South African Institute of Taxation

Legislative Interpretation

SAIT Webinar
9 June 2022

YOUR KEY TO THE TAX COMMUNITY

Agenda

In this webinar, we will cover the following topics:

- Legislation and policy
    - Reactive submissions
        - SARS draft documents for public comment
- Court cases of interest and tax importance

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Presenters

- Keitumetse Sesana: (Tax Technical Specialist at SAIT)
- Thomas Lobban: (Tax Legal Manager at Tax Consulting SA)

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Recent activity

Draft document for comments:

- Draft Interpretation Note – Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans

  Submission date: 29 April 2022

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Draft Interpretation Note – Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans

Purpose

- This Note provides taxpayers with guidance on the application of the arm's length principle in the context of the pricing of intra-group loans. The pricing of intra-group loans includes a consideration of both the amount of debt and the cost of the debt.
- An intra-group loan would be incorrectly priced if the amount of debt funding, the cost of the debt or both are excessive compared to what is arm's length. The Note also provides guidance on the consequences for a taxpayer if the amount of debt, the cost of debt or both are not arm's length.
- The guidance and examples provided are not an exhaustive consideration of every issue that might arise. Each case will be decided on its own merits taking into account its specific facts and circumstances.
- The application of the arm's length principle is inherently of a detailed factual nature and takes into account a wide range of factors particular to the specific taxpayer concerned.

Draft Interpretation Note – Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans

Background

- Taxpayers are broadly financed in two ways, namely using equity and debt. The returns on equity capital and debt capital are treated differently for tax purposes
- The way in which a taxpayer is financed has an impact on the calculation of the taxpayer's taxable income.
- This raises tax concerns regarding the balance between the amount of equity capital and debt capital. A taxpayer that is considered to have too much debt when considered against the amount of its equity is said to be **thinly capitalised** for tax purposes.
- Thin capitalisation becomes a potential issue where a South African taxpayer is directly or indirectly funded by a non-resident relevant party. The funding of a South African taxpayer with excessive intra-group, loans may result in **excessive interest deductions** thereby depleting the South African tax base.

Draft Interpretation Note – Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans (continued)

Thin Capitalisation

- South Africa introduced thin capitalisation rules in 1995, the Commissioner was empowered to have regard to the international financial assistance rendered and if it was considered excessive in proportion to the particular lender's fixed capital in the borrower, the interest, finance charges or other consideration relating to the excessive financial assistance were disallowed.

- This gave birth to Practice Note 2 of 14 May 1996.

- For years of assessment commencing on or after 1 April 2012, thin capitalisation is no longer dealt with by a separate subsection of section 31 and is instead governed by the general transfer pricing provisions of section 31(2).

- Section 31(2) applies to, for example, the amount of the intra-group loan and the rate of interest incurred during years of assessment commencing on or after 1 April 2012 irrespective of whether the underlying loan was initially granted before, on or after that date.

Draft Interpretation Note – Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans (continued)

Thin Capitalisation (continued)

- The pricing of intra-group loans includes a consideration of both the amount of debt and the cost of the debt.

- One of the most significant changes is that taxpayers must determine the acceptable amount of debt applying arm's length principles.

SAIT commentary

- The draft IN states that whether indirect financial assistance will be caught under section 31 will be assessed based on *"a case-by-case basis when taking the particular facts and circumstances of the case into account"*. - Welcomed

Specific comments

- **Paragraph 4.1.1 (Direct and indirect financial assistance/ funding)**
    - Welcome the plethora of examples that outline what could potentially be construed as being indirect financial assistance (Example 1 – 4) that we view are aligned with OECD.
    - Examples are too broad – problematic for taxpayers to understand with ease when the transaction entered into will be viewed as indirect financial assistance.
        - Examples: limited information regarding Treasury functions ("Cash Pooling" and "Cash Pool Leader")– Recommended that SARS provides more information.
    - We believe that by establishing clear parameters and factors to analyse the contribution of an entity to a financial transaction is required to reduce uncertainty and the possibility of a double taxation issue.

