI INCREASES

At its simplest, payment of the ETI is effected by eligible employers being able to reduce the employees' tax liability ordinarily due by the amount of the ETI that they can claim, provided that they meet the requirements of the ETI Act. Currently, the maximum amount that an employer can claim in the first 12 months in which a qualifying employee is employed is R1 000, whereas the current maximum for the second 12 months of employment is R500.

In order to encourage businesses to employ young people, an increase of 50% in the value of the employment tax incentive, effective from 1 March 2022, was proposed in the 2022 National Budget. The ETI therefore increased from a maximum of R1 000 to a maximum of R1 500 per month in the first 12 months, and from R500 to a maximum of R750 in the second 12 months of eligibility with effect from 1 March 2022.

In addition, in order to better encourage small and medium-sized firms to take up the ETI, it has been proposed that there should be improved targeting of the incentive to support jobs for long-term unemployed work seekers together with an expansion of the eligibility criteria for qualifying employees. These are welcome announcements on the back of the Minister of Finance's encouragement to firms to take up the ETI in the 2022 Budget Speech.

However, the good news must be treated with some caution. Since 2020, certain arrangements making use of the ETI have been in the National Treasury and South African Revenue Service's (SARS) crosshairs, which eventually culminated in a series of amendments to the ETI Act with effect from 1 March 2022. Many taxpayers have also been faced with verifications and audits of their ETI claims resulting in additional assessments issued by SARS reversing the ETI initially claimed by these employers. Interestingly, SARS has generally not imposed any understatement penalties in relation to the reversal of the ETI claims. However, it was announced by the Minister that given the abuse of the ETI, Government proposes that the ETI Act be amended to impose understatement penalties on ETI rebates that are improperly claimed. Any anomalies in the legislation (if any) will thus be closed.

The ETI is constantly being refined, expanded and tightened and it is important for employers claiming the ETI to keep their fingers on the pulse in order to ensure they remain within the bounds of the ETI Act and to answer Government's call to assist with decreasing the high unemployment rate.

Jerome Brink

Cliffe Dekker Hofmeyr

Acts and Bills

- Employment Tax Incentive Act 26 of 2013: Preamble.

Other documents

- 2022 Budget Review: Chapter 4.

Tags: employment tax incentive (ETI); additional assessments; understatement penalties.

RULES FOR INDIVIDUALS

On 23 February 2022, following the publication of the 2022 Budget, the Financial Surveillance Department of the South African Reserve Bank (FinSurv) released circulars amending some of the exchange control rules applicable to individuals. Some of these amendments are discussed here.

EXPORT OF MULTI-LISTED DOMESTIC SECURITIES BY PRIVATE INDIVIDUALS

For many years, South African residents who held shares listed on various exchanges, were not allowed to export their South African listed shares to another exchange. In Exchange Control Circular 5/2022 it was announced that the exporting of these dual/multi-listed securities would be allowed, in terms of amendments made to section B.2(B) of the Currency and Exchanges Manual for Authorised Dealers (AD Manual). Section B.2(B) now states that private individuals may, as part of their single discretionary allowance (SDA) and/or foreign capital allowance (FCA), export multi-listed domestic securities, subject to tax compliance and reporting, to FinSurv via a central securities depository participant, in conjunction with an authorised dealer.

The reference to tax compliance appears to refer to section 9K of the Income Tax Act, 1962 (the Act), which came into effect on 1 March 2021 and states that a deemed disposal for capital gains tax purposes arises where a share is delisted from a South African exchange and listed on a foreign exchange.

From a practical perspective, an individual seeking to export shares to a foreign exchange using her annual SDA of R1 million would only need to approach her authorised dealer to assist her to obtain the necessary approval letter from FinSurv. An individual seeking to transfer listed shares worth more than R1 million would have to make use of her FCA and would have to obtain a tax compliance status letter from the South African Revenue Service (SARS) in this regard. The individual would potentially have to deal with the impact of section 9K of the Act in her application.

"From a practical perspective, an individual seeking to export shares to a foreign exchange using her annual SDA of R1 million would only need to approach her authorised dealer to assist her to obtain the necessary approval letter from FinSurv."

ONLINE FOREIGN EXCHANGE ACTIVITIES: GOOD NEWS FOR THE CRYPTO ASSET INDUSTRY

A notable announcement was made in Exchange Control Circular 6/2022 to amend section B.2(B) of the AD Manual to expressly permit individuals to fund their online international trading accounts by using their SDA or FCA. However, individuals may not fund these international trading accounts using South African credit, debt and virtual card transfers. The use of these trading accounts to invest in crypto assets is expressly referred to in the amended section.

This announcement will be welcomed, especially by the crypto asset industry, as it provides much needed clarity. It appears that this amendment was made pursuant to the recommendation being made by the Intergovernmental Fintech Working Group (IFWG) in its position paper released in June 2021. It remains to be seen whether some of the IFWG's other recommendations will be implemented, such as the proposal to include a BOP code (balance of payments code) specifically for crypto asset transactions.

FOREIGN TRUSTS

In terms of Exchange Control Circular 8/2022, section B.2(B) of the AD Manual was further amended to state that FinSurv will now consider applications by private individuals who wish to invest in excess of their annual FCA limit of R10 million in different asset classes and that such offshore investments may also be made via a foreign domiciled and registered trust. The amendment states that this dispensation also applies to private individuals who have existing authorised foreign assets, irrespective of their value.

South African individuals making use of this dispensation must keep in mind that where funds are transferred to an offshore trust structure, either from South Africa or from an offshore account, they would still need to comply with South African tax law provisions applicable to loans and donations, depending on the nature of the transfer made.

FOREIGN DONATIONS AND INHERITANCES

For a long time, there was a distinction between the rules applicable to the receipt of foreign donations and those of foreign inheritances. Whereas foreign inheritances from a *bona fide* non-resident estate have been exempt from Exchange Control Regulations 6 and 7 (made in terms of section 9 of the Currency and Exchanges Act, 1933) for a few years, this did not apply to foreign donations. Pursuant to the amendment announced in Exchange Control Circular 7/2022, foreign donations are now also exempt from the obligations under Regulations 6 and 7, subject to the recipient complying with his tax obligations in this regard. This only applies to foreign donations received on or after 23 February 2022 and contraventions prior to this date would still need to be regularised.

In addition, South African residents may now also donate, lend or dispose of authorised foreign assets to other South African residents, subject to local tax disclosure and compliance by both parties.

In relation to the inheritance of foreign assets, South African residents inheriting foreign assets from a South African resident estate are now also exempt from Regulations 6 and 7, subject to local tax disclosure and compliance. As stated above, this previously only applied to foreign assets inherited from *bona fide* non-resident estates. However, if the foreign assets held by the deceased were unauthorised assets, these assets must still be regularised with FinSurv.

COMMENT

Many of these changes follow the trend that seems to have started with the relaxation of loop structure rules – whereas regulatory oversight was exercised through exchange control rules it is now exercised through rules in tax legislation. This is evident from the fact that for each of the amendments discussed, exchange control relaxation occurs subject to the required tax disclosure and compliance taking place (except in cases where a person only makes use of their SDA). It is thus anticipated that SARS may receive more tax compliance status letter applications under section 256 of the Tax Administration Act, 2011, for individuals seeking to invest abroad using their FCA.

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 9K;
- Tax Administration Act 28 of 2011: Section 256;
- Currency and Exchanges Act 9 of 1933: Section 9.

Other documents

- Exchange Control Regulations, 1961: Regulations 6 & 7 (made in terms of the Currency and Exchanges Act, 1933);
- Currency and Exchanges Manual for Authorised Dealers (AD Manual): Section B.2(B);
- Position paper of the Intergovernmental Fintech Working Group (IFWG) (released in June 2021);
- BOP (balance of payments) code specifically for crypto asset transactions (proposal);
- Circulars amending some of the exchange control rules applicable to individuals, released by Finsurv on 23 February 2022, following the publication of the 2022 Budget:
  - Exchange Control Circular 5/2022 (section B.2(B) of the AD Manual amended);
  - Exchange Control Circular 6/2022 (section B.2(B) of the AD Manual further amended);
  - Exchange Control Circular 7/2022;
  - Exchange Control Circular 8/2022 (section B.2(B) of the AD Manual further amended).

