Issue 68 | 2024
MARCH

South African Institute of Taxation

Unstructured CPD 150mins

TAX CHRONICLES MONTHLY

Official Journal for the South African Tax Professional

CORPORATE REORGANISATIONS
VERTICAL MERGERS

ESTATE PLANNING
CGT AND ESTATE PLANNING

VALUE-ADDED TAX
IMPORTED SERVICES – SECONDED EMPLOYEES

CONTENTS

CORPORATE REORGANISATIONS

0660. Vertical mergers 03

DEDUCTIONS AND ALLOWANCES

0661. ESG-related expenses 06

ESTATE PLANNING

0662. CGT and estate planning 08

EXCHANGE CONTROL

0663. Importance of exchange control compliance 10

TAX ADMINISTRATION

0664. Reviewing SARS decisions in the High Court 13

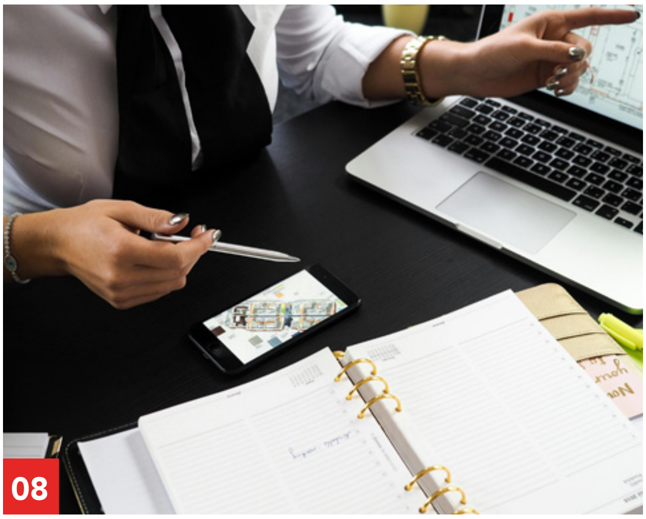
TRANSFER PRICING

0665. Advance pricing agreement programme 16

VALUE-ADDED TAX

0666. Imported services – seconded employees 18

6



08

18

VERTICAL MERGERS

Section 44 of the Income Tax Act, 1962 (the Act), provides for rollover relief from tax where two companies amalgamate to form one company, the other being liquidated.

Section 44(1) defines an "amalgamation transaction" as being a transaction by means of an amalgamation, conversion or merger. The circular reference in this definition does not provide much clarity on what, in fact, an amalgamation is, and there is no specific definition of amalgamation, conversion or merger in the Act. This has led to much debate, as the answer to this question is necessary in determining whether or not the relief provided by section 44 applies to a transaction.

In its *Comprehensive Guide to Capital Gains Tax* (the *CGT Guide*) (Issue 9), the South Africa Revenue Service (SARS) interprets the meaning of "*merger*" (or *confusio*) as "the union in the same person of the characters of creditor and debtor in respect of the same debt". SARS then provides some examples:

> "Examples of how merger may occur include the purchase on the open market of a listed debenture by the issuer, the distribution to a beneficiary by a trust of an amount owed by the beneficiary, or the distribution *in specie* by a subsidiary to its holding company of a debt owed by its holding company."

The *CGT Guide* provides the following in respect of the meaning of a "*conversion*":

> "It is submitted that a conversion involves a substantive change in the rights attaching to an asset. Some examples include the conversion of –
>
> - a company to a share block company and *vice versa*; and
> - a preference share to an ordinary share and *vice versa* (except when the rights are acquired up front)."

Section 1(1) of the Companies Act, 2008 (the Companies Act), defines "amalgamation or merger" as:

> "a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in –
>
> *(a)* the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or

> *(b)* the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with such new company or companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement …"

With reference to the above guidance, on the one hand, a narrow interpretation of an "amalgamation transaction" for section 44 purposes would mean that section 44 only applies where two independent companies, each operating its own business, pool their business assets in one of them, and therefore merge their businesses. On the other hand, a broad interpretation would mean that the business operated in one company could be transferred to another company (the latter of which may or may not necessarily conduct a business as opposed to hold some other type of important asset), the companies being amalgamated, and the business then continuing to operate from this other company.

"SARS' views on these questions were previously answered in two binding private rulings, namely Binding Private Ruling 171 and Binding Private Ruling 231, where the concept of vertical mergers within a South African tax context were approved in principle."

VERTICAL MERGERS

This then leads to the question of a vertical merger. A vertical merger is where one company transfers its assets to a subsidiary, receiving new shares in return and then distributing these to its shareholders before being liquidated. The effect is that the ultimate shareholders will then hold directly into the subsidiary. Although there are other provisions in the corporate rules (namely sections 46 and 47 of the Act), that provide for this type of transaction, the shareholding percentage thresholds necessary for those provisions to apply mean that they are unavailable in some circumstances. If such a vertical merger can in fact fall within the ambit of section 44, this would provide relief where there was none before.

Perhaps the greatest stumbling block in the context of vertical mergers is the shares held by the top company into its subsidiary. As this top company is required to dispose of all assets to its subsidiary in terms of section 44 (including these shares), it is debatable whether this would be possible as the subsidiary would not be able to hold its own shares and it would be required to cancel these. This is because of section 35(5) of the Companies Act, which states that these shares become authorised but unissued shares. Further, if cancelling the shares, it is questionable whether this would be a disposal of an asset received from the top company by the subsidiary, thus triggering consequences in terms of section 44.

SARS' views on these questions were previously answered in two binding private rulings, namely Binding Private Ruling 171 and Binding Private Ruling 231, where the concept of vertical mergers within a South African tax context were approved in principle. However, at some stage SARS noted the following on these rulings:

> "The principle confirmed in this ruling has been reviewed. This ruling should not be relied upon by anyone other than the applicant(s) or class members to whom it was issued."

Despite the fact that vertical mergers are often the most commercial and practical means by which to resolve an internal rationalisation, given these disclaimers from SARS, the question arose whether it was still possible to implement vertical mergers within the confines of section 44.

BINDING PRIVATE RULING 397

In Binding Private Ruling 397 (BPR397), SARS has again opened the door to vertical mergers using section 44 of the Act. Further, it has answered many of the questions and clarified many uncertainties that were highlighted in respect of vertical mergers.

