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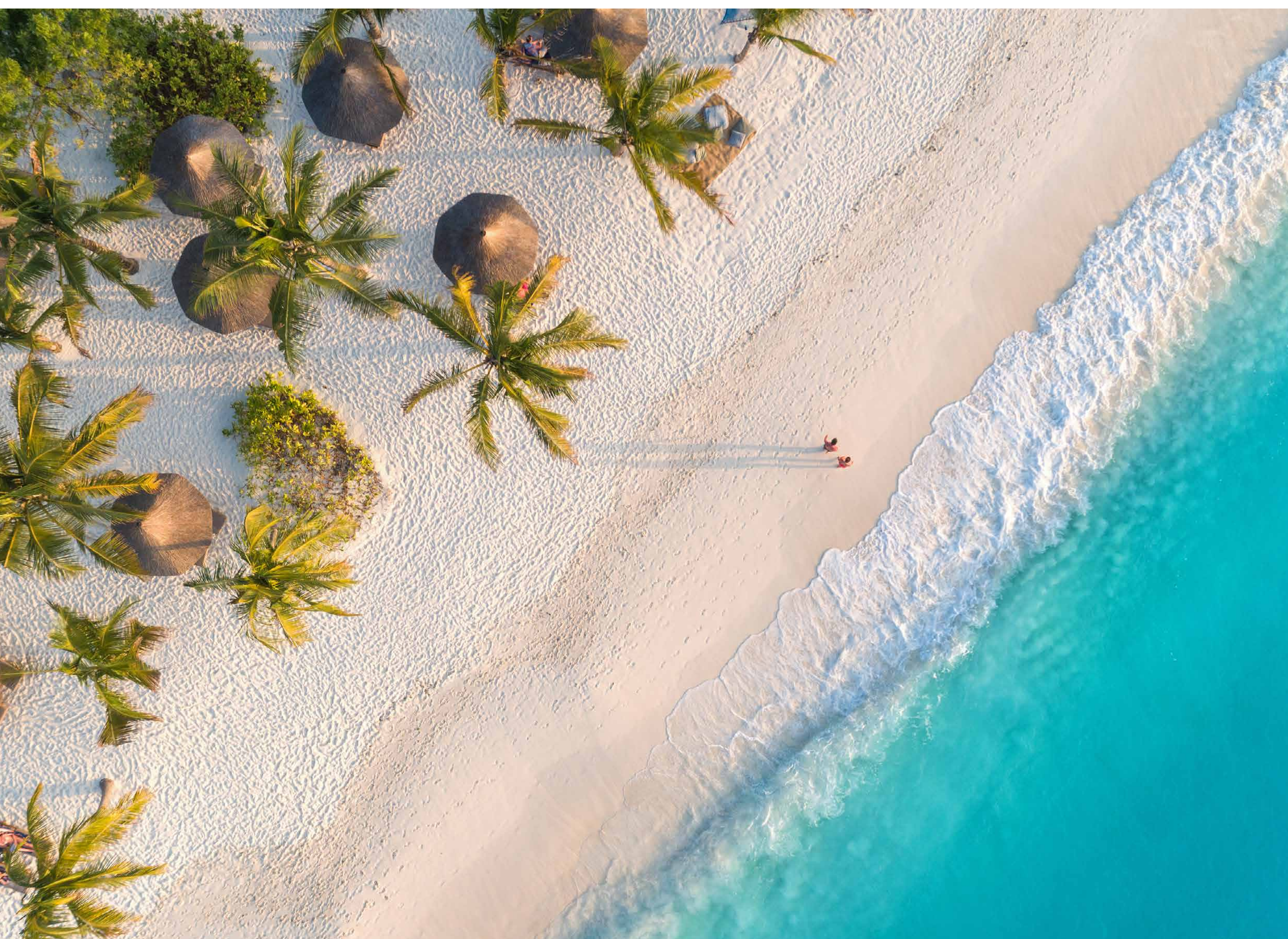

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SARS LETTERS OF DEMAND

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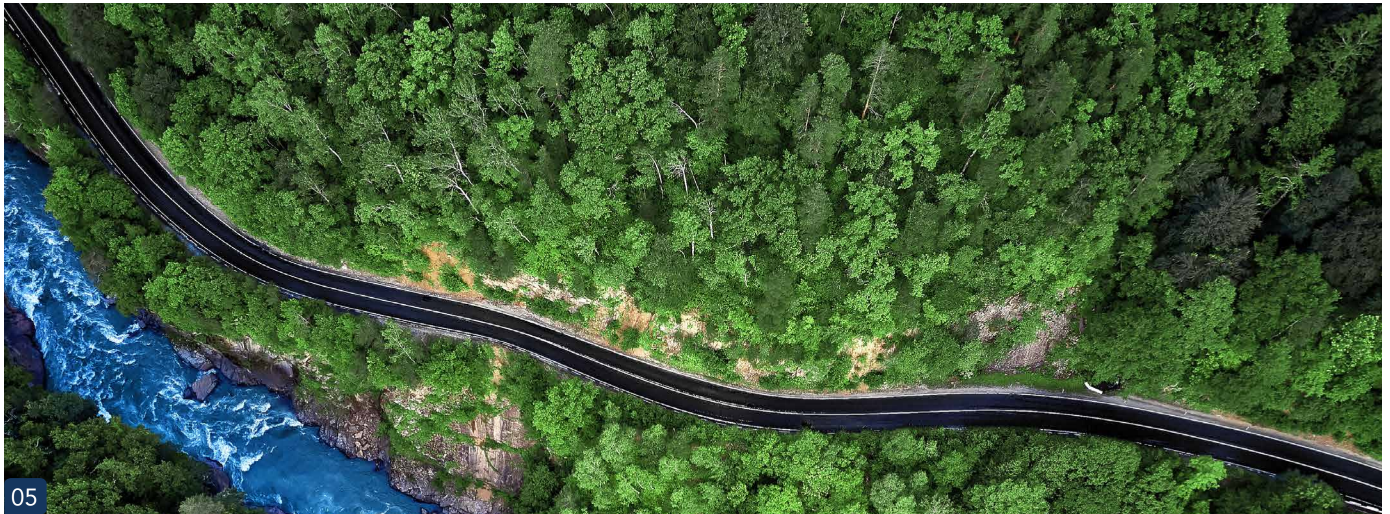
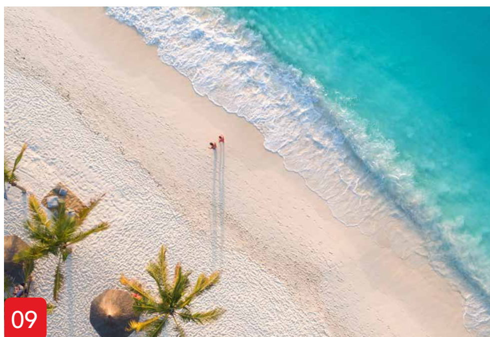
ADVANCE PRICING AGREEMENTS





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Mr KG Karro (Chairman), Mr MA Khan, Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Ms MC Foster

Tax Chronicles Monthly is published as a service to members of the tax community and includes items selected from the newsletters of firms in public practice and commerce and industry, as well as other contributors. The information contained herein is for general guidance only and should not be used as a basis for action without further research or specialist advice. The views of the authors are not necessarily the views of the editorial panel or the South African Institute of Tax Professionals.

UNBUNDLING TRANSACTIONS

"Broadly speaking, an unbundling transaction involves the distribution by one company (referred to as the unbundling company) of all of the equity shares held by it in another company (referred to as the unbundled company) to the shareholders in the unbundling company."

INTRODUCTION

The Taxation Laws Amendment Act, 2020 (the TLAA), was promulgated in the *Government Gazette* on 20 January 2021. One of the significant amendments proposed by the TLAB is to section 46 of the Income Tax Act, which deals with the tax treatment of unbundling transactions.

A proposed amendment to section 46 was initially published by the National Treasury for public comment on 31 July 2020 as part of the Draft Taxation Laws Amendment Bill, 2020 (the DTLAB). Following the receipt of public comments on the DTLAB, the proposed amendment was substantially revised to take these comments into account, and these revisions are reflected in the TLAB.

Broadly speaking, an unbundling transaction involves the distribution by one company (referred to as the unbundling company) of all of the equity shares held by it in another company (referred to as the unbundled company) to the shareholders in the unbundling company.

Generally, in the absence of section 46, an unbundling transaction would give rise to a number of tax consequences. Firstly, the distribution by the unbundling company of the shares in the unbundled company constitutes a disposal of those shares (which, for capital gains tax (CGT) purposes, would generally be taxable in the hands of the unbundling company). Secondly, the distribution is a dividend declared by the unbundling company, which would otherwise trigger dividends tax for the unbundling company. Finally, the transfer of the shares in the unbundled company is subject to securities transfer tax.