Tags: single discretionary allowance (SDA); foreign inheritances; foreign assets.

PLACE OF EFFECTIVE MANAGEMENT

The place of effective management (POEM) principle is applied to determine the tax residence of a company. Where it is determined, for example, that a company is tax resident in South Africa, it will be taxed in South Africa on its worldwide income. However, the impact of the COVID-19 pandemic on the application of the POEM test must also be taken into account, especially in the case of companies with multiple offshore subsidiaries.

On a practical level, a situation may arise where a multinational company with offshore subsidiaries needs to consider how the location of the directors of the offshore subsidiaries may affect the POEM of these subsidiaries. The importance of POEM can arise in a variety of scenarios and should, especially during the somewhat extraordinary time of a global pandemic, be given due attention.

It is widely known that the COVID-19 pandemic has resulted in travel restrictions, resulting in some chief executive officers, or other senior executives and/or board members of foreign companies, being unable to travel from South Africa to attend board meetings, or conduct business in the country where that company is tax resident. However, the question then arises as to whether this places the company at risk of being pulled into the South African tax net by virtue of its POEM.

Considering the myriad of both permanent and temporary changes to the current working environment, such as pandemic-imposed travel restrictions and new workplace policies, the most notable of which being the "work from home" policy, it may be worthwhile for a corporate taxpayer to reassess its POEM. As a result, in many instances, a scenario can arise where the key commercial decisions of a corporate taxpayer are being made outside of the jurisdiction in which it is based. This may have an adverse and unintended impact on the POEM analysis of the taxpayer.

It is therefore important for companies to be cognisant of the criteria and guidelines provided by both the Organisation for Economic Cooperation and Development (OECD) from time to time, and by the South African Revenue Service (SARS) in considering the POEM of a company.

From the outset, it is important to note that the OECD stated (on 3 April 2020) that –

> "It is unlikely that the COVID-19 situation will create any changes to an entity's residence status under a tax treaty. A temporary change in location of the chief executive officers and other senior executives is an extraordinary and temporary situation due to the COVID-19 crisis and such change of location should not trigger a change in residency, especially once the tie breaker rule contained in tax treaties is applied."

"From a South African perspective, it should be noted that the term 'place of effective management' is not defined in the Income Tax Act, 1962."

From a South African perspective, it should be noted that the term "place of effective management" is not defined in the Income Tax Act, 1962. SARS' enforcement and consideration of POEM is constantly developing, and its current approach is contained in SARS Interpretation Note 6 (Issue 2) (IN 6).

"One of the most critical factors as set out in IN 6 is that a company's POEM will be deemed to be the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made."

One of the most critical factors as set out in IN 6 is that a company's POEM will be deemed to be the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made. The analysis, however, considers a number of factors, which include:

- where the real top level of management or realistic, positive management of the taxpayer is exercised;
- where decisions are made at more than one location, the company's place of effective management will be the location where those decisions are primarily or predominantly made;
- a substance over form test, which requires the identification of those persons in a company who actually "call the shots" and exercise "realistic, positive management"; and
- importantly, IN 6 also recognises that changes in telecommunications, information technology, global travel and modern business practices can impact on the place of effective management.

Accordingly, physical meetings of the board may no longer be required, or it may not be possible for the majority of the directors, or the key directors with decision-making powers, to be in the same location as the physical meeting. This is not a fatal consideration in the overall analysis of POEM, but one of the factors that should be considered. IN 6 provides that it is important not to place any undue focus on the location where board meetings take place without considering the surrounding facts and circumstances of a particular case.

From an international tax perspective, the OECD guidelines are set out hereunder. It is important to note that tax treaties also cater for a situation where companies have dual residence as a result of the company being physically located in one jurisdiction and its POEM being elsewhere. In this instance, most treaties contain a "tie breaker rule" which ensures that the entity is resident in only one of the states.

The determination of POEM from an OECD perspective is largely similar to that set out in IN 6 and takes into consideration all the facts and circumstances over the determination period. Specifically, the OECD Commentary on Article 4 of the OECD Model Tax Convention illustrates the range of factors that the competent authorities are expected to take into consideration to make their determination, which include:

- where the meetings of the company's board of directors or equivalent body are usually held;
- where the chief executive officer and other senior executives usually carry on their activities; and
- where the senior day-to-day management of the company is carried on.

The OECD generally considers the concept of "place of effective management" as being ordinarily the place where the most senior person or group of persons (for example a board of directors) make the key management and commercial decisions necessary for the conduct of the company's business.

Therefore, all relevant facts and circumstances should be examined to determine the "usual" and "ordinary" place of effective management, and not only those that pertain to an exceptional and temporary period such as the COVID-19 crisis.

Having regard to the guidelines and criteria considered by both the OECD and SARS, the question whether having executives making key commercial decisions whilst not physically in the same jurisdiction as the company impacts POEM, is dependent on the specific facts and circumstances. As outlined above, to the extent that the circumstances point to an "extraordinary and temporary situation due to the COVID-19 crisis", it is unlikely that POEM will be impacted. However, the situation may become slightly trickier when, for example, travel restrictions and bans are relaxed and executives are no longer prevented from being physically in the jurisdiction of the company concerned. In this scenario, where executives have become comfortable working from their home country, and the convenience of technology and revised post-pandemic work-place policies allow for seamless running of the company from some other location, there is a real risk that POEM is impacted.

To the extent that a company has a POEM issue that is undetected by the checks and balances within the entity and is subsequently subject to an investigation by a revenue authority which deems the POEM of the company to be another jurisdiction, the company may find itself in prolonged engagement with that revenue authority to remedy the failure to account for tax in the correct jurisdiction.

Keshen Govindsamy

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: (No definition of "place of effective management").

Other documents

- SARS Interpretation Note 6 (Issue 2: "Resident – place of effective management (companies)") – 3 November 2015;
- the OECD Commentary on Article 4 of the OECD Model Tax Convention.

Tags: place of effective management (POEM); tax residence.

COURT GRANTS TAXPAYER CONDONATION ON THE BASIS OF SARS' EGREGIOUS DELAYS

The taxpayer, frustrated by SARS' continuous failure to deliver its rule 31 statement, approached the tax court for condonation in terms of rule 52(6), promulgated under section 103 of the Tax Administration Act, 2011 (the TAA). SARS lodged a counter-application for condonation and the determination of a further period for delivery of that statement.

Judge Cloete, in *F Taxpayer v South African Revenue Service* (Case No: IT 45842), handed down the judgment on 25 February 2022.

BACKGROUND

After carrying out an audit on the taxpayer, SARS raised additional assessments amounting to R8.4 million on 17 March 2020 in regard to the taxpayer's 2016 to 2018 years of assessment.

The taxpayer requested SARS to provide reasons for the assessment. SARS missed the prescribed 45-day deadline, and without obtaining consent from the taxpayer, "unilaterally imposed" an extension to furnish its reasons, and delivered its reasons on the last day of the extension, ie, on 7 September 2020.

The taxpayer delivered its objection within the required period, but SARS missed its deadline for delivering its decision on the objection. SARS only gave its decision, a partial disallowance of the objection, after the taxpayer had delivered a rule 56(1)*(a)* notice.

The taxpayer delivered its appeal timeously, but SARS did not deliver its rule 31 statement within the prescribed time limit. SARS did not request a condonation for the late notice, and did not provide a reason for the delay.

Ms Mukwevho from the SARS' litigation unit on 17 June 2021 blamed the delay on the backlog resulting from COVID-19 and the lack of capacity.

The taxpayer gave SARS a one-month extension, which Mukwevho "erroneously interpreted" to be 30 July 2021, some two weeks later. The matter was then allocated to Mr Sehloho in the same unit, who informed the taxpayer that SARS had recently briefed counsel to assist in the preparation of the rule 31 statement. He requested an extension to 31 August 2021. However, counsel was only briefed and given instructions on 12 August 2021.

The taxpayer launched its application for a final order on 10 August 2021. SARS served its rule 31 statement on 21 September 2021, ie, 36 days after the agreed extended timeline.