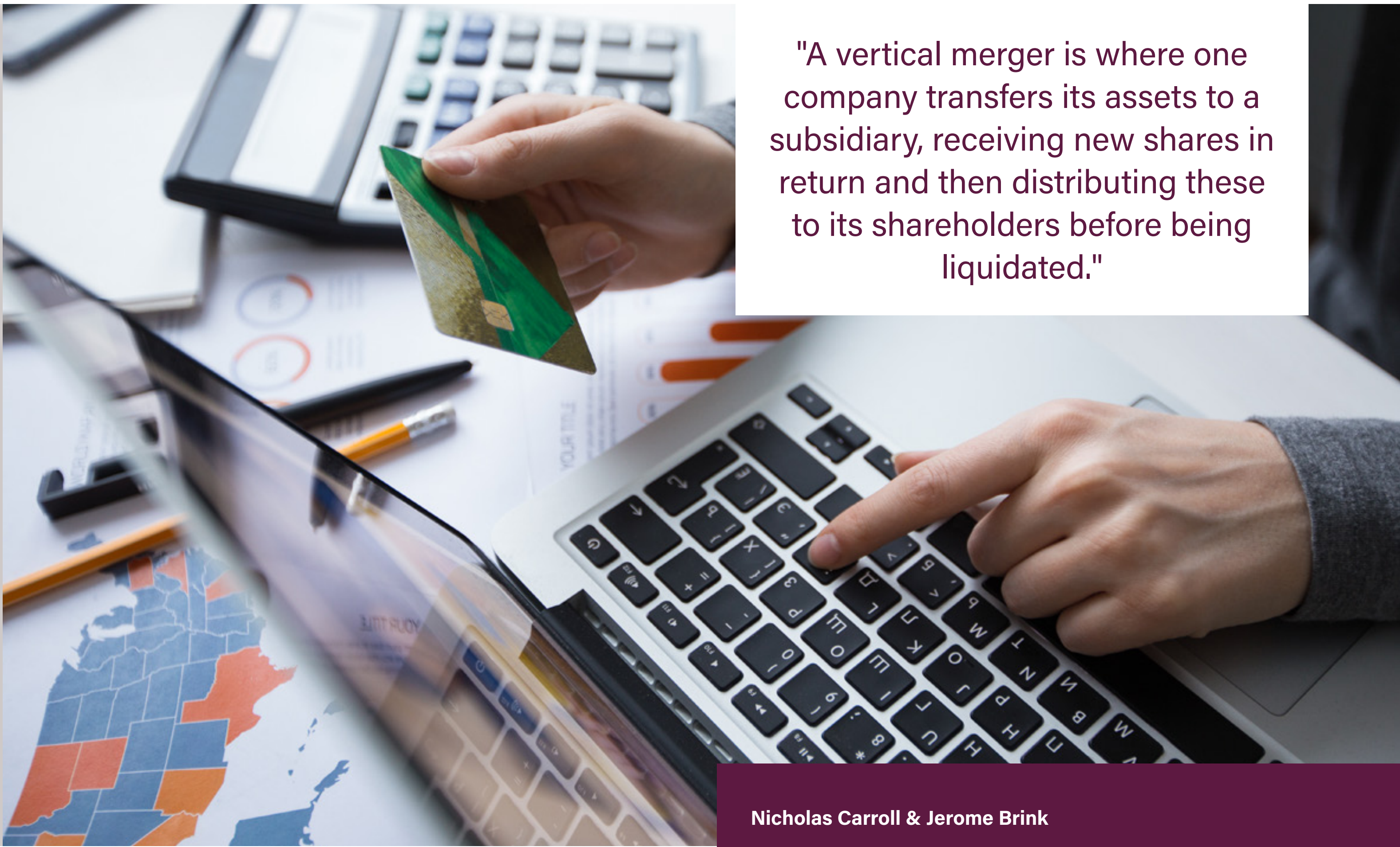
In BPR397, the applicant and co-applicant were a company and its wholly owned subsidiary, respectively. The applicant imported pharmaceutical products, while its subsidiary (the co-applicant) held the necessary licences and marketing authorisations to import and sell these products in South Africa. The proposed transaction was therefore to use section 44 of the Act in order to merge the two into a single entity housed in the subsidiary.

To do this, the applicant proposed that it dispose of all its assets and liabilities (including its shares in the co-applicant) to the co-applicant in exchange for the co-applicant issuing it new shares. These new shares would then be distributed by the applicant to its shareholders, following which the applicant would be liquidated.

The co-applicant, on the other hand, would cancel its own shares which it received from the applicant, and use the other assets received from the applicant, together with its existing assets, in order to run the import and marketing business previously run by the applicant but using its (the co-applicant's) licences and authorisations. This would therefore be an amalgamation of the applicant's import and marketing business, and the co-applicant's assets necessary for this business.

IMPACT OF SARS' RULINGS

The ruling by SARS, firstly, was that this would in fact qualify as an amalgamation in terms of section 44 of the Act. This suggests that SARS has adopted a wider view of what constitutes an amalgamation, and confirmed that this does extend to a vertical amalgamation.



"A vertical merger is where one company transfers its assets to a subsidiary, receiving new shares in return and then distributing these to its shareholders before being liquidated."

Secondly, and perhaps more importantly, however, SARS ruled that the cancellation of shares by the co-applicant would not amount to a disposal under paragraph 11(2)*(b)* of the Eighth Schedule to the Act, and therefore not trigger any adverse consequences for the co-applicant in terms of section 44. The basis for this is not set out in BPR397, but it does raise the question as to whether SARS did not view the co-applicant as ever being capable of holding its own shares, and thus on cancellation not being able to be considered as having disposed of something it never held in the first place.

This question may never be answered. However, BPR397 does leave corporate taxpayers with some comfort that falling short of the thresholds set out in sections 46 and 47 of the Act will not necessarily leave them without any means of winding up an intermediate company where the business housed therein can be amalgamated with that of a subsidiary. This in itself is a welcome change to the tax landscape.

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

Nicholas Carroll & Jerome Brink

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 44(1) (definition of "amalgamation transaction"), 46 & 47; Eighth Schedule;
- Companies Act 71 of 2008: Sections 1(1) (definition of "amalgamation or merger") & 35(5).

Other documents

- *Comprehensive Guide to Capital Gains Tax* (published by SARS): Issue 9 (pp 85 & 134) – meaning of "conversion" & "merger" ("*confusio*");
- Binding Private Ruling 171 ("Amalgamation transaction");
- Binding Private Ruling 231 ("Corporate restructuring by way of asset-for-share and amalgamation transactions");
- Binding Private Ruling 397 ("Income tax and securities transfer tax consequences resulting from an amalgamation transaction").

Tags: rollover relief from tax; amalgamation transaction; conversion; merger/*confusio*; vertical merger; corporate taxpayers.

ESG-RELATED EXPENSES

The sustainability of economies and, in turn, society, largely hinges on how well Environmental, Social, and Governance (ESG) is adopted. Given that naturally this comes at some cost, the tax deductibility of ESG-related expenses is considered in this article.

THE IMPACT OF ESG GOALS IN SOUTH AFRICA

The United Nations Sustainable Development Goals (SDGs) were adopted by UN member states in 2015 as part of the 2030 Agenda for Sustainable Development. The SDGs aim to address global challenges and guide countries and organisations towards a more sustainable and equitable world by 2030. The SDGs address a range of social, environmental, and economic issues, with the objective of promoting prosperity, while at the same time protecting the planet. ESG considerations permeate South Africa's regulatory law, most obviously in our environmental, employment, corporate and B-BBEE legislation.

THREE AREAS WHERE ESG CONSIDERATIONS INFLUENCE TAXATION

The practical considerations of taxation in the ESG context are highlighted below, by expanding on three main areas:

1. ***Tax transparency and disclosure***

   This is a theme that is more advanced in certain of the first world countries where there is particular legislative guidance on how and what one needs to disclose in one's financials from a tax perspective. While South Africa is not there yet, corporate groups are moving forward and starting to be early adopters. This results in ESG impacting on how and what is reported from a tax perspective, throughout the financials.

2. ***Ethical tax contributions***

   The discussion around fair share of tax and whether there is a duty beyond legislation is ongoing, but it is now also informed by ESG. For example, in South Africa, some groups chose not to exercise certain COVID-19-related relief measures because they could financially afford not to, and they regarded it as their duty, speaking to the "S" in ESG.

3. ***Tax treatment of ESG expenditure***

   The tax treatment of this area is the most technical, and it includes some of the following examples of ESG expenditure by a company or group: costs incurred for receiving environmental sustainability advice, calculations of carbon tax credits, or the newly introduced incentives around renewable energy. Furthermore, depending on the industry, for example, the mining industry, certain mandatory costs need to be incurred, yet there is not necessarily a particular tax rule that deals exactly with how to treat the expenditure.

GENERAL PRINCIPLES AND CASE-SPECIFIC ANALYSIS APPLY

To determine the deductibility of ESG-related expenses, the first point to remember is that there is no dedicated section in the Income Tax Act, 1962, that deals specifically with ESG. Instead, general principles apply for business entities:

(i) expenses must be incurred for purposes of trade in the production of income; and

(ii) expenditure must not be of a capital nature.

This also means that the tax deductibility of ESG-related expenditure will require a case-by-case analysis with case-specific rules that may allow for a deduction or allowance in a specific context. In general terms, one cannot say expenditure, A, B, and C will always be deductible and D, E, and F will never be deductible. It will be influenced by the specific case.

PRACTICAL EXAMPLES

Practical examples of where ESG expenditure was incurred and how the tax was treated are mentioned below:

- To proceed with certain projects, often energy projects, taxpayers are required under the National Environmental Management Act, 1998 (NEMA), to incur expenditure for the conservation of biodiversity or to mitigate disturbances of ecosystems to ultimately obtain environmental authorisation to proceed with the relevant project. A taxpayer acquired a piece of land for purposes of satisfying the above-mentioned environmental requirements. In order to consider the deductibility of this expenditure, which was mandatory in terms of legislation, it was necessary for the taxpayer to take a step back and analyse the expenditure against the general criteria. The taxpayer concluded that it would probably not be deductible based on the expenditure being capital in nature.