SAIT commentary

Specific comments (continued)

- **Example 2**
  - The facts of Example 2 consider a scenario whereby a bank is not prepared to provide funding to a South African subsidiary unless its foreign parent company deposits money for a certain period of time
  - This Example suggests that the commercial terms of the loan which is received by the South African subsidiary can be influenced by either party.
  - Recommendation - this Example clearly indicate that from an SA perspective, the commercial terms of loan funding may not arbitrability be influenced in the manner outlined in the Example.
  - Although the OECD Transfer Pricing Guidelines allow for the recharacterisation of loans (but only in specific circumstances), we note that, for example that tax authorities (Australia) are interpreting these guidelines to allow terms and conditions to be altered or even ignored where they would not be found in third party arrangements, which we view to be a disturbing trend.
  - Concerning as this can be construed from Example 2, that the provisions of section 31 of the Act can be used to change/ influence the commercial terms of bona fide business transactions

SAIT commentary

Specific comments (continued)

- **Example 2**
  - **Additional considerations**
    - **Functional analysis -** SARS' interpretation: which covers various commercial considerations from both a lenders and borrower's perspective
- **Determination of whether a purported loan should be regarded as a loan (Paragraph 5.2)**
- Paragraph 5.2 of the draft IN discusses when a loan will be regarded as a loan for the purposes of section 31
- Whilst it is acknowledged that the draft IN proposes that the IFRS standards are a good starting point for determining when a loan should be treated as a loan. The draft IN also makes reference to the need to consider other domestic provisions.
- Recommended that there be alignment of section 31 with other interest sections such as sections 8F and 8FA as well as section 24J and section 8E will ensures consistency in the application of the Act and SARS' view on hybrid instruments.

SAIT commentary

- **Identifying the commercial or financial relations (paragraph 5.3)**
  - Analysis of various factors, *inter alia* the performance of the business in the industry as well as the differences in industry sectors needs to be taken into account.
  - Concerning – non-conformance of factors such as business or product cycle by some companies in a particular industry but non-conformance may be purely for business reasons such as bad management in the MNE group or other factors.
    - Requested that acknowledgement be in the draft IN in some detail so as to ensure that transfer pricing adjustments are not made on entities that have a legitimate basis for not conforming to the industry norms - some level of comfort to taxpayers if it could be indicated that exceptions do exist.

- **Use of credit ratings (paragraph 6.1.2): credit rating determinations (c)**
  - When determining if a loan has been advanced on arm's length conditions, the use of credit ratings must be considered.
  - Perfect way to compare transactions, - but - the preparation and analysis of credit ratings is specialised and not many companies are equipped to prepare these, nor do they have access to databases or the use of specialised tools, that allow them to do so.

SAIT commentary

- **Use of credit ratings (paragraph 6.1.2): credit rating determinations (c)**
  - Being conscious of the economic reality in South Africa, we suggested that SARS give consideration to the provision of a cost-efficient alternative of analysis to relevant cross-border intercompany loans.
  - Paragraph 6.1.2 of the draft IN implies that there may be circumstances where *"the arm's length amount of debt may be nil in circumstances where a taxpayer with a very healthy balance sheet, excess cash reserves and spare borrowing capacity borrowed from an offshore parent company when all the relevant facts indicate that there was no business need or reason or commercial benefit for the additional finance"*.
    - The OECD Transfer Pricing Guidelines caution against tax administrations interfering or dictating on the manner that MNE's choose to operate, including how they choose to finance their business.
    - We recommended that SARS also exercise caution in disallowing interest on *bona-fide* loans simply because it is of the view the borrowing entity did not require funding.

