South African Institute of Taxation

SARS INTERPRETATION UPDATE AND CASES

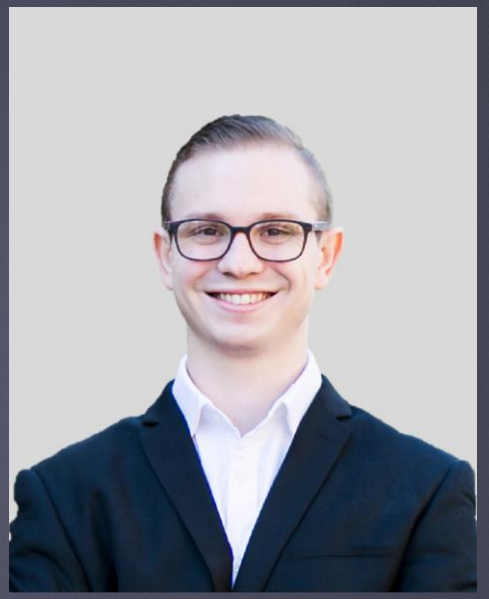
Session 2

Tax Practice on the Move Series

YOUR KEY TO THE TAX COMMUNITY

About The Presenters

Keitumetse Sesana
Tax Technical Specialist



Thomas Lobban
Head of Cross-Border Individual Tax at Tax Consulting SA

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AGENDA

- *Coronation* case – Why the fuss? And should you do tax business different after this case?
- *Medtronic* case – Do the VDP provisions of the TAA prohibit the remission of interest under s39(7) of the VAT Act, once a VDP agreement has been concluded?
- *A v C:SARS* case – Can a taxpayer set-off a foreign assessed loss against recoupment income arising from a foreign deemed disposal under s9H of the ITA?
- *Lance Dickson Construction* case – how should SARS determine an understatement penalty, and can this be altered by SARS or the Tax Court upon a later dispute?

DRAFT LEGISLATION

DRAFT LEGISLATION

- Recent submissions made by SAIT
  - Draft amendments to rules under sections 77H and 120 – Internal administrative appeals; and
  - Draft amendment to Part 3 of Schedule No. 6 – Insertion of Note 14 and refund item 670.05/00.00/01.00.
  - Draft Notice pertaining to returns of information to be submitted by third parties in terms of section 26 of the Tax Administration Act, 2011 (Act No. 28 of 2011)

CFC – Basics of active income (FBE)

Basics of Active Income (Foreign Business Establishment)

Foreign business establishment

- Foreign business establishment income falls outside CFC tainted income
- At the outset, this form of establishment must be:
  - A fixed place of business in a foreign country
  - Must be used to carry on a business
  - For a period of not less than 12 months

