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CAPITAL GAINS TAX
PURCHASE AND SALE OF CONNECTED PERSON LOAN ACCOUNTS

TAX ADMINISTRATION
RAISING ALL GROUNDS OF OBJECTION IS CRITICAL

VALUE-ADDED TAX
VAT REVERSE CHARGE AND MINING

CAPITAL GAINS TAX

0579. Purchase and sale of connected person loan accounts 03

EMPLOYEES' TAX

0580. Registration required for non-resident employers 05

GENERAL

0581. SARS increases interest rates 07

PUBLIC BENEFIT ORGANISATIONS

0582. Proposed amendments in the 2023 Budget 09

TAX ADMINISTRATION

0583. Objections – referral back to SARS 11

0584. Raising all grounds of objection is critical 13

0585. SCA rules on the imposition of USP where a taxpayer relied on an opinion 15

TRANSFER PRICING

0586. Interpretation Note 127 18

TRUSTS

0587. Non-resident beneficiaries 24

VALUE-ADDED TAX

0588. VAT reverse charge and mining 26

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PURCHASE AND SALE OF CONNECTED PERSON LOAN ACCOUNTS

It is not uncommon for loan accounts owing by a company (the debtor company) to a shareholder (creditor) to be sold by the creditor together with the shares in the debtor company.

So too, creditors may be tempted to dispose of a loan owed by the debtor company in circumstances where the debtor company cannot service it because of the prevailing economic downturn. In these instances, the market value of the loan may be less than the face value and also the base cost; and, as such, may be sold at a "discount to face value" resulting in a capital loss.

Where the debtor company is a "connected person" as defined in section 1(1) of the Income Tax Act, 1962 (the Act), in relation to the creditor and the loan is sold at a price less than the base cost of the loan (and assuming the base cost is equal to the face value of the loan), it is crucial that the tax consequences for both the creditor (ie, the seller) and the "acquirer of the debt" (ie, the purchaser) be considered carefully. This would also be imperative to ensure that the transaction is structured in a tax-efficient manner. For purposes of this article, it is assumed that the loan is interest-free or a non-interest bearing loan, and therefore the provisions of section 24J of the Act are not addressed.

Generally, the capital loss arising as a consequence of the disposal by the creditor of the loan owed by the debtor company would be disregarded for capital gains tax purposes. However, a closer look will be taken at when the capital loss need not be disregarded and what would be required from the creditor.

Paragraph 56 of the Eighth Schedule to the Act was introduced to prevent persons from receiving a benefit where losses occur on debt when the debt most likely represents a disguised gift or contribution, neither of which would otherwise create a capital loss (*Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001,* p 87). Thus, paragraph 56 was inserted as a loss limitation rule to avoid the tax base from being eroded by overstated or disguised losses as a consequence of transfers of debt owed by connected persons.

Paragraph 56(1) provides that, where a creditor disposed of a debt owed by a connected person, the creditor must disregard any capital *loss* determined as a consequence of that disposal.

It matters not whether the creditor disposed of the debt *to a connected person*, but only that the debt must *be owed by a connected person*. Importantly, paragraph 56(1) does not apply to capital *gains* since these constitute taxable income (section 26A of the Act) that contributes to the tax base. Paragraph 56(1) is, however, not altogether absolute.

"Where the debtor company is a 'connected person' as defined in section 1(1) of the Income Tax Act, 1962 (the Act), in relation to the creditor and the loan is sold at a price less than the base cost of the loan (and assuming the base cost is equal to the face value of the loan), it is crucial that the tax consequences for both the creditor (ie, the seller) and the 'acquirer of the debt' (ie, the purchaser) be considered carefully."

Paragraph 56(2) provides for carve-outs to avoid the unintended consequences of paragraph 56(1) (*Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002*, p 62 and *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004*, p 82). Notably, the carve-outs relate to those circumstances where the amount of the debt results in some form of tax in the hands of the debtor or the acquirer of the debt. In this respect, paragraph 56(2) provides that the capital loss need not be disregarded by the creditor if –

- the amount reduces the expenditure in respect of an asset of the debtor or must be taken into account by the debtor as a capital gain (paragraph 56(2)*(a)*);
- the amount *which the creditor must prove* must be or was included in the gross income of the acquirer of the debt (paragraph 56(2)*(b)*);
- the amount must be or was included in the gross income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor (paragraph 56(2)*(c)*); or
- the amount *which the creditor must prove* must be or was a capital gain in the hands of the acquirer of the debt (paragraph 56(2)*(d)*).

