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TRANSFER PRICING
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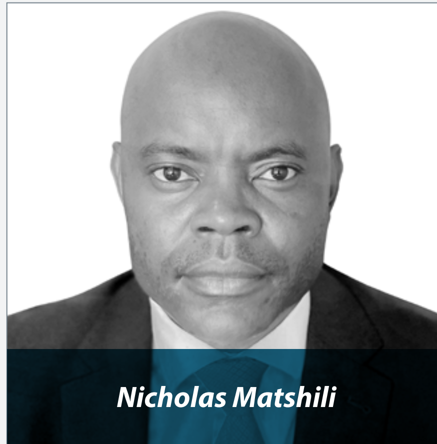

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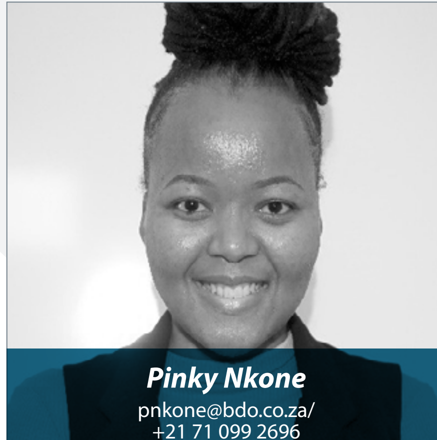

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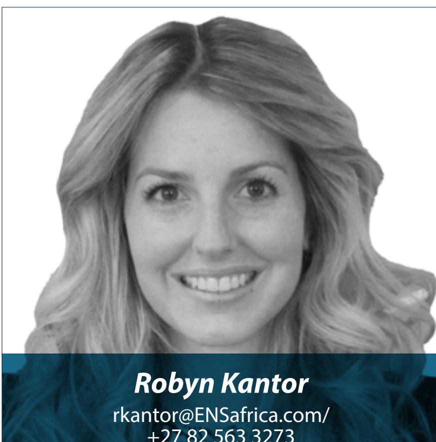

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TRANSFER PRICING IN SOUTH AFRICA AND SECTION 9D . . . WAIT . . . WHAT?

PATRICK McLENNAN, Associate Director at BDO and **PINKY NKONE,** Junior Tax Consultant at BDO

No, transfer pricing did not get its day in court, as section 9D of the Income Tax Act No. 58 of 1962 (ITA) took a lead role in the ongoing tax drama's latest episode brought to us by the Supreme Court of Appeal's (SCA) judgement in *CSARS v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023]. In simple terms, the SCA held that the activities of an Irish company (and controlled foreign company [CFC] of a South African [SA] resident) failed to meet the criteria of a foreign business establishment (FBE); therefore, SARS was correct in imputing the profits of such Irish company for SA tax purposes. So, what does this have to do with transfer pricing? When it comes to FBEs, transfer pricing concepts can certainly play a supporting role.

At the heart of the concept of an FBE are the provisions to exclude the imputation of foreign sourced income in SA. Thus, for multinational enterprises (MNEs) in SA with CFCs, a clear grasp of what defines an FBE is essential to ensure fair taxation, reduce double taxation, mitigate tax uncertainty and, from a commercial standpoint, operate and compete on the global stage.

Criteria for identifying an FBE

Section 9D of the ITA provides the definition of an FBE for SA tax purposes. In a nutshell, an FBE is a fixed place of business located outside of SA, which is used to carry out the operations of a CFC for a minimum of one year when there is a suitable workforce, necessary equipment and resources and suitable facilities tailored to its primary business operations, among other criteria. A simple example that demonstrates the concept of an FBE could be an entity located in Botswana, where a multinational retail chain group based in SA established a store through a subsidiary (Company A), wholly-owned by a SA-resident (Company B). Company A qualifies as a CFC of Company B on the basis of its shareholding. The actual retail operations of Company A are designed to cater to the specific needs and preferences of the local market in Botswana. Company A would set up a retail store, hire local staff, source products from suppliers and comply with Botswana's business regulations.

Operating for over one year, this foreign retail store in Botswana is considered an FBE because it is a CFC (forming part of the legal entity, Company A) of a SA-resident company that operates outside its home country (in this case, outside the country where the group is headquartered). The store's primary operations are to serve the local market in Botswana while contributing to the MNE group's global operations.

"The point of having an FBE and excluding the imputation of any income attributable to such FBE is moot if transactions involving the FBE's activities are not conducted at arm's length"

The link between FBEs and transfer pricing standards

Understanding the nature and criteria of FBEs is essential for businesses involved in cross border transactions. This understanding is foundational for comprehending the essence and standards of transfer pricing, as the allocation of profits based on functions, assets and risks is at the heart of establishing robust transfer pricing arrangements in the MNE context.

The link between transfer pricing and the concept of the FBE appears in sections 9D(9)(b)(i) and (ii) which require, at a high level, that in determining the net income of a CFC, there must not be taken into account any amount which is attributable to any FBE of that CFC and in determining the amount attributable to an FBE:

1. The FBE must be treated as a distinct and separate enterprise engaged in the same or similar activities under the same or similar activities dealing independently of the CFC of which it is a part; and
2. The determination must be made as if the amount arose in the context of a transaction, operation, scheme, agreement or understanding that was entered into at arm's length.

The arm's length principle, put simply, is the terms and conditions (and therefore pricing) that are and would have been agreed between two or more independent persons. Both the concept 'separate entities' and the arm's length principle are enshrined in the Organization for Economic Co-operation and Development (OECD) Model Tax Convention, as well as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). Whereas not expressly mentioned in section 9D, section 31 of the ITA contains the SA rules with regard to transfer pricing. In its own right, Section 31 empowers SARS to adjust prices if they are deemed to deviate from the arm's length principle. With no definition of 'arm's length principle' in the ITA, it would be difficult for taxpayers to argue anything other than the conditions of the arm's length principle as outlined in the OECD Guidelines.

So, in considering a group's tax, and determining SA tax liabilities in the CFC context, it is important to ensure that one's transfer pricing transactions are conducted at arm's length. For purposes of section 9D, the concepts must go hand-in-hand. The point of having an FBE and excluding the imputation of any income attributable to such FBE is moot if transactions involving the FBE's activities are not conducted at arm's length.

SARS *v.* Coronation

The Coronation Investment Management case was a recent court decision by the SCA that has caused much concern among SA taxpayers with CFCs. The case involved an SA asset manager, Coronation and its Irish subsidiary, Coronation Global Fund Managers (Ireland) Limited (CGFM). In considering the facts and circumstances of the case, the SCA relied in part on the information regarding the functions, assets and risks of the contracting parties to the fund management and investment management activities involving CGFM and its related parties. Testimony was provided by industry experts as well as executive management from the Coronation group.

"A clear grasp of what defines an FBE is essential to ensure fair taxation, reduce double taxation, mitigate tax uncertainty and, from a commercial standpoint, operate and compete on the global stage"

Put simply, CGFM was responsible for carrying out certain functions relating to fund management; related parties in SA and the United Kingdom were delegated (or 'outsourced') to perform activities related to investment management and distribution. The SCA ruled that CGFM did not have an FBE in Ireland because the location of its primary functions were outsourced. This means that Coronation had to pay taxes on CGFM's income in SA. The Coronation case is significant because, pending the outcome of the appeal to the Constitutional Court, it has made it more difficult for SA taxpayers to avoid paying taxes on income from foreign companies. It is also a reminder that SA taxpayers should carefully consider the tax implications of owning shares in foreign companies.

- While SARS, in raising the assessment, stopped short of disagreeing with the arm's length nature of the transaction, transfer pricing principles played a role. It is imperative, given SARS' treatment of the FBE rules, that one maintains robust transfer pricing documentation. Furthermore, the disclosures in the documentation should be stress tested to ascertain whether they would stand up to scrutiny in other tax areas (i.e. CFC rules).

Some take-aways

Given the current climate, it is key for taxpayers with CFCs to acknowledge and consider the following:

- SARS' CFC focus: Acknowledge the tax authority's intensified scrutiny on CFCs. It is advisable for taxpayers to periodically assess their offshore operations and seek professional tax guidance when establishing or overseeing offshore entities, maintaining the FBE status.
- Define the subsidiary's business/functional analysis: Clearly specify the subsidiary's intended business activities in the relevant jurisdiction, while also evaluating its resources and workforce to ensure operational efficiency.
- Harmonise with legal and governance documents: Ensure that company records/agreements/ governance documents state business objectives and real business activities.

So, there you have it. Transfer pricing in South Africa, while guided at its core by the arm's length principle as in section 31, also has relevance in other parts of the ITA. The next time someone says that transfer pricing is only two pages (or less) of the Act—let them know it is slightly more.

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EMERGING TRENDS IN TRANSFER PRICING

DR DANIEL N ERASMUS, Chairman at Tax Risk Management Services

Transfer pricing (TP) disputes have always posed challenges to multinational enterprises (MNEs) and tax authorities. The interpretation and implementation of arm's length principles, the backbone of TP regulations, have led to an increasing number of TP disputes across the globe. This article considers emerging trends, emphasising the critical role of TP expert witnesses in any TP dispute.

The significance of TP expert witnesses in TP disputes

A central theme in any TP dispute resolution process is the selection and preparation of a TP expert witness. Such an expert is often called upon to lend their expertise during the trial; however, their participation is required very early in the TP dispute process to aid in finding workable resolutions.

Selecting the right TP expert witness

The onus of proving the arm's length price rests with the taxpayer. It is crucial to choose an expert who possesses the requisite technical knowledge and the capability to present findings credibly in a court environment. Whereas there are many TP specialists globally, only a handful have the experience to serve as an effective expert in such a setting. A list of key considerations in selection follows.

- Availability and commitment: Your chosen expert should be committed and available throughout the dispute resolution process.
- Credentials: An ideal expert should have both formal qualifications and hands-on experience in TP.
- Courtroom experience: Previous courtroom experiences enhance an expert's ability to withstand difficult cross-examination.
- Objectivity: The expert should appear impartial; this strengthens their credibility.
- Communication skills: Given the technical nature of TP, the expert should articulate complex concepts clearly.
- Compatibility: The legal team should have a synergistic working relationship with the expert.

Presenting evidence: Aids for the expert witness

During the evidence presentation, visual aids can be instrumental. Incorporating slide presentations, charts, graphs and diagrams can make technical evidence more digestible. Ensure that the factual foundation of the expert's opinions is accurate and not disputed. Showcasing the appropriate TP method, linked to TP guidelines, will aid the court (or forum) in understanding the significance of the testimony.

Transparency is essential. If there are limitations to the expert's opinions or if assumptions were made, these should be acknowledged upfront. Moreover, experts should strive for clarity by avoiding jargon where possible.

Preparing the TP expert witness for cross-examination

Anticipating potential challenges and areas of attack can bolster the expert's defences. Engaging in role-play sessions and simulated cross-examinations can acclimatise the expert to the courtroom environment. It is also beneficial for the expert to revisit their previous opinions, published works and other experts' reports to prepare comprehensively.

Recent global TP cases and emerging trends

In addition to the role of the expert, the landscape of TP disputes is evolving due to:

- Detailed guidance from OECD and domestic bodies on TP subjects such as business restructuring and intangibles;
- Dedicated audit teams trained in TP with external assistance; and
- TP as an avenue for aggressive tax optimisation, leading to more scrutiny.

Recent landmark cases, for example, the USA Coca-Cola case *(Coca-Cola Co. & Subsidiaries v. Commissioner,* 115 T.C. 145 [2020]) serve as models to prepare for TP disputes, as illustrated in Figure 1 below.

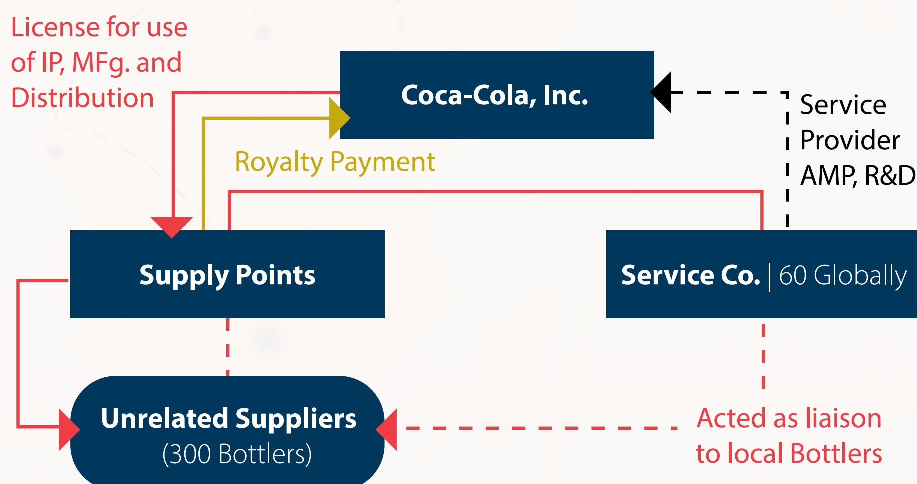

Figure 1: Model of the USA Coca-Cola case.

> *"Transparency is essential. If there are limitations to the expert's opinions or if assumptions were made, these should be acknowledged upfront"*

The court in the Coca-Cola case emphasised the need for coherence between legal agreements and TP policies. The court determined that the Cost-Plus-Method was the appropriate TP method to determine the amounts that the supply points should have paid Coca-Cola for using its intellectual property. The Tax Court found that Coca-Cola's Supply Points were essentially "*wholly-owned contract manufacturers*" executing steps in the beverage-production process and that Coca-Cola, rather than its Supply Points, owned "*virtually all the intangible assets needed to produce and sell*" the company's beverages. Considering these findings, the court concluded that the CPM was "*ideally suited*" to determine Coca-Cola's compensation for the use of its intellectual property.

Recharacterisation

The Canadian Cameco case (*Her Majesty the Queen v. Cameco Corporation, Canadian Federal Court of Appeal*, Case No. 2020 FCA 112 [June 2020]) is an important decision about the recharacterisation of transactions, emphasising the distinction between hypothetical arm's length parties and specific taxpayers. Cameco was a Canadian headquartered uranium producer, refiner and processor. Cameco led a consortium of companies to negotiate purchase agreements for Russian uranium (and over time uranium from other suppliers). Cameco designated what would become its Swiss subsidiary as the signatory to the contracts. At the time, the market price of uranium had been stable for decades but an unexpected jump in the price of uranium resulted in significant profits being realised by Cameco's Swiss subsidiary. The Canadian Revenue Authority (CRA) argued that all the profit should be recognised and taxed in Canada, arguing that: *(1)* the transaction was a sham; *(2)* the transaction should be recharacterised under 247(2)(b) and (d) of the Canadian Income Tax Act ('Act'); or *(3)* the transaction should be repriced under 247(2)(a) and (c) of the Act. The Tax Court rejected all three arguments. The Crown appealed (dropping the sham argument from its appeal). The Canadian Federal Court of Appeal upheld the Tax Court judgement.

The important takeaway from this case is that 247(2)(b) and (d) of the Act do not allow the CRA to simply disregard the separate existence of a foreign subsidiary and tax an entity as if the subsidiary does not exist.

Profit Split Method (PSM)

The Engie case (*Société Engie, Administrative Tribunal of Montreuil (1st chamber)*, Case No. 1812789 [Jan. 14, 2021]) focused on the PSM and its implementation in intercompany transactions. Engie carried out operations on the spot market under an intercompany service agreement. The subsidiaries entrusted their product to Engie, which found customers on the spot market and sold the excess liquefied natural gas. Engie was compensated with a cost +10% remuneration. The French Tax Administration recharacterised Engie as a co-entrepreneur instead of a simple service provider because the functions performed by Engie were over and above that of a simple service provider— Engie made sales on the spot market without receiving instructions from its subsidiaries— and, Engie bore almost all the risks related to the spot activity. Engie had a high value added intangible asset through the master sale and purchase agreement (MSPA) signed with the customers.

The French Tax Administration considered the most appropriate transfer pricing method to be a 50/50 PSM between Engie and its subsidiaries.

In a 2020 decision (Supreme Court of Cassation, Case No. 11387 [Feb. 25, 2020]), the Italian Supreme Court did not challenge the selection of the PSM but its practical determinations, accepting the Tax Office's statement that an additional allocation key (resulting in a higher allocation of profits to the Italian taxpayer) was appropriate. The allocation key related to the maintenance costs incurred by the three companies participating in the PSM, which was adjusted by the revenue authority.

In a Malawi TP unreported dispute, the revenue authority attempted to do the same in respect of contract manufacturing by a subsidiary in the agricultural sector with its associated Swiss enterprise conducting the marketing activities. The writer is lead counsel in this matter, which is due to be set down for trial in the near future. A similar unreported TP matter was argued by the writer in Tanzania and won by the taxpayer. The Tanzanian Tax Authority has not appealed the matter.

The application of the Residual PSM was disputed before the Japanese courts in the NGK case (The Tokyo High Court [appellate court], *NGK* case [NGK Insulators, Ltd.] [Mar. 10, 2022]). A Japanese resident entity manufactured ceramic products. NGK licensed patent and manufacturing know-how to its Polish subsidiary ('Sub A'). Sub A manufactured particulate removal devices (DPF) for diesel engine cars and sold DPF to automobile manufacturers in Europe through another affiliated entity in Germany. As a result of demand driven by new EU regulations and improvements in manufacturing techniques at Sub A, Sub A's profitability significantly increased.