In short, in the absence of any tax relief, the tax implications of an unbundling transaction would simply make most unbundling transactions too expensive to conclude. The problem is compounded when the unbundling company does not have a sufficient level of cash or liquid assets with which to settle the resulting tax liabilities.

THE IMPORTANCE OF UNBUNDLING TRANSACTIONS IN THE SOUTH AFRICAN ECONOMY

There are many commercial benefits of unbundling transactions. These largely revolve around the unlocking of value for shareholders, the deconcentration of ownership and the enhancement of focused growth strategies. Unbundling transactions allow for the separation of different investment profiles, which may have different funding needs or expectations from investors with respect, for example, to dividend yields. From a competition perspective, unbundling transactions may improve competitiveness in an economy by diversifying ownership in a sector.

Given the above, it is clear that unbundling transactions are of fundamental importance not only in ensuring the existence of efficient and well-functioning markets, but also to the economy as a whole.

THE PURPOSE OF SECTION 46

The purpose of section 46 is to effectively make an unbundling transaction tax neutral. Generally, the tax consequences that would have resulted from an unbundling transaction are deferred until such time as the shareholders in the unbundling company subsequently dispose of the shares they acquire as a result of the unbundling or the unbundled company disposes of its assets.

PROTECTION OF THE SOUTH AFRICAN TAX BASE

In order to protect the South African tax base, section 46 contains a number of rules that limit the circumstances under which the relief it affords will apply. It is easy to see that the tax base may be eroded where, for example, a shareholder in the unbundling company will not be subject to tax when it subsequently disposes of the shares that it has acquired pursuant to the unbundling transaction. This is particularly the case if the shareholder in question holds a significant shareholding in the unbundling company and is, as a result, able to drive the transaction.

Accordingly, prior to the amendments proposed by the TLAB, one of the limiting rules in section 46 was that the relief would not apply if, immediately after the distribution, 20% or more of the shares in the unbundled company are held by what is referred to as a "disqualified person" (whether alone or together with any other disqualified person who is a "connected person" in relation to that disqualified person). Generally, a "disqualified person" is any person who will not be subject to tax on a subsequent disposal of the unbundled shares (such as, for example, non-South African residents, retirement funds, government and public benefit organisations).

One of the purposes of this rule was to limit the relief in circumstances where a tax-exempt shareholder has significant influence over the unbundling company and can therefore secure a tax benefit that effectively erodes the South African tax base.

THE AMENDMENT TO SECTION 46 AS PROPOSED BY THE DTLAB

As per the Draft Explanatory Memorandum on the DTLAB, released together with the DTLAB, Government appeared to be concerned with a perceived increase in the use of unbundling transactions to erode the South African tax base, particularly where the distribution of the unbundled shares is made to non-South African residents. The concern was that significant base erosion can take place where 20% or more of the shares in the unbundled company are held by non-residents who are not connected persons in relation to each other. There could, for example, be eight non-South African resident shareholders (who are not connected persons in relation to each other), each holding 10% of the shares in the unbundled company. In this scenario, Government argued, the current limiting rule is inadequate to protect the South African tax base.

In order to address this perceived threat to the South African tax base, the amendments to section 46 proposed by the DTLAB removed the reference to "connected persons" in the limiting rule. The effect of this proposal was that the relief afforded by section 46 would not apply if more than 20% of the shares in the unbundled company are, immediately after the distribution, in aggregate held by disqualified persons, irrespective of the level of shareholding of each of these disqualified persons, and irrespective of whether or not they are connected persons.

THE EFFECT OF THE AMENDMENT PROPOSED BY THE DTLAB

South African-listed groups generally have diverse shareholdings, with a significant portion comprising non-resident investors (private and institutional) and other disqualified persons. As of 2016, some 37% of the market capitalisation of the JSE was held by foreigners and another 24% was held by retirement funds. The 20% threshold would therefore almost always be satisfied for listed companies if the aggregate interest of these disqualified persons was taken into account. Accordingly, the result of the amendment proposed by the DTLAB would have been that very few, if any, unbundling transactions by listed companies would qualify for tax relief.

Had the amendment as proposed by the DTLAB ultimately been promulgated, this would have had a disastrous effect, not only on unbundling transactions themselves, but on South African capital markets and potentially the economy as a whole.

PUBLIC COMMENTS ON THE AMENDMENT AS PROPOSED BY THE DTLAB

Needless to say, the amendment to section 46 proposed in the DTLAB elicited a great deal of public comment.

Aside from the disastrous impact that the proposed amendment would have had, there are many reasons why, commentators argued, it was ill-considered and inappropriate.

Effect of broad definition of "disqualified person"

The concern of Government, as articulated in the Draft Explanatory Memorandum, appeared to be with non-residents that hold 20% or more of the shares in the unbundled company. However, the category of "disqualified persons" is broader than only non-residents. It also includes the government, PBOs, recreational clubs, rehabilitation companies and trusts, retirement funds, medical schemes and various government entities. The effect of the proposed amendment was that the shareholdings of all disqualified persons in the unbundled company would need to be counted to determine whether the 20% threshold was breached. If it was, then no relief would apply to the unbundling transaction in its entirety.

Applying the rule to non-residents only was acknowledged by commentators as not being a viable solution, on the basis that this would result in a breach of the non-discrimination provisions of South Africa's double taxation agreements with other countries. However, including all disqualified persons in such an aggregate rule, regardless of the size of their shareholdings, would have had significant implications. One option suggested by commentators was to narrow the definition of disqualified person, on the basis that, from a policy perspective, there is good reason to exclude certain of these, particularly retirement funds since such funds are not truly exempt from tax. This is because amounts withdrawn from retirement funds are subject to tax on withdrawal and the system of taxation applicable to retirement funds is more akin to a deferral, with both contributions and returns accumulating tax-free but then being subject to tax on withdrawal.

Practical considerations

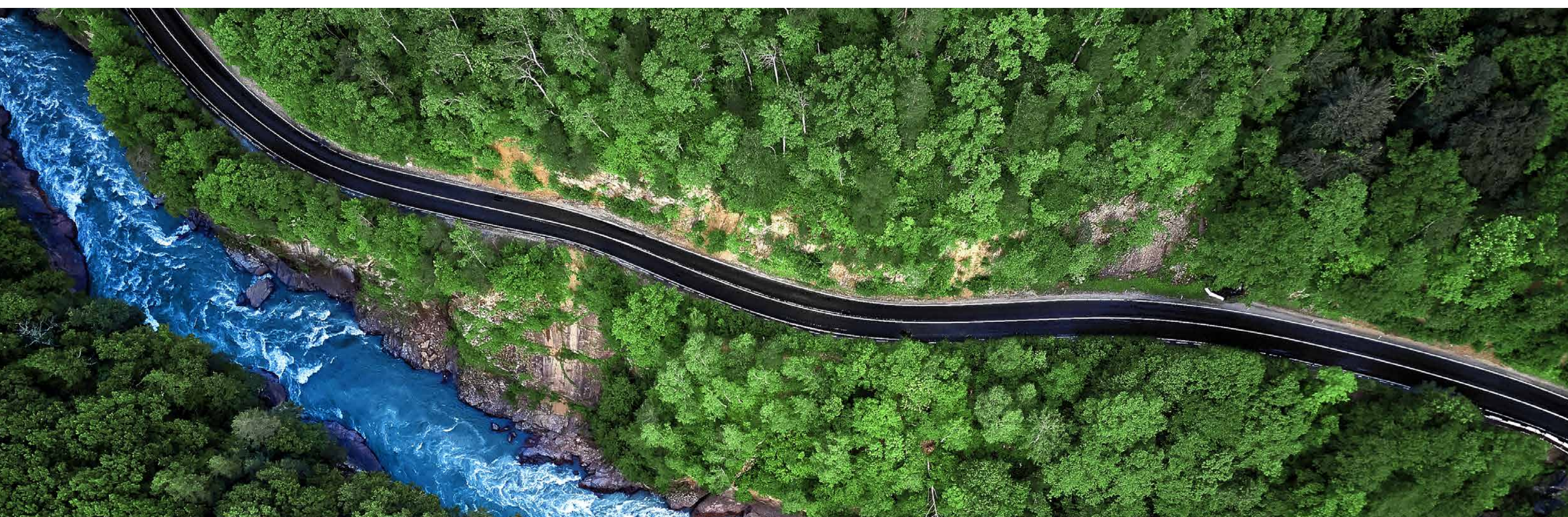
It was implicit in the proposal that a company would need to be able to identify and determine the tax status of every beneficial owner of shares in the unbundling company (and the unbundled company) at the time of the distribution in order to determine whether an unbundling transaction would qualify for relief from tax. Conducting the analysis required to measure the proposed aggregate 20% threshold would, commentators argued, be an impossible task for any listed company. For one, the shareholding in a listed company generally changes on a regular (often daily) basis. Moreover, it is impossible for a listed company to know who all its shareholders are (let alone their tax status) on any given day, given that the shareholdings are usually held through intermediaries.