SAIT commentary

- **Use of credit ratings (paragraph 6.1.2): Guarantees (h)**
  - The draft IN also proposes the impact of guarantees should be considered on a case-by-case basis and may or may not impact the loan arrangement being reviewed.
  - The draft IN states that "*if the guarantee would not have been provided by an independent party it will be ignored when determining the amount the taxpayer could have borrowed*".
  - Third party guarantees are rarely made under the same terms and conditions as those within a MNE context and almost always have some form of *quid-pro-quo*.
  - Thus, applying this test is, in our view unreasonable and goes against international precedent which has repeatedly tested the impact of being part of a group for the purposes of securing third party lending.
  - Recommended that SARS reconsider this.
- **Timing (Paragraph 8)**
  - Testing the arm's length nature of the arrangement = frequently, often quarterly or even more frequently.
  - We consider such frequency places significant burden on taxpayers.
  - We would welcome SARS considering allowing the thin capitalisation test to be an annual test.

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- **De-minimis threshold – safe harbour**

  - SARS has previously provided a safe harbour or risk harbour to create some degree of certainty for taxpayers when looking at thin capitalisation and the associated arm's length rate of interest to be applied on loan transactions
  - Furthermore, the Davis Tax Committee made recommendations that a safe harbour should be considered for loan transactions. The OECD has also warned against adopting a pure arm's length test for loan transactions.
  - move away from this practice and these recommendations places an increased onus on taxpayers to prove that loan transactions are arm's length both in terms of their quantum (thin capitalisation) and price (interest rate). We therefore believe that a provision of a “de minimis’ rule will be appreciated by taxpayers as typically taxpayers tend to object to having full debt capacity and pricing studies performed especially for relatively small loans.
  - SARS should consider allowing small loan transactions to be entered into without testing and a safe harbour for loan transactions where the quantum of the loan is below a certain amount.

SAIT commentary

Additional considerations

- The draft IN does not consider the possibility that an unusual transaction in the market may still adhere to the arm's length principle. i.e., a loan with 30 years of maturity may still be compliant with the arm's length principle, even though there may not be publicly available information of third-party loans with a similar tenor. The banks have recently started to offer 30-year home loans. As such, we request guidance (and would be interested to know) on whether SARS would consider the pricing of these loans.

Recent court cases

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Recent court cases:

- *Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)*

- *MB v Commissioner, South African Revenue Service (Income Tax Case No. 24578) (08 April 2022)*

- *Commissioner, South African Revenue Service v Sasol Chevron Holdings Limited (Case no 1044/2020) [2022] ZASCA 56 (22 April 2022)*

Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)

Background

- The taxpayer applied for default judgment in terms of Rule 56(1) of the Tax Court Rules, read with section 129(2)(b) of the Tax Administration Act, after SARS failed to submit its statement of frounds of assessment and opposing the appeal, in terms of Rule 31 of the Tax Court Rules. As such, the taxpayer sought a final order that the understatement penalty raised by SARS be set aside.

- SARS opposed the application and brought a counter-application for condonation for the failure to file the rule 31 statement in time. The taxpayer opposed the condonation application by SARS.

Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)

Issues before the Court

- The court was required to determine whether SARS had shown good cause for its default to timeously file the Rule 31 statement and if the court should condone its late filing. This would result in the court directing that the appeal (against the understatement penalties) proceeds on the merits.

- Furthermore, should SARS' lateness not be condoned, the further issue was whether default judgment should be granted in favour of the applicant, in terms of Rule 56(1)(a) and section 129 of the TAA.

Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)

Arguments before the Court

- The taxpayer contended that SARS failed to deliver the rule 31 statement for a period of almost two years and that it has failed to give a full account of the reasons for the default.
- SARS disputed that it has been in default for two years and contended that there was an agreement between the parties to suspend litigation, which only lapsed in April 2021.
- The Tax Court found that the objective facts clearly demonstrated that the respondent was not, as alleged by the applicant, in default in filing the rule 31 statement at the time the agreement to pend litigation was reached, and most definitely not for a period of almost two years.

Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)

Arguments before the Court

- On 15 April 2021, the applicant sent a notice of default in terms of Tax Court Rule 56(1), albeit to the incorrect attorney, and in terms of this notice, the respondent was given 45 days to file its rule 31 statement. That meant that the respondent had to file its statement on or before 21 June 2021.