The royalty income from Sub A was thus below the arm's length price. NGK successfully argued that the depreciation expenses of Sub A should also be included in determining the factor for the profit split.

The court acknowledged that there is a factor, other than those relating to important intangible assets (i.e. scale profit), that can be included in the split step under the PSM and that the factor can be split among associated companies relevant to the transaction in the same manner as those related to important intangible assets.

Marketing intangibles

A ruling by the French Supreme Court emphasised the importance of flagship expenses when assessing indirect transfers of profits abroad. Ferragamo France SAS, a French distributor, contributed to the brand value of its foreign-based parent company by incurring those expenses. Its gross margin that was higher than its comparables, but the company suffered operating losses over 13 years. The French Tax Administration noted that the taxpayer's salary costs and some other expenses were significantly higher than its comparables, which led them to conclude that this surplus expenditure was an advantage provided to its parent company. The French Supreme Court ruled against the taxpayer.

Management fees

Management fees and their deductibility have been in dispute in multiple jurisdictions.

The National Court of Spain in *Sierra Spain Shopping Centres Services SLU, National Court of Spain,* Case No. 151/2022 (Jan. 25, 2022) denied the deductibility of fees for strategic management services due to inadequate supporting documentation.

Similarly, the Administrative Court of Appeal of Versailles in *SAS Groupe LAGASSE EUROPE*, Administrative Court of Appeal of Versailles, Cases No. 18VE00059 and 18VE02329 (Jan. 28, 2020) held that invoices alone could not prove the performance of services.

The Tax Court in Zimbabwe in an unreported judgement, delivered a surprising judgement against a taxpayer despite providing evidence of the actual services rendered.

The Italian Supreme Court in *Italian Supreme Court of Cassation*, Decision No. 13085 (June 30, 2020) also emphasised that having an intercompany agreement was not enough to substantiate the effectiveness and benefit of the services to the recipient. A similar argument was advanced by the revenue authorities in Zimbabwe.

Financial transactions

In 2020, the OECD introduced guidance on the transfer pricing aspects of financial transactions for the first time. This was an endeavour to create consistency in the application of transfer pricing.

Elaborating on this, the French Supreme Court in A*pex Tool Group*, French Supreme Court, Case No. 441357 (Dec. 29, 2021) provided insights regarding the kind of evidence a taxpayer can furnish to show that the interest rate of an intragroup loan complies with arm's length principles. The Court opined that the risk profile of a borrowing company should be assessed considering the combined economic and financial situation of the company and its subsidiaries.

German courts (Federal Tax Court of Germany, Case No. I R 19/17, February 19, 2020, Federal Tax Gazette II 2021, 223, and Federal Constitutional Court of Germany, Case No. 2 BvR 1161/19, IStR 2021, 363 [March 4, 2021]) also grappled with similar issues, especially regarding unsecured loans between group entities. Notably, the German Federal Tax Court altered its stance, suggesting that the lack of collateral for a loan does not automatically violate the arm's length principle. Instead, a comprehensive evaluation should be made considering whether a third-party would have offered the loan under similar conditions. This points towards a nuanced understanding of transfer pricing in intercompany financing.

Final remarks

With increased TP audits occurring across the globe, taxpayers should consider alternate dispute resolution processes such as Advance Pricing Agreements, Alternative Dispute Resolution (ADR) processes and Mutual Agreement Procedures (albeit MAPs have not been successful in Africa) to manage their potential TP disputes and prevent revised tax assessments, penalties and double taxation.

Reviewing different TP cases throws light on future TP disputes and creates notable information to consider. For instance, the Coca-Cola case gives detail how to analyse a TP matter, prepare TP documentation, analyse marketing intangibles, ensure that legal agreements are properly executed and ultimately defend against a TP case. In addition, lessons can be learnt from experiences in using TP expert witnesses, which will be required early on in any developing TP dispute.

IS IT TIME YET FOR AMOUNT B TO SHAPE YOUR TAX STRATEGY?

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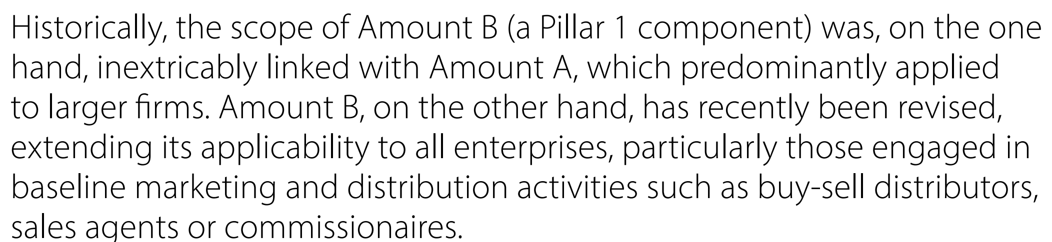

Historically, the scope of Amount B (a Pillar 1 component) was, on the one hand, inextricably linked with Amount A, which predominantly applied to larger firms. Amount B, on the other hand, has recently been revised, extending its applicability to all enterprises, particularly those engaged in baseline marketing and distribution activities such as buy-sell distributors, sales agents or commissionaires.

The purpose of Amount B is to implement measures that simplify and streamline the application of the arm's length principle for baseline marketing and distribution activities within the designated scope and to bring about tax certainty, which includes the establishment of pricing matrices for industry groupings and factor intensities.

The significance of Amount B in simplifying transfer pricing

Whereas Amount A is concerned with the global tax structure as it currently[1] applies to the largest multinational enterprises (MNEs) globally which are profitable, Amount B is concerned with simplifying existing transfer pricing requirements for taxpayers which fall within the envisaged baseline marketing and distribution activities without a revenue or profitability requirement. Amount B's focus is on streamlining transfer pricing rules for baseline marketing and distribution activities only, which are common activities performed by many MNEs. Notably, baseline marketing and distribution activities are the subject of a lot of transfer pricing controversy cases, specifically with low-capacity jurisdictions. Some tax experts argue that a dispute between tax certainty and the arm's length principle lies at the core of Amount B, whereas others may argue that this approach is similar to current analyses which determine an arm's length outcome. According to the Organization for Economic Co-operation and Development (OECD), Amount B is intended to promote tax clarity, minimise compliance and administrative expenses, aid low-capacity jurisdictions and assist with the issue concerning a lack of local market comparables.

Assessing new approaches for qualifying transactions in the scope of Amount B

The new draft report on Amount B envisages a new aspect to determine if a specific transaction falls within the scope of Amount B, labelled as 'Alternative A' and 'Alternative B'. These alternatives aim to address challenges faced by distributors engaged in both baseline and non-baseline activities.

Under Alternative A, a transaction qualifies if the conditions outlined are met, regardless whether the tested party also participates in non-baseline contributions.

Conversely, Alternative B necessitates additional scrutiny to establish whether the tested party indeed undertakes non-baseline contributions, potentially leading to their exclusion from Amount B's application.

[1]It is envisaged that Amount A's threshold will be reduced over time and, as such, more MNEs will soon need to consider Amount A further.

OECD's approach to implementing an arm's length margin: Internal benchmarking and profit level indicators

The OECD is currently conducting an extensive internal benchmarking exercise using data from the BvD Orbis database. The OECD is exploring two methods for implementing potential arm's length margins:

1. Utilising a pricing matrix, which involves the use of relevant indicators (such as asset intensity or the ratio of operating expenses to sales) to calculate a specific margin.
2. Employing a mechanical pricing tool, which examines various profit drivers and determines a margin based on a variety of applied adjustments.

The OECD is considering applying the transactional net margin method, with a return on sales (ROS), also known as operating margin as the price level index (PLI). As a guard rail, the OECD is considering applying a cap and collar approach to pricing baseline marketing and distribution activities. The guardrail is intended to prevent particularly low operating expense intense entities from being over-remunerated under the simplified and streamlined approach and, conversely, particularly high operating expense entities from being under-remunerated under the approach.

This means that the ROS is firstly applied, but then the berry ratio is also considered to ensure that the ROS is within a reasonable range. The cap and collar range is suggested to be set between 1.05 and 1.50, which means that if the berry ratio is less than 1.05 or greater than 1.50, then the ROS is adjusted so that the berry ratio would fall on the respective upper or lower point in that range.

> *"Some tax experts argue that a dispute between tax certainty and the arm's length principle lies at the core of Amount B, whereas others may argue that this approach is similar to current analyses which determine an arm's length outcome"*

Amount B's transfer pricing simplification and its potential implications for South Africa

With the goal of simplification in mind, it is expected that the focus of transfer pricing discussions would move to assessing whether an entity falls in or out of scope of Amount B, depending on what favours an MNE, or tax authority; it is not clear how such a debate would unfold.

Since the specific structure of the final guidelines for Amount B remains unfinished, it is uncertain if the South African Revenue Service (SARS) will accept Amount B, even once it has become an integral part of the OECD Transfer Pricing Guidelines (TPG) and how that would play out with MNEs, which have a presence in jurisdictions that accept Amount B and others that do not. Similar to the low value-adding intra-group services section that was introduced into the OECD TPG, to which SARS has given its reservations.

Some questions also remain about the prospective treatment of carry-forward losses, accumulated by entities that now fall within the ambit of Amount B. The OECD suggests that this is likely going to be addressed by domestic law. However, it is not clear if an entity performing baseline marketing and distribution activities can now operate at a loss, even though unlikely. It is worth emphasising that comparable independent entities may have lower profit margins or could be loss-making for various reasons. For example, these entities may experience supply chain interruptions and challenges because of economic downturns, inflationary threats and currency fluctuations, which all put pressure on already thin profit margins.

It is also essential to emphasise that, in contrast to several other Base Erosion Profit Shifting (BEPS) 2.0 initiatives, Amount B does not incorporate specific financial thresholds. Consequently, it carries the capacity to impact a broad range of MNEs.

Analysing the distinct scopes and interplay of Amount A and Amount B in international taxation

Theoretically, there could only be an Amount B, without Amount A. Politically, that may be a bigger hurdle to overcome. As it stands, the current proposal is for Amount A and Amount B to coexist.

Furthermore, at this stage, Amount A and Amount B seem to lack the expected degree of integration, considering their different legal foundations and scope. The original design of Amount A included the concept of the 'marketing and distribution safe harbour' (MDSH) to prevent double counting of profits in cases where the local jurisdiction already has taxing rights. The MDSH adjustment seeks to address potential overlaps and reduce profit reallocations, thereby avoiding redundancy and ensuring equitable taxation.

Overall, this discussion emphasises the need for a more cohesive implementation approach between Amount A and Amount B as envisioned in the original design, to ensure a seamless and efficient international tax framework. Most will have heard rumours that Amount A is in a state of uncertainty and, even if not formal, tax stakeholders are wondering what this will mean for Pillar 1.

Other conditions and exceptions for Amount B

There are numerous conditions and exceptions to be aware of, key ones include:

- The tested entity should not engage in unrelated activities, with manufacturing, research and development, procurement and financing specifically mentioned.
- In the context of intangibles, the tested entity should refrain from performing 'risk control functions' that would result in assuming economically significant risks associated with development, enhancement, maintenance, protection and exploitation (DEMPE) functions.
- The tested entity should avoid engaging in strategic activities that lead to the creation of unique intangibles.
- Amount B will not be applicable if the baseline marketing and distribution activities are already covered by a bilateral or multilateral Advance Pricing Agreement (APA).

What comes next?

The OECD plans to finalise and complete its work on Amount B by the end of 2023 and to publish the approach in the January 2024 edition of the OECD Guidelines. Although differing views and opinions have been presented, stakeholders are ultimately looking for an easily defined, clear consensus on what Amount B entails and to achieve the main goal of alleviating the tax administrative burden on taxpayers. We are especially looking forward to:

1. Finding a good balance between quantitative and qualitative criteria to define baseline marketing and distribution activities.
2. Assessing the suitability of:
   - The implementation of the framework for distributing wholesale digital goods;
   - Country-specific adjustments within geographic markets; and
   - The criteria for using Amount B through local databases in specific jurisdictions.

UNRAVELLING THE ESSENTIALS OF COMPENSATING ADJUSTMENTS: UNDERSTANDING, IMPLEMENTING AND OPTIMISING

▶ **ROBYN KANTOR,** Tax Manager at ENSafrica

The terms 'compensating adjustments' and 'year-end adjustments' refer to adjustments made by entities to align their year-end figures with their transfer pricing policy. Tax authorities generally accept compensating adjustments, particularly when they are made in accordance with an appropriate transfer pricing policy.

What is a compensating adjustment?

Compensating adjustments, which essentially are economic reallocations of revenues and/or costs among entities within a multinational enterprise (MNE), are often used to align the profitability of limited risk profile entities because these entities' remuneration is tied, in particular, to an arm's length targeted net margin. When this is affected, compensating adjustments would ensure consistency with the arm's length principle. Compensating adjustments are intended to allow entities to calculate their income tax according to the arm's length principle and do not necessarily imply a change in the cash position of the entities involved.

The purpose

The purpose of a compensating adjustment is to ensure that payments between connected persons or associated entities are in line with the arm's length principle. Such an adjustment is made if significant circumstances change and if the original payments were not at arm's length.

Performing an adjustment

Paragraph 4.38 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022 (OECD TP Guidelines) states that "*[c]ompensating adjustments may facilitate the reporting of taxable income by taxpayers in accordance with the arm's length principle, recognising that information about comparable uncontrolled transactions may not be available at the time associated enterprises establish the prices for their controlled transactions. Thus, for the purpose of lodging a correct tax return, a taxpayer would be permitted to make a compensating adjustment that would record the difference between the arm's length price and the actual price recorded in its books and records*."

Therefore, compensating adjustments are usually made before the tax return is filed and are typically done on a yearly basis, although monthly or quarterly adjustments can also be performed. Compensating adjustments can be performed in various ways and they can either be adjusted upward (i.e. an increase in income or reduction of expense) or downward (i.e. reduction of income or increase in expense). For tax purposes, while upward adjustments would generally be taxed, certain downward adjustments may only qualify for a tax deduction if certain conditions are met.

Double taxation and compensating adjustments

Article 9 of the OECD Model Tax Convention on Income and on Capital, 2017 (OECD Model) addresses adjustments to profits that may be made for tax purposes where transactions have been entered into between associated entities (parent and subsidiary companies and companies under common control) on other than arm's length terms.

Economic double taxation, which refers to taxation of the same income in the hands of different persons, can arise from the adjustment of transactions that are not at arm's length between associated entities. An entity of which the profits are revised upward in one state will be liable to pay tax on an amount of profit which has already been taxed in the hands of its associated entity in the other state. With the aim of relieving double taxation, this latter state should make an appropriate adjustment (downward adjustment) to the entity's profits. This downward adjustment is not made automatically, but only if the latter state considers that the amount of adjusted profits correctly reflects what the profits would have been if the transactions had been carried out at arm's length.

Paragraph 6 of the Commentary on Article 9 of the OECD Model states that the latter state is committed to making an adjustment of the profits of the affiliated company only if it considers that the adjustment made in the former state is justified "*both in principle and as regards the amount*".

Paragraph 4.39 of the OECD TP Guidelines further states: "*If compensating adjustments are permitted (or required) in the jurisdiction of one associated entity but not permitted in the jurisdiction of the other associated entity, double taxation may result because corresponding adjustment relief may not be available if no primary adjustment is made. The mutual agreement procedure (MAP) is available to resolve difficulties presented by compensating adjustments and competent authorities are encouraged to use their best efforts to resolve any double taxation which may arise from different jurisdictional approaches to such year-end adjustments*."

Therefore, should a dispute arise between the jurisdictions concerned over the amount and basis of the appropriate adjustment, a company may apply for a MAP under Article 25 of the OECD Model if there is a relevant tax treaty between both jurisdictions.

"First and foremost, it is of utmost importance to ensure that a thorough and robust functional analysis has been performed and transfer prices are constantly being monitored in order to intercept any deviations throughout the group's value chain"

Advance pricing agreements (APAs) are another way of minimising tax risk. APAs offer a chance for tax authorities and taxpayers to have constructive discussions and to avoid or prevent litigation that would have uncertain results. South Africa has recently recognised the importance of offering taxpayers greater certainty and predictability in their tax affairs through the recently proposed APA programme through the Tax Administration Laws Amendment Bill, 2023 (TALAB).

Secondary adjustments

Secondary adjustments may be applied where they are permitted under domestic laws, meaning that where an adjustment is made to an amount paid by a resident company, the amount will be subject to the withholding tax.

Impact on other taxes

When transfer prices are adjusted, MNEs need to consider the effects on customs duties and potentially other indirect taxes, i.e. VAT.

Customs duties

- If the TP adjustment has a corresponding impact on the transaction value of the goods, e.g. if a price increase was required, there is an obligation in terms of section 67 of the Customs and Excise Act to make an adjustment to the declaration of value for purposes of customs duties to avoid penalties and fines. If the customs value is increased by the reported adjustment for TP purposes, the increased duties must also be brought to account by passing a voucher of correction and the SARS records corrected in that manner.
- If the TP adjustment has a corresponding impact on the transaction value of the goods, e.g. if the TP adjustment results in a decrease of the price, the customs duties paid would have been too high and the taxpayer would then have to submit a voucher of correction to correct the previous declaration and submit a claim for a refund of the excess duties paid if this is permitted by the relevant legislation.