Is there really an erosion of the South African tax base?

The argument that unbundling transactions erode the tax base is easily countered when one considers the primary objective of most unbundling transactions: the unlocking of value. This may be illustrated by way of a simple example.

Assume that a listed company (Listco) has a market capitalisation of R10bn and wishes to unbundle and separately list its 100% shareholding in one of its subsidiaries (Subco). Subco has a value of R2bn and a nominal base cost for CGT purposes. A non-resident holds 10% of Listco.

Absent the unbundling relief afforded by section 46, the distribution of the shares in Subco would attract CGT and dividends tax. However, when one considers the tax base from the perspective of the individual companies and shareholders, there is no erosion of the tax base at all, assuming the non-resident is not driving the transaction with the objective of disposing of its interest in Subco in the short run.



"The argument that unbundling transactions erode the tax base is easily countered when one considers the primary objective of most unbundling transactions: the unlocking of value."

From the perspective of the non-resident shareholder in Listco, it had an investment in Listco that was worth R1bn before the unbundling. After the unbundling, it now has a shareholding in Listco that is worth R800m and a shareholding in Subco that is worth R200m. In aggregate, its investment in the combined Listco and Subco is still worth R1bn. It has simply swapped its indirect investment in Subco for a direct investment. No value has been transferred to the non-resident shareholder. Before the unbundling, its investment with a value of R1bn fell outside the tax net. After the unbundling this is still the case. From the perspective of Listco and Subco there is also no erosion of the tax base. Their assets remain wholly within the tax net to the extent of the combined net asset value of R10bn. The only thing that has changed is that a hypothetical disposal of the shares in Subco now partially falls outside of the tax net, whereas a disposal of these shares by Listco would have been wholly within the tax net.

Shares held in the unbundled company (as opposed to being held in the unbundling company)

Another concern expressed by commentators was that (as is the case prior to the proposed amendment to section 46) the test for shareholding is flawed.

In terms of the relevant rule, unbundling relief will not apply where, immediately after the distribution of the shares in the unbundled company, 20% or more of those shares are held by disqualified persons. This would include shares that may not have been held by the unbundling company (and in respect of which no relief is sought). This problem is illustrated by way of the following example.

Assume the unbundling company holds 60% of the shares in the unbundled company, and other shareholders (who are not otherwise involved in the unbundling transaction at all) hold the remaining 40% of the shares in that company. Where the unbundling company distributes its 60% shareholding in the unbundled company to its shareholders, the shareholding of the other shareholders in the unbundled company could affect whether or not the unbundling company qualifies for unbundling relief.

Accordingly, it was argued by commentators that, in determining whether unbundling relief applies, no regard should be had to any shares that are not held by the unbundling company in the unbundled company and that are not distributed under the unbundling transaction.

Effective date

The effective date of the proposed amendment to section 46 in the DTLAB was 31 July 2020 (ie, the date on which the DTLAB was published for public comment). Commentators argued that this had an effect on unbundling transactions that were, at 31 July, already underway. Accordingly, and in light of the fact that unbundling transactions often take many months to finalise, it was argued by commentators that this date should be reconsidered.

REVISED PROPOSAL AS PER THE TLAB

As is reflected in the TLAB (introduced in Parliament on 28 October and passed by the National Assembly on 17 November and by the National Council of Provinces on 8 December 2020), Government has, to a certain extent, acknowledged some of the concerns expressed during the course of the public comment process, and the revised proposed amendment in the TLAB is a significant improvement on the original proposal.

In terms of the revised proposal, a "pro-rata" rule will apply instead of the "all-or-nothing" rule. In this regard, tax deferral under section 46 will not apply in respect of any equity share that is distributed by an unbundling company to any shareholder that:

- is a disqualified person; and
- holds at least 5% of the equity shares in the unbundling company immediately before that unbundling transaction.

Moreover, as is evident from the above, in determining whether unbundling relief applies, no regard will be had to any shares that are not held by the unbundling company and that are not distributed under the unbundling transaction. The revised proposal is a welcome improvement on the original proposal.

> "The amendment to section 46 proposed by the TLAB and enacted in the TLAA, although an improvement from the proposal in the DTLAB, is, unfortunately, still likely to be a hindrance to unbundling transactions."

From a practical perspective, it will no longer be necessary to identify and determine the tax status of every beneficial owner of shares in the unbundling and unbundled companies at the time of the unbundling distribution. In addition, the revised proposal undoubtedly results in a more equitable outcome. This is on the basis that shares distributed to persons that are not disqualified persons will benefit from tax deferral, which will only be disallowed to disqualified persons who hold more than 5% of the shares in the unbundling company. In this regard, it was acknowledged by National Treasury that the "all-or-nothing" rule, which would have disallowed tax deferral in its entirety in the circumstances in which it applied, would have been too punitive.

Regarding the effective date of the proposed amendment, the TLAB changed this date from 31 July 2020 to the date of introduction in Parliament of the TLAB (ie, 28 October 2020). Although commentators requested a later effective date National Treasury was unwilling to accommodate this request on the basis that the revised proposed amendment is "softer" than the original proposal. Moreover, National Treasury argued, the possibility that the revised proposal would be adopted was communicated during the course of the public consultation process, which should have provided sufficient time for taxpayers to plan accordingly.

OUTSTANDING CONCERNS

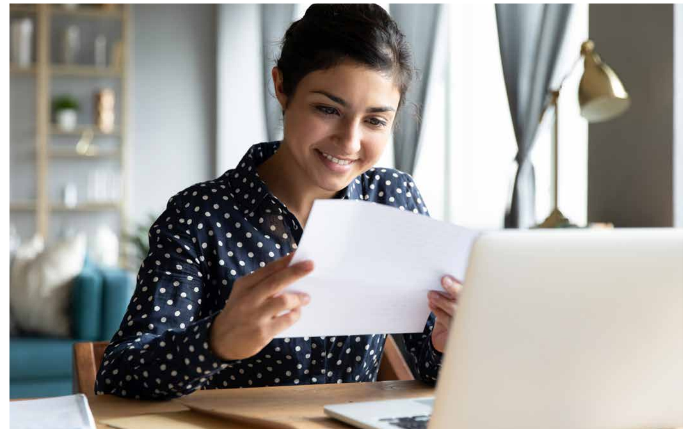
Although the revised proposal is a welcome improvement on the original proposal, there are still some concerns.

One example of these concerns relates to the overly broad definition of "disqualified person". In this regard, National Treasury stated, in its Draft Response Document on the DTLAB, and in the Final Response Document, that:

> "To exclude pension funds or any other category of persons from the definition of 'disqualified persons' would not be desirable as there is no policy change in ensuring that the corporate reorganisation rules continue to operate as tax deferral provisions and not exemptions (as would be the case if tax deferral is allowed for transfers to persons outside of the South African tax net)".

The above statement ignores the fact that retirement funds are not truly "outside of the South African tax net" – amounts withdrawn from retirement funds are subject to tax on withdrawal – and simply ignores the submission that there is therefore good reason, from a policy perspective, to exclude them from the definition of "disqualified person". Some listed companies do have retirement funds that hold more than 5% of the shares in the company. The Government Employees Pension Fund is a notable example in this regard and was the reason why the 20% threshold was introduced in the first place.

As a general matter, there is concern relating to the undue emphasis placed by National Treasury on the fiscal effect of granting a tax deferral in the context of an unbundling transaction. As discussed above, unbundling transactions are fundamentally important in the South African economy (and, in fact, in any economy).



In this context, the concern of Government with the erosion of the tax base as a result of tax deferrals arising from unbundling transactions is, it is submitted, misplaced. Tax relief for unbundling transactions should not be seen as an "incentive" or as a "special dispensation". Instead, the appropriate enquiry should be as to whether the tax regime facilitates or hinders unbundling transactions.

The amendment to section 46 proposed by the TLAB and enacted in the TLAA, although an improvement from the proposal in the DTLAB, is, unfortunately, still likely to be a hindrance to unbundling transactions.

PwC

Acts and Bills

- Income Tax Act 58 of 1962: Section 46;
- Taxation Laws Amendment Act 23 of 2020;
- Taxation Laws Amendment Bill 27B of 2020.

Other documents

- Draft Taxation Laws Amendment Bill, 2020;
- Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2020;
- Draft Response Document on the Draft Taxation Laws Amendment Bill, 2020 (released on 13 October 2020);
- Final Response Document on the Draft Taxation Laws Amendment Bill, 2020 (released on 20 January 2021).

Tags: unbundling transactions; capital gains tax; tax neutral; unbundling company; unbundled company; unbundled shares; connected persons; listed company; disqualified person.