- A court case in March 2023 (*SSN Taxpayer v Commissioner for the South African Revenue Service,* [2023]) involved the expansion of a mining pit, but the area to which they planned to expand was occupied by a community. The taxpayer then decided to relocate the whole community, which included existing roads, railways, water, electricity, infrastructure, and housing. The taxpayer also reconstructed electricity lines for Eskom and railways for Transnet before the taxpayer could continue with the expansion project. The question then arose whether this expenditure was deductible. Apart from the general rules, South Africa's tax legislation does contain special mining provisions, which allows for broader criteria for deductibility. This means that expenditure that will normally not be deductible due to it being capital in nature may be deductible if one conducts mining operations. The court held that the expenditure was not incurred as part of the taxpayer's mining operations (or rather its mining right). In addition, the court also held that the taxpayer was attempting to claim deductions for infrastructure, such as the electricity lines and the housing of employees of the mine, which neither belongs to it, nor will be used by it, in its mining operations. The taxpayer is now taking this matter to the Supreme Court of Appeal, and one of the grounds of appeal specifically is to obtain clarity on the deductibility of typical ESG expenditure.

- The installation of solar panels, for example, is a typical expenditure that should be deductible. While the panels themselves may be capital in nature, taxpayers are allowed to sometimes claim capital allowances against the expenditure, essentially resulting in a claim of the capital cost over a period of time.

- If a company engages in a community cleanup project, the expenditure incurred to buy refuse bags, and the transport to have the bags collected and removed, for example, should be deductible.

SUMMARY

From a tax treatment perspective –

- There is no particular ESG-related tax rule;

- tax deductibility should be analysed on a case-by-case basis; and

- ordinary principles should be applied.

Cor Kraamwinkel, Candice Meyer & Margaret Vermaak

Webber Wentzel

Acts and Bills

- Income Tax Act 58 of 1962;

- National Environmental Management Act 107 of 1998.

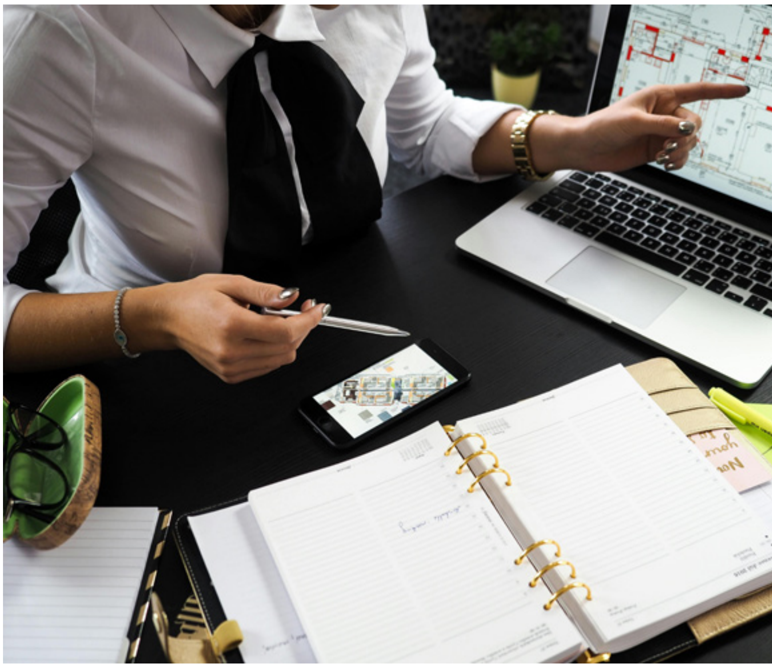
Cases

- *SSN Taxpayer v Commissioner for the South African Revenue Service* (25334) [2023] ZATC 10 (31 March 2023),

Tags: Environmental, Social, and Governance (ESG); incentives around renewable energy; ESG-related expenditure.

CGT AND ESTATE PLANNING

When assisting clients with estate planning and discussing the tax considerations applicable to their estate upon their death, an often misunderstood and unplanned for consequence following a death is capital gains tax (CGT). This article takes a closer look at some of the considerations that come into play with respect to CGT and how a regular review of one's estate plan is important to ensure that the latest tax considerations have been incorporated into one's estate plan.



The death of a person is a major event resulting in various consequences. When focusing on the taxation side of the event, several taxes come into play. The aim of proper estate planning is to forecast and plan for these taxes in advance. The foremost taxes are income tax, CGT and estate duty, and all of these bear consideration in estate planning as tax changes may affect the effectiveness of one's overall estate plan and the ultimate liquidity of the estate upon death.

Death is an event that will trigger CGT. A deemed disposal of the assets of the deceased person will arise for an amount equal to the market value of the assets on the date of death. A deceased person will therefore incur a CGT obligation.

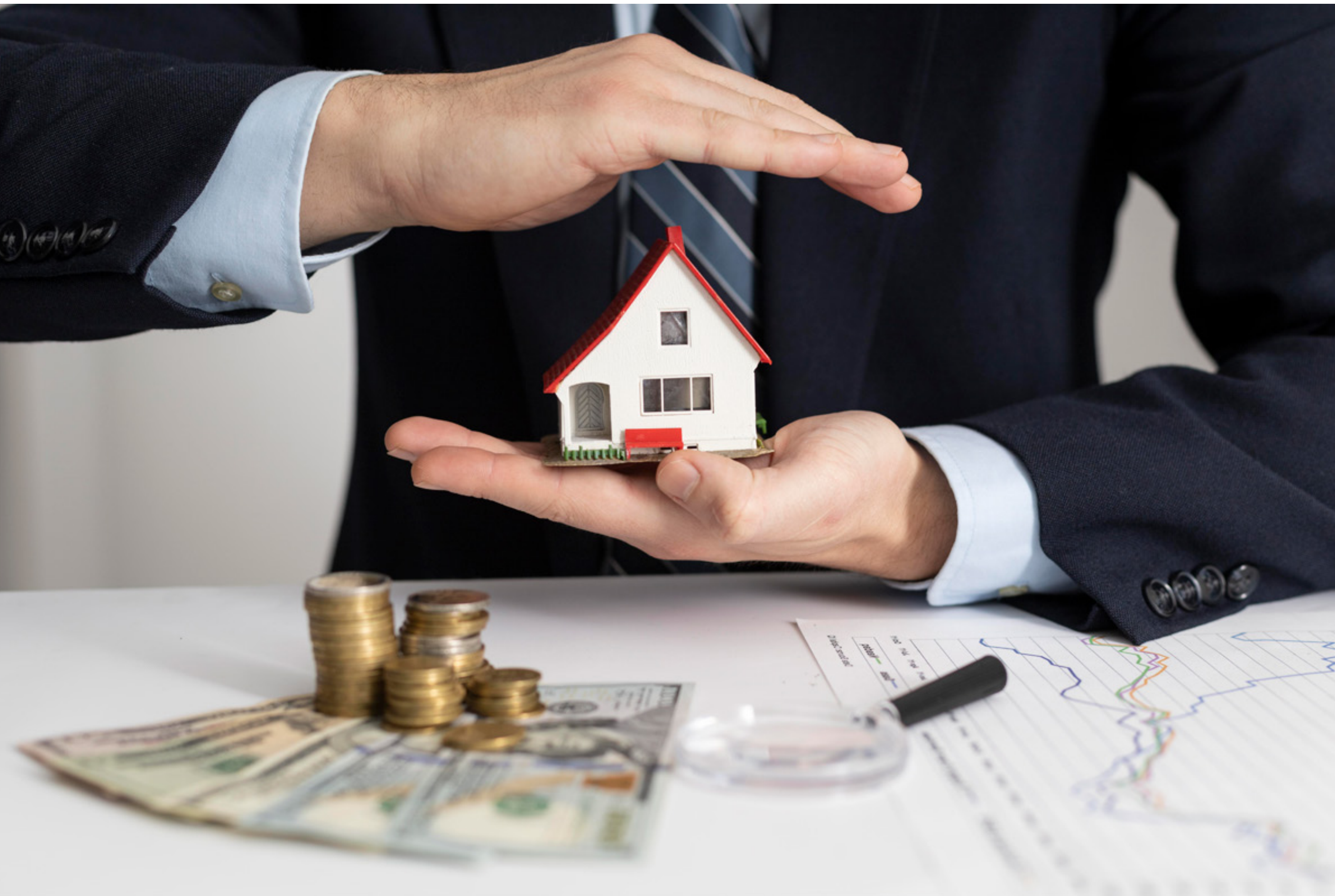
This CGT liability can be deferred if the assets are acquired from the deceased by a resident surviving spouse, as these assets will be subject to the "roll-over" principle included under section 25(4) of the Income Tax Act, 1962 (the Act). The resident surviving spouse inherits the base cost and all aspects of the history of the assets (date of acquisition and usage) from the deceased spouse and will have to account for any capital gains or capital losses when the asset is ultimately disposed of. This provision is not an exclusion from CGT, but merely a roll-over measure that has the effect of shifting the incidence of the tax from the deceased to the surviving spouse. The roll-over relief applies automatically and neither the deceased nor the surviving spouse can elect out of it.