VAT

- The VAT Act does not provide specific rules about TP adjustments made under section 31 of the Income Tax Act 58 of 1962 (the SA Income Tax Act). However, adjustments under section 31 of the SA Income Tax Act may require corrective actions by the taxpayer to ensure compliance with the provisions of the VAT Act.
- For example, where goods were imported for the first time, VAT would have been paid on the value thereof for customs duty purposes. An upward adjustment to the value of the goods will result in additional VAT being payable on the increased value for import VAT purposes.

Key considerations

The following aspects should be considered in order to manage taxpayer voluntary compensating adjustments and help prevent future disputes with tax authorities.

- First and foremost, it is of utmost importance to ensure that a thorough and robust functional analysis has been performed and transfer prices are constantly being monitored in order to intercept any deviations throughout the group's value chain.
- Prepare and maintain contemporaneous transfer pricing documentation, which accurately delineates the factual arrangements and information related to inter-company transactions. Ensure that benchmarking studies are updated and consistent with changes occurring to the business model (if any).
- Ensure that compensating adjustments comply with transfer pricing requirements aligned with the business perspective and that the taxpayer is able to explain the reasons why the previously estimated prices did not correspond to the arm's length principle.
- The compensating adjustment must be made symmetrically in the accounts of the associated entities. This is to avoid double taxation or double non-taxation. (i.e. one taxpayer increases the taxable income and the other decreases it by the same amount).
- Unless the TP adjustments arise from APAs or MAPs agreed with the tax authority, the best way to eliminate double taxation and mitigate controversy is to ensure that the TP adjustments are made in a timely manner.

Conclusion

Transfer pricing compensating adjustments serve as a crucial mechanism in the realm of MNE business operations, allowing companies to rectify and align their inter-company transactions with arm's length principles. These adjustments play a pivotal role in mitigating the risks of transfer pricing disputes and fostering transparency in cross-border transactions. Understanding, implementing and documenting these adjustments are essential for companies to achieve a harmonious balance between global tax obligations and operational success.

CONSIDER THIS – 'CORRESPONDING ADJUSTMENTS'

▶ **CHRISTIAN WIESENER,** Associate Director at KPMG

The South African Revenue Service (SARS) raised R11.9 billion in respect of cases involving international tax and transfer pricing matters during the 2021/2022 financial year.[1] Similarly, other revenue authorities around the globe have included tax revenue from transfer pricing adjustments in their collections.

However, a transfer pricing adjustment in one country made unilaterally in that country results in double taxation, which is unfair and costly for the taxpayer; it inhibits free trade between countries. Agreements for the avoidance of double taxation (DTAs) are designed to remove double taxation.

Introduction

Transfer pricing has been a focus area for both Multinational Enterprises (MNEs) as well as Tax Authorities, including South Africa and other African countries. This has led to an increase in transfer pricing audits. The outcome of a transfer pricing audit often is a transfer pricing adjustment, which results in additional income tax payable as well as, potentially, a secondary adjustment,[2] penalties and interest.

Transfer pricing adjustment

A South African resident taxpayer involved in cross-border intragroup transactions is obligated to transact at arm's length. This taxpayer must transact with its foreign group company at the same level as if this foreign group company were an independent third-party. If the taxpayer fails to do so, that is, if the relevant transaction is not at arm's length and there is a (South African) tax benefit for one of the parties in the transaction, then the taxable profit of the taxpayer must be calculated as if the transaction had been entered into at arm's length. This adjustment to the taxable income is referred to as a (primary) transfer pricing adjustment.

For example, if a taxpayer sells goods to its foreign-related group company for R100 million but it is then established that an arm's length price for these goods would have been R110 million, and SARS makes a transfer pricing adjustment to reflect the correct income (R110 million), then the taxpayer will be subject to additional tax payable in South Africa on the R10 million additional sales, that is, R2.7 million at a corporate income tax rate of 27%, together with potentially other tax, penalties and interest.

Similarly, a transfer pricing adjustment may also be made in the country where the other party to the transaction is a resident.

It should be noted that a transfer pricing adjustment can be made by the tax authority or the taxpayer with different implications depending on the transfer pricing rules applicable.

Corresponding adjustment

The term 'corresponding adjustment' is defined in the glossary of the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as follows:

[1]Commissioner for SARS Edward Kieswetter, SARS' 25th anniversary revenue results announcement, by TimeLIFE, 2 April 2022.

[2]A secondary adjustment is an adjustment that arises from imposing tax on a secondary (constructive) transaction after a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. South Africa is one of a few countries levying secondary adjustments. In South Africa, the secondary adjustment takes the form of a deemed distribution of an asset in specie and dividends tax at 20% is accordingly levied.

"An adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent."

Thus, the purpose of a corresponding adjustment is to provide a mechanism to ensure that the profits of two related parties are not taxed twice where a transfer pricing adjustment is made in one of the two jurisdictions.

For example, a South African taxpayer charged its foreign group company, which is based in the UK, R50 million for goods sold but an arm's length price would have been R40 million. It is assumed that in this scenario, SARS taxed R50 million; however, the UK's tax authority reviewed the UK entity's tax affairs and only allowed R40 million as deduction. Thus, R10 million was taxed in both South Africa and the UK. To have this remedied, the South African entity can approach the competent authority and apply for a compensating adjustment in terms of Mutual Agreement Procedure to have the taxable profits reduced in South Africa by R10 million to R40 million.

It should be noted that often tax authorities will not entertain Transfer Pricing Mutual Agreement Procedure requests if the transfer pricing adjustment is self-effected, that is, not by the tax authority. In addition, a corresponding adjustment would not apply to a secondary adjustment.

Mutual Agreement Procedure

Article 9(2) of the OECD Model Tax Convention on Income and on Capital (the most recent version was released in 2017) is included in South Africa's DTAs and provides for the mechanism to achieve this corresponding adjustment. The mechanism is provided in terms of Mutual Agreement Procedure by the two competent authorities, experienced officials at the tax authority or government.

In terms of DTAs entered into by South Africa which follow the OECD Model Tax Convention on Income and Capital, the article following Article 9(2) of the OECD Model Tax Convention on Income and Capital, however, does not consistently provide that the competent authorities 'shall' make an appropriate (compensating) adjustment. Thus, this suggests a discretion on the side of the competent authorities. Therefore, given that Mutual Agreement Procedure is a process between the competent authorities and while a taxpayer may initiate the process to which it is not part, i.e. does not have the ability to influence, Article 9(2) in the pre- 2017 version does not give sufficient certainty to a taxpayer and makes the Mutual Agreement Procedure process less desirable. However, this position changed with the update to Article 9 of the OECD Model Tax Convention from 2017; the BEPS Action 14 minimum standard provides that jurisdictions should provide access to MAP in transfer pricing cases. Although South Africa's DTAs were not automatically updated and renegotiation of a DTA can take many years, the introduction of the Multilateral Instrument (MLI) was an important development.

"Thus, the purpose of a corresponding adjustment is to provide a mechanism to ensure that the profits of two related parties are not taxed twice where a transfer pricing adjustment is made in one of the two jurisdictions"

The Multilateral Instrument – Fast implementation of DTA provisions

As part of its Base Erosion and Profit Shifting (BEPS) project, the OECD released a 15 BEPS Actions Plan in order to counter tax avoidance and make the global international tax environment more fit for purpose. Action 15 of the BEPS Action Plan concerns the MLI. The MLI is a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting designed to implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by MNEs.[3] Specifically, the purpose of the MLI on a high level is the prevention of treaty abuse and the improvement of dispute resolution mechanisms.

The MLI entered into force on 1 July 2018 and, for South Africa, on 1 January 2023. South Africa listed 76 tax treaties under its MLI Position. In addition, 5 tax treaties will not be covered (Germany, Malawi, Grenada, Zambia, and Sierra Leone [Germany, Zambia, and Malawi are being renegotiated—Grenada and Sierra Leone do not meet the requirements]).

It is important to note that different countries agreed to different aspects as set out in the MLI and countries have the option to make reservations. This means that one needs to carefully assess what the ultimate rules applicable will be, considering the existing DTA and the MLI positions taken by both countries with regard to a transaction. To assist with this, the OECD published the BEPS MLI Matching Database. It presents detailed up-to-date information on the application of the BEPS MLI to tax treaties. While the specific legal texts reflecting the MLI positions taken by each country must be considered, the Matching Database is a useful tool.

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[3] *https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.*

It should be noted that 50 of the 76 jurisdictions listed by South Africa have ratified the MLI and as of 1 January 2023, the BEPS MLI covered 100 jurisdictions.

Article 17 of the MLI deals with corresponding adjustments and it implements the BEPS Action 14 minimum standard which provides that jurisdictions should provide access to MAP in transfer pricing cases.

Corresponding adjustments – Article 17 of the MLI

Article 9 as per the 2017 version of the OECD Model Tax Convention on Income and Capital has been updated in line with the BEPS 15 Action Plan to reflect that a competent authority 'shall' make a corresponding adjustment if the requirements are met. However, prior versions including those reflected in many double taxation agreements entered into by South Africa contain the word 'may', which suggests a much softer approach and a discretion by the competent authorities.

The BEPS Action 14 Report pointed out that it would be important for jurisdictions to provide for countries to ensure that Mutual Agreement Procedure on transfer pricing is available to taxpayers to assist in dealing with corresponding adjustment matters.

Therefore, Paragraph 1 of Article 17 of the MLI provides for a corresponding adjustment where a tax authority makes an adjustment in the other country. From a South African perspective, Paragraph 1 of Article 17 is in line with Article 9(2) of the 2017 OECD Model Tax Convention on Income and Capital and it applies to the replacement of an existing Article 9(2) provision in a covered tax agreement that does not follow the 2017 wording; or, where an article equivalent to Article 9(2) of the OECD Model Tax Convention on Income and on Capital does not exist, it introduces a corresponding adjustment provision of the DTA. Thus, this should consistently result in DTAs providing for a Mutual Agreement Procedure mechanism for corresponding adjustments, provided the other jurisdiction has ratified the MLI and a covered tax agreement with South Africa.

An example where a DTA contains an article similar to Article 9(2) of the OECD Model Tax Convention on Income and on Capital exists, is South Africa's DTA with the UAE, but the relevant clause states 'may'. The DTA with Brazil, however, does not include such a clause at all. In both matters the MLI would incorporate the 2017 provisions.

Conclusion

Easy access for taxpayers to a competent authority in order to pursue Transfer Pricing Mutual Agreement Procedure to address double taxation issues suffered from a transfer pricing adjustment in the other country, is important to achieve tax certainty and to encourage investment and support international trade. Article 17 of the MLI is therefore a useful development for South Africa to achieve this. However, it should be noted that the taxpayer must carefully consider the use of the Mutual Agreement Procedure route for corresponding adjustments, as it will set precedent and it will also require an adjustment to Transfer Pricing policies in order to avoid repeatedly having to engage in the Mutual Agreement Procedure.

EXPERIENCE
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ORIGINAL THINKING

TIGHTENING THE SCREWS ON CROSS-BORDER DEBT

▶ **STEVEN BRESLIN,** Associate Director at Deloitte

In this article, I will be discussing the concept of 'indirect' financial assistance from a thin capitalisation perspective. During 2023, the South African Revenue Service (SARS) issued further guidance to taxpayers in the form of the final Interpretation Note 127 (IN 127) on the concept of inbound financial assistance, be it in the form of loans, guarantees, securities and other forms of debt.

SARS' IN 127 summarises the concept of 'indirect' financial assistance under paragraph 4.1.1. as follows:

- SARS is of the view that the wording of section 31 is wide enough to not just encompass a loan between two of the parties specified in paragraph (a) of the definition of an 'affected transaction' but takes into account the chain of borrowing entities, including the ultimate borrower.
- Indirect financial assistance may include, but is not limited to:
  - *back-to-back transactions* with *banks or other financial institutions* (e.g. one in which a non-resident MNE places funds on deposit with a bank and the bank then loans funds to a South African resident Multinational Entity [MNE]);
  - the *provision of guarantees* by a non-resident MNE to a bank or other financial institution in connection with funding given by that bank or financial institution to a resident MNE; or
  - *other arrangements* in which funding provided by a foreign relevant party is *routed through one or more special purpose entities* or other accommodating or tax-indifferent parties.
  - In general, indirect financial assistance will be treated as if the funding had been provided *directly between the two relevant parties*.

Based on the preceding summary, this article will look further into transactions referred to as 'other arrangements' and SARS' view of how these transactions should be dealt with for thin capitalisation purposes and resultant challenges from a taxpayer's perspective stemming from SARS' viewpoint.

A typical related party loan funding scenario can be illustrated by using the following example. During 2023, *Company A*, the parent company of a multinational group which is tax resident in the United Kingdom (UK), provides loan funding of R100 million to *Company B*, a holding company which is tax resident in South Africa, which, in turn, on-lends the entire loan amount to *Company C*, an operating company which is tax resident in South Africa. The terms of the loan funding include an interest rate of 10% per annum; the loan is unsecured and is repayable at the end of 2025. Furthermore, we can assume that both *Company B* and *Company C* are loss-making entities and that a thin capitalisation analysis has indicated that both companies can be considered to be thinly capitalised at their financial year end for 2023. In addition, we also assume the taxpayer referred to SARS' IN 127 for guidance when determining which of the South African entities will need to be tested for thin capitalisation purposes, referred to as a debt capacity analysis.

The flow of a loan funding transaction is presented in Figure 1 below.

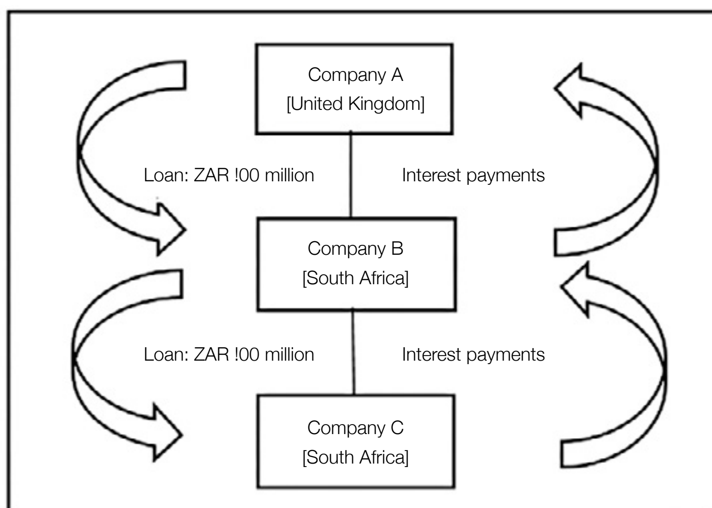

Figure 1: Flow of a loan funding transaction

Based on the example above, we will look at the following examples:

- Example 1: Back-to-back loan arrangement: Where Company A lends funds to Company B, which then on-lends the funds to Company C and
- Example 2: Loan arrangement with amended terms and conditions: Company B changes the terms and conditions of the loan funding arrangements prior to providing funding to Company C.

Example 1: Back-to-back loan arrangement

Company B does not change any of the initial terms and conditions of the loan funding when on-lending the funds to Company C.

In this example, I have tried to highlight the guidance provided by SARS in the IN 127 and, in particular, under paragraph 4.1.1., which deals with indirect financial assistance together with various examples illustrating SARS' view of this assistance, but at the same time falls short of identifying which of the entities in relation to this example will need to be assessed for thin capitalisation purposes. As such, the following scenarios may arise:

- Whether to assess Company B's thin capitalisation position;
- Whether to assess Company C's thin capitalisation position; or
- Whether to assess both Company B and Company C.

In other words, which entity will SARS consider as the applicable entity for assessing the thin capitalisation at year end? Therefore, without any further guidance on this issue, I have illustrated what I consider to be the potential thin capitalisation implications arising from each scenario listed above.

"It is evident from the analysis above that there is currently a level of uncertainty regarding the SARS' view on how it defines indirect financial assistance for thin capitalisation purposes which, in turn, creates challenges for taxpayers when trying to analyse their thin capitalisation position on a regular basis"

Assessing Company B's thin capitalisation position

In this scenario, SARS may consider Company B to be selected as the appropriate party for assessing thin capitalisation due to the fact that the transaction between Company A and Company B may be considered as an 'affected transaction (without regard to paragraph (b) of the definition), since the transaction took place between a tax non-resident connected person and a South African tax resident company. If so, the following tax implications may occur, assuming the entire loan is disallowed:

- Primary adjustment: 27% of R10 million.
- Secondary adjustment: 20% of R10 million
- Withholding tax on interest: Double Taxation Agreements (DTAs) typically do not offer withholding tax relief on the excessive portion of the loan funding; therefore, a withholding tax rate of 15% will apply (15% of R10 million).
- The above amounts to a total potential tax liability of R6.2 million.
- Please note that other finance costs such as arrangement fees or costs in relation to the inbound loan funding, will also form part of the primary and secondary adjustments.

Assessing Company C's thin capitalisation position

Although Company C does not transact directly with Company A, would SARS nevertheless consider, in a scenario where the loan funding arrangement is a 'back-to-back' arrangement, whether Company C is the appropriate party for being assessed for thin capitalisation? In addition, would SARS then consider Company B as acting in an intermediary capacity in relation to the funding transaction? If so, then the following tax implications may occur, assuming the entire loan is disallowed:

- Primary adjustment: 27% of R10 million.
- Secondary adjustment: 20% of R10 million.
- Total potential tax liability for Company A of R4.7 million.
- Please note that other finance costs, such as arrangement fees or costs in relation to the inbound loan funding, may also form part of the primary and secondary adjustments.