The circumstances referred to in paragraph 56(2)*(a)* to *(d)*, arguably, are keeping in step with the mischief at which the loss limitation rule of paragraph 56 is aimed. However, paragraph 56(2)*(b)* and *(d)* specifically provide that the "creditor must prove" that the acquirer of the debt must be or was subject(ed) to normal tax. Interestingly, section 102(1) of the Tax Administration Act, 2011 (the TAA), also provides that the creditor bears the onus of proof. The burden of proof must be discharged as a matter of probability.

The standard is often expressed as requiring proof on a "balance of probabilities" but that should not be understood as requiring that the probabilities should do no more than favour the creditor in preference to the South African Revenue Service (SARS). What is required is that the probabilities in the creditor's case be such that, on a preponderance, it is probable that paragraph 56(2) would apply.

Although paragraph 56(2) does not explicitly state that the circumstances referred to therein require the application of these circumstances to a hypothetical transaction, in our view, on a purposive interpretation to make sense of these provisions, it must be so. In fact, SARS holds the same view. SARS' *Comprehensive Guide to Capital Gains Tax (Issue 9)* calls for a hypothetical enquiry.

It is, however, not as easy as to assert that – from a hypothetical point of view – one of the exceptions in paragraph 56(2) would apply to the amount of the debt so disposed of.

Given the potential tax implications and complexities involved in the circumstances referred to in paragraph 56(2), it is essential for creditors to consult with their experienced tax professional before the disposal of debts owed by connected persons. By doing so, creditors would obtain certainty as to whether the capital loss determined in consequence of the disposal of debts owed by connected persons would be caught by the clutches of paragraph 56(1); it will also ensure that the creditor would be able to prove its case and utilise the capital loss arising from such disposal.

Andries Myburgh & Emilé Cronje

Acts and Bills

- Income Tax Act 58 of 1962: Sections 1(1) (definition of "connected person"), 24J & 26A; Eighth Schedule: Paragraph 56(1) & (2)*(a)*–*(d)*;
- Tax Administration Act 28 of 2011: Section 102(1).

Other documents

- *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001*, p 87;
- *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002*, p 62;
- *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004*, p 82;
- SARS' *Comprehensive Guide to Capital Gains Tax (Issue 9).*

Tags: debtor company; connected person; loss limitation rule; capital loss; capital gain.

REGISTRATION REQUIRED FOR NON-RESIDENT EMPLOYERS

Subject to certain exclusions and exemptions, income earned for employment services rendered in South Africa is generally subject to South African employees' tax.

The system where employees' tax is deducted and accounted for monthly is generally referred to as Pay-As-You-Earn (PAYE). PAYE is therefore a withholding tax on employment income, which will be offset against the employee's final income tax liability for the relevant year of assessment.

The obligation to withhold employees' tax is provided for in paragraph 2(1) of the Fourth Schedule to the Income Tax Act, 1962 (the Act), which reads as follows:

> "Every –
>
> *(a)* employer who is a resident; or
>
> *(b)* representative employer in the case of any employer who is not a resident,
>
> ... who pays or becomes liable to pay any amount by way of remuneration to any employee shall, unless the Commissioner has granted authority to the contrary, deduct or withhold from that amount ... by way of employees' tax an amount ... in respect of the liability for normal tax of that employee ... ".

"Although the obligation to deduct PAYE rests on the employer, the income tax liability still remains for the account of the employee. Therefore, employees earning a remuneration in South Africa from non-resident employers should also ensure that their employers are duly registered as employers in South Africa and that they are remitting the correct amount of PAYE on their behalf to SARS."

In terms of the above provision, it is clear that South African-sourced employment income that a resident or non-resident earns is subject to employees' tax if it is paid by an employer who is a tax resident in South Africa. Furthermore, where the employer is not a resident of South Africa, employees' tax must be deducted either by an agent or representative who has the authority to pay the remuneration to the non-resident employee.