Key Features of a Foreign Business Establishment

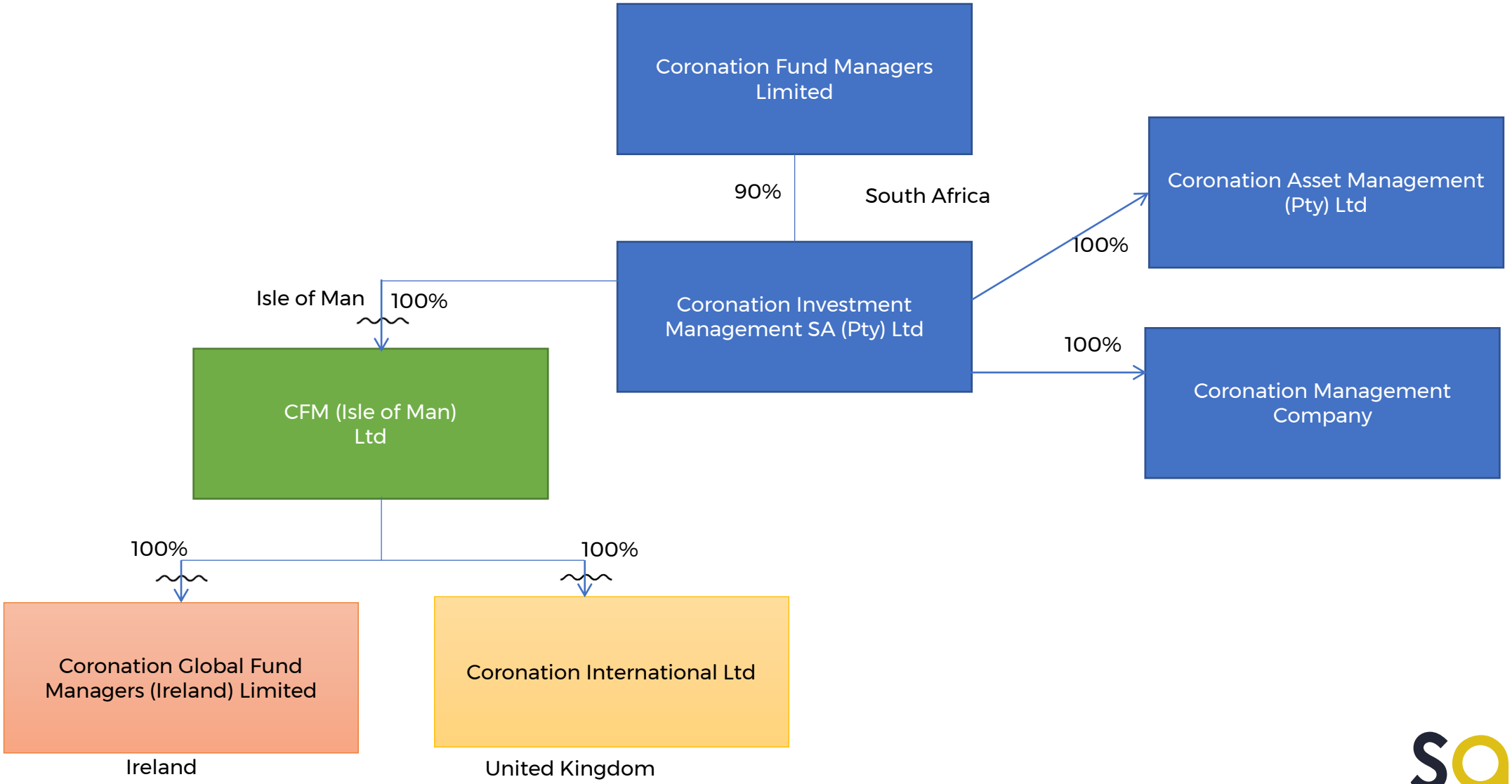
- A foreign business establishment has 5 basic requirements:
  - The business is conducted through offices, shops, factories, warehouses and other structures
  - The primary operations are suitably staffed with on-site managerial and operational employees
  - The primary operations are suitably equipped for conducting business
  - The primary fixed place of business has suitable facilities
  - Primary purpose other than tax avoidance

Automatic Fixed Places of Business

- Some businesses are automatically fixed:
  - Mining (exploration, production, etc…)
  - Construction sites lasting at least 6 months
  - Agricultural land used for farming
  - Vessels used for offshore fishing and mineral exploration / extraction
  - International shipping

CSARS v Coronation Investment Management SA (Pty) Ltd (1269/2021)

Abbreviated Coronation group structure



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Background of Coronation Global Fund Managers (Ireland) Limited

- Incorporated in Ireland in 1997 with the aim of "provide opportunities for clients to invest in South African and Irish domiciled collective investment funds (CIS)."
- On 25 October 2007, Coronation Global Fund Managers (Ireland) Limited received its licence from the Central Bank of Ireland (CBI) as a 'management company'
- Coronation Global Fund Managers (Ireland) Limited's business plan outlined a outsource business model with Coronation Global Fund Managers (Ireland) Limited mainly being a 'product provider'
- Investment, administration and custodial functions were all outsourced
- Core investment management and trading functions were outsourced to 'specialist investment managers' at Coronation Asset Management (Pty) Ltd (SA) and Coronation International Ltd (UK)
- Core fund administrative functions were sub-contracted to JP Morgan Hedge Fund Services (Ireland) Limited and JP Morgan Administration Services (Ireland) Limited
- The core distributive functions were outsourced to Coronation International Ltd (UK) and Coronation Asset Management (Pty) Ltd (SA)
- Outsourced functions were performed under the oversight, direction and supervision of Coronation Global Fund Managers (Ireland) Limited as the ultimate fund manager - Coronation Global Fund Managers (Ireland) Limited "does not abdicate responsibility for those functions but exercises oversight and supervision over the conduct of its service providers from Dublin"
- The actual performance of investment trading functions is not envisaged as part of Coronation Global Fund Managers (Ireland) Limited's business, nor as part of the approved license issued by the CBI