LOOP STRUCTURE CHANGES

On 4 January 2021 the South African Reserve Bank released Exchange Control Circular No 1/2021, which provides for the long-awaited relaxation of the South African exchange control rules relating to "loop" structures and investments.

On 28 October 2020 the Minister of Finance announced in the 2020 Medium Term Budget Policy Statement that the prohibition on loop structures for exchange control purposes would be relaxed. As a result, the South African Reserve Bank advised that the full loop structure restriction would be lifted from 1 January 2021 to encourage inward investments into South Africa, subject to the normal criteria applying to inward investments and reporting to the Financial Surveillance Department (FinSurv).

Prior to 1 January 2021 South African individuals, companies, trusts and private equity funds were prohibited from utilising funds or any other authorised foreign assets to enter into a transaction or a series of transactions in order to, directly or indirectly through any structure or scheme of arrangement, acquire shares or any other assets or interests in the Common Monetary Area (CMA), which consists of Eswatini, Lesotho, Namibia and South Africa. (ie, loop structures).

"In simplified terms a loop structure is a structure where South African residents hold South African assets directly or indirectly through a non-resident entity."

In simplified terms a loop structure is a structure where South African residents hold South African assets directly or indirectly through a non-resident entity. However, an exception to this applied in that South African residents were permitted to individually or collectively acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign target entity, which may in turn hold investments and/or make loans into any CMA country.

The changes to the South African exchange control rules have lifted the loop structure restrictions as they relate to individuals, companies and private equity funds; however, South African trusts will continue to be prohibited from establishing loop structures.

Interestingly, the amendments to the exchange control rules provide that individuals, companies and private equity funds with authorised foreign assets may invest in South Africa through offshore structures, subject to the reporting of the transactions through an authorised dealer (AD) to FinSurv. It would seem, based on the wording of the Circular, that the restrictions in terms of loop structures have therefore only been lifted to the extent that the relevant exchange control residents already have authorised foreign assets. A South African resident would not be able to a create loop structure without prior exchange control approval where it does not have authorised foreign assets.

It is also important to note that section B.2(C)(i)(f)(ee) of the Currency and Exchanges Manual for Authorised Dealers has been deleted and substituted. It provided that a South African company is permitted to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign target entity, which may in turn hold investments and/or make loans into any CMA country.

"Importantly, the establishment of loop structures by the contribution of assets to an offshore entity, such as a joint venture vehicle, remains subject to FinSurv approval."

The substitute wording now states that corporates with authorised foreign assets may invest in South Africa through an offshore structure, subject to the reporting of the transactions through an AD to FinSurv. This creates ambiguity. The interpretation will still be clarified, but it is our view that under the foreign direct investment (FDI) dispensation the corporate may apply through an AD to invest in an offshore company which holds investments and/or makes loans into South Africa without the 40% limitation, but subject to the normal reporting which the AD will do when approving the FDI.

Importantly, the establishment of loop structures by the contribution of assets to an offshore entity, such as a joint venture vehicle, remains subject to FinSurv approval.

These changes are also not industry-specific as is the case with section B.2(F)(ii) of the Currency and Exchanges Manual for Authorised Dealers, which provides that unlisted South African technology, media, telecommunications, exploration and other research and development companies may establish offshore companies to raise foreign funding for their operations, subject to certain conditions. Companies established in terms of this dispensation have been permitted to hold investments and/or make loans into South Africa in terms of section B.2(F)(iii) of the Currency and Exchanges Manual for Authorised Dealers. The changes to the exchange control rules do not affect sections B.2(F)(ii) and B.2(F)(iii) of the Currency and Exchanges Manual for Authorised Dealers, which have not been deleted or amended.

The provisions relating to foreign assets inherited from a resident estate have also been amended; the assets may, on application to FinSurv, be retained abroad provided that the assets were held abroad by the deceased in compliance with the provisions of the South African Exchange Control Regulations. Where it is disclosed that the foreign assets inherited were held by the deceased in a manner contrary to the provisions of the regulations, including loop structures, an application for regularisation of such assets must be submitted via an AD to FinSurv.

The approval of FinSurv to retain foreign inherited assets abroad will be subject to the condition that the foreign assets may not be placed at the disposal of other South African residents.

Existing unauthorised loop structures created prior to 1 January 2021 and unauthorised loop structures where the 40% shareholding threshold was exceeded will not be automatically regularised as a result of the changes to the exchange control rules. These structures must still be regularised with FinSurv. Furthermore, where assets are contributed by a South African corporate to an offshore structure, FinSurv approval will still be required as this would continue to constitute an externalisation of South African assets. This aspect is of particular relevance to the private equity industry where "dual structures" (South Africa versus rest of world) has become the industry norm to comply with the historic loop structure prohibitions.

From a tax perspective, various amendments have been proposed to existing tax legislation (in some instances punitive) to curb any tax leakage arising due to the relaxation of the rules to loop structures. Once promulgated, these changes may have negative tax consequences for South African residents in existing or planned loop structures. Future difficulties may have to do with tax pitfalls instead of the former exchange control rules.

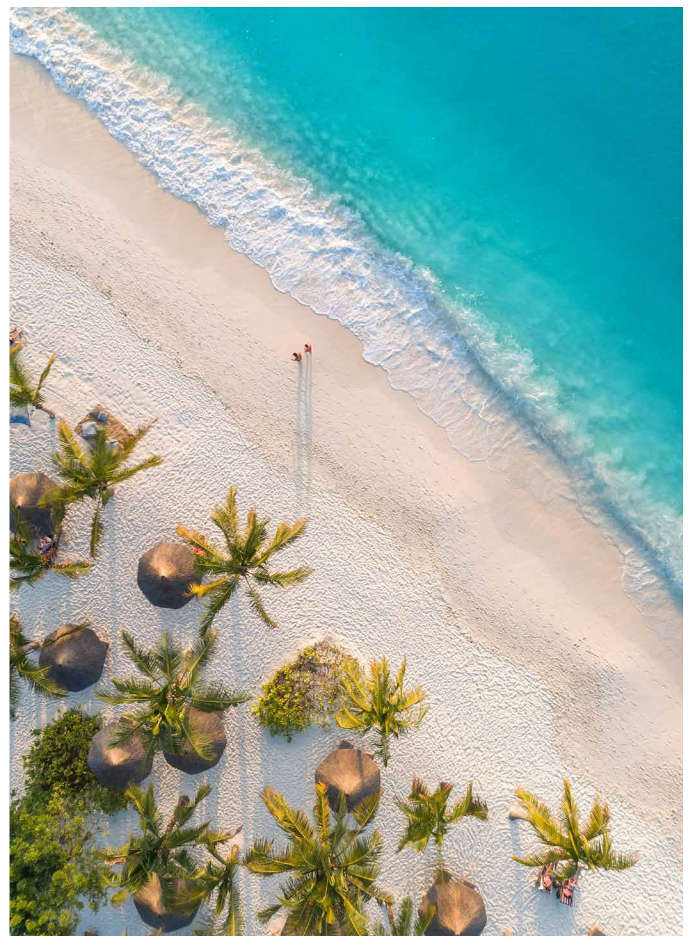
The relaxation of loop structure prohibitions has perhaps fallen short of what was hoped for. The reason for this is that the changes are limited to South African exchange control residents who already have authorised foreign assets and thereby continues to subject residents without authorised foreign assets to exchange control approval when intent on establishing a loop structure.