The employees' tax so withheld must be paid over to SARS as partial (or full) payment of that employee's annual tax liability by no later than the seventh day of the next month. Should the employer fail to pay the amount due to SARS by this date, the employer will be subject to a 10% penalty as well as interest, unless a deferral arrangement is in place. The amount withheld is calculated according to the employee's level of earnings using the applicable tax rate.

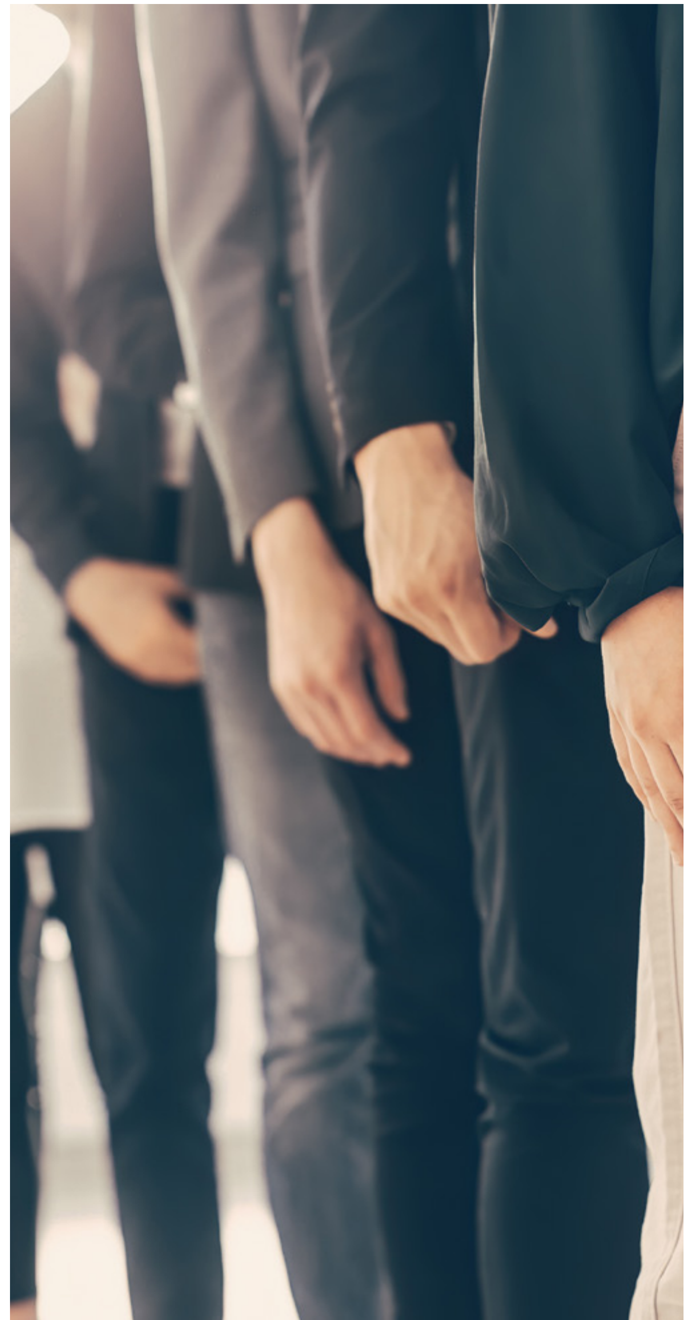
The above provision, however, arguably does not adequately cater for a scenario where the employer is not a resident and does not have an agent or a representative in South Africa for employees' tax purposes. In this context, National Treasury has proposed in the 2023 Budget Review that it will amend various provisions in the Act to ensure that non-resident employers who pay remuneration to employees who render services in South Africa register as such in South Africa, notwithstanding the fact that they may not have a representative or agent in South Africa.

Therefore, clarity will be provided that non-resident employers will also be held liable to withhold (or deduct) employees' tax from remuneration that is paid to their employees in South Africa. The proposed amendments will also ensure that non-resident employers are also liable for skills development levies and unemployment insurance contributions where applicable.

National Treasury, however, has not yet expounded on how non-residents will be able to register. As it stands, registration as an employer must be done through eFiling.