IS CONDONATION IN THE INTERESTS OF JUSTICE?

The court noted that the standard to be applied in determining an application for condonation is whether it is in the interests of justice, and discussed the concepts to be considered:

- The "nature of the relief sought; the extent and cause of the delay; the effect of the delay on the administration of justice and other litigants; the reasonableness of the explanation for the delay; the importance of the issue to be raised…".
- Existing case law such as *Grootboom v National Prosecuting Authority*, [2014] at para [22], referring to *Brummer v Gorfil Brothers Investments (Pty) Ltd and Others*, [2000], at para [3], and *Van Wyk v Unitas Hospital and Another (Open Democratic Advice Centre as Amicus Curiae)*, [2007], at para [20].
- Section 195 of the Constitution, 1996, which sets out the basic values and principles governing public administration. Essentially, a high standard of professional ethics; efficient, economic and effective use of resources; services must be provided impartially, fairly, equitably and without bias; transparency; public administration must be accountable.
- In *Buffalo City Metropolitan Municipality v Asla Construction (Pty) Ltd*, [2019], the Constitutional Court considered whether a flexible approach should be taken, and the delay overlooked.
- Section 33 of the Constitution entrenches the right of everyone to administrative action that is lawful, reasonable and procedurally fair.
- It is crucial to the taxpayer's operations to be reflected on SARS' efiling system as tax compliant.

SUSPENSION OF PAYMENT, OR NOT

On 11 June 2020 (the day after expiry of the initial period in which SARS was required to provide reasons but failed to do so) the taxpayer submitted a request to SARS in terms of section 164(2) of the TAA for suspension of payment.

The court noted that there is no suggestion in SARS' papers that any SARS official believed that the taxpayer's assets were at risk of dissipation, yet, SARS proceeded with collection steps and issued a final demand for payment on 18 June 2020.

The taxpayer pointed out SARS' error and SARS formally approved the payment suspension request on 3 September 2020.

Though SARS was obliged to reflect the taxpayer's status as compliant on the efiling platform, it insisted that the taxpayer first pay the disputed (yet suspended) tax debt before it would reflect it as tax compliant.

On 26 January 2021, the taxpayer notified SARS in terms of section 11(4) of the TAA that it would approach the High Court for an order compelling SARS to reflect its status as tax compliant. SARS finally corrected the status to "tax compliant" on 29 January 2021.

On 22 February 2021, SARS informed the taxpayer that the payment suspension had been revoked, purportedly on the basis that the dispute had been "resolved". However, the period in which the taxpayer had to file its notice of appeal to the partial disallowance of its objection, had not yet expired.

The taxpayer pointed out that the dispute had not been resolved, and on 29 March 2021 SARS reinstated the suspension of payment.

On 14 September 2021, without any notice to the taxpayer, SARS again altered the taxpayer's status to non-compliant.

The taxpayer gave examples of the severe prejudice it suffered:

- It forfeited an export registration with a regulatory body.
- Its credit facilities with two major banking institutions required proof of consistent tax compliance.
- To qualify for funding from the Department of Trade and Industry to attend international trade exhibitions, it had to be able to produce proof of its tax compliant status.
- Some 50 employees would lose their jobs if the taxpayer could not continue with its business.
- The taxpayer was unable to arrange some of its financial affairs with any reasonable degree of predictability, in the period that the dispute remained unresolved.

"Sehloho told the court that the delay was not unreasonable, considering the highly technical issues around the deductibility of insurance premiums, and that this was of public importance."

SARS' POSITION

Counsel for SARS submitted that SARS' officials were "duty bound to consider the matter afresh at each stage". The court noted that there was nothing in SARS' papers to support this assertion.

The court observed that "SARS had two opportunities to take the court into its confidence": firstly, in filing its answering affidavit coupled with its condonation application; and, secondly, when on 15 September 2021, it unilaterally altered the taxpayer's tax status to non-compliant. The court remarked that "SARS did not even address this allegation in its replying affidavit and it thus also stands uncontested."

Sehloho told the court that the delay was not unreasonable, considering the highly technical issues around the deductibility of insurance premiums, and that this was of public importance. The court questioned why, if the issues were of such public importance, SARS had delayed in the manner it did. SARS attempted to explain why it had refused the taxpayer a deduction of its insurance premiums paid to RMB Structured Finance Insurance Ltd under section 23L(2) of the Income Tax Act, 1962. Section 23L(2) provides that an insurance premium is not deductible if it is not classified as an expense for International Financial Reporting Standards (IFRS) purposes.

IFRS 4 deals with all insurance contracts that an insurer issues. SARS and the taxpayer agreed that there is no IFRS standard dealing with the accounting treatment of insurance contracts from the perspective of the policy holder. The taxpayer argued that it has no access to the funds accumulated, no control over the credit risk, and that payment of the insurance premium by it results in a decrease in its asset base. It thus constitutes an expense. Despite SARS having previously agreed that IFRS 4 does not apply, in its affidavit as well as in its heads of argument it relied on IFRS 4.

The court held that "…the defence which SARS raised in its papers is contradicted by, and is at odds with, its own argument. In these circumstances the only reasonable inference to be drawn is that, on its own version, SARS lacks prospects of success on the merits on its defence as currently formulated".

JUDGMENT

- The court held that SARS had displayed a persistent disregard for the time limits prescribed in the rules. SARS failed to request extensions, and did not provide reasons for its delays.
- The court found that SARS had made a number of misrepresentations to the taxpayer, including, that Mukwevho had been allocated all three appeals when according to her she had been allocated only one; the date of the extension to which the taxpayer had agreed; the reason why the appeal was reallocated to Sehloho, and the untrue statement that counsel had "recently" been briefed.
- The court declined to accept SARS' request to ignore its delays prior to 30 July 2021, as it regarded the recent delays to be a "perpetuation of a pattern of disregard for the rules and what is required of administrative functionaries such as the SARS officials in the present matter".
- The court found that SARS had flouted the basic values and principles governing public administration enshrined in the Constitution, of a high standard of professional ethics; efficient; economic and effective use of resources; impartiality, fairness, equitableness, and without bias; accountability and transparency.
- The court found SARS' continued delays to be egregious, and that these delays placed a severe strain on the taxpayer. SARS had failed dismally to fulfil its obligations, both under the Constitution as well as the TAA.

The taxpayer was granted final relief and awarded costs against SARS.

Barbara Curson

Acts and Bills

- Income Tax Act 58 of 1962: Section 23L(2);
- Tax Administration Act 28 of 2011: Sections 11(4), 103 & 164;
- Constitution of the Republic of South Africa, 1996: Sections 33 & 195.

Other documents

- Rules promulgated under section 103 of the TAA: Rules 52(6) & 56(1)*(a)*;
- Rule 31 statement;
- IFRS 4 (International Financial Reporting Standards).

Cases

- *F Taxpayer v SARS* [2022] Case No: IT 45842;
- *Grootboom v National Prosecuting Authority* [2014] (2) SA 68 (CC) at para [22];
- *Brummer v Gorfil Brothers Investments (Pty) Ltd and Others* [2000] ZACC 3; 2000 (2) SA 837 (CC) at para [3];
- *Van Wyk v Unitas Hospital and Another (Open Democratic Advice Centre as Amicus Curiae)* [2007] ZACC 24; 2008 (2) SA 472 (CC) at para [20];
- *Buffalo City Metropolitan Municipality v Asla Construction (Pty) Ltd* [2019] (4) SA 331 (CC).

Tags: reasonable and procedurally fair; tax compliant; tax compliant status.

HIGH NET WORTH TAXPAYERS

The 2022 Budget Speech saw the announcement of a new tax disclosure for wealthy taxpayers. This disclosure serves as a building block for SARS' high net worth individual strategy, serving to further inform the dedicated unit, which is now operating within SARS, focused on these wealthy taxpayers. The new disclosure will place a significant compliance burden on wealthy taxpayers, and has received formal endorsement from the National Treasury in the 2022 Budget Speech:

> "To assist with the detection of non-compliance or fraud through the existence of unexplained wealth, it is proposed that all provisional taxpayers with assets above R50 million be required to declare specified assets and liabilities at market values in their 2023 tax returns. The additional information will also help in determining the levels and structure of wealth holdings as recommended by the Davis Tax Committee." – (Budget Review 2022: Chapter 4 – page 45).