CSARS v Coronation Investment Management SA (PTY) Ltd – Tax Court

BACKGROUND

- The Tax Court held that the net income of Coronation Global Fund Managers (Ireland) Limited was shielded from the South Africa's CFC rules under the FBE exemption during the 2012 tax year.
- The Tax Court was satisfied that Coronation Global Fund Managers (Ireland) Limited has '*economic substance and does not merely exist on paper*', on the basis that its conduct did not amount to housing its activities in a foreign company to avoid tax in the home country on the income it produced.
- The Tax Court was also satisfied that the management function performed by Coronation Global Fund Managers (Ireland) Limited was the primary operation of the business of Coronation Global Fund Managers (Ireland) Limited
- SARS disagreed with the judgement and approached the SCA arguing against the previous decision of the Tax Court that the net income of Coronation Global Fund Managers (Ireland) Limited was not subject to tax in SA for the 2012 tax year.

ISSUES IN QUESTION

- Coronation Global Fund Managers (Ireland) Limited, a CFC of Coronation Investment Management SA (Pty) Ltd had adopted an "outsource" business model.
- The FBE exemption would only be applicable if the primary functions of Coronation Global Fund Managers (Ireland) Limited were conducted in Ireland.
- Another question before the SCA was whether the primary business of Coronation Global Fund Managers (Ireland) Limited "is that of investment (which is not conducted in Ireland), or that of maintaining its licence and managing its service providers (which is conducted in Ireland)".

CSARS v Coronation Investment Management SA (PTY) Ltd: SCA Judgement

Judgement

- Evidence given suggested that the key operations of the business was investment management. These functions were determined to have been outsourced.
- A pertinent question that the court asked – *"Without the investment management operations, can it be said to conduct its primary operations in Ireland? The answer must be, 'no'."*
- The court further held that *"the essential operations of the business must be conducted within the jurisdiction in respect of which exemption is sought. While there are undoubtedly many functions which a company may choose to legitimately outsource, it cannot outsource its primary business."*
- It was thus concluded that "*the primary operations of Coronation Global Fund Managers (Ireland) Limited 's business (and, therefore, the business of the controlled foreign company as defined) is that of fund management which includes investment management. These are not conducted in Ireland. Therefore, CGFM does not meet the requirements for an FBE exemption in terms of s 9D(1). As a result, the net income of CGFM is imputable to CIMSA for the 2012 tax year in terms of s 9D(2).*"

Interactive discussion with our subject matter expert - Lance Collop

Lance is a Chartered Accountant and Chartered Tax Adviser with extensive experience in all aspects of corporate and international tax, including domestic and cross border structuring, acquisition funding structuring, empowerment deals, and share schemes. Lance is also an M&A tax specialist, and provides tax support across the M&A life-cycle, including pre-deal preparation, financial model reviews, due diligence, and post-closing execution and implementation. Before joining Regan van Rooy, Lance practised as a tax partner at CDH, one of the largest law firms in South Africa, and prior to that Lance led the M&A tax teams at Deloitte and KPMG in the Western Cape region

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Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L (456/2021) [2023] ZASCA 20

Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L

Background

Medtronic ("the taxpayer") was a victim of fraud perpetrated by an ex-employee, in the sum of approx. R460 million, resulting in it being in a non-compliant position with SARS.

The taxpayer applied for relief under the Voluntary Disclosure Programme ("VDP"), and the parties concluded a VDP agreement. During the negotiations, the taxpayer requested that the interest in respect of the default be waived, to which SARS noted that it was not empowered to do so. The taxpayer paid the full amount in terms of the VDP agreement, including the interest.

The taxpayer applied for the remission of the interest, under the VAT Act. The remission application was considered invalid as this was not catered for in the VDP provisions of the Tax Administration Act ("TAA"), and suggested that a Notice of Objection be filed instead. The taxpayer then brought a review application against SARS in the High Court.

Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L

Background – *High Court*

The High Court found that the taxpayer's approach was misguided, and noted that what needs to be determined is not from the pleaded case but, rather, the decision sought to be reviewed. A court is guided by what is relevant, and only relevant evidence is admissible.