Webber Wentzel

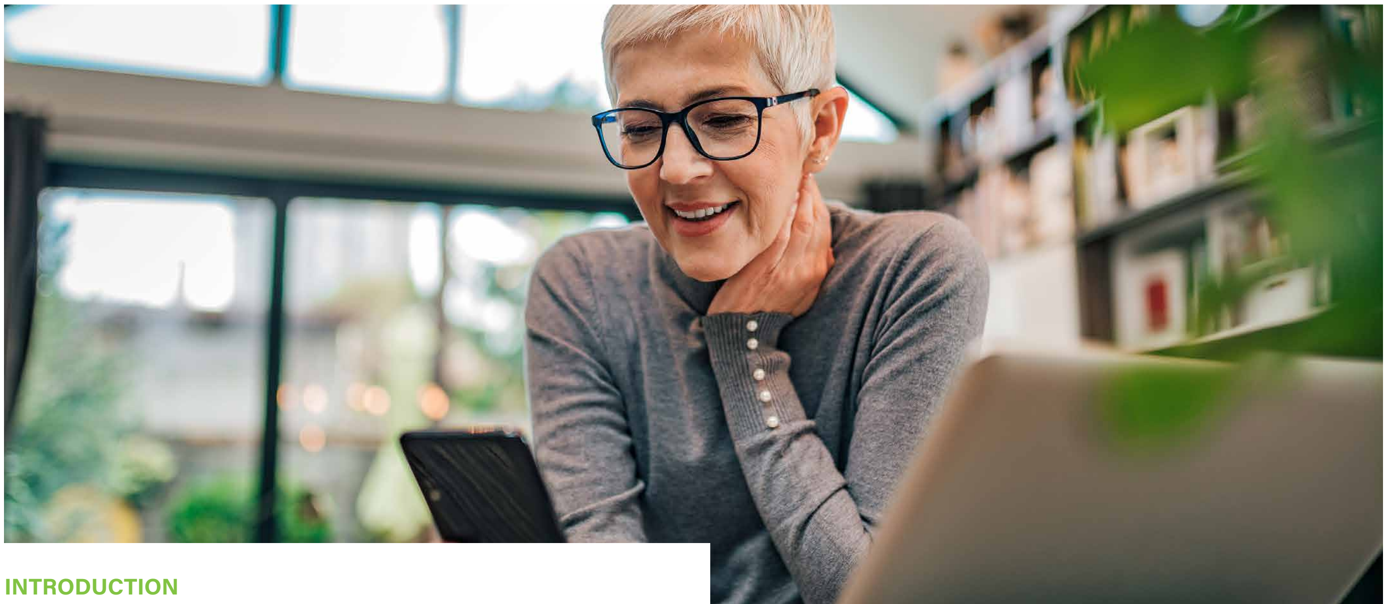
Other documents

- 2020 Medium Term Budget Policy Statement;
- Exchange Control Circular No 1/2021 (released by South African Reserve Bank on 4 January 2021);
- Currency and Exchanges Manual for Authorised Dealers: sections B.2(C)(i)(f)(ee); B.2(F)(ii) & (iii).

Tags: loop structures; private equity funds; authorised dealer; foreign inherited assets.



PENSION PAYMENTS FROM A FOREIGN PENSION FUND



INTRODUCTION

The Taxation Laws Amendment Act, 2020, contains amendments to the Income Tax Act, 1962 (the Act), dealing with the withdrawal of retirement funds upon emigration. These amendments came into effect on 1 March 2021.

In a related matter, it is interesting to note that, on 22 November 2020, SARS issued Binding Private Ruling 355 (BPR 355 / the Ruling), regarding the taxation of amounts that accrue to a South African resident from a foreign pension fund. The Ruling is discussed below.

FACTS OF BPR 355

- The applicant in the Ruling is a South African tax resident individual, but a citizen of country X (Applicant).
- He was employed in country X for 15 years by Company A, a company resident in country X and was a member of a foreign pension fund (the Fund), which is also resident in country X.
- The Applicant rendered services solely to Company A for the first 12 years of his employment, but from year 13 to 15, he was seconded to Company B, a company resident in South Africa (SA), while he was employed by Company A.
- The Applicant became ordinarily resident in SA after year 15 and became permanently employed with Company B.
- During the first 12 years of the Applicant's employment, Company A made contributions in respect of the Applicant to the Fund and from year 13 to 15, Company B made pension contributions to the Fund in respect of the Applicant.
- The Applicant made no contributions to the Fund as it was a non-contributory fund.
- The Applicant has reached the retirement age as stipulated by the rules of the Fund, but pension payments have not yet accrued to him as he first needs to make an election in this regard.

LEGAL FRAMEWORK

In terms of section 10(1)*(gC)*(ii) of the Act, a lump sum, pension or annuity received by or accrued to any South African tax resident from a source outside SA will be exempt from normal tax in the hands of such resident if the following requirements are met:

- The amount constitutes consideration for past employment outside SA;
- The amount must not accrue to or be received by the resident from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined in section 1(1) of the Act (Retirement Fund) or a company that is tax resident in SA and that is registered in terms of the Long-term Insurance Act as a person carrying on long-term insurance business; and
- If the amount accrues to or is received by the resident from any Retirement Fund or an insurer referred to in the previous bullet, it will still be exempt from normal tax in the hands of the South African tax resident, if it was transferred to that fund or that insurer from a source outside SA in respect of that resident.

RULING

SARS ruled as follows:

- The pension amounts that will accrue to the Applicant from the Fund must be included in the Applicant's gross income subject to the exemption under section 10(1)*(gC)* applying proportionally;
- The portion of each pension amount that will accrue from the Fund that is in respect of past employment services rendered outside of SA will be exempt from normal tax under section 10(1)*(gC)*.

The formula to determine the exempt amount is the following:

$$\frac{\text{Period of services rendered outside SA}}{\text{Total period during which services were rendered}} \times \text{Amount of lump sum or pension accrued or received} = \text{Amount exempt under s 10(1)}(gC)$$

It should be noted that the Ruling is subject to the additional condition and assumption that the Applicant is ordinarily resident in SA and not deemed to be exclusively a resident of country X or another country for purposes of the application of any double tax agreement between SA and another country.

COMMENT

The Ruling is welcomed in that it explains how section 10(1)*(gC)*(ii) practically applies. It also appears that the formula used in the Ruling is the same formula set out in Binding General Ruling 25, which applied until 4 October 2018, where SARS explained its interpretation of section 10(1)*(gC)*(ii).

Furthermore, the Ruling raises important practical issues to consider for South Africans intending to work temporarily abroad. Where such a person renders services abroad and the person's employer makes contributions towards a retirement fund as part of the person's remuneration benefits, it may be better to contribute to a foreign retirement fund and not to a South African retirement fund, so that the exemption in section 10(1)*(gC)*(ii) will apply. If the services are rendered outside South Africa, but the contributions are made to a South African retirement fund, the amounts received from the retirement fund in future will likely not qualify for exemption under section 10(1)*(gC)*(ii).

Cliffe Dekker Hofmeyr

Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding 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.

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definitions of "pension fund", "pension preservation fund", "provident fund", "provident preservation fund" & "retirement annuity fund"); 10(1)*(gC)*;
- Taxation Laws Amendment Act 23 of 2020;
- Long-term Insurance Act 52 of 1998.

Other documents

- Binding Private Ruling 355 (published on 20 November 2020) ("Accrual of pension payments to a resident from a foreign pension fund");
- Binding General Ruling 25 (applied from 14 November 2014 until 4 October 2018) ("Exemption – Foreign pensions").

Tags: tax resident; foreign pension fund.

SARS REFUNDS

2020 was a tough year – even more so for taxpayers expecting long-outstanding refunds from the South African Revenue Service (SARS).

Early in 2020, SARS trumpeted the fact that it had paid R2.4 billion in refunds to taxpayers. It acknowledged that these refunds were "a major cash injection into the economy at a very critical period". But SARS has generally been slow to refund amounts of excess payments due to taxpayers. The Tax Ombud, for instance, reported that in the 2018/2019 financial year, 24.43% of all complaints received by its office had related to delayed refunds – the second highest number of complaints.

The serious delays often experienced by taxpayers in this regard have been the subject of a systemic investigation by the Tax Ombud, too. But it seems that this frustrating practice will persist for as long as the current pressure on the fiscus prevails. Fortunately, taxpayers are not without legal recourse when a refund is due by SARS.

In this article, we consider five important considerations to take into account when SARS owes a refund.

SARS "MUST" PAY A REFUND WHEN A TAXPAYER IS ENTITLED TO IT

Section 190(1) of the Tax Administration Act, 2011 (the TAA), determines that SARS "*must*" pay a refund, together with interest on that amount, to any taxpayer who is entitled to it. This provision extends to refunds of *inter alia*: income tax, value-added tax (VAT), mineral royalties, or pay-as-you-earn. Enforcing this right, as a first step, would typically require the taxpayer to request a refund from SARS in respect of the amounts that are due.

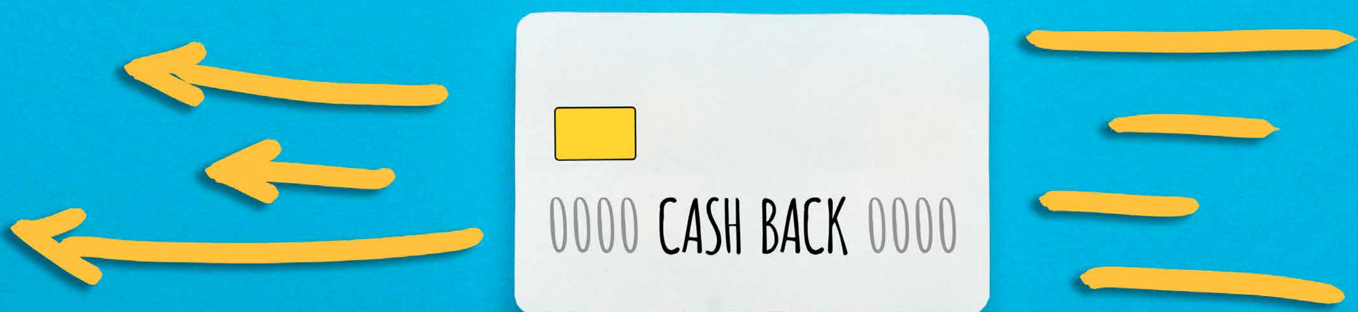
That being said, the right afforded to taxpayers is subject to certain further provisions of section 190.