Assessing both Company B and Company C

Alternatively, would SARS expect taxpayers to assess both Company B and C for thin capitalisation purposes at year-end, i.e. could SARS require that thin capitalisation adjustments be made by both entities? It could be argued that this treatment would not be fair and does not make sense as it would effectively expect adjustments to be made by two South African legal entities in respect of single inbound cross-border loan. However, based on the wording of the IN 127, the possibility of this approach being required cannot altogether be excluded.

A further point to be considered is whether, even if the primary and secondary adjustments are made by Company C and not by Company B, the withholding tax relief is still available in respect of the interest paid by Company B to Company A. It could be argued that the interest paid by Company B is still excessive (even though the primary and secondary adjustments are not made in its hands because the transaction is treated as financial assistance made to Company C) and, therefore, that Company C cannot claim such relief.

Example 2: Loan arrangement with amended terms and conditions

In this example, Company B changes the interest rate on the loan funding arrangement to 15%, also includes other terms of the loan which are different to those of the loan from Company A and avails the loan funding to Company C in the form of a revolving credit facility.

In this scenario, it seems more probable that SARS may consider selecting Company B as the applicable party for assessing its thin capitalisation position as the company does not act as an intermediary but instead performs financing-type functions. Furthermore, a supporting fact is that the actual cross-border related party transaction takes place between Company A and Company B. Nevertheless, there is currently still some level of uncertainty regarding SARS' view regarding the treatment of this type of transaction as SARS does not give definitive guidance on what indirect financial assistance encapsulates and therefore, there is currently no definitive answer.

Notwithstanding the facts mentioned above, should SARS consider testing Company B for thin capitalisation purposes, the following tax implications may occur, assuming the entire loan is disallowed:

- Primary adjustment: 27% of R10 million.
- Secondary adjustment: 20% of R10 million.
- Withholding tax on interest: The Double Taxation Agreement (DTA) does not offer withholding tax relief on the excessive portion of the loan funding; therefore, a withholding tax rate of 15% will apply (15% of R10 million).
- Total potential tax liability for the group of R6.2 million.
- Please note that other costs such as arrangement fees or costs in relation to the inbound loan funding, will also form part of the primary and secondary adjustments.

It is evident from the analysis above that there is currently a level of uncertainty regarding the SARS' view on how it defines indirect financial assistance for thin capitalisation purposes which, in turn, creates challenges for taxpayers when trying to analyse their thin capitalisation position on a regular basis. Therefore, it is imperative that going forward, SARS provides more definitive guidance on their views regarding indirect financial assistance and how it applies to similar funding arrangements as discussed in this article.

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REGIONAL AFRICAN TRENDS IN TRANSFER PRICING AUDITS

VALDIS LEIKUS, Executive Director at Graphene Economics

In November 2023, the Organization for Economic Co-operation and Development (OECD) released Revenue Statistics in Africa 2023[1]. The report underscores the financing challenges facing African countries as a result of the COVID-19 pandemic, which have resulted in widespread increases in borrowing and debt service costs. Interestingly, the report indicates that tax-to-GDP ratios remained below pre-pandemic levels in 17 of the 33 African countries covered in 2021, widening the gap between tax-to-GDP ratios in Africa and other regions.

This indicates that revenue authorities will continue focusing on collection of tax revenues through tax audits. Transfer pricing is no exception in this regard. Even though there is no official publicly released data, most multinational enterprises and tax advisors would agree that transfer pricing audits are on the rise and are becoming more frequent. This article summarises five key trends observed over the last several years from the author's experience and from discussions with various stakeholders.

[1]OECD/AUC/ATAF (2023), Revenue Statistics in Africa 2023, OECD Publishing, Paris, https://doi.org/10.1787/15bc5bc6-en-fr.

Trend No. 1: Intra-group service transactions are still high on the radar of tax authorities

Historically, intra-group service transactions have always been a 'low hanging fruit' for tax authorities, i.e. these transactions were frequently challenged, especially from the perspective of a company receiving these charges and claiming deductibility of costs for income tax purposes. Tax authorities continue to challenge intra-group service transactions, especially those involved in providing centralised support such as management support services, technical support or shared support services. The good news is that more and more African tax authorities acknowledge that the receipt of management support within the multinational group has a commercial rationale (historically, tax authorities used to argue that charging for intra-group services is just a mechanism to erode the local company's tax base). Even though it becomes less common to deny deductibility of the full cost of intra-group services recognised by the service recipient, tax authorities still challenge taxpayers on these transactions, especially if the charge for these transactions makes up a significant cost to the taxpayer. Typical reasons for making an assessment may include the following:

- The service recipient company cannot prove that services were actually rendered;
- The service recipient company cannot prove that it has requested these services and that they are not duplicative of the functions performed by locally employed personnel;
- The service recipient company cannot prove that services cannot be purchased locally;
- Allocation keys used to determine charges for various support activities are not aligned with the consumption of services by service recipients;
- Certain activities would not benefit the local company, therefore, these costs are either reclassified as shareholder costs or as incidental benefits; and
- Charges are based on budgeted financial information and there is no consideration of actual costs.

In light of the above, it is imperative that taxpayers develop a robust transfer pricing model for charging intra-group services and collect supporting information contemporaneously.

"In light of the above, it is imperative that taxpayers are comfortable to defend transactions entered into with their related parties in these jurisdictions"

Trend No. 2: Focus on more complex/unique intercompany transactions

An emerging trend in recent transfer pricing audits is the focus on more complex and unique intercompany transactions, especially if they are material to the local company's tax base. For example, transactions involving intellectual property (franchise concept or use of internally developed technology platforms) are scrutinised more often, transfers of assets and rights are reviewed from a transfer pricing perspective and transactions based on cost contribution arrangements are being challenged. Through various initiatives, such as Tax Inspectors Without Borders, tax authorities are getting more upskilled in tackling these complex transactions.

In light of the above, taxpayers must ensure that any complex or unique transactions have robust transfer pricing analysis and supporting documentation in place.

Trend No. 3: Challenging a point in an arm's length range derived from a benchmarking study

In order to meet transfer pricing requirements, taxpayers often require performing or updating benchmarking studies, which assist in testing the price or profitability of their intercompany transactions. Tax authorities always challenged benchmarking studies performed by taxpayers. The approach taken by tax authorities was usually to perform their own benchmarking study and adjust the taxpayer's profit markup or margin accordingly. However, more recently, some tax authorities have been focusing on benchmarking studies that have been performed and have looked to reject certain comparables to cause the range to change. They then target the median of the range and make an adjustment to that point.

For taxpayers, this means that they need to ensure greater levels of scrutiny on searches performed. In particular, it must be ensured that accepted comparables are reliable and that they can be defended. Also, it is important to carefully consider where the taxpayer is within the range. In most cases, any point within the interquartile range should be fine. However, if the taxpayer's result deviates significantly from the median of the range, additional considerations should be given to justify the point in the range.

Trend No. 4: The rise in exchange of information

When performing transfer pricing audits, tax authorities are more frequently requesting for information from other tax authorities. These requests are made to confirm the information provided by the taxpayer or where the taxpayer refuses to provide information or cannot provide it due to confidentiality purposes. The exchange of information might take place even in the absence of bilateral tax information of exchange agreements between the governments (tax administrations) of two jurisdictions, which enables them to exchange tax information upon request.

For multinational companies operating in various African jurisdictions, this means that they need to ensure the consistency of information submitted to tax authorities in relation to their intercompany transactions and applicable transfer pricing policies.

Trend No. 5: Transactions with perceived low-tax jurisdictions are likely to be scrutinised from a substance perspective

Intercompany transactions with perceived low-tax jurisdiction such as Mauritius, United Arab Emirates, Switzerland, Singapore, Hong Kong and similar jurisdictions still attract the attention of tax authorities. However, tax authorities no longer focus on the pricing of intercompany transactions only. They investigate whether companies in these low-tax jurisdictions are fully staffed and assume/manage risks related to intercompany transactions. If tax authorities determine that there is not enough substance in these jurisdictions, they look to make an adjustment to transfer prices agreed between the taxpayer and its related party .

In light of the previous paragraph, it is imperative that taxpayers are comfortable to defend transactions entered into with their related parties in these jurisdictions. If the perceived low-tax jurisdictions lack substance, taxpayers should consider reviewing and adjusting transfer pricing models to align them with local and international transfer pricing legislation and regulations.

As can be seen from these trends, transfer pricing audits will continue to be on the rise and will become more rigorous. As information requested by tax authorities during transfer pricing audits gets longer, taxpayers could be more proactive and put safeguards in place to be audit ready. For example:

- Review of transfer pricing models—taxpayers should constantly review and scrutinise their own intercompany transactions to ensure that they can withstand the scrutiny from tax authorities. It must be noted that Africa has its own operational challenges, therefore, global transfer pricing policies might have to be adapted to this region.
- Build a defence file—in order not to scramble with information that must be provided to tax authorities during the transfer pricing audit, taxpayers should start developing the defence files contemporaneously, which would include supporting information that is likely to be requested by tax authorities.
- Prepare the local company personnel—during transfer pricing audits, tax authorities often undertake interviews with local personnel to better understand the company's activities as well as how intercompany transactions relate to the company's business activities. If the company's personnel is not prepared, tax authorities may take certain responses out of context and make assessments on intercompany transactions without reviewing documentary evidence.

TUG OF WAR WITH THE TAX MAN: TIGHTENING THE GRIP ON THE DISPUTE RESOLUTION PROCESS

NICO THERON, Managing Director at Unicus Tax Specialists SA and
HOPOLANG MOLLO, Junior Tax Consultant at Unicus Tax Specialists SA

Not too long ago, securing a positive result for a taxpayer in a tax dispute was relatively easy. In fact, at one point in time, the South African Revenue Service (SARS) was conceding to over 90% of appeals, according to the office of the Tax Ombud. In our experience, this is no longer the case.

Disputes which, less than two years ago, would probably be resolved at the latest by settlement or agreement during alternative dispute resolution (ADR), now appear more likely to proceed to litigation. In fact, in our experience, lately, 'simple' issues of condonation for late objections/appeals have also become a more regular subject of dispute that progresses far into the dispute resolution process before the merits of a case are even considered. This is contrary to the position in the not-so-distant-past, in which, according to the findings of the Tax Ombud, SARS was allowing late objections and appeals in the vast majority of cases at the first asking.

In addition, the grounds on which SARS is raising assessments also seem to be improving, as it becomes more common practice for SARS auditors to seek legal opinions, be it internal or external, for raising assessments and considering objections—mental prowess thus being the order of the day in a tug-of-war with the tax man.

Why is this happening?

While sharing insights on the future of taxation for South Africa, during the 'PSG Think Big Series' held in February, the Commissioner for SARS suggested that SARS is neither in favour of wealth tax nor an increase in tax rates. Rather, SARS will be focusing on what he called 'compliance dividends'. To many, this seemingly meant that SARS was going to focus on getting their dues from what may be best described as 'full-blown tax dodgers'.

"Backing off from a case is not something that should necessarily be done because SARS is perceived to be always right nor should taking on a case because SARS is perceived to be always wrong"

While this may be the case, it certainly also appears to mean that SARS is making more of an effort to find the 'ostensibly compliant taxpayer' wanting and holding on to their assessments more tightly by closely analysing their tax positions and subsequently, if necessary, raising such in accordance with the tax laws (or at least trying to), being more aggressive in keeping taxpayers to time limits and procedures and not easily allowing objections or accepting settlement offers.

How to deal with it

Winning a dispute no longer simply requires moving papers around and filling out a form. Tax disputes, even as early as in the objection phase have, in many cases, turned into a full-blown battle of facts and/or law.

It should, then, come as no surprise that having a chance of winning an objection or appeal nowadays requires, for a start, a solid understanding of the law and the facts. The relevant law, in broad terms, consists of two main parts, as it were: substantive law and procedural law. Substantive law is the tax law that regulates the relevant assessment or decision, for example, the Income Tax Act or the Value-Added Tax (VAT) Act, etc. Procedural law is the law that governs the process, for example the Tax Administration Act (TAA) and the dispute resolution rules. In the past, one could achieve pretty good results in the dispute process with a limited knowledge of substantive law and almost none of procedural law—not anymore.

The facts are what the evidence proves they are. People often tend to struggle with disputes due to an unsubstantiated understanding of the facts. Allow us to give some perspective on this statement. For example, saying in an objection that an amount is not received by the taxpayer for the purposes of gross income as defined in the Income Tax Act because there is no beneficial receipt by the taxpayer, means nothing unless you have the evidence to show the cognisable legal context which prevents beneficial receipt.

Once you have the law and the facts under control, you need to be able to read and interpret what SARS is saying about the facts and the law. Stated differently, you need to understand what the grounds for their assessment are by reading their grounds. Probably the biggest part of your job, when it comes to dispute resolution, is to displace the grounds for SARS' assessment. Stated differently, you must show, with relevant evidence, that the facts upon which SARS is relying are incorrect or that their interpretation of the law is incorrect or that both are incorrect. If you do not understand their grounds for assessment, you are likely to miss your target and lose the case.

Then comes the writing and layout of your objection. Writing an argument that is solid in both facts and law and that is also crisply laid out in a convincing manner is not only an art but an essential part of securing a win. Bear in mind that, especially in the early stages of dispute resolution (i.e. at the objection phase), taxpayers rarely have an opportunity to explain anything verbally. Rather, taxpayers must submit a written objection.

SARS can only read what you wrote down (as opposed to reading your mind) and what you think you wrote may not be what can be understood from your writing, especially if you are not used to writing legal documents. The importance of being able to write well is further highlighted by the fact that the person in SARS who will read your objection has to explain your grounds to an objection committee who, in turn, makes a decision. This means that someone must read what you have written down, understand it, summarise it, and then convey it to other people who must make a decision. Suffice it to say that there is much room in this process for misunderstanding, even more so if your arguments are not well presented and laid out.

In addition, the first person you must convince with your objection (i.e. the first person to read your objection) is often the very person who raised the assessment in the first place. Think realistically about that for a second: the auditor works on raising the assessment, often for months on end; what you are effectively doing is trying to undo all (or some) of that work. Suffice it to say that convincing writing and presentation of evidence is crucial.

Understanding (and accepting) the power imbalance

The bar set by the legislature for SARS to raise additional assessments is relatively low compared to what the taxpayer must do to overturn the assessment or secure a reduced assessment. It is what it is. The sooner this is accepted, the sooner the quality of objections and appeals will increase.

One of the biggest mistakes made in drafting objections is that taxpayers simply turn SARS' logic on its head, so to speak, in an objection and expect this to suffice. Allow me to explain by way of a simple example. If SARS does a reconciliation between bank deposits and what was declared over a three-year period and finds under declarations in two years and over declarations in another, taxpayers argue that if SARS' approach was good enough to raise an additional assessment, then it must also be good enough to issue a reduced assessment. In most cases, it is not good enough for a reduced assessment. Is it fair? Perhaps not, but nobody cares. Why? Because unlike what may have been the case in the past, disputes (even as early as in the objection phase) are not about basic logic or fairness but about the facts and the law; not allowing a reduced assessment in my example is often perfectly in line with the law.

The reality

The fact is that objections and appeals have always been only about the facts and the law. The only difference between what we are seeing now and what may have been the case in the past is that SARS appears, on a larger scale and sooner in the dispute resolution process, to be enforcing this fact more strictly. Indeed, then, SARS appears to be tightening its grip on the dispute resolution process and, in doing so, may very well be able to cash in more 'compliance dividends'.

This, however, does not mean taxpayers should not be entering into the dispute resolution process. What it does mean is that being successful in the dispute resolution process requires specialist skills. If you don't rope in tax dispute resolution experts, don't be surprised if you find yourself ending up with a knife in a gunfight.

Having experts on hand who are just as adept at the law and facts as SARS officials, puts taxpayers in a position to fight fire with fire. It also avoids inadvertent breaches of public trust and unnecessary disputes. In our experience, taxpayers, in the absence of guidance to the contrary, tend to believe SARS officials because, after all, they are SARS and SARS' people are expected to be tax experts. This mindset is probably caused by the public trust that SARS enjoys (which, indeed, a revenue authority ought to enjoy). In our experience, the reality is that mindset does not always serve taxpayers well because SARS is quite simply not always right. Backing off from a case is not something that should necessarily be done because SARS is perceived to be always right nor should taking on a case because SARS is perceived to be always wrong. The facts and the law determine whether a case is to be pursued or abandoned, nothing else.

Gone are the days where disputes are won or lost based on what is logical in the mind of the taxpayer, their advisors or SARS. SARS appears to be tightening its grip by trying to focus only on the law and the facts, and fairly so. The authority's job is to collect taxes and part of that job, I guess, means not easily allowing objections or appeals by defending their assessments just as vigorously as the taxpayer is trying to overturn these.

To really break free of SARS' tightening grip, you need to buckle down, keep your focus on the facts and the law and use it skilfully. Failing this, you may find your case buckling and eventually breaking under their grip.

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TRENDS IN JUDICIAL CASES IN TAX ADMINISTRATION

30 minutes CPD

JULIA CHOATE, Senior Associate at Bowmans

Recent years have seen a number of landmark decisions and the emergence of prominent trends and principles shaping tax administration in South Africa, just over a decade after the promulgation of the Tax Administration Act 28 of 2011 (TAA).

Perhaps the most striking trend is that of the Constitutional Court hearing tax disputes with ever increasing frequency, usually on appeal from the Supreme Court of Appeal (SCA).