SARS believes wealthy taxpayers remain under the radar

The reason for the new disclosure is specifically given as being the detection of non-compliance or fraud. There is a yet to be reported success of conviction of a R50-million plus wealthy individual for tax fraud serving time in jail, but there appears to be a clear mandate to change this. The disclosure change is aimed specifically at unexplained wealth. This may allude to reported overseas trips, high end cars, properties or extravagant lifestyles advertised on social media, with no means-correlation to what SARS sees being disclosed on the taxpayer's annual and/or provisional tax returns.

Individuals with assets, not net worth, above R50 million seem targeted

The announcement refers to a declaration pertaining to provisional taxpayers owning assets in excess of R50 million in value. This proposal refers to these taxpayers having to declare "specified" assets and liabilities, at current market value. This implies that not all assets need to be disclosed and that SARS is only interested in certain types of assets, details of which have yet to be announced. The disclosure will also include liabilities, which implies that SARS' interest will be on a pure asset value in excess of R50 million, and not necessarily the taxpayer's net worth. For example, if you have a farm valued above R50 million and a bank mortgage of R30 million, your net worth on this asset is only R20 million. As National Treasury's announcement specifically calls for disclosure of assets above R50 million, it suggests the above scenario will fall under this new rule, but again this remains to be seen.

"The announcement refers to a declaration pertaining to provisional taxpayers owning assets in excess of R50 million in value."

Is this announcement contradictory?

There could be an argument that this announcement may serve to only further burden compliant, wealthy taxpayers, subjecting them to even further scrutiny. However, this being said, SARS has announced in the 2022 Budget that "The dedicated new unit focussed on high net wealth individuals is taking shape".

This suggests that the tax disclosure is merely part of a wider strategy, and will be a streamlined process, having a dedicated relationship manager from this new unit being appointed to the respective wealthy taxpayers. It must be noted, however, that where an individual does not file a tax return required by law, or does not make full and correct disclosure therein, this may open them up to criminal charges.

Market values may create a significant compliance burden

Giving market values creates a serious compliance burden and risk for any taxpayer in this category. Taxpayers do not want to get into valuation arguments with a SARS criminal investigator who will ask piercing questions on how the current value of assets has been determined. Does this mean property must be valued each year or, in what could be a more complex case, where a person has a privately owned business, must their net worth be valued on an annual basis? It remains to be seen how SARS will find the correct balance between getting the information they require and not placing undue burdens on compliant taxpayers.

How will family structures be treated?

SARS' approach is aimed at all provisional taxpayers with assets above R50 million. This suggests that it will impact privately owned companies and family trusts too, as they are also provisional taxpayers. One can clearly see how this can quickly become very complex and time-consuming.

Prudent measures to act upon now

National Treasury's announcement leaves little doubt that there is a renewed focus on wealthy taxpayers and their structures. The positive factor is that there is sufficient warning given that this will only be implemented in 2023. High net worth taxpayers have been assisted extensively to financially emigrate over the past couple of years; this announcement may expedite the decision for those on the fence.

With time running out, high net worth individuals are encouraged to perform a tax diagnostic on compliance and have a hard look at whether heritage structures remain valid or can be improved. Of course, where taxpayers have been in the naughty corner or even unknowingly non-compliant, they need to consider doing a SARS voluntary disclosure application.

Jashwin Baijoo

Tax Consulting SA

Other documents

- Budget Review 2022: Chapter 4 (page 45).

Tags: compliance burden; high net worth individuals.

PURVEYORS V CSARS: THE MEANING OF "VOLUNTARY DISCLOSURE"

"The primary issue in this appeal is whether SARS was correct in rejecting Purveyors' voluntary disclosure application for non-compliance with s 227, more specifically on the ground that it was not made voluntarily. The issue therefore resolves itself into this: does the exchange or discussions between the representatives of SARS and the officials of Purveyors have any material bearing on the application? Purveyors contends that the prior information disclosed to SARS in the process of ascertaining its tax liability is irrelevant and should not preclude it from making a valid voluntary disclosure application. Purveyors' case is that the exchanges have no formal or binding effect on the views expressed by the taxpayer. Essentially, it argues that the application must not be considered at the historical point but crucially at the time when the application is made. In other words, prior knowledge disclosed by the taxpayer is no bar to a valid voluntary disclosure application and does not affect the validity and voluntariness of the application."

This is the nub of the recent judgment of the Supreme Court of Appeal (SCA) in *Purveyors South Africa Mine Services (Pty) Ltd v CSARS* Case No 135/2021 (not yet reported), delivered on 7 December 2021.

In January 2015, Purveyors entered into a dry lease agreement with a USA company, Freeport Minerals Corporation, for the lease of an aircraft to operate air charter services for Tenke Fungurume Mining SARL, a non-resident company owning and operating a mine in the Democratic Republic of Congo. At the date of the agreement, Freeport owned 100% of the equity of Purveyors and 80% of Tenke. Purveyors entered into an air charter agreement with Air Katanga to manage, operate and maintain the aircraft on behalf of Purveyors.

The aircraft transported employees, subcontractors, suppliers and business guests from Johannesburg to Lubumbashi and Katanga, generally three times a week. When it was not in use, the aircraft was kept in a hangar leased to Purveyors at OR Tambo International Airport.

In November 2016, Purveyors became a subsidiary of CMOC DRC Limited, a company incorporated and tax registered in Hong Kong. A sister company of CMOC DRC assumed the initial dry lease agreement and concluded a new one with Purveyors. The agreement between Purveyors and Tenke remained undisturbed.

In January 2017 Purveyors received an opinion from PwC stating that Purveyors ought to have paid value-added tax on the importation of the aircraft into South Africa. On 30 January Purveyors then approached SARS with a view to regularising its VAT obligation. On the following day a SARS official responded in an email that the aircraft was subject to penalty implications.

On 29 March 2017 the official wrote to Purveyors explaining the reasons for the penalties and informing the taxpayer of the need to appoint a clearing agent. Purveyors replied immediately, indicating that it understood that VAT and customs duty were payable, as well as fines and penalties. On 30 March the SARS official responded in order to clear any misunderstandings and indicated that no waiver of potential penalties existed and that if the tax payable to SARS was late, penalties and interest would arise. On 16 May 2017, in response to a further request from Purveyors, PwC confirmed its earlier opinion.

Purveyors took no further steps for nearly a year, until it applied for voluntary disclosure relief under section 226 of the Tax Administration Act (the TAA) on 4 April 2018. SARS countered with reference to section 227, which provides that an application falls to be rejected if it is not voluntary and contains facts of which SARS was aware prior to the application.

Purveyors appealed unsuccessfully to the tax court, which found that the application had not been voluntary as there was an element of compulsion on the part of Purveyors when it made the application.

"Purveyors contended that the prior information disclosed to SARS in the process of ascertaining its tax liability was irrelevant and should not preclude it from making a voluntary disclosure application."

On appeal to the SCA, following an unrewarding appeal to the High Court, the issue was whether the earlier exchanges or discussions between SARS and Purveyors had any material bearing on the application. Purveyors contended that the prior information disclosed to SARS in the process of ascertaining its tax liability was irrelevant and should not preclude it from making a voluntary disclosure application. The application should not be considered at the historical point but only when the application was made. In other words, prior knowledge disclosed by the taxpayer is no bar to a valid voluntary disclosure obligation.

Purveyors relied on a comment in an article by SP van Zyl and TR Carney (in *Tydskrif vir Hedendaagse Romeins-Hollandse Reg (THRHR)*), where the learned authors state in relation to the Purveyors case *a quo*: "…'disclosure' is neither restricted in its denotation nor does its context in the TAA limit its meaning to 'new' or 'secret' information explicitly. To argue this would be precarious in the least". SARS contended that the application did not disclose information or facts of which SARS was unaware, and was not voluntary as Purveyors had been prompted by SARS with the warning that it would be liable for penalties and interest arising from its failure to pay the tax due. The customs officials had already gained knowledge of the default and had advised Purveyors as early as 1 February 2017 that the aircraft should be declared and VAT paid.