- As a result of the notice of default being sent to the incorrect attorney, the respondent only became aware that the agreement to pend litigation was terminated by the applicant on 22 April 2021.

Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)

Findings of the Court

- The Tax Court held that there was no default on SARS' part prior to 21 June 2021 as there was an agreement in place that all litigation was pended, including the exchange of pleadings. This agreement was only terminated, at best for the taxpayer, on 15 April 2021, when the notice was served on the incorrect attorney.

- The court further held that the taxpayer was not in default of delivery of its rule 31 statement before 15 April 2021 (i.e., the date upon which the agreement to suspend litigation, on the applicant's version, was terminated) and that there must be a default prior to the delivery of a rule 56 notice.

- The taxpayer's application for default judgment was premature and fatally defective. Another reason why the notice was not valid was that the default relied on by the applicant in the notice was the failure to advise whether alternative dispute resolution proceedings would be appropriate and not the respondent's failure to file the rule 31 statement.

Taxpayer M v Commissioner, South African Revenue Service (Income Tax Case No. VAT 1826) (10 May 2022)

Findings of the Court

- SARS had to file the rule 31 statement on 21 June 2021 but only filed the statement on 21 July 2021. The delay was not a result of any non- compliance on the part of SARS, but as a result of the conduct of the SARS' attorney and counsel (SARS' attorney had contracted COVID-19 at the beginning of June 2021 and, on 28 June 2021, SARS' junior counsel, who had been briefed to draft the rule 31 statement, tested positive for COVID-19).

- The Tax Court held that the opposition to the condonation application was unreasonable. The period for which condonation was sought was slight and the default was explained satisfactorily. There would furthermore be no significant prejudice to the taxpayer. The application for condonation was therefore granted with costs.

MB v Commissioner, South African Revenue Service (Income Tax Case No. 24578) (08 April 2022)

Background

- Involved 3 applications before the Tax Court, derived from an appeal brought by the taxpayer against additional assessments initiated by the Commissioner in relation to the 2013 to 2015 tax years.

- The taxpayer owned and operated 3 mines, AA, BB, and CC. Two of the main issues in this appeal were, firstly, whether certain expenses incurred by the taxpayer (mainly expenses incurred at the AA mine) in the 2013 to 2015 tax years constituted expenditure incurred in the production of taxable income or capital expenditure; and secondly, whether the taxable income in the taxpayer's tax returns for each of these years was understated and whether an understatement penalty ("UP") should be imposed on the taxpayer.

- To decide these issues, the court engaged in the question of whether the AA mine was contiguous to the BB and CC mines.

MB v Commissioner, South African Revenue Service (Income Tax Case No. 24578) (08 April 2022)

Rule 56 Application

- One of the taxpayer's contentions regarded the imposition of a UP. In this regard, the taxpayer sought the record of the deliberations of the Commissioner's staff who decided that a UP should be imposed for each of the tax years in question, which the Commissioner refused.

- The Tax Court dismissed the Tax Court Rule 56 application on the basis that the Commissioner was correct to invoke the protection afforded by confidentiality of his internal operations as envisaged in section 68(1)(e) of the TAA.

- The kind of communications that the Commissioner's employees engaged in when considering whether each of the relevant the taxpayer's tax returns was blemished with an understatement, and whether in terms of section 222 of the TAA they were obliged to impose a UP, is precisely the one that is protected from disclosure by legislative fiat.

MB v Commissioner, South African Revenue Service (Income Tax Case No. 24578) (08 April 2022)

Better Discovery Application

- The Commissioner called for better discovery for use of the documents at the relevant hearing. This would allow the Commissioner to vet the veracity of certain claims made by the taxpayer.
- By not availing them, the taxpayer denied the Commissioner this opportunity. These would be the source documents which made it possible for the taxpayer to generate their spreadsheets. The spreadsheets provide greater detail.
- The Tax Court found that the documents were self-evidently relevant and that the taxpayer should avail the documents requested by the Commissioner.