The Court further held that SARS stated that, on the basis that the VDP agreement being in force, SARS cannot consider the request for remission of the interest levied. The taxpayer's legal representative was aware that the refusal to consider the remission of interest request was based on a question of law. The High Court thus dismissed the taxpayer's application.

Pursuant to the adverse finding by the High Court, the taxpayer further launched an appeal in the Supreme Court of Appeal ("SCA").

Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L

Issues before the Court

In this matter, the issues to be considered by the SCA were two-fold:

1. Whether the VDP provisions of the TAA prohibited the remission of interest under s39(7) of the VAT Act, once a VDP agreement has been concluded; and

2. Whether, regardless of the VDP agreement, SARS had a statutory duty to consider and adjudicate a taxpayer's request for remission of interest.

Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L

SARS' Argument

SARS' argument was predicated on 4 pillars, namely:

- The VDP programme under the TAA offers a standalone process for a taxpayer to regularise its affairs with SARS without the risk of penalties that would usually arise.

- A remission of interest under the VAT Act, after the payment of interest or an undertaking to do so, after the conclusion of a VDP agreement, would undermine the VDP agreement.

- Act 8 of 2010, which dealt with defaults before 17 February 2010, provided for the remission of interest by SARS. However, the TAA does not make provision for remission of interest, instead providing in s229 what form of relief must be granted by SARS.

- Both s39(7) of the VAT Act and s187(6) of the TAA currently deal with the remission of interest, and serve similar purposes, but are not couched in identical terms and are distinguishable from each other.

Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L

Taxpayer's Argument

The taxpayer contended that, notwithstanding the commencement of the TAA, s39(7) of the VAT Act still remains in force and is the only statutory provision in terms of which interest on the late payment of VAT is levied. The taxpayer's liability for interest on the outstanding VAT debt arose in terms of s39(1) of the VAT Act.

Furthermore, the function of the VDP programme is to provide a dispensation for errant taxpayers to regularise their tax affairs, and does not by itself levy tax, interest or penalties for the late payment of tax.

In refusing to consider the request for remission, SARS is not consistent in its application of the TAA, as it had done so in *PwC Inc. & Another v Minister of Finance & Another*, thus treating taxpayers differently, being inimical to the values underpinning the Constitution. The taxpayer relied on PAJA (Act 30 of 2000) in this regard.

Commissioner for the South African Revenue Service v Medtronic International Trading S.A.R.L

Findings of the Court

The SCA considered the matter on a narrow basis, determining whether SARS lawfully could have refused to consider the request for remission and make a decision thereon, which entailed an administrative decision.

The SCA found that SARS refused to even entertain the taxpayer's application and, thus, did not consider the application on its merits. The lawfulness hereof was determined in relation to s33 of the Constitution, which guarantees lawful, reasonable and procedurally fair administrative action.

The SCA, therefore, found that SARS' refusal undermined a fundamental right enshrined in the Bill of Rights. SARS had a statutory duty, affirmed by the Constitution, to at least consider the request and make a decision based on the merits. This was unjustifiable and eligible for review under s6 and s8 of PAJA.

The appeal was dismissed and the decision referred back to SARS, to consider on the merits. Costs were awarded in favour of the taxpayer.

A v Commissioner for the South African Revenue Service (IT Case No. 46206)

A v Commissioner for the South African Revenue Service

Background

The taxpayer was a resident until 3 September 2017, whereafter she ceased residency and emigrated to the UK. Prior thereto, the taxpayer was a partner in a partnership which owned and operated a passenger aircraft for charter purposes. The aircraft was registered and based in the UK, where the business' offices were situated.

The taxpayer accumulated certain foreign assessed losses in relation to the air charter trade, including losses arising from capital allowances (i.e., depreciation) in respect of the aircraft.

The taxpayer underwent a deemed disposal (s9H) of her share of the aircraft, at market value, and set-off the accumulated assessed losses against the exit charge arising from the deemed disposal. However, SARS rejected the deduction claimed by the taxpayer in the 2018 return.

The taxpayer disputed the assessment, which was declined by SARS, and thus further appealed the matter to the Special Tax Court for adjudication.