Several additional exemptions can be claimed. For instance, in the case of a primary residence, there would be an exemption of up to R2,000,000 that can be utilised in the year of passing. However, this does not apply to a non-primary residence, or where the residence is not directly owned by the deceased, eg by a company or a trust. This exemption is supplemented by increasing the usual annual CGT exemption of R40,000 per annum available to individuals, to a higher amount of R300,000 in the particular tax year of passing.

To calculate any potential CGT payable, the base cost of the assets has to be established. Then, upon death, the assets have to be valued to ascertain the current market value, from which the base cost is deducted to calculate any possible CGT payable.

As mentioned earlier, estate planning and assessing the impact of taxes on a deceased estate is a continuing process, as a failure to do so could have dire unforeseen consequences. To illustrate with an example taken from a typical farmer's estate: livestock was previously considered a capital asset and subject to capital gains tax upon the death of the farmer. However, the introduction of section 9HA into the Act had the effect, for persons dying after 1 March 2016, that the deceased is now deemed to have disposed of his or her livestock and produce as trading stock upon date of death at fair market value.

This results in an inclusion in gross income similar to that of the livestock disposed of in the ordinary course of farming operations and income tax will therefore be payable by the deceased person and not CGT on the livestock. This could have repercussions for the estate and its liquidity and would need to be factored into the farmer's estate planning.



"The aim of proper estate planning is to forecast and plan for these taxes in advance. The foremost taxes are income tax, CGT and estate duty, and all of these bear consideration in estate planning as tax changes may affect the effectiveness of one's overall estate plan and the ultimate liquidity of the estate upon death."

The above example illustrates the importance of having a proper strategic, multi-generational estate plan and strategy in place that is regularly reassessed and updated to ensure that one's wealth and family's well-being are taken care of and not affected prejudicially by unforeseen consequences.

It is important to contact fiduciary and estate planning specialists if one needs assistance with planning for or reviewing one's current estate planning strategy.

André van Niekerk

PH Attorneys

Acts and Bills

- Income Tax Act 58 of 1962: Sections 9HA & 25(4);
- Taxation Laws Amendment Act 15 of 2016: Section 22(1)*(b)*.

Tags: roll-over measure; non-primary residence; annual CGT exemption; capital asset.

IMPORTANCE OF EXCHANGE CONTROL COMPLIANCE

South Africa, with its sophisticated financial system, has an extensive legal framework that regulates this system and its proper functioning. One of the components of this regulatory framework is South Africa's exchange control (Excon) regime, captured mainly in the Currency and Exchanges Act, 1933, the Exchange Control Regulations, 1961 (the Regulations) and the Currency and Exchanges Manual for Authorised Dealers (the AD Manual).

The AD Manual contains the permissions and exceptions contemplated in the Regulations. In *South African Reserve Bank and Another v Shuttleworth and Another,* [2015], it was held, amongst other things, that the Excon regime (referring mainly to the Regulations in that case) was:

> "...introduced and kept to shore up the country's balance of payments position...to regulate and discourage the export of capital and to protect the domestic economy... The fickle nature of the international financial environment required the exchange control system to allow for swift responses to economic changes. Exchange control provided a framework for the repatriation of foreign currency acquired by South African residents into the South African banking system. The controls protected the South African economy against the ebb and flow of capital."

Transactions between South African and non-South African parties, in particular involving the cross-border transfer of funds, rights or interests between such parties, must comply with South Africa's Excon rules. In practice, this often means that Excon approval for a particular transaction will be included in the contract as a suspensive condition that has to be met and without which the agreement cannot become unconditional. Alternatively, even if not dealt with as a suspensive condition, the absence of such exchange control approval may affect enforceability or a party's ability to perform, as the absence of such approval will mean that the funds payable or the rights that need to be transferred abroad under the agreement, cannot be paid, or transferred abroad as such. Depending on the nature of the transaction and the permissions and exceptions provided for in the AD Manual, read with the Regulations, a transaction will generally require either the approval of an authorised dealer (most South African banks) or the Financial Surveillance Department of the South African Reserve Bank (FinSurv).

THE *DOLBERG* CASE

The importance of obtaining the necessary Excon approval and its potential impact on a particular transaction, is illustrated by the judgment in *Dolberg Asset Finance Ltd v Dolberg South Africa (Pty) Ltd,* [2021] (the *Dolberg* case).

In this case the applicant, a company registered in Mauritius (Mauritius Co) approached the court to enforce an intercompany guarantee that was granted by the respondent, registered in South Africa (SA Co), to Mauritius Co, in terms of a written finance agreement.

It was common cause between the parties that payment of the guarantee in question was dependent upon the fulfilment of a suspensive condition in the finance agreement, namely that payment under the guarantee is conditional upon the approval of an authorised dealer and/or the South African Reserve Bank (SARB), under which FinSurv falls, which approval the guarantor (SA Co) shall do everything in its power to obtain, when required. Mauritius Co argued, amongst other things, that SA Co had failed in its obligation to obtain the SARB approval and that it had consequently dismally failed in its obligation to do everything in its power to obtain the approval. Essentially, Mauritius Co's argument

> "The court reiterated that the parties were aware that the grant of the approval was wholly within the SARB's discretion and its policies."

went even further as it contended that SA Co had to obtain SARB approval, as anything less would result in it not doing everything in its power to obtain approval.