MB v Commissioner, South African Revenue Service (Income Tax Case No. 24578) (08 April 2022)

Application for Further Particulars

- The Commissioner requested that the court order the taxpayer to provide answers to certain questions and furnish copies of relevant documents sought. The court found it to be inappropriate to call for documents in an application for further particulars and held that the Commissioner cannot in such application be granted the order for documents to be furnished and he should have sought the documents in the application for further and better discovery.

- The Tax Court held that the taxpayer should provide the answers to the questions raised in the Commissioner's request for further particulars – these focused on alleged inconsistencies or contradictions in the case presented by the taxpayer and which create uncertainty as to what the taxpayer's case at trial will be. The Tax Court held that the answers to the questions would be strictly necessary for the preparation of the trial hearing and that by providing the answers, the taxpayer will be doing no more than clarifying what its case is.

Commissioner, South African Revenue Service v Sasol Chevron Holdings Limited (Case no 1044/2020) [2022] ZASCA 56 (22 April 2022)

Background

- This case was an appeal by SARS against a judgment by the High Court in Pretoria, in favour of Sasol Chevron Holdings Limited ("the taxpayer").

- A division of Sasol (A Co) sold goods to another Sasol division (B Co), which immediately on-sold them to an unrelated third party for export to Nigeria. Regulation 15(1) of the Export Regulations requires that goods sold for exportation purposes must be exported within 90 days of the sale. However, B Co failed to do so.

- As such, A Co requested SARS to issue a ruling extending the prescribed 90-day period and SARS declined the application for extension. The taxpayer then instituted a review application under the Promotion of Administrative Justice Act, 2000 ("PAJA") seeking an order to review and set aside SARS' decision albeit more than 180 days after SARS' decision was given.

Commissioner, South African Revenue Service v Sasol Chevron Holdings Limited (Case no 1044/2020) [2022] ZASCA 56 (22 April 2022)

Arguments before the Court

- SARS asserted that section 7(1) of PAJA requires such a review application to have been instituted within 180 days from the date of the decision, or within such an extended period as has been agreed between the parties or as has been granted by a court in terms of section 9 of PAJA.

- However, since there was no agreement between the parties, and the Respondent had not brought such an application for extension of the 180-day period, this period stands and cannot be extended. Therefore, SARS argued that the review application must be dismissed on that ground alone without consideration of the merits of the review.

- The taxpayer contended that SARS' reasons for the decision were only provided at a later date, and therefore the 180-day period had only begun to run from 27 March 2018. Accordingly, the taxpayer's review application (which was submitted on 21 September 2018) was within the 180-day period.

Commissioner, South African Revenue Service v Sasol Chevron Holdings Limited (Case no 1044/2020) [2022] ZASCA 56 (22 April 2022)

Findings of the Court

- The High Court had agreed with the taxpayer and considered the merits of the review application. However, the Supreme Court of Appeal (SCA) found that the fact that the parties continued to exchange further correspondence beyond the date of SARS' decision (6 December 2017) cannot detract from the fact that SARS' impugned decision was taken on 6 December 2017.

- The Court went further to state that the decision taken on 6 December 2017 is the decision that the taxpayer referred to in its application and sought to set aside. Because the decision was made on 6 December 2017, the taxpayer had submitted its review application outside of the 180-day period.

- The Court noted that where no application for the extension of the 180-day period has been made, it has no authority to enter into the substantive merits of a review application. It therefore held that, in favour of SARS, the High Court's decision should be overturned and the merits of the review application need not be considered.

Thomas Lobban biography

Thomas is a SARS-registered tax practitioner, and a co-author of the LexisNexis Expatriate Tax textbook. Thomas holds an LLB and LLM Tax Law degree and specializes in tax technical matters, with a focus on cross-border taxation and fin-tech matters.