A v Commissioner for the South African Revenue Service

Issue before the Court

In this matter, the Tax Court considered the issue of whether the taxpayer may, in terms of s20(1) of the Income Tax Act ("ITA"), set-off the balance of the foreign assessed loss from an aircraft partnership trade, carried forward to the 2018 year of assessment, against her income in the form of recoupments arising from the deemed disposal under s9H.

NB: Per Adams J, this dispute turned on the source of the recoupment income included in the taxpayer's 2018 year of assessment, arising from the deemed disposal of the aircraft.

A v Commissioner for the South African Revenue Service

Legislative Context – *s20(1) of the ITA*

Section 20(1) of the ITA provides, *inter alia*, that, in determining taxable income derived by any person from carrying on any trade, there shall be set off against the income of that person –

- any balance of assessed loss incurred by that person, in any previous year, which has been carried forward from the preceding year of assessment;

- any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others,

Provided that there shall not be a set off against any amount derived by any person from a source within the Republic, any assessed loss incurred by such person during such year; or any balance of assessed loss incurred in any previous year of assessment in carrying on any trade outside the Republic [proviso (b) to s20(1)].

A v Commissioner for the South African Revenue Service

Legislative Context – *para. (n) of "gross income" definition*

Paragraph (n) was since repealed, but applied at the relevant time. This provided for the specific inclusion, in a taxpayer's gross income, of –

"any amount which in terms of any provision of [the ITA] *is specifically required to be included in the taxpayer's income and that amount must –*

(i) for the purposes of this paragraph be deemed to have been received by or to have accrued to the taxpayer; and

(ii) in the case of any amount required to be included in the taxpayer' income in terms of section 8(4), be deemed to have been received or accrued from a source within the Republic notwithstanding that such amounts may have been recovered or recouped outside the Republic."

A v Commissioner for the South African Revenue Service

SARS' Argument

SARS' view was that the deemed disposal originated in South Africa, and thus formed part of the taxpayer's taxable income. SARS almost exclusively relied on paragraph (n)(ii) of the definition of "gross income", which was applicable at the time.

SARS argued that, per para. (n)(ii), the income derived by the taxpayer in the 2018 year of assessment, in the form of a "recoupment" (under s8(4) of the ITA), is deemed to have been received or accrued *"from a source within the Republic"*, which means that proviso (*b*)(ii) of s20(1) in the ITA was applicable.

Accordingly, the accumulated assessed loss is not deductible against the 2018 income.

A v Commissioner for the South African Revenue Service

Taxpayer's Argument

Per the taxpayer, the assessed loss was not ring-fenced against the recoupment income, as foreign assessed losses can be set-off against foreign-sourced income. The legislature had previously amended proviso (*b*) in s20(1) to apply not merely to income from a trade carried on in South Africa, but to income derived *"from a source within the Republic"*.

However, in the 2018 year, the taxpayer had foreign-sourced income (i.e., the recoupment) arising from the deemed disposal of the aircraft. Thus, the accumulated foreign assessed loss was deductible against this foreign-sourced income.

Alternatively, the taxpayer contended that even if para. (*n*)(ii) applies, on a proper interpretation of the ITA, s9(4)(*d*) read with s9(2)(*k*) will prevail, as this expressly provides that the recoupment amount is regarded as arising from a source outside the Republic.

A v Commissioner for the South African Revenue Service

Findings of the Court

The court found that recoupment proceeds accrued in respect of the disposal of an asset not from a source within the Republic under s9(2)(j) or (k), s9(4)(d) positively identifies the amount as having been received or accrued "from a source outside the Republic".

For that reason, proviso (b) to section 20(1) of the ITA does not apply to disqualify the set-off of the foreign assessed loss against the recoupment income.

The sole operative effect of the now repealed para. (n)(ii) was to deem an amount to be from a South African source for purposes of the gross income definition, and is application was limited thereto. The court further agreed with the taxpayer's contention that, in the alternative, s9(4)(d) would prevail over para. (n)(ii).

The court upheld the taxpayer's appeal and set aside the additional assessment.