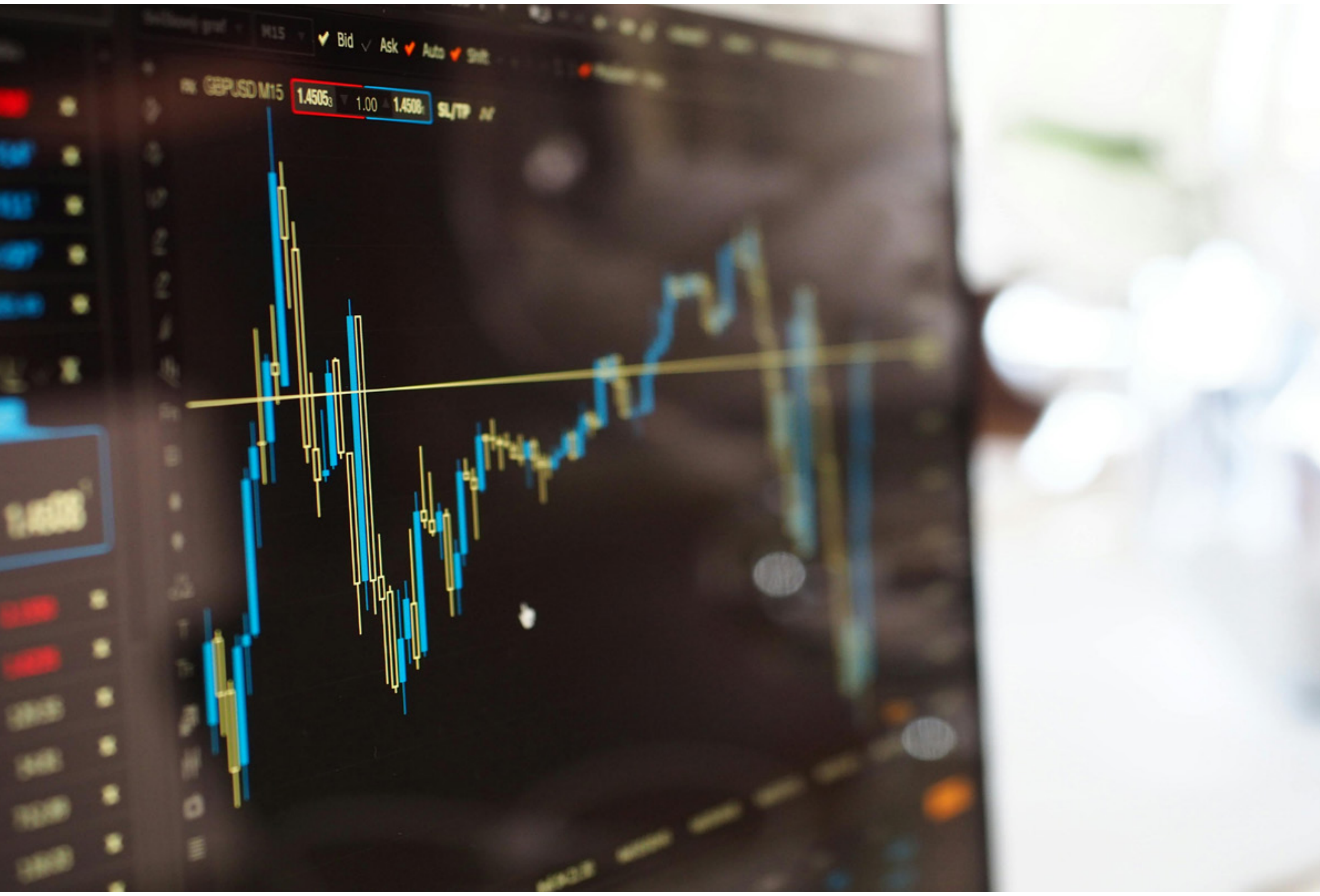
In the current instance, the parties agreed that the flow or export of monies across the borders of any country to another country requires the necessary approval of the country's appropriate authority, which in the current case was the SARB. SA Co had instructed an authorised dealer (AD) to apply to the SARB for approval to make payment in terms of the guarantee to Mauritius Co. The judgment notes the most important information included in the AD's application. However, for purposes of this article it is only relevant to note that the application (SARB application) indicated the amount to be transferred abroad as MUR54,311,776 and that the guarantee would yield an indirect benefit to South Africa, being the success of the Dolberg Group of companies, which could also benefit SA Co. The SARB (FinSurv) responded to the application as follows:

> "I thank you for the information furnished and advise that, since there may not be direct financial or monetary benefit to South Africa and that there is no direct interest of shareholding between the parties concerned, we are unable to favourably consider the applicant's request."

Mauritius Co alleged that the following conduct of SA Co justified an inference that SA Co "shrugged off its duty" to do everything in its power to obtain approval:

- SA Co's alleged tardiness in providing Mauritius Co timeously with a copy of the SARB application.
- The belated advising of the denial of approval of the application.
- The half-hearted and unpersuasive content of the SARB application for the approval of the cross-border transfer of monies.
- Alleged material deficiencies in the SARB application, such as approbation and reprobation in describing the relationship between the two companies (unrelated foreign company and sister company), the absence of details of SA Co's position as guarantor in the group structure and the benefit of the finance agreement to the Dolberg Group.

SA Co disputed these submissions and the court held that where the SARB has a discretion whether or not to grant approval for the cross-border flow of monies, Mauritius Co's contention that SA Co was obliged to in fact obtain approval, at all costs, had no merit. As there was a value judgement to be made in respect of the value of the monies to be transferred and the reciprocal return value to be received within South Africa, there was no obligation on SA Co to obtain approval.



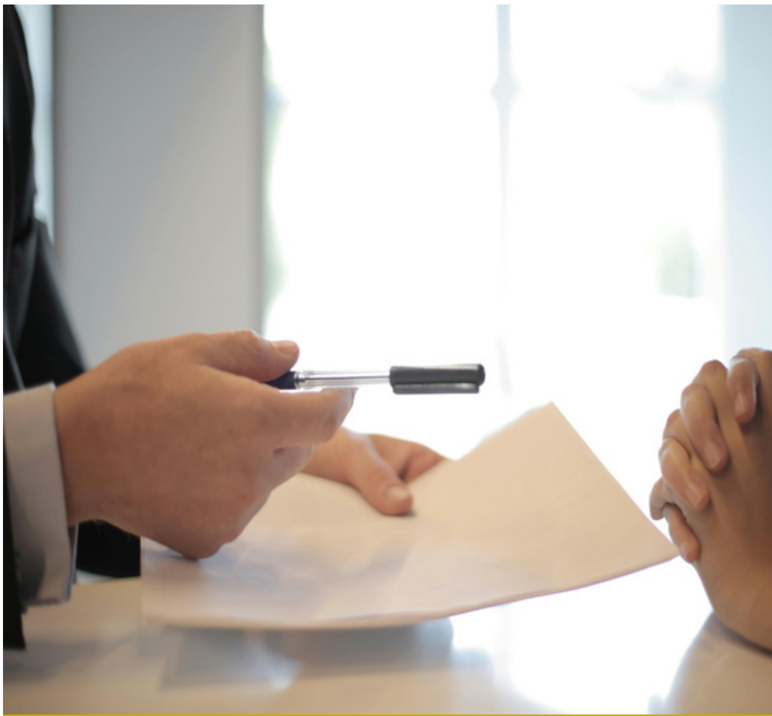
The court reiterated that the parties were aware that the grant of the approval was wholly within the SARB's discretion and its policies. The court noted that the facts on which Mauritius Co's above arguments were based were true. For example, Mauritius Co did not deny that it and SA Co were separate companies independent of each other and that there was no direct shareholding between them. Furthermore, the court decided that it was not of concern whether a "further" or "better" explanation of the benefit to the Dolberg Group in terms of the agreement should have been provided in the SARB application, as such explanation would only highlight the fact that South Africa would receive no reciprocal value through the cross-border flow of funds. As such, the court concluded that no negative inference could be drawn against SA Co. The court remarked that the SARB's discretion to grant approval is fettered and dependent on policy considerations which, when considered in light of the common cause facts, resulted in the SARB application being refused.

The court also declined to grant the alternative relief sought by Mauritius Co, namely that SA Co be ordered to pay the guarantee amount into Mauritius Co's attorneys trust account for the benefit of South Africa, as this was "bad in law". This was because, amongst other things, the parties were aware that the agreement, that is, the guarantee, would be unenforceable if Excon approval was not obtained and that SA Co would commit an offence if it paid the guarantee amount into the trust account in this manner, as it would contravene Regulation 22 of the Regulations. It would circumvent the purpose of the suspensive condition of the guarantee to obtain SARB approval.

OBSERVATION

It is the view of many that the problems faced by the South African economy, some of which are seen as structural, have adversely affected foreign direct investment into South Africa. While it is hoped that this situation will improve, South African companies who are party to such cross-border transactions would be well advised to consider the need for the contracting parties to comply with South Africa's exchange control rules that apply to the transaction at hand. An issue such as the one that arose in the *Dolberg* case can easily be avoided if the parties receive the proper advice at an early stage, from advisors experienced in exchange control matters.

In addition, one should also note that South Africa's exchange control rules are often relaxed or amended, which could impact a particular transaction. By way of example, the AD Manual was amended in May 2023 in Exchange Control Circular 4/2023 to amend the rules for the issue of guarantees. Specifically, the amendment states that in the context of the outward investment regime for South African companies, dealt with in section B.2(C) of the AD Manual, a South African company can directly issue a foreign denominated guarantee to cover borrowing facilities of its authorised foreign subsidiary abroad, if it obtains prior FinSurv (SARB) approval.



Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Currency and Exchanges Act 9 of 1933.

Other documents

- Exchange Control Regulations, 1961;
- Currency and Exchanges Manual for Authorised Dealers (AD Manual): Section B.2(C);
- Exchange Control Circular 4/2023 (23 May 2023).