Previously, the Constitutional Court's influence over tax disputes was limited to those matters which concerned specific constitutional principles such as *Metcash Trading Ltd v Commissioner, South African Revenue Service and Another* 2001 (1) SA 1109 (CC), in which the constitutional validity of the 'pay-now-argue-later' principle was tested and confirmed; or, *Marshall and Others v Commissioner for the South African Revenue Service* 2019 (6) SA 246 (CC), where the court confirmed, in dismissing SARS' appeal, that SARS Interpretation Notes do not constitute binding precedent.

Following the amendment of section 167(3) of the Constitution to expand the court's jurisdiction to hear matters which raise an "*arguable point of law of general public importance, which ought to be considered by that Court*", a steadily growing stream of matters have been making their way to our apex court for reconsideration.

The first of these 'new era' judgments was handed down in *Big G Restaurants (Pty) Limited v Commissioner for the South African Revenue Service* 2020 (6) SA 1 (CC), where the court agreed to hear an appeal concerning the interpretation of section 24C of the Income Tax Act 58 of 1962, on the basis that this was a purely legal issue which affected a number of taxpayers across different industries in South Africa. The Constitutional Court has also dismissed a fair number of appeals, particularly where it has determined that the point being raised on appeal is a point of fact, rather than law. It is incumbent on the appellant's counsel to demonstrate that the section 167(3)(b)(ii) factors are met, in other words, that there is a point of law in dispute, which is arguable and of general public importance.

Although the distinction can be difficult to draw, it follows that the Constitutional Court will only hear matters where the dispute centres around the interpretation of legislation and not the correct application of the law to a specific set of facts, which also raises a matter of general public importance. Given that tax legislation is generally of broad application to the tax base or at a minimum, to a class of taxpayers (e.g. '*employers*' as defined in the Fourth Schedule to the Income Tax Act), it is likely that the former consideration will be the determining factor in whether or not the Constitutional Court hears a tax dispute on appeal from the SCA.

"There is arguably an element of inherent unfairness in taxpayers having to follow this lengthy and convoluted process while incurring significant costs which, from a tax perspective, are neither refundable nor deductible, in order to dispute an assessment which should ultimately be set aside..."

There are currently a number of tax appeals pending before the Constitutional Court, including at least two matters where the Constitutional Court will be asked to interpret the term 'bona fide inadvertent error' in the context of understatement penalties and up to four matters relating to the determination of the High Court's jurisdiction to entertain judicial review applications in respect of tax assessments.

These latter cases arguably reflect a recent and somewhat concerning trend in tax administration, being the apparent limitation of taxpayers' administrative law rights in the context of disputed tax assessments.

Historically, in *Metcash Trading Limited v Commissioner for the South African Revenue Service and Another* the Constitutional Court confirmed that the "*tailor-made mechanism for redressing complaints about the Commissioner's decisions*", which is now contained in Chapter 9 of the TAA (being the objection, appeal and Tax Court litigation process) does not oust the High Court's jurisdiction to entertain review applications brought by a taxpayer with a purely procedural or otherwise administrative law-based grievance.

In a series of pre- and post-TAA judgments, the High Court concluded that it could adjudicate review applications dealing only with a point of law (*Rossi and Others v Commissioner for the South African Revenue Service* (2010/34417) [2011] ZAGPJHC 16), but that where the issue in dispute ultimately rested on a question of fact, the matter should be referred back to the Tax Court as the specialist forum created to adjudicate tax disputes (*Ackermans Limited v Commissioner for the South African Revenue Service* (2015) 77 SATC 191). In *South Atlantic Jazz Festival (Pty) Ltd v Commissioner for the South African Revenue Service* (2015) 77 SATC 254, the High Court confirmed that the Tax Court has the necessary jurisdiction to hear tax appeals founded on administrative law principles, such as the legality of an additional assessment.

Whereas the scope and ambit of the High Court's review jurisdiction may seem like an academic or theoretical question, the answer may well hold serious practical and financial implications for taxpayers.

The Chapter 9 dispute resolution process is internally adjudicated by SARS until the matter reaches Tax Court litigation stage. This usually takes a minimum of 18–24 months (but often much longer, in practice), having regard to the timeframes provided for in the TAA. This process can also involve significant costs to the taxpayer, who is required to engage advisors and counsel to argue the matter in the Tax Court.

There is arguably an element of inherent unfairness in taxpayers having to follow this lengthy and convoluted process while incurring significant costs which, from a tax perspective, are neither refundable nor deductible, in order to dispute an assessment which should ultimately be set aside, regardless of the strength of SARS or the taxpayer's arguments on the merits of the matter, on the basis of the administrative law rights afforded to each person in terms of section 33 of the Constitution.

"Viewed against the prevailing socioeconomic and political landscape in South Africa, the impact these trends may have on tax morale and voluntary compliance should not be lightly disregarded"

For the time being, the SCA has settled the debate as regards the 'review jurisdiction' of both the High Court and Tax Court in a series of decisions handed down in 2023, beginning with *Commissioner for the South African Revenue Service v Rappa Resources (Pty) Ltd* [2023] ZASCA 28. In this matter, the taxpayer had launched an urgent application in the High Court seeking to review and set aside VAT assessments raised by SARS. Crucially, the taxpayer had not disputed the additional assessments using the Chapter 9 internal dispute resolution process but had argued that the procedural deficiencies in the assessment process were sufficient to merit the assessments being set aside on review, without any interrogation of the substantive aspects of the matter.

The SCA found that the purpose of section 104 read with section 105 of the TAA is to ensure that the Tax Court hears tax disputes; thus, the default position is that tax assessments should be disputed in accordance with the Chapter 9 process (objection and appeal). The SCA held further that section 105 of the TAA requires that taxpayers must first apply to the High Court for a direction that it has jurisdiction to hear a proposed review application and that the High Court should only exercise the discretion to hear review applications in respect of tax assessments where 'exceptional circumstances' are present. Since the taxpayer had not taken this initial step in Rappa, the SCA dismissed the taxpayer's appeal.

In *United Manganese of Kalahari v Commissioner for the South African Revenue Service* [2023] ZASCA 29, decided the next day and with reference to the judgment in Rappa, the SCA confirmed this principle. Most recently, in *Commissioner, SARS v Absa Bank Ltd and Another* [2023] ZASCA 125, the SCA reiterated that the discretion afforded to the High Court by section 105 of the TAA can only be exercised favourably in exceptional circumstances. Since the dispute in Absa turns on the application of the General Anti-Avoidance Rules (GAAR), which is a highly factual question, the matter was referred back to the Chapter 9 dispute resolution process.

These decisions arguably narrow the scope of taxpayers' administrative justice rights considerably. Whereas it is correct that the Tax Court, as a specialist forum, is both the most appropriate court to hear tax disputes and is also capable of adjudicating purely legal tax disputes founded in PAJA or the principle of legality, curtailing taxpayers' access to the High Court (a far more expedient remedy than prosecuting a matter all the way through the Chapter 9 dispute resolution process) strikes a discordant note, particularly when viewed against the considerable power imbalance which already exists between taxpayers and SARS. Any other person whose rights are materially and adversely affected by the unlawful, unreasonable or unfair exercise of public power has immediate recourse to the High Court to review the affected decision, whereas taxpayers are required to progress through an often frustrating and unnecessarily protracted internal dispute resolution process that may well exhaust their resources and appetite for litigation long before the matter is heard in an independent and impartial forum such as the Tax Court.

In *Trustees of the CC Share Trust and Others v Commissioner, SARS* ZAGPPHC 597, the High Court has already interpreted the requirement of 'exceptional circumstances' as set out in *Rappa Resources*, to exclude a dispute that turns wholly on a point of law, finding that something more is required to justify the High Court having jurisdiction to entertain a review application in respect of an assessment.

A fourth judgment concerning the High Court's review jurisdiction, which may also come before the Constitutional Court on appeal, is *Forge Packaging Proprietary Limited v The Commissioner for the South African Revenue Service* ZAWCHC 119. Although it predates the abovementioned SCA judgments, this matter was decided on the same basis as Rappa, United Manganese, and Absa regarding the interpretation of section 105 of the TAA.

However, *Forge Packaging* raises another interesting issue outside of the question of the High Court's review jurisdiction: whether a SARS verification process is subject to the same administrative justice principles as SARS' audit powers contained in sections 40–42 of the TAA.

In this dispute, the taxpayer had submitted information to SARS in response to a verification notice. Following the taxpayer's submissions, SARS raised additional assessments impacting three separate years of assessment, which included significant understatement penalties.

The taxpayer initially disputed the matter using the Chapter 9 dispute resolution process but instead of filing its Rule 32 Statement in the Tax Court proceedings, brought an application in the Tax Court for the review and setting aside of the additional assessments. SARS, in turn, sought to have the proposed review application set aside as an irregular step in terms of the Tax Court Rules.

The taxpayer sought to have the additional assessments set aside on the basis that SARS was required to comply with the notice and comment process set out in section 42 of the TAA. The taxpayer argued that SARS had exceeded the scope of a verification process and was, in fact, conducting an audit.

The court refused the review application on the basis that the issue of whether or not SARS should have followed the section 42 process was not purely one of law. The court held that in order to determine whether the exercise was a 'verification' or an 'audit', the parties would have to refer to the factual evidence, canvassing the steps actually taken by SARS leading up to the issuing of the additional assessments. The court expressed the view that if the appeal were capable of determination on a purely legal basis without the need to interrogate the facts, the taxpayer would not be prejudiced by the time taken to bring the matter before the Tax Court.

Arguably, a trend in tax administration emerging from recent judgments is the curtailment of taxpayers' rights in favour of SARS being entitled to robustly administer its various powers. Viewed against the prevailing socioeconomic and political landscape in South Africa, the impact these trends may have on tax morale and voluntary compliance should not be lightly disregarded.

Certainly, taxpayers need to exercise caution when choosing a litigation strategy to avoid costly mistakes and unnecessary delays in the dispute resolution process.

15 minutes CPD

SARS tax debt collection: External collectors to fill the fiscal pothole?

▶ **JASHWIN BAIJOO,** Head of Strategic Engagement & Compliance at Tax Consulting SA

You have a historic tax debt which you simply cannot afford to settle in full, so you reach out to SARS in the hopes of being granted either a payment arrangement or a Compromise of Tax Debt. You have tried the call centre to no avail, so your next port of call was logging into the SARS website and following the step-by-step guide on handling a debt query.

It is now months later and your plea for help to contactus@sars.gov.za has gone unanswered. You then receive a call from a private debt collector advising you of how the debt will be recovered if you fail to pay over what is due—panic sets in; there goes your festive budget, maybe even your retirement policy if you are not careful.

Many South Africans may soon find themselves in this position, especially in light of the current economic climate—here is what you need to know and do!

Compliance keeps the collectors away

As a proactive and legal measure, tax return filing obligations must always be met. SARS has little patience for late submission and the monthly levying of administrative penalties will commence once the filing deadline has passed; in some instances, SARS does permit slight extensions. These are recurring penalties of approximately R250 per outstanding tax return on a monthly basis.

While this may not sound like a heavy price to pay for your non-compliance, the monthly administrative penalties can quickly rack up, where multiple returns are outstanding for an extended period of time. Practically, we have seen this climb, as the excerpt below illustrates.

To top it all off, there are also potential underpayment / understatement penalties that SARS imposes, together with interest. Over time, this can land you with an insurmountable tax debt, for which you bear the full liability!

Summary Information: Penalty Account	
Administrative Penalty Assessment	81 750,00
Closing Balance	**81 750,00**

Figure 1: Example of a penalty assessment

> *"A word to the wise: when you receive a final demand at the beginning of the collection process, your high hope that it will go away is nothing more than a fantasy. With the fiscus low on finances, SARS is aggressively and proactively pursuing collections, which start with a final demand"*

SARS' internal collection measures

Where you have failed to meet your tax debt payment and/or filing obligations, do not think SARS has missed this beat; you may think that you are safe as SARS has not collected against your tax debt. . . yet. This may be because you have been making some nominal payments or simply that your debt is ripe for handover to external collectors.

Remember, SARS is a strategic mover and currently has its focus on the 'low-hanging fruit', being the most prevalent tax debt. This does not mean SARS will not work its way through to you while allowing interest upon interest to accrue.

SARS has been consistently increasing the pressure of its collection measures with final demands sent to taxpayers for each and every debt owed. With the follow-through on non responsiveness becoming more drastic, collection proceedings can include, but are not limited to:

- Collection of an outstanding tax debt via third-party appointment, i.e. employer, bank or debtor of the taxpayer;
- Taking a civil judgement against the taxpayer, including potential credit bureau blacklisting; and
- Attachment and auction of taxpayer assets to satisfy the tax debt owed to SARS.

A word to the wise: when you receive a final demand at the beginning of the collection process, your high hope that it will go away is nothing more than a fantasy. With the fiscus low on finances, SARS is aggressively and proactively pursuing collections, which start with a final demand. What this is, in substance, is a formal letter demanding full payment of your tax debt within ten business days, failing which, quick and effective collection of the debt will proceed.

> According to the records of the South African Revenue Service (SARS) you have failed to comply with final demand dated **2023/06/14.**
>
> As a result of your failure to comply, a certified statement setting out the amount of tax payable was filed with **Kimberley High Court** and a civil judgement was entered against you on **2023/09/06.** A copy of the judgment is enclosed.
>
> Unless your total tax debt specified in the judgment is paid within 10 business days from the date of this **notice, a** warrant of execution will be issued for the Sheriff of the Court to attach and sell your assets.

Figure 2: Example of notice about non-compliance issued to the taxpayer

In recent times, we have not only seen more aggressive collections in terms of incessant emails and calls from SARS' Debt Management Team, but also a drastic increase in the number of civil judgements taken against taxpayers in debt to SARS. It has become clear that after the ten days have lapsed, SARS is under no obligation to notify you before acting on the threat of collection!

Legitimacy of the call

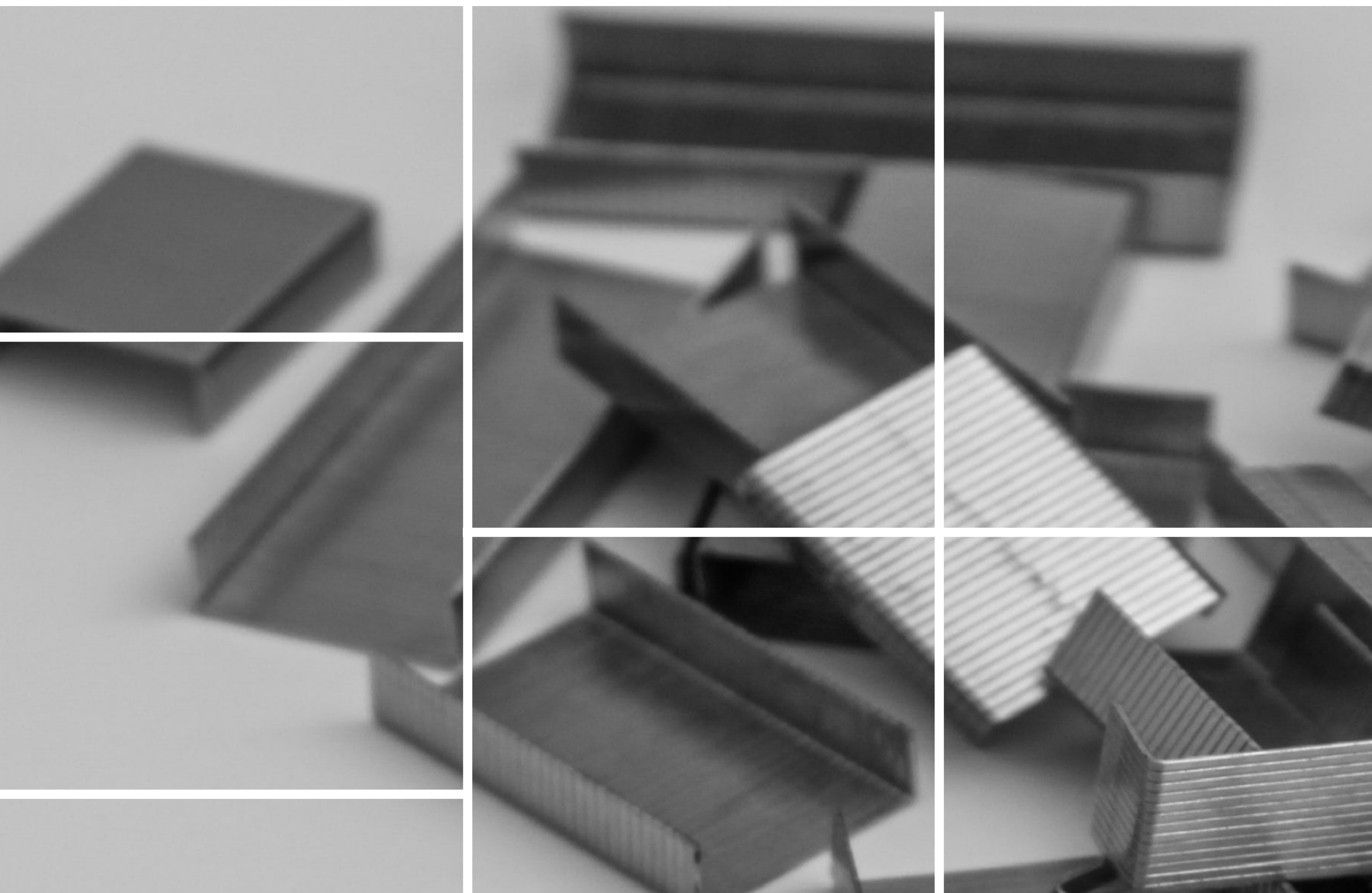
Now, where every weapon forged in SARS' arsenal has failed, that is when the outsourcing begins. Whilst taxpayers may find it odd to receive a call from a debt collector rather than from SARS itself, this is because SARS is outsourcing its debt collections. The parameters for this exercise are that the tax debt must be overdue for more than five years and no interim payments have been received. Further, the indebted taxpayer must not have entered into any payment arrangement discussions with SARS.