Lance Dickson Construction CC v Commissioner for the South African Revenue Service (A211/2021) [2023] ZAWCHC 12

Lance Dickson Construction CC v Commissioner for the South African Revenue Service

Background

The taxpayer owned immovable property, and concluded a sale agreement with a related entity, "KMC", in terms of which KMC purchased the property for R25.2 million. This calculated on the basis that, once subdivided, the property comprise 72 individual erven valued at R350,000 each. KMC would pay R350,000 to the taxpayer when each erf was on-sold to a final purchaser. The agreement stated that the CGT on the entire transaction would be paid by the taxpayer on an ad-hoc basis, as and when each erf was on-sold, and the relevant amount had been received by the taxpayer.

When the taxpayer rendered its 2017 return, none of the individual erven had been on-sold and, therefore, the taxpayer did not disclose the sale. SARS picked up on this, and it held the view that the taxpayer was liable for the full CGT amount, raising additional tax and an understatement penalty of 25%, for *reasonable care not taken in completing return* under s223(1).

Pursuant to a dispute by the taxpayer, the matter was heard in the Tax Court, which upheld SARS' view and the 25% penalty. The taxpayer then took the matter on further appeal to the High Court.

Lance Dickson Construction CC v Commissioner for the South African Revenue Service

Issue before the Court

In this matter, taxpayer had conceded that there was indeed an understatement. Thus, the High Court was seized with the following remaining issues –

1. Whether the correct behaviour was applied by SARS as a basis for the 25% penalty, i.e., *reasonable care not taken in the completion of the return*, or if a penalty of 50% should have been imposed in respect of no reasonable grounds for the tax position taken; and

2. Should the 25% penalty imposed by SARS be incorrect, then whether a higher (i.e., 50%) penalty may instead be imposed.

Lance Dickson Construction CC v Commissioner for the South African Revenue Service

SARS' Argument

SARS argued that the imposition of the understatement penalty by SARS was justified, on the basis that the taxpayer had not taken reasonable care in completing the tax return. Per SARS, reasonableness would have required the taxpayer to have known that the sale of the property in September 2016, and the subsequent registration on 27 October 2016, was a disposal event that triggered proceeds which accrued to the taxpayer during the 2017 year of assessment. The failure to make this declaration fell below the standard of a reasonable person in similar circumstances. Therefore, the understatement penalties were correctly imposed at 25%.

However, it should be noted that, during cross-examination in the Tax Court, the SARS official ("the witness"), who was tasked with investigating the taxpayer's 2017 return, accepted that she had chosen the wrong behavioural category vis-à-vis the understatement penalty. Specifically, the witness conceded that SARS had erred in imposing a 25% penalty but went on to suggest that the taxpayer *"should be happy with the lesser penalty because its conduct had been unreasonable either way"*.

Lance Dickson Construction CC v Commissioner for the South African Revenue Service

Taxpayer's Argument

The taxpayer contended that it had not acted unreasonably in adopting the tax position; nevertheless, the understatement did not arise from its return completion process and, therefore, the basis of the understatement penalty was inappropriate. An understatement in this case will have instead arisen from the tax position taken by the taxpayer.

As any understatement in this case was not causally connected to the process followed by the taxpayer in completing its return, SARS identified the incorrect behaviour in applying the understatement penalty. In this case, it was a difference in legal interpretation.

The failure to levy a higher understatement penalty confirmed that SARS was satisfied that the underestimation was not deliberate or a result of negligence, otherwise it would have been obliged to levy a higher penalty.

Lance Dickson Construction CC v Commissioner for the South African Revenue Service

Findings of the Court

The Court considered the evidence adduced by the parties, including pre-trial statements in terms of Rule 31 and Rule 32, as well as the judgment of the Tax Court *a quo*.

In dealing with the power of the Tax Court to vary an understatement penalty, the Court was of the view that the court *a quo* misinterpreted the *Purlish* case and held that the Tax Court does indeed have the power to increase an understatement penalty, albeit contingent on SARS making the allegation in its Rule 31 Statement and having discharged its onus of proof.

If SARS elected to impose a 25% understatement penalty, it was required to prove the factual basis therefor when its determination was challenged by the taxpayer. SARS did not do so, and there is no basis for it to recover that penalty from the taxpayer. The Tax Court was thus wrong in confirming the understatement penalty of 25%. As SARS also did not prove any basis for the 50% understatement penalty, this was not contended by the taxpayer and, therefore, it did not apply.

The taxpayer's appeal to the Court was upheld, with costs awarded in favour of the taxpayer.

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