Cases

- *South African Reserve Bank and Another v Shuttleworth and Another* [2015] (8) BCLR 959 (CC); [2015] (5) SA 146 (CC);
- *Dolberg Asset Finance Ltd v Dolberg South Africa (Pty) Ltd* (2020/25831) [2021] ZAGPPHC (20 September 2021).

Tags: exchange control (Excon) regime; authorised dealer (AD); cross-border transfer of monies.

REVIEWING SARS DECISIONS IN THE HIGH COURT

The ability to review the decisions of the South African Revenue Service (SARS) in the High Court is a question that has plagued South Africa's legal system since the amendment of section 105 of the Tax Administration Act , 2011 (the TAA).

The highly anticipated decision of the Supreme Court of Appeal (SCA) in *Commissioner for the South African Revenue Service v Absa Bank Ltd and Another,* [2023] (*Absa*), dealing with just this issue, was handed down on 29 September 2023. However, no ground-breaking decision, as hoped, was forthcoming, and taxpayers have returned to square one.

THE TAA AND REVIEW

Where SARS assesses a taxpayer, section 104 of the TAA provides for the remedy of objection and then appeal to the tax court (in the event that SARS disallows the taxpayer's objection). Section 104 also provides for the objection and appeal process to be used for certain other decisions taken by SARS that affect a taxpayer. In practice, this means that SARS' decisions are not open to review – they must be dealt with in terms of the objection and appeal process. While not expressly stated in case law, the view seems to be consistent with section 7 of the Promotion of Administrative Justice Act, 2000 (PAJA), which provides that internal remedies must be exhausted before PAJA is applied.

However, section 105 of the TAA provides for an exception to the rule. This section states that assessments issued and decisions taken by SARS can be disputed outside of the objection and appeal process at the discretion of the High Court. Arguably, section 105 therefore treads the line between the High Court's inherent jurisdiction, and the legislatively prescribed process for resolving tax disputes.

Section 105 therefore set the stage for the dispute in *Absa*. Here, the question concerned when it is appropriate for the High Court to exercise its discretion in section 105 and thus allow a taxpayer to deviate from the prescribed process of objection and appeal set out in the TAA.

THE ROAD WELL-TRAVELLED

The road to the *Absa* decision has already been covered extensively. Not just the original High Court decision (discussed here), but also the decisions of courts in other matters concerning the question of review.

In *Commissioner for the South African Revenue Service v Rappa Resources (Pty) Ltd,* [2023] (*Rappa*), and *United Manganese of Kalahari (Pty) Ltd v Commissioner for the South African Revenue Service* [2023], the SCA found that the High Court would only be permitted to exercise its discretion under section 105 of the TAA in exceptional circumstances. There, the SCA decided that exceptional circumstances would be where the dispute turned solely on a question of law (as opposed to fact).

These previous decisions culminated in the question of review being brought before the court again in *Absa*.

THE *ABSA* DECISION

In *Absa*, the question of reviewability arose in the context of an assessment issued by SARS to the taxpayers following the application of the general anti-avoidance rules (GAAR) by SARS. In short, the taxpayers had entered into a transaction which, in SARS' view, was an impermissible avoidance arrangement as defined in section 80L, and described in section 80A, of the Income Tax Act, 1962 (the Act). Therefore, SARS issued the taxpayers with notices in terms of section 80J of the Act, inviting the taxpayers to make submissions as to why the GAAR should not be applied.

The taxpayers submitted a request to SARS that it withdraw the section 80J notices. They also requested that SARS grant an extension to the deadline by which they had to submit their responses to these notices.

SARS granted the extension, but denied the taxpayers' request for the section 80J notices to be withdrawn. As a result, the taxpayers launched an application in the High Court in order to review SARS' decision not to withdraw the notices. Simultaneously, the taxpayers submitted their responses to the section 80J notices to SARS.

While waiting for their High Court review application to be heard, the taxpayers received SARS' letters of assessment which arose from the initial section 80J notices. The taxpayers therefore extended their review application to include a review of these assessments as well as SARS' original decision not to withdraw the section 80J notices.

Therefore, the taxpayers sought two reviews: one review of SARS' decision not to withdraw the section 80J notices, and another review of the assessments issued by SARS. The first review was based on the principle of legality, the taxpayers claiming that SARS had issued the section 80J notices based on an error of law. The second review was based on PAJA, or the principle of legality in the alternative.

> "Therefore, where a dispute involves a factual question, it is arguably appropriate for the High Court not to exercise its discretion in section 105 of the TAA."

Both of these reviews were substantially based on the assertion by the taxpayers that they were not aware of the impermissible avoidance arrangement in which SARS alleged they were participants. Both reviews were also submitted to the High Court under section 105 of the TAA, the taxpayers requesting the High Court to exercise its discretion under this section in their favour.

Therefore, the question became whether the taxpayers were entitled to use the review process and approach the High Court directly, or whether they should have challenged SARS' decision in terms of the objection and appeal process.

Firstly, the High Court decided that a decision by SARS to issue a notice to a taxpayer (such as the section 80J notices) was not final, and was therefore not administrative action (not being subject to review). However, the High Court held that a decision by SARS not to withdraw a notice, even if not final, had sufficiently adverse consequences to be subject to review.

Following from this, the High Court affirmed that it would only be permitted to consider the reviews if they concerned a question of law, as was decided in *Rappa*. On this point, the High Court agreed with the taxpayers that SARS could not apply the GAAR to them if they were not participants in (had no knowledge of) the impermissible avoidance arrangement in which SARS alleged they were participants. This, in the High Court's view, was a question of legal application of the GAAR, and thus empowered it to exercise its discretion under section 105 of the TAA.

BEFORE THE SCA

On appeal, the SCA disagreed with the High Court. Firstly, the SCA stated that if a decision by SARS to issue a notice (such as the section 80J notices) is not final, and thus not subject to review, then the decision not to withdraw that notice (therefore leaving the notice in force) cannot be seen to be final enough for it to be subject to review. Therefore, the SCA dismissed the first of the taxpayers' reviews.

Regarding the taxpayers' second review, the SCA confirmed the principle from *Rappa* (and applied by the High Court) that the discretion afforded to the High Court in section 105 of the TAA can only be exercised in exceptional circumstances, this being where there is a pure question of law. However, the SCA disagreed with the High Court on the application of the principle to the taxpayers in *Absa*.

Here, the nub of the taxpayers' argument was that they were not aware of the impermissible avoidance arrangement in which SARS alleged they were participants. Therefore, they argued that the GAAR could not be applied to them, and its application was an error of law, irrational and thus offended the principle of legality.

Unlike the High Court, however, the SCA found that the taxpayers' argument hinged on a factual dispute – whether or not the taxpayers were aware of the impermissible avoidance arrangement. SARS had not accepted in its section 80J notices, or the subsequent assessments, that the taxpayers did not have this knowledge. Therefore, the only undisputed fact was that the taxpayers had participated in steps that SARS alleged formed part of an impermissible avoidance arrangement, not that the taxpayers were unaware of this arrangement.

On this basis, the SCA found that the High Court was incorrect in its exercise of its discretion under section 105. Therefore, the SCA found that the taxpayers would have to dispute the assessments issued by SARS using the objection and appeal process.

THE SITUATION AFTER THE SCA DECISION

Following the SCA's decision in *Absa*, one is left with little more than confirmation of the position that existed before it. The promise of potential change regarding the reviewability of SARS' decisions that came with the High Court decision has evaporated (for now), and the principle set out in *Rappa* (that section 105 only applies where there is a question of pure law) has been confirmed.

On the one hand, it appears that section 105 does not limit the High Court's discretion to exceptional circumstances, let alone these circumstances being a purely legal question. Arguably, the interpretation of this section adopted in *Rappa*, and confirmed in *Absa*, therefore limits a taxpayer's ability to review SARS' decisions.

On the other hand, however, there is arguably sound legal reasoning for this approach. The process of objection and appeal fulfils a function that is two-fold.

Firstly, it provides for engagement with SARS, and thus allows for the issues at the heart of a dispute between the taxpayer and SARS to be fully ventilated before the dispute reaches the courts. In general terms, this appears to be the principle which informs the requirement for exhaustion of internal remedies found in section 7 of PAJA.