The court proceeded to interpret section 227 in terms of the definitive *Endumeni* judgment (2012), that "consideration must be given to the language in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production". According to the Shorter Oxford English Dictionary on Historical Principles, "voluntary" means "performed, or done of one's own free will, impulse or choice; not constrained, prompted or suggested by another". "Disclosure" means "to open up the knowledge of others, to reveal".

These two words required, according to the court, that the application must measure up fully to the requirements of section 227. No purpose would be served if the TAA enabled errant taxpayers to obtain informal advice from SARS and then, when the advice did not suit them, apply for voluntary disclosure relief.

On 29 March 2017 Purveyors' office manager sent an email to the responsible SARS official, stating:

> "We understand from your mail and our telephonic discussion that a VAT output is applicable and customs duties are applicable as well. However the VAT input is claimable back. Fines and penalties are applicable; however, based on the fact that the company might have been misinformed at the inception of the operation of the aircraft, you are willing to advance that as mitigating circumstances in order to waive the applicable fines and penalties. Furthermore, if we follow the process outlined below we will be in compliance with all the laws and regulations and you (SARS) will award a document of compliance."

The court found that this email made three things clear: the application was prompted by compliance action by SARS, which was aware of the interaction between Purveyors and SARS officials; Purveyors appreciated that it was liable for fines and penalties which had to be paid before Purveyors became tax compliant; and the application was to avoid the payment of fines and penalties rather than a desire to come clean. To grant relief in circumstances where SARS had prior knowledge of the default would be at odds with the purposes of the programme, which was to enhance voluntary compliance with the tax system by enabling errant taxpayers to disclose defaults of which SARS was unaware and to ensure the best use of SARS' resources.

On a true analysis of the facts, Purveyors' application did not pass the test. It disclosed no information of which SARS was unaware. The submission that the application should be treated as if no exchanges, approaches or contact were made prior to the application was without merit.

Purveyors attempted one further argument, namely that SARS had not given notice of an audit or investigation as contemplated in section 226. Had SARS done so, Purveyors would have been precluded from applying under the programme. Because there had been no such notice, Purveyors was at large to apply. The court rejected this contention by pointing out that it was under section 227, not section 226, that SARS had correctly rejected the application.

It would be difficult to take issue with this judgment. The court, with respect, arrived at the only tenable interpretation of the voluntary disclosure programme in the TAA.

Prof Peter Surtees

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 226 and 227.

Other documents

- Shorter Oxford English Dictionary on Historical Principles (1) 3 ed 1973: Definitions of "voluntary" and "disclosure";
- Van Zyl, SP, and Carney, TR, "Just How Voluntary Is 'Voluntary' for Purposes of a Voluntary Disclosure Application in terms of section 226 of the Tax Administration Act 28 of 2011 – *Purveyors South Africa Mine Services (Pty) Ltd v Commissioner: South African Revenue Service* (61689/2020) [2020] ZAGPPHC 404 (25 Aug 2020)" 2021 *THRHR* 84 at 95–110.

Cases

- *Purveyors South Africa Mine Services (Pty) Ltd v CSARS* Case No 135/2021 (not yet reported) (delivered on 7 December 2021);
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA); [2012] ZASCA 13.

Tags: voluntary disclosure application; tax compliant.

REQUESTS FOR EXTENSION OF TAX PAYMENTS

Albert Einstein once said: "The hardest thing in the world to understand is the income tax." This is certainly true when trying to understand SARS' application of the legislation dealing with penalties and deferred payment arrangements (typically requests for suspension of payment pending the outcome of an objection or appeal).

In its Annual Performance Plan for 2021/22, SARS casually states that it intends to "make it easy" for taxpayers to become and remain tax compliant. SARS continues that it aims to provide "an easily accessible, professional and efficient service" and that it "will ensure that taxpayers and traders are provided with seamless services from registration".

Unfortunately, some obligations and remedies are not so clear, accessible, or seamless as one would hope them to be. Tax compliance can be defined as the degree to which taxpayers fulfil their tax obligations, as and when required by law. One of the obligations taxpayers may have difficulty adhering to would be the timeous payment of their outstanding debt, especially in instances where there is a significant amount of debt involved. SARS, acting within the legislative framework as laid down by the legislature, has therefore put certain practices in place, in addition to the legal remedies available to taxpayers to manage the payment of outstanding debt before it becomes overdue.

SARS' debt collection processes include the issuing of Letters of Final Demand to make taxpayers aware of their outstanding debt. Remedies available to taxpayers include applications for deferments to SARS' debt management offices as well as the submission of requests for suspension of payment.

In its Annual Performance Plan SARS states that "the aim of its enforcement activities is to promote fairness and deter non-compliance". Whilst indicating that it strives to build the necessary capabilities to detect and investigate non-compliance, SARS also intends to provide taxpayers with reasonable time and clear guidance on how to respond.

Although some guidance is provided regarding the remedies available to taxpayers, in some instances reasonable time and "clear" guidance appear to be illusive goals. Many tax practitioners and taxpayers struggle to achieve satisfactory outcomes in this regard.

For example, a taxpayer who is aggrieved by an assessment issued by SARS has the right to object thereto. The SARS dispute resolution rules state that a taxpayer may submit a request for reasons if they wish to do so. This has to be done within 30 business days from the date of the assessment. The Act allows SARS 30 business days to issue the response to the request for reasons. In practice, SARS often misses this deadline. Be that as it may, once the reasons for the disputed assessment have been issued by SARS, the taxpayer has 30 business days within which to lodge an objection to the assessment. In practice, this is also the first opportunity that the taxpayer has to submit a request for the suspension of payment, pending the outcome of the objection and any subsequent appeal.

In the meantime, the due date for the payment of the disputed assessment would have come and gone, and SARS typically issues a Letter of Final Demand. The Act provides that if a taxpayer fails to respond to the Letter of Final Demand within 10 days from the date of issue thereof, SARS may legally commence with collecting the amount due. This routinely includes issuing a Third-Party Appointment letter to the taxpayer's bank, thus enabling SARS to withdraw the disputed amount from the taxpayer's bank account. So, while the aggrieved taxpayer is still well within the legally prescribed period for lodging an objection to the disputed assessment, SARS has already taken the money out of its bank account.

"Arguably, demanding payment of the debt within 10 days of issuing a Letter of Final Demand while the taxpayer is in the process of formally lodging an objection or awaiting the outcomes thereof, would appear to be unfair."

This application of the so-called "Pay Now, Argue Later" principle has left numerous taxpayers impoverished and caused severe hardship to them, particularly where their businesses are already battling to overcome the devastating effects of the COVID-19 lockdowns of the last two years.

In some cases, taxpayers require tax clearance certificates for business tender purposes. The current SARS system forces them to settle the disputed assessments, pending or even after the submission of a valid objection, purely to obtain the essential tax clearance certificates. Once paid, it often takes many months to obtain a corrected assessment and the tax refund.

Tax practitioners are finding it impossible to submit a request for Suspension of Payment on efiling without simultaneously submitting the notice of objection. The efiling system does not cater for requests for suspension of payment to be submitted separately. Requests for suspension of payment submitted to SARS via other channels, eg, by way of emails to the official SARS tax practitioners' mailboxes are in practice flatly ignored. This mismatch of the objection and suspension of payment processes needs urgent attention.

Does SARS really allow reasonable time and clear guidance for taxpayers on how to manage their outstanding debts? Is SARS' aim of enforcement activities promoting fairness? Based on many taxpayers' experience, the answer to these questions must be "No". Arguably, demanding payment of the debt within 10 days of issuing a Letter of Final Demand while the taxpayer is in the process of formally lodging an objection or awaiting the outcomes thereof, would appear to be unfair.

It can also be argued that SARS does not take information at its disposal into account. As mentioned above, Letters of Final Demand are still issued while taxpayers await the outcomes of formally submitted Objections and Suspension of Payment letters. Additionally, SARS is then taking collection steps when legally barred from doing so as decisions have not been taken on these requests yet.