SARS made their announcement to outsource collections very publicly in August 2023, advising that the handover process would start in October 2023. As a last-ditch attempt at debt recovery before handover, SARS did issue numerous letters of Intention to Handover to indebted taxpayers.

While unconventional and potentially viewed as threatening by taxpayers, SARS did what was only fair and fired a warning shot.

> **Dear Taxpayer**
>
> **NOTICE OF INTENTION - HANDOVER TO EXTERNAL DEBT COLLECTORS**
>
> **According to our records your account is overdue and no active payment or attempts to make payment arrangements have been made.**
>
> **SARS has repeatedly contacted you, and the most recent letter of demand detailed options for resolving your debt; however, according to our records, you have failed to settle your account or approach us to secure payment terms.**
>
> **Failure to make payment arrangements or to settle your debt urgently upon receipt of this letter shall result in your account being handed over to external third-party debt collectors that SARS is currently appointing.**

Figure 3: Excerpt from Notice of Intention—Handover to External Debt Collectors



Unconventional, yet effective

Receiving a 'Notice of Intention—Handover to External Debt Collectors' definitely is not the surprise gift you hoped for when approaching the festive season. However, this is not the first time SARS has outsourced its debt collections.

According to SARS, as stated at the 10th Annual Tax Indaba hosted by the South African Institution of Taxation, these Notices have not gone unanswered and have yielded some collections to fill the fiscal pothole. From a market perspective, this is most likely based purely on taxpayer fear of being handed over.

From SARS' comments on the Indaba discussion, titled 'SARS Debt Collection', as facilitated by Keith Engel, CEO of SAIT, the procedure would be handed over to external collectors, where SARS has hit a stone wall on collecting.

Although individual taxpayers seldom have a debt situation anywhere near that of corporate taxpayers, this new strategy adopted by SARS will aid in alleviating pressure on the fiscus. In light of an approximately R28 billion decline in Corporate Income Tax Collection at the end of the 2nd quarter 2023, this may be the ace SARS has up its sleeve to recover.

Keeping the collectors at bay

When faced with an insurmountable tax debt problem, there are proactive steps which can be taken to prevent not just the handover to debt collectors, but also to facilitate your financial rehabilitation! We have seen, in select cases, some empathy shown by the revenue authority, where a large tax debt has snowballed and become wholly unaffordable to the taxpayer. In most instances, this is either due to interest and penalties having mounted or to an adverse shift in financial circumstances.

"Remember, SARS is a strategic mover and currently has its focus on the 'low-hanging fruit', being the most prevalent tax debt"

Taxpayers wishing to rectify historical non-compliance by means of voluntarily approaching SARS, either to rectify prior under-declarations, inaccurate losses or to settle their outstanding tax debts to the revenue authority in an attempt to ensure both current and future compliance, do have access to specifically tailored solutions from a legal standpoint.

The Compromise of Tax Debt ('the Compromise') is one such solution; it is aimed at aiding taxpayers in financial distress, both individual and corporate, to reduce their tax liability by means of a Compromise Agreement ('the Agreement'), which is entered into with SARS.

Where SARS is approached correctly, a tax debt can be reduced, and the balance paid off in terms of the Compromise, allowing some much-needed breathing room and helping taxpayers all over the country to become tax compliant, granted that their financial circumstances warrant this.

Once the Compromise is accepted by SARS and the agreement duly executed with payment made as proposed by the taxpayer, the balance of the liability due to SARS is written-off by the revenue authority.

Prevention is better than cure

In order to protect your financial interests from unopposable collections, it remains the best policy that you always ensure compliance. Where you find yourself on the wrong side of SARS, there is a first-mover advantage in seeking the appropriate tax advisory and legal support.

This will ensure that necessary steps are taken to protect yourself and your economic interests from falling victim to SARS' Collections Team or, even worse, being handed over for external debt collection!

As a rule of thumb, any and all correspondence received from SARS should be immediately addressed by a qualified tax specialist or tax attorney. This will not only serve to safeguard your financial interests against SARS implementing collection measures, but also ensure that you are correctly advised on the most appropriate and affordable compliance strategy!

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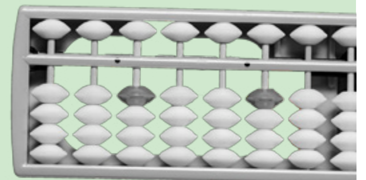

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SARS' usage of third-party data to ensure compliance with tax obligations

▶ **CECILE DIEDRICKS,** Consultant at SAIT

The usage of third-party data sources by the South African Revenue Service has increased in recent years. The process of collecting third-party data started many years ago when it was born out of the vision of the SARS leadership at the beginning of its modernisation process, which started in 2007/2008.

At the time, the vision of the leadership was to provide the SA taxpayer, one day, with a fully completed return where the only thing that was needed to be done on the side of the taxpayer was to sign and accept. The purpose of this is twofold in that it simplifies the completion process for many taxpayers and it helps to prevent taxpayers from hiding information from SARS. At the time when this was announced, SARS had only just released the first dynamic returns in Adobe format. The assessment process was not even fully automated and many returns were still received manually. The turnaround time of the assessment process was still 60–90 days. At that time, it almost seemed like a laughable prospect and a pie-in-the-sky dream. Nonetheless, SARS slowly began achieving this vision. Starting with the collection of third-party data from banks, insurers, financial institutions, medical aids, etc. This was a mammoth task and SARS has stabilised the systems and processes over the years until all the information could be submitted with very few glitches.

At the same time, SARS introduced a data processing engine that could track the demographic information of the taxpayer, helping SARS to identify who was related to whom, who was a representative of which company and what the nature of the relationship was. This process fell under the broad heading of single registration. The main intention behind this was to build a complex relationship database where income could be tracked and accredited to a specific person, thereby ensuring that income was not moving between family members who perhaps had lower income brackets.

Third-party data collection fine-tuned

What we then started seeing over the years was SARS third-party databases growing progressively to the point that this information was being used in the assessment processes and by auditors to confirm whether all income and expenditure were being declared. SARS then focused its attention on the Pay As You Earn (PAYE) system and started insisting that taxpayers have their IRP5s corrected at source. This was the beginning of what is currently in production at SARS. SARS has locked the IRP5 for editing on the ITR12 tax return and has forced the changes to be made at the source with the employer. With the PAYE process in place, SARS then applied the same principle to other third-party sources, thereby forcing the taxpayer to ensure that the underlying source data on the return is corrected rather than merely correcting this on the ITR12. This appears to be the approach that SARS is going to keep going forward.

Third-party data collection expanded

Many taxpayers are still under the impression that they can still hide their earnings from SARS. What they do not realise is that SARS already has access to many government departments' records such as the Deeds Office , eNatis and Home Affairs. Coupled with this is the implementation of information-sharing between countries for the purposes of tax administration. "*This information is required by law (US Foreign Account Tax Compliance Act (FATCA) and the OECD Common Reporting Standard [CRS]) to be collected by financial institutions around the world for reporting to tax authorities. Tax authorities will exchange this information to help make sure everyone pays the right amount of tax. The three forms of information exchange between tax authorities are spontaneous exchange, exchange of information on request (EOIR) or automatic exchange of information (AEOI). AEOI involves the systematic and periodic transmission of 'bulk' taxpayer information by the source country to the residence country concerning various categories of income. In addition, information concerning the acquisition of significant assets may be used to evaluate the net worth of an individual, to see if the reported income reasonably supports the transaction. As a result, the tax authority of a taxpayer's country of residence can check its tax records to verify that taxpayers have accurately reported their foreign source income or assets. Thus, AEOI has a deterrent effect on tax evasion and promotes voluntary compliance.*" (taken from the SARS website on AEOI). However, taxpayers still believe they can get away with not reporting overseas bank accounts or income earned outside of SA. The world is getting smaller and SARS will be making full use of these agreements in future when they have the capacity to process this information and attribute it to the correct taxpayer.

Third-party reporting and the beneficial owner

Further to this massive drive that SARS is spearheading towards fully prepopulated returns, it has now focused once again on refining the relationship network, which started during the single registration process. SARS started with the trust return by capturing the information of the beneficiaries of a trust. This process has further been expanded; it now requires the information of the beneficial owners of all legal entities. Although this process was not a SARS initiative and rather stemmed from the changes in the laws about Anti-Money Laundering and Combating Terrorism Financing, these new requirements also benefit SARS. SARS can now clearly see who the beneficial owner of a company or trust is. With the advent of the introduction of third-party reporting on trust distributions made to beneficiaries (the IT3(t)), one can easily see that this component of the ITR12 will now be prepopulated—yet another move to a fully prepopulated and correct automated assessment by SARS.

Third-party data and the future

Most recently, SARS announced its intention to integrate payroll systems into its processing engines, thereby alleviating the need for the EMP201/501 submission processes. All of this falls under the banner of the SARS 2024 vision, which is to become a "*future revenue authority informed by data-driven insights, self-learning computers, AI and interconnectivity between people and devices*".

> *"Lifestyle audits will become the norm for SARS, especially when it has a holistic view of the taxpayer's income"*

Taken from the monthly PAYE submission bank reconciliation statement (BRS), the following has relevance: "*The SARS PIT/PAYE journey to end state is to replace the current employees' tax, provisional tax and assessment filing seasons for employers and individuals by a modern, fully automated process of near real-time tax liability estimation, withholding and paying to SARS of the correct tax due. This would be underpinned by a taxpayer account that reflects taxable events and 3rd party data in real time (or close to real-time), in a manner that allows SARS to transition all their value chain activities (like verification & disputes) to real-time*". This is going to completely revolutionise the employer and individual filing seasons. SARS is going to begin with the PAYE system by implementing a monthly reporting process straight from the payroll data into SARS systems. This data, coupled with the third-party data received from banks and other institutions, will result in a near real-time assessment and payment model, thereby eliminating the chance of fraudulent tax submissions. Let us not forget the VAT modernisation initiative, where SARS intends to integrate invoice data into their systems, which will then inform the VAT return submission. Many may think that this process may not impact the Income Tax processes but this may prove to be an incorrect assumption. This information may be used to inform the ITR14 and sole proprietor's tax returns.

Conclusion

SARS has been gathering more and more third-party information from different sources by integrating and collecting data from other government departments, building a rigorous demographic and relationship management system and coupling this with the automatic exchange of information agreements with foreign countries. Consequently, a fully prepopulated and correct automated assessment becomes more and more achievable.

SARS will disclose income sources, both foreign and local, to the taxpayer. Things that most taxpayers think they can hide from SARS will now be presented to them in a fully automated return. SARS' ability to identify non-compliant taxpayers becomes a simple matter in future.

Lifestyle audits will become the norm for SARS, especially when it has a holistic view of the taxpayer's income. It will be easier for SARS to see that a taxpayer is hiding an income source when it compares the income received to the type of lifestyle the taxpayer is living. For example, the risk engine will be able to see that the taxpayer has a house valued at a certain amount (Deeds Office), has a car valued at X amount (eNatis), is a director of Company ABC and is a beneficiary of XY Trust; yet, the taxpayer's declared income does not support their lifestyle.

The possibilities of how SARS will use this information is becoming very clear. The world is getting smaller; SARS is getting more and more innovative. Automating and processing data to issue an assessment and identify risk will start improving immensely. With this comes SARS' ability to properly charge understatement penalties and to prove the often-elusive tax evasion.

THE VOLUNTARY DISCLOSURE PROGRAMME:

A CONFIDENTIAL WAY TO RESET PAST TAX DEFAULTS

NICHOLAS MATSHILI, Head of the Voluntary Disclosure Unit at SARS

The Voluntary Disclosure Programme (VDP) was introduced as a permanent measure to increase voluntary compliance in the interest of enhanced tax compliance, good management of the tax system and the best use of SARS resources.

It is an internationally accepted mechanism and encourages taxpayers to voluntarily regularise their tax affairs; it facilitates personal accountability and ownership for their tax matters. SARS has ensured a strictly confidential process for taxpayers and direct access to the VDP Unit within SARS to make it easy for taxpayers to comply with their tax obligations and receive clarity and certainty after having regularised any defaults. This article outlines the principles and process of the VDP.

Benefits and relief offered by the Voluntary Disclosure Programme

Confidentiality and security of the process

The rules on confidentiality of information as prescribed in the Tax Administration Act, 2011 apply in respect of any information that is submitted through the VDP process. In addition, information, including the VDP01 application form and supporting documents provided through the VDP process, is not shared with any other division of SARS. Statistics to determine broad trends are drawn from the information database. Payments that emanate from a VDP agreement between SARS and a taxpayer are strictly managed within the VDP process.

Anonymous applications

Anonymous applications for VDP relief are also allowed where a taxpayer or potential applicant would like to determine whether their tax matter is eligible for relief and the kind of relief that would be granted before they formally apply. In this case, SARS issues a non-binding private tax opinion. The no-name or anonymous application can be selected on eFiling as can all VDP applications.

Relief of penalties and prosecution for the tax offence

Relief is limited to the defaults disclosed and recorded as part of the VDP Agreement. SARS will not pursue criminal prosecution for a tax offence arising from the 'default'. A taxpayer receives 100% relief for an administrative non-compliance penalty that was or may be imposed under Chapter 15 of the Tax Administration Act, 2011, or a penalty imposed under any tax Act, but excluding a penalty for the late submission of a return. Relief is provided in respect of understatement penalties to the extent listed in column 5 or 6 of the understatement penalty percentage table in terms of section 223 of the Tax Administration Act, 2011. See below:

Understatement penalty percentage table

1	2	3	4	5	6
Item	Behaviour	Standard case	If obstructive, or if it is a 'repeat case'	Voluntary disclosure after notification of audit or criminal investigation	Voluntary disclosure before notification of audit or criminal investigation
(i)	'Substantial understatement'	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing a return	25%	50%	15%	0%
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	'Impermissible avoidance arrangement'	75%	100%	35%	0%
(v)	Gross negligence	100%	125%	50%	5%
(vi)	Intentional tax evasion	150%	200%	75%	10%

Principles of the Voluntary Disclosure Programme

The voluntary aspect before detection is what makes the VDP application valid. A matter that SARS has knowledge of or is being verified does not fall within the VDP and should be addressed within the normal SARS processes.

Where an applicant has been given notice of the commencement of an audit or criminal investigation which has not been concluded and is related to the disclosed default, such an application is regarded as not being voluntary. However, certain considerations can be made under strict circumstances contemplated in section 226(2) of the Tax Administration Act, 2011, where a senior SARS official is of the view, having regard to the circumstances and ambit of the audit or investigation, that the default would not otherwise have been detected during the audit or investigation, and is also of the view that the application would be in the interest of good management of the tax system and the best use of SARS' resources; the application may be deemed voluntary.

A VDP application is valid if it involves a behaviour referred to in column 2 of the understatement penalties table above, does not result in a refund nor includes a similar default that the taxpayer may have disclosed previously in the last five years. Defaults that result in a refund should be regularised through normal SARS processes.

Disclosure must be full and complete in material respects; information withheld that is deemed material renders the application invalid. Taxpayers are expected to remain compliant after using the VDP, hence the limitation of five years for disclosures of similar defaults.

Defaults

A tax irregularity or 'default' refers to submitting inaccurate or incomplete information, not submitting information or making a declaration about a taxpayer's tax liability to SARS, which resulted in an incorrect assessment, an incorrect refund or an incorrect amount being paid by the taxpayer. A default also refers to adopting a 'tax position' that resulted in an understatement.

The term 'tax position' is defined in section 221 of the Tax Administration Act, 2011 and it means an assumption underlying one or more aspects of a tax return, including whether: an amount, transaction, event or item is taxable; an amount or item is deductible or may be set-off; a lower rate of tax than the maximum applicable to that class of taxpayer, transaction, event or item applies; or an amount qualifies as a reduction of tax payable.

"Anonymous applications for VDP relief are also allowed where a taxpayer or potential applicant would like to determine whether their tax matter is eligible for relief and the kind of relief that would be granted before they formally apply"

Since 2001, the South African tax system has been operating on a residence-based system, meaning that South African tax residents are taxed on their worldwide income. Income often undeclared includes local and foreign rental income, foreign interest income, and employment income earned from performing services domestically or abroad, including commission.

Eligible tax types

All tax types are covered under the VDP except customs and excise duties. Some of the major taxes include income tax, VAT, as well as donations tax, estate duties, withholding taxes, transfer duties, turnover tax and mineral and petroleum resource royalties. It also covers payroll taxes.

Who may apply

The programme is available to all taxpayers, including individual taxpayers, companies, trusts and the representative of the individual, company or trust.

VDP application submissions

A VDP application is required on the prescribed form via eFiling. Anonymous applications can be selected. The taxpayer and the representative taxpayer must both be registered on eFiling and the representative taxpayer must be linked to the tax types and profiles of the taxpayer. Information or supporting documents relevant to the default must be submitted and SARS may accept reasonable estimates where a default goes beyond the prescription period.