Secondly, however, proceedings in the tax court include the examination and cross examination of witnesses. These proceedings are therefore tailored to disputes which are factual in nature, and not purely legal. Therefore, where a dispute involves a factual question, it is arguably appropriate for the High Court not to exercise its discretion in section 105 of the TAA.

Therefore, taxpayers and tax practitioners are back to square one where review is concerned. As such, *Absa* may not have delivered the groundbreaking decision which many taxpayers (and tax practitioners) were eagerly awaiting. It did, however, affirm the principles applicable to a dispute with SARS, and in the process banked the question of review for now until the Constitutional Court potentially rules on this issue.

Nicholas Carroll

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 80A (description of "impermissible avoidance agreement"), 80J & 80L (definition of "impermissible avoidance agreement");
- Tax Administration Act 28 of 2011: Sections 104 & 105;
- Promotion of Administrative Justice Act 3 of 2000: Section 7.

Other documents

- Section 80J notices (notices in terms of section 80J of the Income Tax Act).

Cases

- *Commissioner for the South African Revenue Service v Absa Bank Ltd and Another* [2023] ZASCA 125 (29 September 2023);
- *Commissioner for the South African Revenue Service v Rappa Resources (Pty) Ltd* (1205/2021) [2023] ZASCA 28; 2023 (4) SA 488 (SCA) (24 March 2023);
- *United Manganese of Kalahari (Pty) Ltd v Commissioner for the South African Revenue Service* [2023] JDR 0863 (SCA); (1231/2021) [2023] ZASCA 29 (24 March 2023).

Tags: general anti-avoidance rules (GAAR); impermissible avoidance arrangement; letters of assessment.

ADVANCE PRICING AGREEMENT PROGRAMME

South Africa has recognised the importance of offering taxpayers greater certainty and predictability in their tax affairs through the recently proposed Advance Pricing Agreement (APA) programme.

On 31 July 2023, the National Treasury released draft legislation for a proposed APA Programme through the Draft Tax Administration Laws Amendment Bill, 2023 (the Draft TALAB). This draft Bill includes a clause (clause 10) indicating that a "Part IA" (on the APA programme) is to be inserted in Chapter III of the Income Tax Act, 1962 (the Act). It follows the 2020 release of a draft public discussion paper on the introduction of an APA programme and the model draft legislative framework of the South African Revenue Service (SARS), released in 2021.

On 1 November 2023 the Tax Administration Laws Amendment Bill, 2023 (the TALAB 2023), was introduced – its clause 10 also deals with the insertion of "Part IA" mentioned above. Whereas the Draft TALAB still stipulated that the insertion of Part IA would be with effect from a date determined by the Minister in the *Government Gazette*, section 10 (the same as clause 10 of the TALAB, 2023) of the Tax Administration Laws Amendment Act, 2023 (the TALAA, 2023), came into operation on the date of the promulgation of the TALAA, 2023, in the *Government Gazette* (ie, 22 December 2023).

The introduction of the APA programme is a positive and significant development in South Africa's efforts to enhance its tax administration system. It provides taxpayers with an alternative and binding arrangement with SARS, and it will also offer upfront certainty on transfer pricing positions for a defined period.

In an effort to further develop and refine the model, a pilot APA project is planned that will only accept bilateral APA applications; this should allow the SARS APA unit to learn from other countries and expand capacity before considering multilateral APA applications. The eagerly awaited draft response document of the National Treasury was released on 25 October 2023.

WHAT IS AN APA?

An APA is an agreement between a taxpayer and a tax authority (eg, SARS) in terms of which the transfer pricing methodology for the pricing of a taxpayer's cross-border related-party transactions is determined in advance, ie, for future years.

APAs are voluntary agreements, which means that taxpayers can choose to enter into them with tax authorities. APAs are legally binding agreements between the taxpayer and the tax authority.

Transfer pricing continues to be a significant income tax issue facing many multinational groups worldwide. As tax authorities seek to ensure that transactions are conducted at arm's length, companies engaging in international operations often face heightened transfer pricing scrutiny and the risk of double taxation.

With growing transfer pricing disputes involving tax authorities, the use of APAs is on the rise. APAs offer a way to attain certainty by enabling taxpayers to proactively negotiate with tax authorities to establish the right transfer pricing methods for their transactions.

THE PURPOSE OF APAs

The primary goal of APAs is to –

- prevent and resolve potential transfer pricing disputes;
- promote fairness; and
- provide greater certainty to taxpayers regarding their transfer pricing obligations.

APAs enable tax authorities and taxpayers to collaborate and ultimately agree on the appropriate transfer pricing methodologies.

UNDERSTANDING THE SOUTH AFRICAN APA FRAMEWORK

The proposed legislation deals with crucial aspects such as –

- clarifying who is eligible to apply for APAs;
- applicable fees;
- pre-application consultation meetings and what they entail;
- application processing procedures;
- amendments to the APA application; and
- withdrawal or rejection of an APA application.

It further sets out the –

- processing and finalisation of an APA application;
- submission of compliance reports; and
- extension and termination of approved APAs and record retention.

The Commissioner may, by public notice, specify procedures and guidelines for the implementation and operation of the APA system.

TAXPAYER BENEFITS

The introduction of the APA programme will bring numerous benefits for taxpayers engaged in cross-border transactions:

- **Certainty:** APAs provide taxpayers with a clear understanding of how their inter-company transactions will be treated for tax purposes.
- **Conflict avoidance:** By agreeing to certain transfer pricing methodologies in advance, APAs help prevent transfer pricing disputes and potential audits. This can save both taxpayers and tax authorities' time and resources that would otherwise be spent on resolving conflicts.
- **Customisation:** APAs are tailored to the specific circumstances of taxpayers and their inter-company transactions. This means that the agreed-upon methods are designed to reflect the unique economic realities of the taxpayer's business.
- **Double taxation avoidance:** APAs often involve bilateral or multilateral agreements with multiple tax authorities. This helps prevent the issue of double taxation, where the same income is taxed in more than one country.
- **Enhanced collaboration:** APAs encourage collaboration between taxpayers and tax authorities. This cooperative approach fosters a better understanding of complex transfer pricing arrangements and helps build trust between the two parties.
- **Enhanced reputation:** The implementation of an APA programme can enhance a country's reputation within the global business environment. Overall, a positive reputation can encourage businesses to invest in South Africa and foster goodwill among international partners.
- **Long-term benefits:** APAs typically have a multi-year duration, often three to five years or more. This long-term perspective provides stability for taxpayers, allowing them to make strategic decisions with confidence.
- **Reduced compliance burden:** With an APA in place, taxpayers can often streamline their transfer pricing documentation and reporting requirements. They can rely on the agreed-upon methodology, reducing the need for extensive record-keeping and documentation efforts.

All these factors contribute to a more stable and predictable tax environment, which can benefit both businesses and the government. Overall, a well-implemented APA programme can help improve South Africa's tax administration and create a favourable environment for economic growth and investment.

CHALLENGES FACED

It is important to note that while APAs offer numerous benefits, they also involve a detailed, often time-consuming and costly negotiation process. Taxpayers considering APAs should be prepared to invest resources in the application and negotiation stages. Additionally, it is essential to maintain compliance with the terms of the APA throughout its duration to fully realise the benefits.

One of the biggest challenges faced in South Africa relates to the scarcity of transfer pricing expertise in the country, which will require resources and time to develop at SARS. Although the APA unit will require independence from the transfer pricing unit, it is envisaged that in the APA unit's early stages of development the relationship between the units will be relatively fluid, resulting in the exchange of expertise and personnel between the units.

CONCLUSION

The proposed APA programme in South Africa has the potential to significantly enhance the country's tax landscape and promote tax certainty, as well as international business growth, compliance, and transparency. It is seen as a progressive initiative that can benefit various stakeholders and pave the way for improved tax planning and transfer pricing strategies within the country.