Considering the above, SARS also states that it strives to expand the use of data analytics and artificial intelligence to improve the integrity of its records, risk management and to derive critical inputs and improve outcomes. However, the scenarios briefly described above do not in fact suggest that SARS is taking adequate measures to ensure efficiency and fairness in its actions.

The institutional integrity and capabilities of SARS therefore also remain questionable.

Perhaps Albert Einstein was in fact correct.............

Jacqueline Viljoen

BDO

Other documents

- SARS' Annual Performance Plan for 2021/22;
- Letters of Final Demand;
- Third-Party appointment letter;
- Tax clearance certificates;
- notice of objection.

Tags: tax compliance; Letters of Final Demand; "Pay Now, Argue Later" principle; tax clearance certificates; Objections and Suspension of Payment letters.

RISKS OF TAX RETURN NON-DISCLOSURE

A fundamental reason for the existence of the rules of "prescription" in South African tax law is to provide a taxpayer with certainty as regards its tax position. Under certain circumstances, SARS is barred from changing a favourable to an unfavourable assessment. In disputes, prescription is a powerful defence available to compliant taxpayers, allowing them to bring finality to their tax assessments. Whether the defence of prescription is available to a taxpayer is, inter alia, *dependent upon disclosure in its annual tax return.*

The importance of tax return disclosure was dealt with in quite some detail in the recent Supreme Court of Appeal decision in the matter of *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd*, [2021]. The court found against the taxpayer both on the merits of the case, which related to the deductibility, in terms of section 11*(a)*, read with section 23H, of the Income Tax Act, 1962 (the Act), of a contribution made to a share incentive trust, as well as in respect of the taxpayer's prescription defence. This latter aspect of prescription is dealt with in this article. Neither the tax court nor the majority decision of the High Court had to deal with the taxpayer's prescription defence as both those courts found in favour of the taxpayer.

GENERAL PRESCRIPTION PRINCIPLES

Section 99 of the Tax Administration Act, 2011, deals with the period of limitations for the issuance of assessments (ie, replacing a favourable assessment with an unfavourable one).

More specifically, section 99(1) provides that the Commissioner may not make an assessment three years after the date of the original assessment by SARS. However, section 99(2)*(a)* provides that the Commissioner *is not* bound by the three-year period of limitation where –

> "in the case of assessment by SARS, the fact that the full amount of tax chargeable was not assessed, was *due to*–
>
> (i) fraud;
>
> (ii) misrepresentation; or
>
> (iii) non-disclosure of material facts." (*our emphasis*)

There are therefore two requirements for the application of section 99(2)*(a)*. Firstly, one of the listed behaviours must be present and, secondly, such behaviour must have caused SARS not to assess correctly from the outset. SARS bears the onus to show that the original favourable assessment was the result of one or more of the listed behaviours at the time of the original assessment. This presupposes that the assessor in question, if they had the full and correct information, at the time of the issue of the original assessment, would have issued it on an unfavourable basis. The test is not whether the assessor would have revisited the original favourable assessment if it had the full information. To emphasise the point, nothing that happens after original assessment is relevant. In previous cases like *Commissioner for the South African Revenue Service v Bosch and Another* (394/2013) [2014], for example, it was necessary for the SARS to "go back in time" to the date of original assessment and give evidence that they would have assessed differently if proper disclosure had been made at the time of considering the return on which the assessment was based.

Arguably, the SCA has dramatically reinterpreted these rules in *Spur*.

THE FACTS OF THE CASE

The *additional* assessments that the Commissioner made in 2015 were in respect of Spur's 2005-2009 years of assessment, all of which were raised after the three-year period contemplated in section 99(1).

Spur raised the defence of prescription; however, the Commissioner averred that the amounts of tax chargeable in terms of the additional assessments were not so assessed by SARS in the 2005–2009 years of assessments due to misrepresentation and non-disclosure of material facts by Spur. In this regard, the following extracts from the judgment which relate to the disclosures made by Spur are quoted:

> "[43] It is common cause that Spur, in submitting its 2005 income tax return, (IT14), answered 'no' to the following questions:
>
> > 'Were any deductions limited in terms of s 23H?;
> >
> > . . .
> >
> > Did the company make a contribution to a trust?
> >
> > . . .
> >
> > Was the company party to the formation of a trust during the year?'
>
> [44] In the 2006 income tax return, Spur answered 'no' to the question: 'Were any deductions limited in terms of s 23H?'
>
> [45] Lastly, in each of the 2005–2008 income tax returns, the amount of deductions claimed in respect of the contribution, which were limited by s 23H of the ITA, were disclosed by Spur under the category 'other deductible items' and not under the line item 'prepaid expenditure (as limited by s 23H)'".

Spur's defence to the allegation of misrepresentation and non-disclosure of material facts was that the aforesaid statements were negligently and inadvertently made and that the Commissioner had failed to establish the requisite causal nexus. This excuse did not assist the taxpayer at all. It highlights the fact that there is no excuse for the nondisclosure; it is simply a question of fact, not of the taxpayer's state of mind or blameworthiness in the incorrect disclosure.

THE JUDGMENT

The judgment included some interesting insights into the SARS audit process which, in our view, highlights the importance of the accuracy of tax return disclosure. This disclosure automatically alerts SARS as to whether further investigation or audit is required to be conducted, in which case SARS has the opportunity to reassess timeously; similarly, a taxpayer who had made proper disclosure would then be able to validly rely on the prescription defence if the new assessment was not made within the three-year period.

With regard to the SARS auditing system, the court observed that a taxpayer's return is initially accepted at face value and an assessment is issued accordingly; thereafter, during the ensuing three years, the return and assessment must be reconciled. In this regard, the SARS official in the case testified that the tax return contains specific questions which were inserted deliberately as so-called "triggers". Depending on the manner in which the questions were answered by the taxpayers, a trigger could arise when a particular code is activated; further steps would then be taken and the matter could either be resolved at that stage or could proceed to an audit.

The Commissioner submitted that in this case a "yes" answer to the section 23H question, and to the question of whether a contribution was made to a trust, are risk factors which, according to the testimony, would have triggered a risk alert for SARS at the time when the returns were submitted for the relevant year of assessment. The court accepted this evidence.

We observe that there was no evidence mentioned that the trigger would have stopped the original face value assessment from being issued. Thus regardless of the trigger being activated, the original assessment (face-value assessment) might have been issued anyway. It might thus be an interesting argument for another day, whether SARS can discharge the onus of proof that the original assessment would have been issued on a different basis had SARS had full disclosure. (We do not have sufficient insight into SARS' AI systems to comment further.) In any event, it also appears that no human being could be called upon to give evidence in respect of the causation of the face value assessment, as this process is automated.

" 'Clearly, the integrity of the SARS assessment process depends largely on the correctness of the information provided in the return, and on SARS' ability to conduct audits of returns in the ensuing three-year period to ensure a proper tax treatment.' "

It is the disclosure in the tax return itself which would flag certain matters to SARS. The fact that supporting documents such as annual financial statements, for example, were submitted with a return would not remedy incorrect or misrepresented disclosure in the return as the AI only looks at the return. In this regard, the SARS official in the case testified that only the tax return, and not any supporting documents or schedules, is taken into account for purposes of issuing an original assessment, with the court commenting that "Clearly, the integrity of the SARS assessment process depends largely on the correctness of the information provided in the return, and on SARS' ability to conduct audits of returns in the ensuing three-year period to ensure a proper tax treatment."

This will cause some consternation to taxpayers and advisers who typically seek to supplement disclosure in the return with additional documents. Often, the way the questions are posed makes it difficult in practice to answer "yes" or "no". Taxpayers may also have to make judgment calls which they explain by additional documentation. The court held that SARS was not alerted to the relevant facts in this matter *due to* misrepresentation and non-disclosure of material facts, even though it could have detected these facts from looking at the supporting documents. This meant that the taxpayer could not rely on the defence of prescription.