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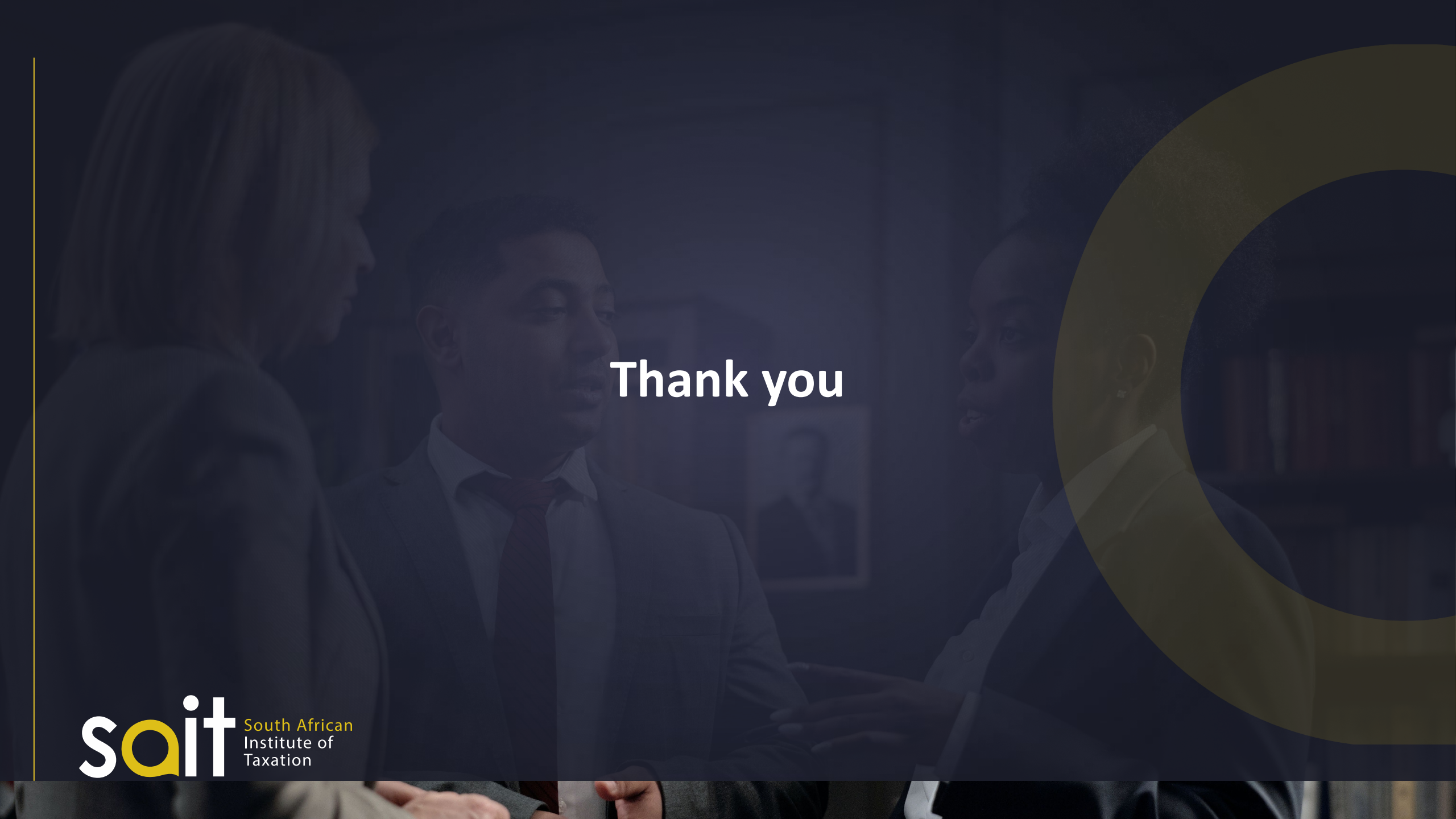

Thank you

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