SARS HAS THE RIGHT TO CONDUCT AN AUDIT BEFORE PAYING A REFUND

Section 190(2) contains a potential hurdle for taxpayers waiting on a refund to be paid. This section provides that SARS is not required to pay a refund until such time as a "verification, inspection or audit" in respect of that refund has been finalised in terms of Chapter 5 of the TAA. In other words, the subsection preserves SARS' right to *launch and finalise an audit of the refund* (as opposed to, for example, a general VAT or mineral royalty audit) before paying a cent to the taxpayer. So, arguably, SARS cannot use the defence that it is busy with a general tax audit and therefore refuse to make the refund. However, each case must be considered on the relevant facts at hand.

The recent matter of *Rappa Resources (Pty) Ltd v The Commissioner for the South African Revenue Service*, [2021], illustrates the potential headaches of this section. In this matter, Rappa alleged that it was owed a substantial amount of refunds. On the other hand, SARS argued that the amounts were still under audit and that no refunds could be paid. But, by the time of the judgment, the audit in respect of the March 2020 VAT return had not yet been completed. The High Court cautioned that "SARS cannot be allowed an indefinite time to complete an audit" and, accordingly, the court directed SARS to conclude the audits by 11 December 2020, and by no later.

The effect is that a taxpayer who is subjected to a protracted audit may approach the court, in principle, for an order (or a so-called *mandamus*) directing SARS to conclude its audit by a certain date. The court will, of course, consider various factors before granting such order.



"Accordingly, taxpayers who are owed refunds should ensure that they enforce their rights without any delay. Crucially, a refund that has prescribed will not be recoverable from SARS."

SARS "MUST" PAY A REFUND IF THE TAXPAYER TENDERS SECURITY

Section 190(3) provides that SARS "*must*" pay a refund – even before the finalisation of an audit – if the taxpayer has tendered security "*in a form acceptable to a senior SARS official*". In the *Rappa* case, the court confirmed that a taxpayer is not required to tender security for the whole amount of the refund. If the taxpayer, for instance, provides security for 50% of the refund, then SARS must concomitantly pay 50% of that refund.

A REFUND CAN PRESCRIBE

It should be borne in mind that section 190(4) contains prescription provisions. This section provides that a refund that stems from an erroneous overpayment of taxes will be forfeited to the State, unless a refund is made:

- in the case of an assessment by SARS (such as income tax), within three years of certain dates; and
- in the case of a self-assessment (such as VAT and mineral royalties), within five years from certain dates.

Accordingly, taxpayers who are owed refunds should ensure that they enforce their rights without any delay. Crucially, a refund that has prescribed will not be recoverable from SARS.

OUTSTANDING TAXES (AND RETURNS) COULD IMPACT ON THE PAYMENT OF REFUNDS

Lastly, taxpayers must take note that, in terms of section 191 of the TAA, SARS may allocate a refund against certain other outstanding taxes. For instance, SARS may set off a VAT refund against outstanding income tax. Very often, the result of this provision is that SARS will not pay any amount of a refund if there are outstanding returns recorded on the taxpayer's account.

Taxpayers should engage with SARS in respect of any refunds due. However, if they are left in the dark or subjected to bureaucratic stonewalling, taxpayers will not be without any recourse; a taxpayer who is aggrieved by SARS' inaction may, in principle, approach the High Court to compel SARS to pay the refunds that are due. In reaching a decision, the court will invariably consider all of the provisions discussed above and the applicable factual matrix.

Whatever the course of action, taxpayers should seek professional tax advice on the available remedies, the use and timing of such remedies, and most importantly, the overall strategy, so as not to be tripped up by some administrative or procedural issues.

ENSafrica

Acts and Bills

- Tax Administration Act 28 of 2011: Chapter 5 (sections 40–66); sections 190(1), (2), (3) & (4) & 191.

Cases

- *Rappa Resources (Pty) Ltd v The Commissioner for the South African Revenue Service* [2021] JDR 0043 (GJ).

Tags: tax audit; prescription provisions; self-assessment.

SARS LETTERS OF DEMAND

The South African Revenue Service (SARS) has been clamping down on taxpayers who have outstanding tax debts due. The impact of COVID-19 on tax revenues in 2021 resulted in tax revenue forecasts having been revised downwards by R312bn from the 2020 Budget forecast. This was attributed to both the sluggish economy and the effects of the COVID-19 lockdown. With a disrupted year of business activities and the negative impact on revenue collections, taxpayers now, more than ever, need to be vigilant, proactive and organised when it comes to understanding their tax affairs and dealing with SARS. One such revenue-collection mechanism increasingly used by SARS is the issuance of letters of demand to taxpayers. Such outstanding tax debts do not need to be new or recent tax debts but can span over a period of years.

The receipt by taxpayers of letters of demand for payment often creates undue stress and panic, which can result in a slow reply to SARS. It is therefore important, as a starting point, for taxpayers to know their remedies. The diagram below contains some key points that taxpayers should take note of upon receipt of a letter of demand from SARS.

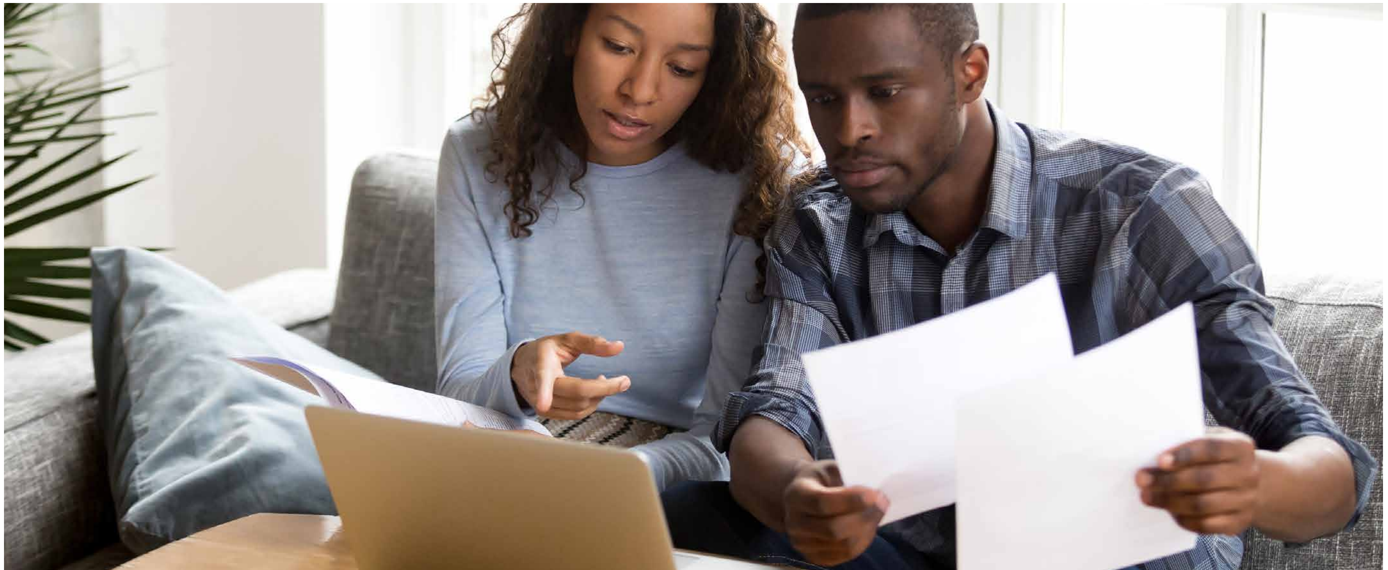
Whether the individual/entity which the letter of demand is addressed to is in fact the taxpayer. In addition, it is important to check the date of the letter of demand.

Whether the amount of the tax debt allegedly due to SARS is correct. To make this determination, taxpayers must check the amount on the letter of demand against the amount of their statement of account.

whether there is a business day time limit within which to take the next step. SARS usually gives the taxpayer 5 to 10 business days to take the next step.

Consider the next step/remedies

It is crucial for taxpayers to understand which of the following remedies are available to them to mitigate or suspend collection steps by SARS or third-party appointments by SARS in satisfaction of the taxpayers' tax debt or even judgment taken against the taxpayer.



1. **Payment of the full tax debt:**

    a. Taxpayers can elect to pay the full amount due to SARS in satisfaction of the outstanding tax debt in terms of section 169 of the Tax Administration Act, 2011 (the TAA).

    b. This is the appropriate remedy where the taxpayer has sufficient resources to pay the outstanding tax debts and will ensure that no collection steps are taken by SARS.