The court concluded that:

> "[62] Spur accepted that false statements were contained in the returns. Against that, it contended that scrutiny of the financial statements and a more alert auditing process would and should have ensured a proper assessment within the prescribed period. It overlooked the face value assessment process understandably undertaken by SARS. Audits are implemented because of triggers caused by specific answers in tax returns. If the questions that would give rise to the triggers are wrongly answered, as happened in this case, the matter may not come before an auditor within the three-year period, and the clarification questions will therefore never be asked.
>
> [63] I should also add that as a matter of policy, a court would be loath to come to the assistance of a taxpayer that has made improper or untruthful disclosures in a return. Clearly, this would offend against the statutory imperative of having to make a full and proper disclosure in a tax return."

CONCLUSION

In practice, taxpayers are now more keenly aware of the risks of ticking the wrong box, and may well err in favour of answering "yes" to an ambiguous question, risking a possibly unnecessary audit, rather than an open-ended exposure to additional assessment without the benefit of the three-year bar. The difficulty of supplementing return disclosure to ensure a full and accurate tax return is now an open issue.

Robert Gad & Taryn Solomon

ENSafrica

Acts and Bills

- Income Tax Act 58 of 1962: Sections 11*(a)* & 23H;
- Tax Administration Act 28 of 2011: Section 99 (more specifically subsections (1) and (2)*(a)*).

Other documents

- Income tax return (IT14).

Cases

- *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* [2021] JDR 2530 (SCA);
- *Commissioner for the South African Revenue Service v Bosch and Another* (394/2013) [2014] ZASCA 171; 2015 (2) SA 174 (SCA) (19 November 2014).

Tags: rules of prescription; tax return disclosure; non-disclosure of material facts; SARS audit process.

TO OBJECT OR TAKE SARS ON REVIEW

A recent transfer pricing case raised a number of interesting issues about procedure in the event that a taxpayer disputes SARS' findings following an audit.

South Africa has seen its third "transfer pricing" case which, once again, does not actually deal with the merits of the transfer pricing analysis. Following on from *Crookes Brothers Ltd v Commissioner for South African Revenue Service*, [2018], and *ABC (Pty) Ltd v Commissioner for the South African Revenue Service*, [2021], the merits of procedure as opposed to the merits of the transfer pricing analysis under audit are considered in *United Manganese of Kalahari (Pty) Ltd v The Commissioner for the South African Revenue Service*, [2020].

United Manganese of Kalahari (Pty) Ltd (UMK) made an application to the High Court to review and set aside SARS' decision to raise additional income tax and dividends tax assessments and make a declaratory order. UMK approached the High Court directly without first exhausting its remedies of objection and appeal to the tax court. The High Court believed that the tax court was better suited to adjudicate the dispute. UMK had to exhaust its internal remedies before approaching the High Court unless it could show that exceptional circumstances existed. UMK tried to argue that exceptional circumstances existed, as set out in more detail below. The High Court disagreed and held that where the Income Tax Act, 1962 (the Act), or the Tax Administration Act, 2011 (the TAA), prescribes a method of achieving a particular goal instead of having to approach the High Court, there are no exceptional circumstances. UMK's application was ultimately dismissed.

However, the case does raise some interesting aspects worth keeping in mind in the event that you find yourself in the unenviable position of being under audit.

THE FACTS IN BRIEF

The taxpayer was notified of a transfer pricing audit in 2017. SARS issued a letter of audit findings in April 2019 informing UMK of the outcome of the audit. After further correspondence between the parties, UMK responded to the letter of audit findings on 30 August 2019. The parties then agreed to extend the period within which SARS could raise additional assessments to 31 January 2020. On 31 January 2020 SARS issued a Finalisation of Audit Letter, which resulted in an adjustment to the taxpayer's taxable income for the 2011–2013 years of assessment in terms of section 31(2) of the Act and a dividends tax assessment for the 2013 year of assessment under section 31(3) of the Act.

The taxpayer took SARS' decision to issue additional assessments on review. It argued that SARS changed the basis of the assessment without affording the taxpayer the opportunity to consider the changed basis of assessment and as such unlawfully issued additional assessments in breach of section 42 of the TAA. SARS disputed this, on the basis that the taxpayer had not followed due process in line with Chapter 9 of the TAA by lodging an objection against the additional assessments, specifically section 104 of the TAA.

SARS maintained the taxpayer was simply "forum shopping" in taking the decision on review, rather than following the correct procedures under Chapter 9 of the TAA. These procedures would ultimately lead the dispute to the tax court and, if appealed, to the High Court.

WHAT CONSTITUTES ADHERING TO SECTION 42?

While the Promotion of Administrative Justice Act, 2000 (PAJA), was also a bone of contention for the taxpayer, in this article we are staying away from that thorny issue and instead considering whether the taxpayer had grounds to argue that SARS contravened section 42 of the TAA.

Section 42 requires the SARS official involved in the audit to keep the taxpayer informed about the process of the audit, including the initial notification of commencement of the audit and, more importantly, on conclusion of the audit "a document containing the outcome of the audit, including the grounds for the proposed assessment". In transfer pricing cases this typically takes the form of a Letter of Audit Findings, setting out SARS' findings and generally inviting the taxpayer to respond. After considering the taxpayer's response (or not, which is often the case), SARS will issue a Finalisation of Audit Letter accompanying the additional assessments.

The taxpayer argued that SARS was in breach of section 42 because it changed the basis of its assessment without informing the taxpayer, making a material error in the application of the "connected person" definition to the facts. SARS issued its Letter of Audit Findings on 17 April 2019, after several requests for information and conducting interviews with employees of the taxpayer. In our experience, this is SARS' normal approach to transfer pricing audits. SARS also afforded the taxpayer 21 days to respond to the letter. The case notes that SARS indicated in its Letter of Audit Findings that it proposed to raise additional assessments under section 31(2) of the Act for the 2011–2013 years of assessment. Correspondence followed between SARS and the taxpayer which culminated in a Finalisation of Audit Letter issued on 31 January 2020, accompanied by the additional assessments.

Two aspects are clear. Firstly, the initial notification of audit letter in March 2017 stated that the scope of the audit was "transactions between the taxpayer and its offshore connected parties". Secondly, the Finalisation of Audit Letter stated: "This letter follows an audit of the transactions between UMK's and its offshore related parties". In the Letter of Audit Findings SARS stated: "SARS is of the view that the provisions of s 31 of the Income Tax Act 58 of 1962 are applicable to UMK's 2011 to 2013 years of assessment".

The court held, and we must agree, that both the Finalisation of Audit Letter and the Letter of Audit Findings stipulated the basis of the assessment and gave the taxpayer the opportunity to object to SARS' findings and correct any errors SARS may have made in arriving at its view.

Jumping directly to litigation, as the taxpayer sought to do, also eliminated the opportunity for the matter to be resolved without litigation. SARS argued that this undermined the administrative process set out in Chapter 9 of the TAA.

The timeline suggests that the taxpayer requested an extension on 16 July 2019 to respond to the Finalisation of Audit Letter and responded on 30 August 2019.

Whether SARS needs to expressly indicate in its findings *how* the parties to the transaction are connected is discussed below. However, we believe the Judge ruled correctly that the taxpayer erred in its argument that SARS contravened section 42. SARS issued multiple letters, including the Finalisation of Audit Letter and the Letter of Audit Findings. These two letters, plus the other correspondence, would satisfy the requirements of section 42.

Does SARS need to state explicitly why it views the parties to be connected in its findings in order to legitimise any adjustment under section 31 of the Act?

The taxpayer argued that SARS made material errors in interpreting the application of section 31, notably the "connected person" requirement. SARS relied on paragraph *(d)*(vA) of the definition of "connected person" in section 1(1) of the Act to connect the two parties to the transaction, which was adjusted in terms of section 31(2).

Paragraph *(d)*(vA) relies on management and control, a specific test. SARS maintains that the two entities had common management and control, making them connected persons. The taxpayer argued that SARS erred in making this connection.

Although this article does not go into the merits of the "managed and controlled" argument, suffice it to say the interpretation of paragraph *(d)*(vA) is fact-specific. It hinges on *de facto* management and control as opposed to *de jure* management and control, a point on which both parties agreed. The parties did, however, disagree on how *de facto* management and control should be interpreted.

The question arises whether SARS, in making an adjustment under section 31, is required to stipulate the basis for the parties being connected as defined. Arguably SARS did provide its basis for the connection in its Finalisation of Audit Letter, but the detail may have been lacking in the earlier Letter of Audit Findings. Was section 42 of the TAA contravened because both letters did not provide the same detail?