Robyn Kantor *(Reviewed by* ***Peter Dachs)***

ENSafrica

Acts and Bills

- Income Tax Act 58 of 1962: Insertion of Part IA (sections 76A to 76P) in Chapter III;
- Draft Tax Administration Laws Amendment Bill, 2023 (clause 10 was to have come into operation "on a date determined by the Minister in the *GG*");
- Tax Administration Laws Amendment Bill 37 of 2023: Clause 10 (inserting Part IA in Chapter III of the Income Tax Act);
- Tax Administration Laws Amendment Act 18 of 2023: Section 10 (inserting Part IA in Chapter III of the Income Tax Act) – came into operation on 22 December 2023.

Other documents

- Draft Response Document (released by National Treasury on 25 October 2023 – *Draft Response Document on the 2023 Draft Revenue Laws Amendment Bill, 2023 Draft Revenue Administration and Pension Laws Amendment Bill, 2023 Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2023 Draft Taxation Laws Amendment Bill and 2023 Draft Tax Administration Laws Amendment Bill).*

Tags: Advance Pricing Agreement (APA) programme; transfer pricing disputes; double taxation avoidance.

IMPORTED SERVICES – SECONDED EMPLOYEES

INTRODUCTION

In this article a compelling tax case is examined which saw the potential value-added tax (VAT) liabilities that may arise when expatriate employees are sent to provide services in a foreign jurisdiction becoming a reality.

The case, *Citibank, NA South African Branch and Another v Commissioner for the South African Revenue Service,* [2023], revolves around an application launched by Citibank, NA, a South African branch of a US incorporated entity and part of the Citigroup Inc (Citigroup), and Citigroup Global Markets (Pty) Ltd, a wholly owned subsidiary of Citigroup Financial Products Incorporated (USA) (collectively called Citigroup SA), which was contested by the South African Revenue Service (SARS).

BACKGROUND

Citigroup, a global financial conglomerate, routinely seconded employees to its various international entities, including Citigroup SA, by concluding assignment and intra-city service agreements (the agreements) with these respective international entities.

In this matter, Citigroup SA sought a court order declaring that payments it made to the Citigroup foreign entities, in relation to seconded employees, comprised the reimbursement of salary costs paid to Citigroup SA's employees on Citigroup SA's behalf, which fell outside the scope of VAT, and which were exempt from section 7(1)*(c)* of the Value-Added Tax Act, 1991 (the VAT Act), in terms of section 14(5)*(d)* of the VAT Act.

SARS, on the other hand, argued that payments made by Citigroup SA for foreign staff seconded to South Africa should be categorised as payments for an "imported service" rather than a mere reimbursement of costs to the foreign entity.

In simpler terms, "imported services", as defined in section 1(1) of the VAT Act, refer to services provided by a supplier or business located outside of South Africa to a recipient within South Africa. These services are subject to VAT if they are used or consumed within South Africa and are not used to make taxable supplies.

Given the nature of its business as a bank, Citigroup SA would generally be required to apportion its input claims. It follows that the payments made to other Citigroup entities abroad are thus partly used, and partly not used, to make taxable supplies.

CITIGROUP SA'S ARGUMENT

Citigroup SA contended that the seconded employees were their employees, since the seconded employees placed their productive capacity at their disposal and furthered the enterprise of Citigroup SA, and furthermore, that Citigroup SA exercised the right of supervision and control over the seconded employees for the duration of their secondment. They also maintained the position that the payments made to the foreign entities for the supply of services to Citigroup SA, should not be subject to VAT.

It is important to note that a liability to pay VAT on imported services under section 7(1)*(c)* would not arise where the exemption in section 14(5)*(d)* applies. This exemption refers to a supply of services contemplated in proviso (iii)*(aa)* to the definition of "enterprise" in section 1(1) of the VAT Act. In terms of this proviso, the rendering of services by an employee to his employer in the course of his employment is not regarded as an "enterprise" to the extent that any amount which constitutes "remuneration" as defined in the Fourth Schedule to the Income Tax Act, 1962 (the Act), is payable.

Citigroup SA was accordingly of the view that the services provided by the seconded employees were like those of regular employees and did not constitute "imported services" as defined in the VAT Act.

SARS' STANDPOINT: VAT ON IMPORTED SERVICES

SARS disputed the classification of the seconded individuals as employees of Citigroup SA and that the foreign entity paid the salaries of these individuals on behalf of Citigroup SA, with Citigroup SA subsequently reimbursing the foreign entities. In terms of SARS' interpretation, the payments made by Citigroup SA under the agreements were seen as payments made to a service provider (the foreign entity) for services rendered via the seconded employees.

This categorisation was pivotal since, because the payments were, according to SARS, payment for services, SARS sought to charge VAT on the basis that they were payments for "imported services."

Citigroup SA's obligation to make payments to the foreign entities stems from a careful reading of both the assignment agreement and the inter-city agreement. The assignment agreement explicitly stated that the seconded employees' services are "lent" to Citigroup SA by the foreign entity, with the seconded employees retaining their status as employees of the foreign entity. The assignment agreement also referred to a profit margin being levied on the service which arguably undermines Citigroup SA's contention that its payments abroad only amounted to remuneration paid (indirectly) to the secondees.

"SARS disputed the classification of the seconded individuals as employees of Citigroup SA and that the foreign entity paid the salaries of these individuals on behalf of Citigroup SA, with Citigroup SA subsequently reimbursing the foreign entities."

THE COURT'S DECISION AND REASONING

Following the arguments raised by Citigroup SA and SARS, the court then considered whether the seconded employees could, indeed, be classified as employees of Citigroup SA. The court agreed with SARS' view that the issue as to whether the secondees were employees should be determined under South African tax legislation, rather than under the South African labour laws.

The court considered the definitions of "employer" and "employee" as provided for in the South African Income Tax Act, 1962 (the Act). According to the Fourth Schedule to the Act, an "employee" is any natural person who receives remuneration. "Remuneration" includes various forms of compensation, such as salaries, wages, bonuses, commissions, etc.

In determining whether the taxing provisions in section 7(1) applied, or whether the exemption to section 7(1)*(c)* applied, the court analysed the wording of proviso (iii)*(aa)* to the definition of an "enterprise" (in other words, the provision of services by an employee to their employer), in the context of these income tax definitions.

In the end, the court ruled against Citigroup SA and this decision ultimately hinged on the failure of Citigroup SA to discharge the burden of proof on two crucial aspects:

1) That it (Citigroup SA) was the "employer" of the seconded employees as defined by the Act; and

2) that the payments it made to the foreign entity constituted "remuneration."

On the first point, the court held that Citigroup SA had not provided compelling evidence to establish that the seconded employees were under its direct supervision and control. It noted that Citigroup SA's assertion of supervision and control merely recited statutory language without demonstrating the practical aspects of such control over the seconded employees.

Circling back to the issue of payments, the court found that Citigroup SA had not shown that these payments constituted "remuneration" as defined in the Act. The fact that the foreign entity, as per the agreements, remained responsible for the salaries of the seconded employees, was a significant point of consideration. In that regard, the court held that the evidence of issuing IRP 5 tax certificates alone was not compelling enough to establish that these payments constituted remuneration.

CONCLUSION

This case has significant implications for international businesses operating in South Africa and is a prime example of how intricate tax regulations can lead to contentious disputes.

Further, the judgment underscores the intricate challenges faced by multinational corporations dealing with tax regulations, both local and international. The outcome of this case could set a significant precedent, affecting how businesses structure their cross-border employment arrangements and navigate complex tax laws. It further demonstrates the need for taxpayers to seek clarity and consistency in international tax laws when dealing with increasingly common global employment arrangements.

Jaco Jansen van Vuuren

Regan van Rooy

Acts and Bills

- Income Tax Act 58 of 1962: Fourth Schedule: Paragraph 1 (definitions of "employee", "employer" & "remuneration);
- Value-Added Tax Act 89 of 1991: Sections 1(1) (definitions of "enterprise" (proviso (iii)*(aa)*) and "imported services"), 7(1)*(a)* & *(c)* & 14(5)*(d)*.

Cases

- *Citibank, NA South African Branch and Another v Commissioner for the South African Revenue Service* (2022/043103) [2023] ZAGPPHC 1209 (20 September 2023).

Tags: imported services; taxable supplies; seconded employees; enterprise.

South African
Institute of
Taxation