2. **Instalment payment plan:**

    a. Taxpayers can apply for an instalment payment arrangement with SARS in terms of section 167 read with section 168 of the TAA.

    b. This is the appropriate remedy where the taxpayer can demonstrate a short-term cash flow problem and is unable to settle the tax debt in one payment. In addition, the payment plan must facilitate the collection of the debt and ideally be presented to SARS at the highest possible instalment over the least amount of time.

3. **Suspension of payment:**

    a. Taxpayers can apply for the suspension of payment of a (disputed) tax debt in terms of section 164(3) of the TAA.

    b. This is the appropriate remedy where the taxpayer intends to submit or has already submitted a formal dispute and does not have sufficient resources to pay the assessments raised by SARS.

4. **Compromise of debt:**

    a. Taxpayers can apply for the compromise of their (undisputed) tax debt in terms of section 200 of the TAA.

    b. This is an appropriate remedy where the proposal will provide a higher return to the fiscus than liquidation, sequestration, or other collection measures and if the compromise is consistent with considerations of good management of the tax system and administrative efficiency.

5. **Settlement of the dispute:**

    a. Taxpayers can apply for the settlement of a (disputed) tax debt in terms of section 146 of the TAA.

    b. This is an appropriate remedy if it is, *inter alia*, to the best advantage of the state to settle the dispute in whole or in part on the basis of fairness and equity to the taxpayer and SARS.

SUMMARY OF KEY ELEMENTS:

- Upon receipt of a letter of demand from SARS, taxpayers must check that all factual details on the letter of demand are correct and that it is addressed to the correct person; the date of the issuance of the letter and the timeframe within which the next step must be taken should also be checked.
- Since time is of the essence in respect of this revenue collection mechanism, taxpayers should not ignore these demands and it is advisable that they seek the assistance of their tax advisers to mitigate collection steps on the part of SARS, judgment taken against the taxpayer by SARS or the appointment of third parties by SARS in satisfaction of the tax debt owed by the taxpayer.
- Each of these debt collection mechanisms is governed by a specific technical legislative process.
- The good news is that there are remedies available to taxpayers who find themselves in receipt of a letter of demand, and the circumstances of each taxpayer will inform the appropriate remedy to be utilised by the taxpayer.

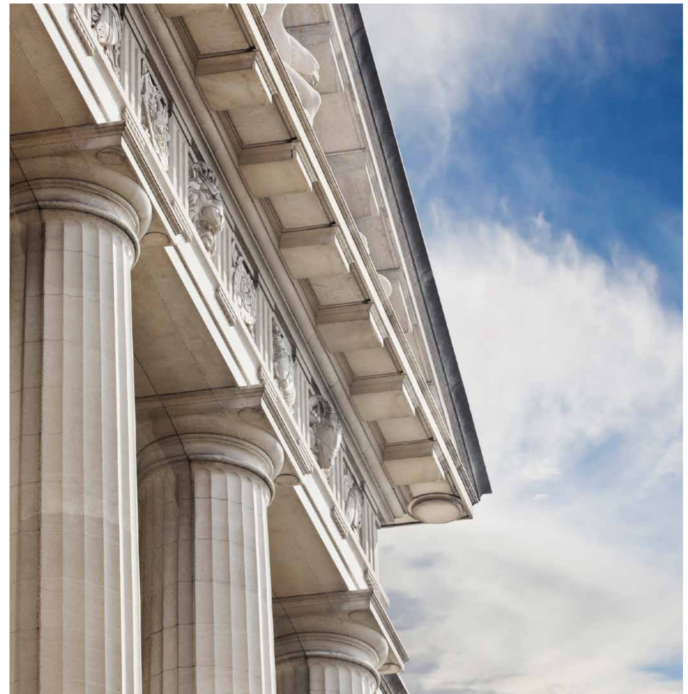
PwC

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 146, 164(3), 167, 168, 169 & 200.

Tags: letter of demand; tax debt.

OBJECTION TO SARS INTEREST CHARGES



In the judgment of Commissioner for the South African Revenue Service v The Executor of the Estate late Lot Maduke Ndlovu, *[2020], the High Court of South Africa had to determine whether the Tax Court had erred in its findings that, amongst others, the taxpayer should be entitled to raise a new ground of objection during the appeal when such ground had not been raised by the taxpayer in his objection.*

FACTS

The late taxpayer had been granted options to acquire shares in his employer, which options were exercised by him during his tenure of employment. These shares were subsequently sold by the taxpayer in three tranches, as a result of which a gain of R7 121 744.43 was realised by the taxpayer. Despite the sale of the shares being dealt with by the administrator of the trust established by the taxpayer's employer, the administrator did not deduct and withhold any tax in respect of the gain that was realised. The three IT3(a) returns given to the taxpayer by the administrator indicated that no tax was deducted by reason of the fact that the gain constituted "*non-taxable earnings*". The taxpayer queried this, to which the administrator replied that the "*earnings arising from the options exercised were non-taxable*". As a result, the taxpayer did not declare the gain in his 2007 tax return.

Following an audit by SARS, an additional assessment was raised, which included the gains realised from the disposal of the shares in the taxpayer's taxable income. This additional assessment imposed additional tax in terms of the then section 76(1)*(b)* of the Income Tax Act, 1962 (the Act), which section has since been repealed with effect from 1 October 2012. The assessment also imposed interest in terms of section 89*quat*(2) of the Act. In light of the fact that section 76 has since been repealed, this article deals primarily with the issues before the High Court that pertain to the section 89*quat*(2) interest that was imposed by SARS.

In the objection to the additional assessment, the taxpayer opposed the imposition of additional tax in terms of section 76(1)*(b)* and submitted that the gain of R7 121 744.43 could not be taxed as a capital gain in terms of the Eighth Schedule to the Act, nor could it be taxed as income in terms of sections 8A and 8C of the Act. Of critical importance in this case was that the taxpayer did not object to the imposition of interest in terms of section 89*quat*(2) in his objection to the additional assessment raised by SARS.

This objection was disallowed on 8 February 2012, and in a letter dated 10 February 2012, SARS informed the taxpayer that certain adjustments had been made in the calculations of his taxable income for, amongst others, the 2007 year of assessment.

The taxpayer noted an appeal against the disallowance of his objection on 7 March 2012 on the same grounds as those set out in his objection, and the Tax Court unanimously upheld the appeal in favour of the taxpayer. To this end, and in respect of the appeal against the interest imposed by SARS, the Tax Court found that the letter dated 10 February 2012 created a legitimate expectation that SARS would issue a further assessment and that the taxpayer would have objected to such assessment. On this basis, it was held that SARS would suffer no prejudice if a new ground of appeal pertaining to the interest (which was not part of the original objection) was introduced.

SARS took the decision by the Tax Court on appeal to the High Court to determine, amongst others, whether the Tax Court's finding that the taxpayer could challenge the raising of section 89*quat*(2) interest for the first time on appeal was correct.

JUDGMENT

Section 89*quat* makes provision for the imposition of interest on underpayments and overpayments of provisional tax. In respect of the underpayment of provisional tax by a taxpayer, section 89*quat*(2) provides that if the taxable income of any provisional taxpayer exceeds R20 000 (in the case of a company) or R50 000 (in the case of any person other than a company), and the normal tax payable by that taxpayer in respect of such taxable income exceeds the credit amount in relation to that year, interest shall be payable by the taxpayer. This interest is calculated at the prescribed rate on the amount by which the normal tax payable by the taxpayer exceeds the credit amount.

In its determination of the correctness of the Tax Court's decision to allow a new ground of appeal, the High Court considered the Rules of the Tax Court, issued in terms of section 103 of the Tax Administration Act, 2011 (the Rules). Rule 7(2) provides that a taxpayer who lodges an objection to an assessment must –

(a) complete the prescribed form in full; and

(b) specify the grounds of objection in detail including –

(i) the part or specific amount of the disputed assessment objected to;

(ii) which of the grounds of assessment are disputed; and

(iii) the documents required to substantiate the grounds of objection that the taxpayer has not previously delivered to SARS.

In terms of Rule 10, a taxpayer's notice of appeal must specify on which grounds of the objection referred to in Rule 7 the taxpayer is appealing. This rule also states that a taxpayer may not appeal on any ground that constitutes a new objection against a part or amount of the disputed assessment that was not objected to in terms of the objection under Rule 7.

The High Court acknowledged that a court should not be unduly rigid in its approach when deciding whether to allow a new ground of objection only at the appeal stage and stated that the circumstances of each case should be taken into consideration in order to come to a decision in this regard. However, it was also reiterated that it is in the public interest that disputes should come to an end as soon as practicable and that consistently allowing either party to change the basis upon which their case is made would be contrary to the public interest.