Ensure that you have received an acknowledgement of your application 48hrs after application, if not, contact the VDP Unit.

Direct access to a VDP consultant

Taxpayers may contact the SARS VDP Unit at vdp@sars.gov.za or via the direct VDP toll free number on 0800 864 613. More information including a VDP guide may be found on the SARS website.

Information sessions for tax practitioners and taxpayers

The SARS VDP Unit embarks on regular stakeholder engagements. Contact the Unit to arrange an information session.

Further information is available at Voluntary Disclosure Programme (VDP) | South African Revenue Service (sars.gov.za) and https://www.sars.gov.za/legal-pub-guide-tadm14-guide-to-the-voluntary-disclosure-programme/?swpmtx=6ed2ab43778133f159f4d9f45f7ead86&swpmtxnonce=ef8dab855f

Disclaimer: *This article is not an 'official publication' as defined in section 1 of the Tax Administration Act, 2011 (the Act) and accordingly does not create a practice generally prevailing under section 5 of the Act. It should, therefore, not be used as a legal reference. It is also not a binding general ruling under section 89 of Chapter 7 of the Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.*

SARS EFILING UPGRADES, INCLUDING THE NEW EFILING LANDING PAGE

▶ **NEILLE VORSTER,** Manager: Online Channels at SARS Business Relations division

The SARS eFiling platform has become a digital tax world where taxpayers or their representatives can complete a plethora of tax transactions without needing to visit a SARS office. Over 90% of tax payments are made through eFiling.

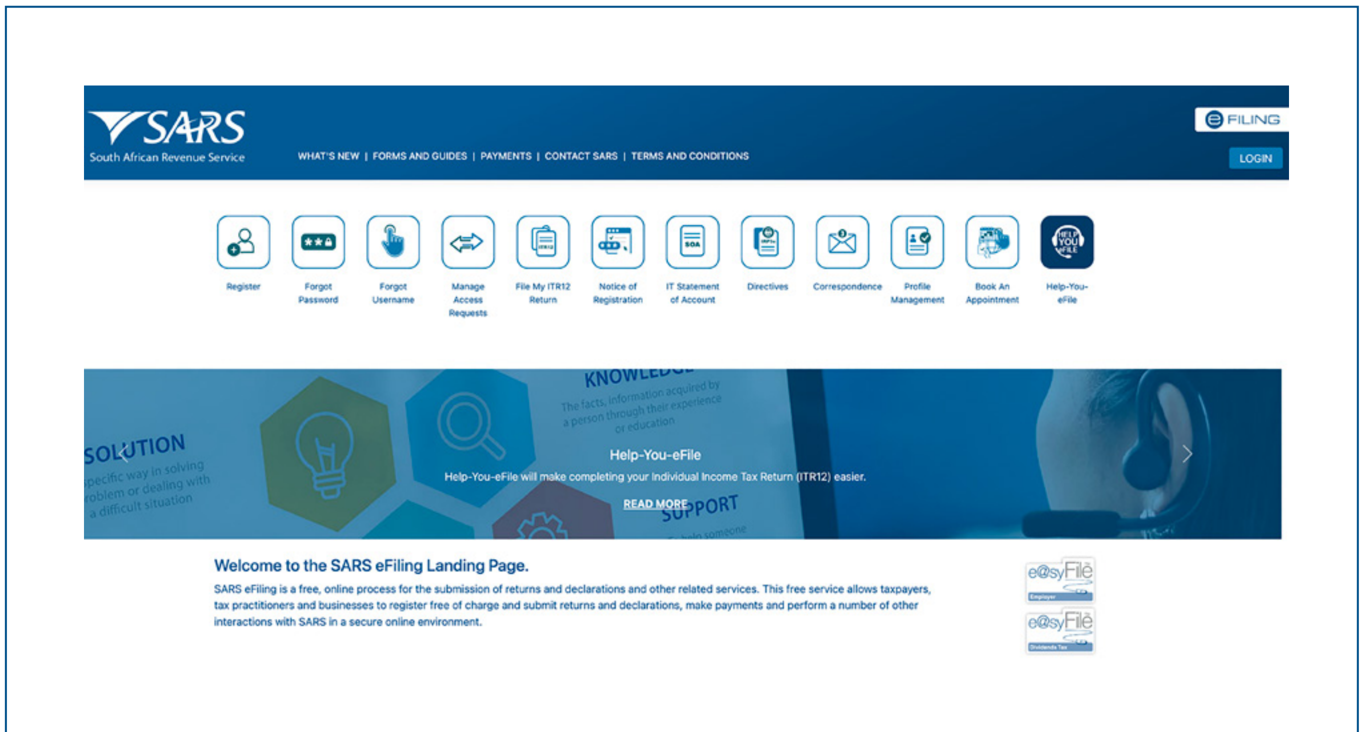
SARS has invested in digital platforms to offer taxpayers the ability to transact virtually and with each filing season, these platforms are enhanced and upgraded, honing on ways to simplify navigation and usability, facilitating ease of compliance and revenue collection. These enhancements are informed by user feedback from taxpayers and tax practitioners, internal review and international and local best practices in technology and usability.

SARS maintained its focus on digital filing channels during COVID-19 through continuous system enhancements and modernisation that enabled taxpayers to manage their tax affairs during a time of restricted movement. We are proud that a year-on-year comparison between the 2022 and 2023 financial years saw more than a 50% reduction in the number of eFiling system issues reported and encountered by taxpayers.

Welcome to the new eFiling landing page—everything you need is right there

This year, SARS upgraded the eFiling landing page with a simple interface of quick links to tax transactions, significantly reducing navigation time and enabling even first-time users to quickly find what they are looking for. Upon opening eFiling, one can easily select to register for tax, reset your password or username, file your personal income tax return (ITR12), check correspondence from SARS, manage your profile, book an appointment or request a SARS consultant to co-browse through Help-you-eFile. Taxpayers or their representatives can also quickly select to manage a tax type transfer, receive a notice of Registration or give a Directive. The interface is aligned with the functionality of the eFiling MobiApp. Some links can be selected without logging into eFiling, whereas others require the taxpayer to log in. Other features include links to important forms, guides and news updates on the SARS website.

A view of the new eFiling landing page



Enhancements and upgrades

The eFiling service offering has grown from general tax products to game-changing and user friendly services over the past few years to make tax compliance simpler and easier. Below are a few of the major enhancements made to eFiling since 2017.

eFiling server upgrade

The eFiling server was upgraded for optimised performance and speed during the 2022–2023 financial year. Test coverage was exorbitant, including all tax products, functions, processes and transactions on eFiling for each of the servers on both Chrome and Edge Browsers. The process included testing of navigation, administrative rights and dashboards. The same upgrade was performed on the SARS MobiApp for three App stores, including Huawei, Android and IOS.

Cellphone tax filing: The SARS Mobi App

The introduction of cellphone tax filing through the SARS MobiApp was a groundbreaking initiative for SARS and taxpayers, taking forward the intention of making tax as simple and easy for the taxpayer as possible. In 2022, a total of 599 991 tax returns were filed on the MobiApp. This excludes all the other transactions taking place on MobiApp daily, which include registering for tax, making a payment, accessing correspondence, obtaining your statement of account and the recent addition of tax practitioner functionalities. Two-factor authentication was an enhancement to MobiApp, requiring a username, password and a one-time pin, which is sent to the taxpayer's cell phone for authentication.

Help-you-eFile and co-browsing

Help-you-eFile and co-browsing is another significant service that was introduced, allowing a SARS consultant to view a taxpayer's eFiling screen when needing assistance with a tax transaction such as the submission of a tax return; it also saves the taxpayer a trip to a SARS office.

Lwazi Chatbot

Lwazi Chatbot was introduced on eFiling to provide taxpayers with instant answers on questions regarding tax transactions. Questions from taxpayers are regularly reviewed and the knowledge-base of responses is enhanced.

Third-party enrolment and activation

Third-party enrolment and activation were enhanced to allow third parties to submit data in bulk for seamless pre-population of personal income tax returns. This is a benefit for both third party data providers such as banks and the taxpayer who files their income tax return.

HTML5 technology conversion

Tax return templates and forms were converted to HTML5 technology, allowing taxpayers to open their returns on a browser of their choice.

Uploading supporting documents

The capacity of uploading supporting documents was increased from 2MB per document to 5MB per document up to 20 documents.

"SARS maintained its focus on digital filing channels during COVID-19 through continuous system enhancements and modernisation that enabled taxpayers to manage their tax affairs during a time of restricted movement"

Country-by-Country Reporting

An enhancement for Country-by-Country Reporting, a new international tax requirement for the exchange of information, also allows for easy bulk data submissions.

Tax practitioner verification page

The tax practitioner verification page was enhanced for the visually impaired.

Tax type transfer process

The tax type transfer process was modernised, making it easier for tax practitioners to assume a taxpayer profile for a particular tax type.

Complaints management

A complaints management mechanism was introduced on eFiling, allowing the taxpayer to lodge a complaint without having to contact the SARS contact centre.

One-time pin enhancements

One-time pin enhancements were introduced to reduce cybercrime such as profile hijacking.

Live tax compliance status

Obtaining a tax clearance certificate was digitised. The enhancement further enabled access to a taxpayer's tax compliance status in real-time, allowing a taxpayer to regularise any outstanding tax matters. A taxpayer may permit a third party to verify their standing with SARS, for example, in the case of applying for a business contract.

In conclusion, the evolution and enhancement of the eFiling system aims to make tax compliance easy and effortless for taxpayers and their representatives while providing taxpayers clarity and certainty about their tax matters. SARS' digital platforms and technology infrastructure are pivotal to this. The stability of the eFiling system remains the key focus for SARS as we strive to achieve Vision 2024 of a smart, modern SARS with unquestionable integrity that is trusted and admired.

CASE LAW WRAP-UP

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TRUSTEES OF THE CC SHARE TRUST AND OTHERS V COMMISSIONER FOR SARS (38211/21) [2023] ZAGPPHC 822 *(24 JULY 2023)*

Issue

The issue in the original dispute was whether SARS had correctly assessed the applicant trustees ('taxpayers').

There were three issues in dispute: (i) whether the taxpayers have been correctly assessed; (ii) whether SARS followed the correct process prior to issuing the assessments; and (iii) whether the taxpayers were required to exhaust internal remedies instead of launching proceedings in court. This case only concerned the second and third issues in dispute.

Facts

The taxpayers are trustees of six trusts. These trusts directly and indirectly own an interest in the companies of a group known as Amalgamated Metals Recycling ('AMR'). In 2016, Insimbi, a JSE listed company, sought to buy certain of the companies forming part of AMR.

The taxpayers adopted what was termed a "disposal methodology that gave effect to their commercial objectives", thereby performing the transactions in ways that they considered would avoid liability for capital gains tax ('AMR transactions').

SARS challenged the transactions in terms of the General Anti-Avoidance Rules ('GAAR' in the Income Tax Act, No. 58 of 1962 ('the Act'). One of the tests applied is that the arrangement is conducted in a manner that "lacks commercial substance in whole or in part".

On 30 July 2020, SARS issued each taxpayer with a notice in terms of section 80J (1) of the Act, inviting the taxpayers to give reasons to SARS as to why it should not apply GAAR as per the Act ('July Letter').

The taxpayers' attorneys responded to the July Letter in October of the same year in terms of section 42(2)(b) read with section 42(3) of the Tax Administration Act, 28 of 2011 ('the TAA'). SARS responded requesting further information under section 80J (3) of the Act.

The next letter that SARS issued to the taxpayers was delivered in March 2021, entitled 'Finalisation of audit: Restructuring and sale of AMR Group Year of assessment: 2017' ('March Letter').

The March Letter sets out SARS' reasons for rejecting the taxpayers' responses and why it considered that GAAR applied to the transactions. On the same day, SARS further delivered a letter of assessment to each taxpayer setting out the relevant adjustment and penalties.

On 26 April 2021, SARS responded to letters from the taxpayers' attorneys requesting the withdrawal of the March Letter and assessments, which requests were refused. The taxpayers referred to these decisions as the second decisions.

The subject of the taxpayers' case was for the court to review and to set aside the March letter and the further letter of 26 April 2021.

The taxpayers' case

To support their allegations of unlawful administrative action by SARS, the taxpayers relied on the Promotion of Administrative Justice Act, No. 3 of 2000 ('PAJA') and in the alternative raised a legality review. In relation to the first decision, the taxpayers contended that they were denied audi alteram partem (the right to be heard).

The taxpayers noted that this right was compromised in the following respects:

1) Their right to receive an audit outcome letter;
2) The right to be able to consider an audit outcome letter;
3) The right to respond to the audit outcome letter; and
4) The right to have SARS consider their response to the letter.

SARS' case

SARS contended in its argument on the merits of the review that it has given adequate opportunity for the taxpayers to be heard. However, SARS further argued that this point did not need to be decided until its preliminary objections had been considered.

SARS argued that the review was incompetent on two grounds. Firstly, the case cannot be considered without a directive from the High Court in terms of section 105 of the TAA. Although belatedly, such a directive was sought; SARS argued that the threshold to get such directive was not met in the papers.

Secondly, SARS stated that relief was incompetent as the taxpayers failed to exhaust internal remedies as required in section 7(2) of PAJA, and both statutes required the taxpayers to demonstrate that exceptional circumstances existed.

Outcome

The court dismissed the application based on SARS succeeding in its preliminary objections. It was ordered that the taxpayers be, jointly and severally, liable for costs including that of two counsel.

Core reasoning

The requirement to exhaust internal remedies is not a technical machination to deny a party their day in court. The court held that there are important policy grounds for doing so, such as preserving the autonomy of the administrative process, avoiding prematurity and the need to benefit from specialist knowledge.

The taxpayers did not require SARS to withdraw its decision in terms of section 9 of the TAA. The court held that the section makes it clear that an objection and appeal can be made without the need for a withdrawal. The taxpayers were not prejudiced from having to go through the whole internal appeal if they might succeed on their review point.

All the issues raised by the taxpayers could have been decided in terms of the provisions of the TAA. The first remedy was the objection process and, failing that, then the taxpayer's right to appeal.

The court agreed with SARS' argument that there was nothing that the taxpayers could obtain from a withdrawal that they could not get from the objection and appeal process. It was thus not accepted that there was any basis for the relief sought either, given the nature of the internal remedies available to the taxpayers.

The taxpayers did not make out a case for the matter to be heard in the High Court in terms of section 105 of the TAA, i.e. "*A taxpayer may only dispute an assessment or 'decision' as described in section 104 in proceedings under this chapter, unless a High Court otherwise directs*".

For the same reasons but by a different mechanism, it was held that the taxpayers did not make out a case for why they have not exhausted their internal remedies in terms of the TAA; therefore, they did not comply with section 7(2) of PAJA. The taxpayers were required to satisfy the threshold issues evidencing that they had exhausted internal remedies for the reasons the court had given and they had not done so.

SARS succeeded in its preliminary objections and as such, the taxpayers' application failed.

Takeaway

The case makes concrete the importance and ensures that all internal remedies are exhausted before considering a review under PAJA. This is a threshold that taxpayers bear when proving exceptional circumstances. The High Court will not entertain any matter until it is confident that, indeed, there are no other remedies available internally.

COMMISSIONER FOR SARS V ABSA BANK LIMITED & ANOTHER (596/2021) [2023] ZASCA 125
(29 SEPTEMBER 2023)

Issue

The issue before the Supreme Court of Appeal ('SCA') in this procedural matter concerned the jurisdiction of the High Court to review a tax assessment raised in terms of section 80B of the Income Tax Act, No. 58 of 1962 ('the Act').

Facts

The respondents, Absa Bank Limited ('Absa') and its wholly owned subsidiary, United Towers Proprietary Limited ('United'), had entered into an investment arrangement in terms of which a series of interlinked transactions followed. The details of the transactions are summarised as follows:

(i) Absa and United subscribed for preference shares in PSIC Finance 3 ('PSIC 3') and PSIC 3 used the proceeds of the share issue to subscribe for preference shares in PSIC Finance 4 ('PSIC 4'). In turn, PSIC 4 made a capital contribution to Delta 1 Finance Trust ('D1 Trust').

(ii) The D1 Trust made an interest-bearing loan to Macquarie Securities South Africa ('Macquarie') and invested the interest earned on the loan in Brazilian Government Bonds. In terms of the double tax treaty between South Africa and Brazil, a tax-free income stream was provided to D1 Trust through this arrangement.

(iii) D1 Trust distributed the income stream to PCIS4 who, in turn, paid dividends to PSIC 3. PSIC 3 then paid dividends to Absa and United.

Following an investigation into Macquarie, SARS issued notices to Absa and United in terms of section 42 of the Tax Administration Act, No. 28 of 2011 ('the TAA'), signifying an audit of their tax affairs.

Upon completion of its preliminary audit of the respondents, SARS notified Absa and United that it would be raising assessments in terms of the General Anti-Avoidance Rule ('GAAR') provisions of the Act. The notices were issued in terms of section 80J of the Act ('the notices').

Absa and United, in terms of section 9(1) of the TAA, submitted a request to SARS to withdraw the notices. SARS, however, informed the respondents that it would not do so. The respondents launched an application with the High Court, seeking an order to review SARS' decision and to substitute the decision with one withdrawing the notices.

After the institution of the application in the High Court, SARS raised additional assessments for the 2014 to 2017 tax years, on the basis that the investment returns in the scheme constituted taxable income. Absa and United accordingly amended its notice of motion to include the review and setting aside of the additional assessments.