Counsel for SARS maintained that there was consistency in the two letters, as they both concluded the parties were connected in accordance with the definition in section 1(1) of the Act. The Judge accepted this.

We agree with the Judge. If SARS raised additional assessments under section 31 of the Act, the requirement for the parties to the transaction to be connected is implied, even if it is not clearly stated. The taxpayer had the opportunity to: (1) dispute that the parties were connected in its response to the Letter of Audit Findings; (2) ask SARS for its reasons for concluding that the parties were connected under section 103 of the TAA, following the issue of the Finalisation of Audit Letter; and (3) raise its objection to the application of paragraph *(d)*(vA) of the "connected person" definition through a formal objection under section 104 of the TAA.

Although arguably SARS should be clear on how the parties are connected when applying section 31 of the Act to legitimise the application of the section, the taxpayer was afforded several opportunities to clarify or contest this.

Whether SARS' witness interviews constituted functional analysis

A side point of interest in this judgment relates to the discussion about the interviews SARS held with employees of the taxpayer.

In our experience, SARS in most transfer pricing audits conducts interviews with operational personnel to understand the functions undertaken and risks assumed and how these are managed. This is commonly referred to as a functional analysis.

SARS will usually start its analysis with any transfer pricing documentation provided by the taxpayer. The case did suggest the taxpayer provided a transfer pricing document, but it is not possible to determine whether that document provided a comprehensive functional analysis for each of the parties to the transactions under audit. Irrespective of this, section 46 of the TAA gives SARS wide powers to obtain information it considers relevant to the audit. This can be provided in written form or orally.

The taxpayer maintained that the interviews held could not be regarded as functional analysis interviews because no list of questions was provided in advance.

The OECD Transfer Pricing Guidelines (the Guidelines) define a functional analysis as "an analysis aimed at identifying significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions". Section D.1.2 of the Guidelines recognises the importance of undertaking a functional analysis to accurately delineate the controlled transactions and identify comparability between the controlled transactions and uncontrolled transactions (arm's length transactions). The analysis focuses on what the parties do and the capabilities they provide. The Guidelines do not prescribe how a functional analysis should be conducted and certainly do not prescribe the need for questions to be provided in advance of any meetings with the parties being analysed.

SARS' Practice Note 7 describes a functional analysis as "a tool assisting in the selection of a transfer pricing method and the proper determination of the arm's length price". The Practice Note provides guidance on the characteristics of a functional analysis but does not prescribe how it should be conducted.

We agree with the Judge that there is little merit in the taxpayer's argument on this point. It is well known that SARS commonly uses interviews in undertaking a functional analysis. Advisers assisting their clients to complete a detailed functional analysis for the purposes of their transfer pricing documentation employ the same approach. For this reason, taxpayers should ensure that all employees are sufficiently briefed before such interviews to ensure they remain within their area of expertise and knowledge and assist SARS concisely and correctly and do not wander into the realms of self-promotion and hearsay.

CONCLUSION

This case presents a good example of how not to fight a transfer pricing dispute. The TAA provides a solid process for navigating a transfer pricing audit, from the initial notification, through to the information requests in terms of section 46 and managing the dispute resolution process in Chapter 9 in the event that additional assessments are raised.

Any taxpayer facing a transfer pricing audit needs to ensure it fully understands the information being requested and provided to SARS and the section of the Act that SARS is applying to the facts. There are examples of transfer pricing audits succeeding and failing over the correct application of the "connected person" definition, which is vital to the application of section 31. As the Judge stated, "absent this requirement section 31 of the Act will not find application". It is perhaps more important to understand the basis for any adjustment being proposed by SARS under section 31, the characterisation of the entities to the transaction arising from the functional analysis, the appropriateness of the transfer pricing methods used and the availability of robust comparable data. These are the tools which enable a taxpayer to mount a defence against any adjustment, whether that is through the domestic dispute resolution provisions in Chapter 9 of the TAA or through the relief afforded by a double taxation agreement.

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Karen Miller

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "connected person", more specifically paragraph *(d)* (vA)) & 31(2) & (3);
- Tax Administration Act 28 of 2011; Sections 42, 46, 103 & 104; Chapter 9 (sections 101–150);
- Promotion of Administrative Justice Act 3 of 2000.

Other documents

- Letter of Audit Findings (of SARS);
- Finalisation of Audit Letter;
- Notification of audit letter;
- OECD Transfer Pricing Guidelines: Section D.1.2;
- SARS' Practice Note 7.

Cases

- *Crookes Brothers Ltd v Commissioner for South African Revenue Service* [2018] 80 SATC 439; 2018 ZAGPHC 311;
- *ABC (Pty) Ltd v Commissioner for the South African Revenue Service* (IT 14305) [2021] ZATC 1 (7 January 2021);
- *United Manganese of Kalahari (Pty) Ltd v The Commissioner for the South African Revenue Service* [Case 21563/2020].

Tags: dividends tax assessments; Finalisation of Audit Letter; Letter of Audit Findings; connected person; OECD Transfer Pricing Guidelines; controlled transactions; uncontrolled transactions (arm's length transactions); transfer pricing audits.

VAT IMPLICATIONS FOR EXPAT EMPLOYERS

Sending your employees to carry out services on the company's behalf in a foreign jurisdiction always needs to be carefully planned in terms of the employee's personal tax liability and the corporate tax implications, but expats can also create a VAT liability in that jurisdiction. Let us take an example of a holding company that decides to send certain employees to its South African subsidiary, to assist with the implementation of a building project for a period of three months.

The first question which is usually asked is whether the holding company's employees will create a permanent establishment for income tax purposes, but the question as to whether a VAT liability is established is equally important.

In assessing whether a VAT liability will be created, it is important to bear in mind that, although they may be aligned in some areas, the criteria for establishing a permanent establishment (PE) for income tax purposes, and establishing a VAT enterprise or taxable activity, are in most cases different. This is often ignored, so you can have a corporate tax PE without a VAT enterprise and vice versa. Further, double tax agreements do not provide VAT relief, although they may provide relief from double taxation for corporate tax.

The South African VAT legislation requires a person to register for VAT where two requirements are met:

- An enterprise is carried on. This requires an activity to be carried on, on a continuous or regular basis, in or partly in South Africa, in the course or furtherance of which goods or services are supplied for consideration; and
- Taxable supplies must have exceeded R1 million in the past 12 months or be expected to exceed R1 million in the next 12 months, in terms of a contractual obligation in writing.

The terms on which the employees are "seconded" may well make a difference – for example, the permanent employment of the employees with the holding company may be temporarily suspended, and the employees employed by the SA subsidiary for the period over which the building services are to be provided; alternatively, the holding company may continue to employ its employees and recover their salaries from the subsidiary. A dual contract could even be entered into.

Let us assume that the employees remain in the employ of the holding company whilst providing the building services to the subsidiary; that they provide their services whilst physically located in South Africa; and that the holding company recovers a fee for the services. In this case, there will be an activity carried on by the holding company in, or partly in, South Africa. This activity will be carried on over a period of three months and this will likely be seen as being on a continuous or regular basis: the South African Revenue Service, in past rulings, has seen the performance of services locally, even if only over a period of a few weeks, as being carried on on a regular basis.

There is therefore no "cut-off period" as there may be, for example, under a double tax agreement, which may provide that services rendered for less than certain defined periods, often six months, will not create a permanent establishment.

Therefore, if the holding company earns fees for the services exceeding R1 million, a VAT liability may arise.

This may not be the case, however, if the holding company seconds its employees to the subsidiary while the employees are providing the services, ie, they enter into a temporary contract with the local company and thus the holding company does not itself conduct any activities in South Africa.

In summary, equal consideration, therefore, needs to be given to the VAT consequences of employees rendering services while physically located in a different jurisdiction to their employer, as it is to the income tax implications. In addition, consideration needs to be given to whether the method of contracting will make a difference to the employer's tax liabilities.

The moral of the story is – ignore VAT at your peril!

Regan van Rooy

Tags: permanent establishment (PE); taxable supplies; holding company.