The High Court then contemplated the Tax Court's reasoning for its finding that the new ground of appeal pertaining to the imposition of interest could be raised, which finding was based on a legitimate expectation that was created by the letter sent to the taxpayer dated 10 February 2012. However, the High Court found that no evidence to this effect had been presented in the Tax Court such that the finding by that court could be substantiated. In addition, no reasons were advanced regarding why the taxpayer had failed to object to the imposition of interest in terms of section 89*quat*(2).

Ultimately, on the specific facts of this case, the High Court found that the Tax Court had erred in deciding that the taxpayer was entitled to raise the issue pertaining to the interest only at the appeal stage. As such, it was held that the ruling by the Tax Court that the interest be waived was also incorrect.

COMMENT

It is apparent from the judgment that a court has a discretion as to whether or not a new ground of appeal may be raised only at the appeal stage of the dispute proceedings between SARS and a taxpayer. However, taxpayers should always be careful to introduce new grounds of appeal that were not raised during the objection stage of the proceedings.

The interest that is imposed in terms of section 89*quat*(2) will constitute part of an assessment that is issued by SARS. If such interest is not objected to by a taxpayer in their objection, they may be precluded from challenging the imposition of the interest on appeal as such a challenge constitutes a "*new objection against a part or amount of the disputed assessment not objected to under Rule 7*". This is in direct contravention of Rule 10(3) of the Rules.

As such, it is best for taxpayers to object to the imposition of all interest in an objection, even if the assessment issued by SARS does not clearly indicate that interest has been or will be imposed.

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 8A, 8C, 76(1)*(b)* & 89*quat*(2); Eighth Schedule;
- Tax Administration Act 28 of 2011: Section 103.

Other documents

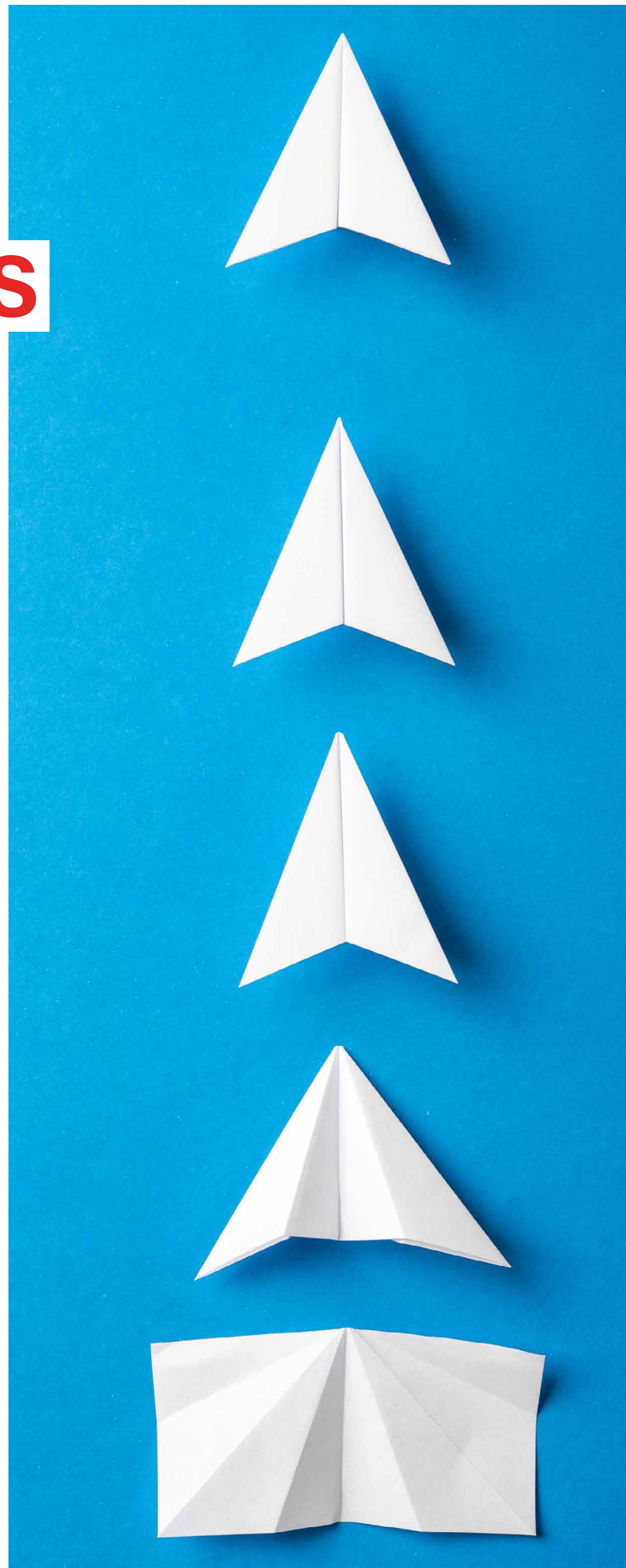
- Rules in terms of section 103 of the Tax Administration Act 28 of 2011: Rules 7(2) and 10.

Cases

- *Commissioner for the South African Revenue Service v The Executor of the Estate late Lot Maduke Ndlovu* [2020] ZAGPPHC 601 (12 October 2020); 2020 JDR 2405 (GP).

Tags: taxable income; additional assessment; underpayment of provisional tax; ground of appeal.

ADVANCE PRICING AGREEMENTS



An advance pricing agreement (APA) is an agreement between a taxpayer and 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 for future years.

On 11 November 2020, SARS released a discussion paper on APAs, indicating its intention to have such a system introduced in South Africa (SA). The release of this discussion paper should be considered against the backdrop of the increased focus by the South African Revenue Service (SARS) on transfer pricing matters and the SA government's call for more foreign businesses to invest in SA.

APAs help to avoid transfer pricing disputes, reduce mutual agreement procedures (MAPs) and create an environment of tax certainty that investors look for before they invest. SA does have an advance tax ruling (ATR) system in place which also attempts to provide tax certainty. An application for an ATR, in relation to the pricing of goods supplied or services rendered to a connected person, is however not properly catered for in terms of this system. As a result the implementation of an APA system has been recommended by the Davis Tax Committee.

The discussion paper notes that it appears as if SA has fallen behind its peers on the African continent when it comes to putting an APA system in place. The paper notes that this is a dent in SA's status as a leader on the African continent and its position as a gateway for foreign investment into Africa. The only other African countries which have promulgated APA legislation are, however, Nigeria, Tanzania and Uganda. It should also be mentioned that the APA programmes in these countries have been largely inactive, with the revenue authorities being hesitant to issue any APAs mainly due to a lack of transfer pricing capacity.

"APAs help to avoid transfer pricing disputes, reduce mutual agreement procedures (MAPs) and create an environment of tax certainty that investors look for before they invest."

"The discussion paper also specifically notes that SARS is still focused on building its transfer pricing capabilities and is not ready to implement an APA system at this stage. SARS notes that it will take three to four years to implement an APA system and suggests a phased approach, given its limited capacity."

Given the capacity constraints at SARS, specifically in respect of highly specialised areas such as transfer pricing, the effectiveness with which it would be able to administer an APA system should also be considered. It generally takes from one to four years for tax authorities, which have already implemented these systems, to negotiate an APA with a taxpayer. The time to resolution of an APA also varies significantly based on the nature of the related-party transaction being considered, the complexity of the proposed transfer pricing method, and the specialisation of the revenue authority's staff involved. Given the current capacity constraints referred to above, it is likely to take much longer for an APA to be concluded with SARS. The discussion paper refers to the possibility that SARS could outsource some of these matters on a temporary basis to obtain the necessary skills in respect of transfer pricing.

The discussion paper also specifically notes that SARS is still focused on building its transfer pricing capabilities and is not ready to implement an APA system at this stage. SARS notes that it will take three to four years to implement an APA system and suggests a phased approach, given its limited capacity. The discussion paper consequently states that it is important to start with the planning and drafting of legislation in this regard as soon as practically possible. A proposed legislative framework for an APA system is set out, which also interestingly refers to SARS' capacity and funding constraints which may require it to charge fees for processing APAs, similar to those being charged for ATRs.

It follows that it may still take a number of years before an APA system is fully implemented in SA, although we may see draft legislation issued in this regard in the near future.

The intention of the discussion paper was to obtain comments from interested parties, which had to be provided to SARS by 18 December 2020. As mentioned above, the effectiveness with which an APA system would be administered by SARS could be questioned. The indication to introduce such a system in SA is welcomed given the benefit of tax certainty which foreign investors require.

Mazars

Other documents

- SARS discussion paper on advance pricing agreements (APAs) – released on 11 November 2020.

Tags: advance pricing agreement (APA); transfer pricing; mutual agreement procedures (MAPs) advance tax ruling (ATR).