The High Court set aside the decision by the Commissioner of SARS refusing to withdraw the notices, as well as the additional notices of assessment.

SARS thereafter appealed to the SCA to set aside the order of the High Court.

The SCA Judgment

First and foremost, the SCA considered whether a decision not to withdraw a section 80J notice is reviewable in terms of section 9 of the TAA, either prior to or after the issuing of a notice of assessment in terms of section 80B of the Act.

In terms of section 80B of the Act, the Commissioner may determine the tax consequences of any impermissible tax avoidance agreement. To give effect to these consequences, section 80J regulates the procedure to be followed before a determination can be made in terms of section 80B.

It was held that an interpretation of section 9 of the TAA was not required and that it patently allows for the withdrawal of a notice issued in terms of section 80J.

Secondly, the SCA considered whether the High Court's characterisation of the challenge to the assessments was wholly a question of law, which entitled it to exercise its jurisdiction in terms of section 105 of the TAA.

As section 105 of the TAA does not allow for direct referral of a dispute to the High Court, it may only exercise its jurisdiction in exceptional circumstances – such as when a dispute concerns a question of law.

The High Court found that SARS had accepted the facts disclosed in the notices and further accepted that Absa and United had no knowledge of the arrangement in which they were participating. The High Court concluded that the application of the GAAR provisions to circumstances where they did not apply, was irrational and offended the principle of legality.

According to the SCA, however, this position is incorrect. SARS' notices set out the reasons for the belief that the GAAR provisions apply and do not speak to the acceptance of any facts. The application of the GAAR provisions, in this particular matter, was thus not solely a question of law, but rather a question of fact.

The SCA further relied on the CIR v Conhage matter which held that the effect, purpose and normality of a transaction are essentially questions of fact and that the subjective purpose of the taxpayer must be determined.

The High Court accordingly did not have jurisdiction to hear the matter, and the application should have been dismissed.

Outcome

The SCA found in favour of SARS and the appeal succeeded with costs, including the costs of two counsel. The orders of the High Court were set aside and substituted with an order dismissing the application with costs, including the costs of two counsel.

Takeaway

This case demonstrates the importance of understanding the exceptional grounds upon which a matter may be referred directly to the High Court prior to exhausting internal remedies. Where it is alleged that such exceptional grounds concern a question of law, taxpayers must be certain that the issue is not actually a factual matter.

COMMISSIONER FOR SARS V FREE STATE DEVELOPMENT CORPORATION (1222/2021) [2023] ZASCA 84 *(31 MAY 2023)*

Issue

This procedural matter brought was on appeal from the Free State Tax Court, Bloemfontein ('Tax Court'), which granted an order permitting the Free State Development Corporation ('FSDC') to file an amended statement of grounds of appeal against additional assessments raised by SARS. The issue at hand was whether such amended statement should be allowed.

Facts

FSDC, the official economic development agency for the Free State, is a registered VAT vendor in terms of the Value-Added Tax Act, No. 89 of 1991 ('VAT Act'). FSDC was tasked by the Department of Trade and Industry ('DTI') to manage a Special Economic Zone ('SEZ') in terms of the Special Economic Zones Act, No. 16 of 2014.

The DTI and FSDC entered into a Memorandum of Funding Agreement in 2014, for purposes of establishing a SEZ hub in the Free State. The taxpayer was granted an amount of R4.5 million under this agreement. In 2015, FSDC and the DTI entered into a SEZ Funding Agreement, in terms of which R240 million was provided to FSDC for bulk structure development and facilitating investments into its SEZ.

The taxpayer declared its output tax as zero-rated on its VAT201 returns. In response, SARS raised additional assessments and averred that the taxpayer had erroneously declared that its supplies were zero-rated.

FSDC objected to the additional assessments and contended that the transactions were zero rated in terms of section 11 of the VAT Act. FSDC further submitted that it received no financial benefit from the transactions, as it was a mere conduit for the funds. SARS disallowed FSDC's objection and FSDC appealed to the Tax Court.

In terms of the appeal, the initial statement of grounds of appeal by FSDC, in terms of Tax Court Rule ('TCR') 32(1), was based on an erroneous legal conclusion. Accordingly, FSDC instituted an application to withdraw this statement and to file an amended statement to include the correct legal grounds for appeal.

The application for withdrawal and amendment of the TCR 32(1) statement was granted by the Tax Court, which gave the client leave to file the amended statement within 20 days. The court further granted leave to SARS to file a reply within 20 days of receipt of the amended statement. Leave to appeal to the High Court was further granted, upon which SARS acted.

SARS' case

SARS opposed FSDC's application to amend on the grounds that the proposed amendment sought to introduce amended grounds of objection against a part of the assessment that was not previously objected to by FSDC. This contravened Tax Court Rule 10 and was thus not permitted.

The taxpayer's case

The initial TCR 32(1) statement filed by FSDC was based on advice received from its legal advisors. Following the filing hereof, FSDC obtained a second legal opinion, which concluded that the supply of services by FSDC was not a supply that was subject to VAT in the first place.

As the issues raised in its amended statement were covered by the substance of the objection, TCR 10 was not contravened.

Outcome

The SCA found in favour of FSDC and the appeal was dismissed with costs, including the costs of two counsel.

Core reasoning

FSDC's initial and subsequent grounds of appeal were based on the nature of the transactions and, furthermore, the amended grounds were clearly foreshadowed in the initial objection. The SCA confirmed that FSDC's objection has been and continues to be based on the legality of imposing a VAT liability to the transactions in question.

The Court held that on a proper interpretation of TCR 10(3) read together with TCR 32(3), taxpayers are not precluded from raising a new ground of appeal in its amended statement, when the grounds are, in substance, the same as those initially raised.

Finally, the SCA determined that in granting FSDC's application to amend its grounds of appeal, the Tax Court appropriately used its discretion and concluded that SARS would suffer no prejudice from the amended grounds of appeal.

Takeaway

When amending grounds of appeal, taxpayers should be certain that the substance of the objection is not amended and that no new grounds of appeal are raised. Even where an application for amending grounds of appeal is granted, the taxpayer will still bear the onus of proof in terms of section 102 of the TAA.

BINDING RULINGS

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BINDING PRIVATE RULING: BPR 393 – INCOME TAX CONSEQUENCES RESULTING FROM CONSECUTIVE ASSET-FOR-SHARE TRANSACTIONS (15 JUNE 2023)

Issue

This Ruling determines the income tax consequences following two consecutive asset for share transactions, as part of the restructuring within a group of companies. In terms of the transactions, two separate business operations of a resident company would be disposed of.

Facts

The Applicant, a resident company, is a financial services provider who further conducts a separate insurance business. All of the equity shares in the Applicant are held by Company X, and all of the equity shares in Company X are held by Mr X.

The Applicant wishes to separate its financial services business and insurance business by establishing a new Holding Company ('New Holdco'), which will hold all of the equity shares in the newly formed Subco A and Subco B.

The financial services business and the insurance business will be sold as two separate going concerns by way of two separate asset-for-share transactions, as defined in paragraph (a) of the definition of "asset-for-share transaction" in section 42(1) of the Income Tax Act, No. 58 of 1962 ('the Act').

The proposed transaction will be structured as follows:

- **Step 1A:** The Applicant will sell its cash and loan books, at market value, to Subco A on loan account. This transaction will not be done in terms of section 42 of the Act.
- **Step 1B:** The remainder of the assets held by the financial services business will be transferred to the New Holdco as a going concern, in terms of an asset-for-share transaction of section 42 of the Act.
- **Step 1C:** The New Holdco will immediately, in terms of an asset-for-share transaction, transfer the financial services business assets to Subco A.
- **Step 1D:** The assets held by the insurance business will be transferred to New Holdco in terms of an asset-for-share transaction of section 42 of the Act.
- **Step 1E:** The New Holdco will immediately, in terms of an asset-for-share transaction, transfer the insurance business assets to Subco B.
- **Step 2:** Unrelated black economic empowerment investors will subscribe for approximately 32% of the equity shares in New Holdco. New Holdco will utilise the proceeds to subscribe for additional equity shares in Subco A.

  Subco A will accordingly apply a portion of the subscription proceeds to settle the loan account arising from Step 1A.

- **Step 3:** Once the above steps are complete and after a period exceeding 18 months, the Applicant will unbundle its shareholding in New Holdco in terms of section 46 of the Act as a dividend in specie to Company X; the Applicant will in due course be liquidated or amalgamated with another group company once all its debts have been paid.

Ruling

This binding private ruling is subject to the additional condition and assumption that the market values of the assets transferred under the section 42 transactions will exceed their base costs.

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

(a) The proposed transactions under steps 1B, 1C, 1D, and 1E respectively, will meet the requirements of paragraph (a) of the definition of "asset-for-share transaction" in terms of section 42(1) of the Act.

(b) New Holdco will hold the assets acquired from the financial services business and the insurance business on capital account pending its disposal to Subco A and B.

(c) As the facts and circumstances of this matter are very specific and in the context of the corporate rules under Part III of Chapter II of the Act, New Holdco will not deal with the assets as trading stock.

(d) Section 42(7) of the Act will apply to Steps 1C and 1E. No gain or loss will arise on those disposals as the assets will be deemed to be disposed of at their base cost or tax costs under section 42(2).

(e) Section 42(8) of the Act will not apply to the future disposal of the consideration shares received under Steps 1B, 1C, 1D, and 1E of the proposed transactions.

BINDING GENERAL RULING (VAT): BGR 065 – VALUE-ADDED TAX TREATMENT OF ROUNDING DIFFERENCE IN CASH TRANSACTIONS (28 AUGUST 2023)

Issue

This ruling sets out the circumstances and conditions under which a supplier need not issue a credit note and the input tax consequences for the recipient vendor when a rounding difference occurs as a result of a cash transaction.

Facts

On the basis that the consideration for the supply has been altered as contemplated in section 21(1)(c), the tax charged as shown on the tax invoice exceeds the tax that should have been charged. In practice, suppliers generally account for output tax on the consideration due before the rounding difference (in the above example, on the amount of R49,98 instead of R49,90). It follows that the supplier is entitled to an adjustment contemplated in section 21(2) for the difference of eight cents and the recipient vendor must reduce the amount of its input tax as required under section 21(6).

In the event of a tax invoice consisting of multiple supplies (that is, standard-rated, zero-rated and non-taxable supplies), a recipient vendor must do a reasonable split in order to determine the correct input tax to be deducted. No adjustment of the input tax must be made by a recipient vendor that acquires only zero-rated and non-taxable goods and services.

Under section 21(3)(a), the supplier is required to issue a credit note as the tax shown on the tax invoice exceeds the actual tax charged. As a result, the supplier is, under section 16(3)(a)(v) read with section 21(2)(b), entitled to deduct the excess tax as input tax, or alternatively, to reduce the amount of output tax attributable to the tax period in which the adjustment is to be made by the amount of the excess tax.

The Commissioner may, however, direct that a credit note is not required to be issued under section 21(5)(b), if the Commissioner is satisfied that:

- there are, or will be, sufficient records available to establish the particulars of a supply; and
- it is impractical to issue a full credit note.

Ruling

The Commissioner directs that, under section 21(5)(b), the supplier is not required to issue a credit note as contemplated in section 21(3) in respect of the rounding difference, subject to the following conditions:

- The tax invoice must clearly indicate that due to the rounding difference, input tax can only be deducted on the adjusted amount in the case of a cash transaction.
- The supplier may only make an adjustment (that is, by reducing output tax or making a deduction under section 16[3]) as contemplated in section 21(2), to the extent that it relates to standard rated supplies made.
- The supplier must retain the relevant records to substantiate the adjustment referred to above for the period contemplated in section 55 read with Part A of Chapter 4 of the TA Act.

The recipient vendor may use the tax invoice issued by the supplier as described above, for the purpose of deducting input tax, under section 16(3)(a)(v) read with section 16(2)(b)(ii) and the definition of 'input tax' in section 1(1). Input tax can only be deducted on the adjusted amount for cash transactions. The recipient vendor must do a reasonable split for the purpose of deducting input tax on acquisition of goods and services charged with different tax rates.

BINDING PRIVATE RULING: BPR 392 – SALE OF SHARES IN A CONTROLLED FOREIGN COMPANY (CFC) (15 JUNE 2023)

Issue

This ruling determines the tax consequences for a resident shareholder disposing of its shares in a CFC.

Facts

The Applicant is the holding company for a group of companies and holds various subsidiaries and associates through various intermediary holding companies. Company B is a CFC and holds the European group entities, which constitute various chains of CFCs. The Applicant proposes to dispose of its interest in Company B (and thereby the underlying European entities therein) to a connected non-resident person in the group.

The result of the disposal will be that the European entities held by the Applicant will cease to be CFCs.

Ruling

This binding private ruling is not subject to any additional conditions and assumptions.
The ruling made in connection with the proposed transaction is as follows:

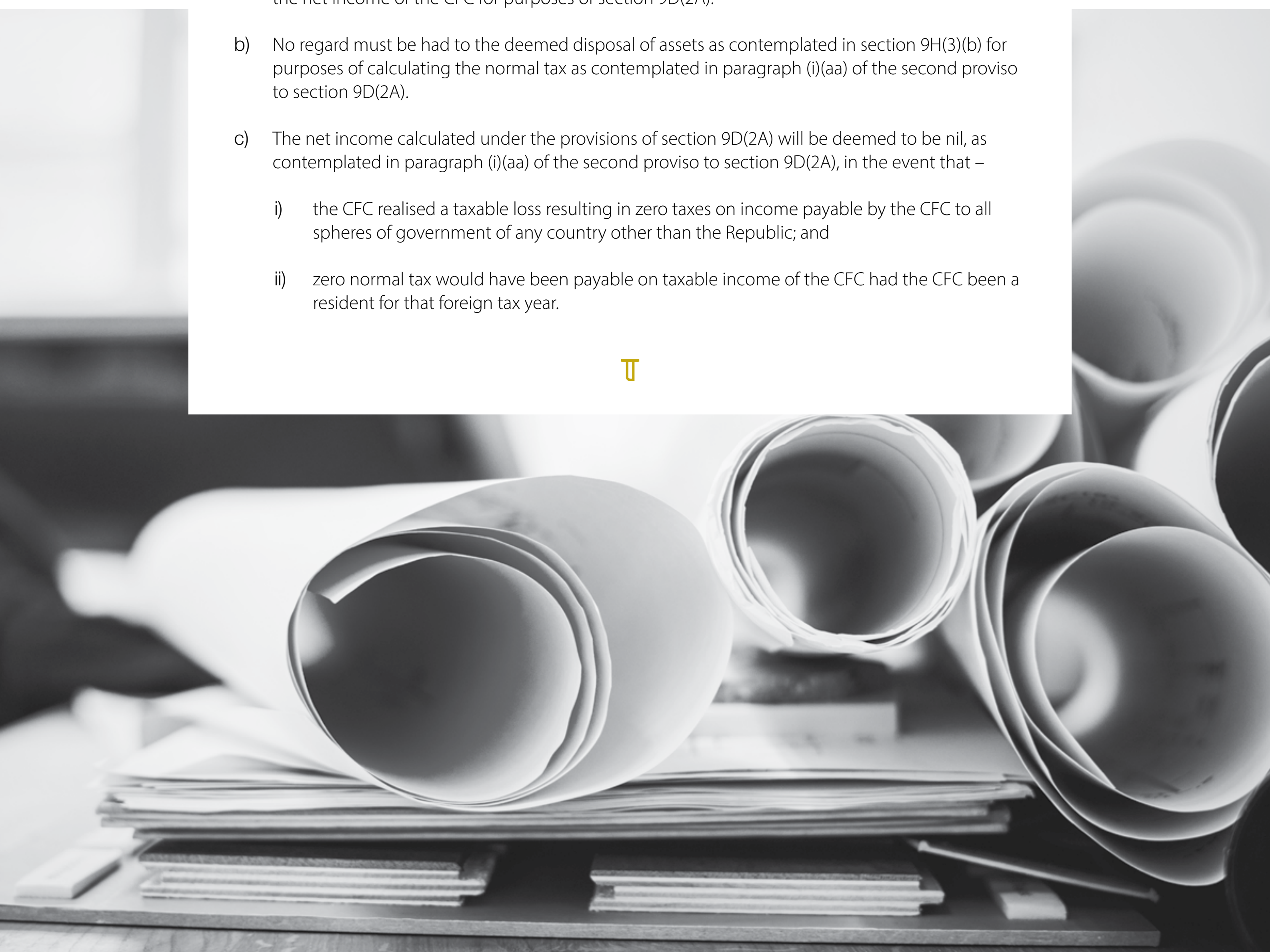
a) The deemed disposal as contemplated in section 9H(3)(b) must be considered when calculating the net income of the CFC for purposes of section 9D(2A).

b) No regard must be had to the deemed disposal of assets as contemplated in section 9H(3)(b) for purposes of calculating the normal tax as contemplated in paragraph (i)(aa) of the second proviso to section 9D(2A).

c) The net income calculated under the provisions of section 9D(2A) will be deemed to be nil, as contemplated in paragraph (i)(aa) of the second proviso to section 9D(2A), in the event that –

   i) the CFC realised a taxable loss resulting in zero taxes on income payable by the CFC to all spheres of government of any country other than the Republic; and

   ii) zero normal tax would have been payable on taxable income of the CFC had the CFC been a resident for that foreign tax year.



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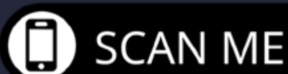

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