Having regard to the above, it is recommended that, as soon as the legislation is made effective and registration is made possible, foreign employers who pay remuneration to employees rendering services in South Africa register as employers with SARS and start withholding PAYE as contemplated in the Fourth Schedule to the Act to avoid incurring any penalties and interest being imposed by SARS. Although the obligation to deduct PAYE rests on the employer, the income tax liability still remains for the account of the employee. Therefore, employees earning a remuneration in South Africa from non-resident employers should also ensure that their employers are duly registered as employers in South Africa and that they are remitting the correct amount of PAYE on their behalf to SARS.

Editor's note: As this is only a Budget *proposal*, it is *not* law yet. Although it is an important alert to possible future developments in the tax arena, one should remember to follow closely what happens in respect of these proposals in the coming months and to take note of what eventually is enacted as part of our tax legislation. The current proposal will likely form part of the draft tax amendment legislation to be published in July or August this year.



Puleng Mothabeng

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Fourth Schedule: Paragraph 2(1).

Other documents

- 2023 Budget.

Tags: employees' tax; representative employer; tax resident; non-resident employers.

SARS INCREASES INTEREST RATES

TAX, VAT, FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX

The continuing increases in the repo rate by National Treasury forces SARS to again adjust its own rates.

It is important to remember that interest and penalties paid to SARS are not deductible expenses for income tax purposes. On the other hand, interest received from SARS is fully taxable (after deducting the current initial exemption of R23 800 per annum (R34 500 if you are 65 or older) for all local interest income earned by natural persons).

"For employees' tax purposes, the amount of the tax benefit must be calculated as accruing to the employee with reference to whenever interest is payable."

- **Income tax, provisional tax, dividends tax, etc**

  Payable to SARS on short payments of all such taxes (other than VAT): 11.25% per annum from 1 July 2023 (was 10.75% per annum with effect from 1 May 2023).

  Payable by SARS on refunds of tax (where interest is applicable): 7.25% per annum from 1 July 2023 (was 6.75% per annum with effect from 1 May 2023).

  If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 11.25% per annum from 1 July 2023 (was 10.75% per annum with effect from 1 May 2023).

- **VAT**

  Payable to SARS on late payments: 11.25% per annum from 1 July 2023 (was 10.75% per annum with effect from 1 May 2023).

  Payable by SARS on VAT refunds after prescribed period: 11.25% per annum from 1 July 2023 (was 10.75% per annum with effect from 1 May 2023).

- **Fringe benefits**

  Official interest rate for loans to employees, below which a deemed fringe benefit arises: 9.25% per annum with effect from 1 June 2023. See below for details of historical changes.

- **Dividends tax**

  Official interest rate for loans (designated in rands) to shareholders below which the interest on such loans can be deemed to be dividends on which dividends tax is payable: 9.25% per annum with effect from 1 June 2023. See below for details of historical changes.

- **Donations tax**

  Loans to trusts by connected natural persons with interest charged at rates below the official rate create a donation subject to donations tax at 20% on the interest forgone each year.

- **Penalties**

  The amount of penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX – CONSEQUENCE OF INADEQUATE INTEREST RATES

- If inadequate interest is charged to an employee (including working directors) on loans (other than for the purpose of furthering their own studies) in excess of R3 000 from their employer (or associated institution), tax on the fringe benefit may be payable.

  Unless interest is charged at the "official" rate or greater, the employee is deemed to have received a taxable fringe benefit calculated as being the difference between the interest actually charged and interest calculated at the "official" rate.

  For employees' tax purposes, the amount of the tax benefit must be calculated as accruing to the employee with reference to whenever interest is payable; if not regularly, then on a monthly basis for monthly paid employees, weekly for weekly paid employees, etc.

- Subject to a number of exceptions, distributions of income and capital gains from a company / close corporation are normally subject to dividends tax at the flat rate of 20%. Loans or advances to or for the benefit of a shareholder / member will be deemed to be dividends but only to the extent that interest is not charged on the loan at the "official" rate (or market-related rate in the case of foreign currency loans) and to the extent that fringe benefits tax is not payable on an interest-free (or subsidised-interest) loan where the shareholder is an employee.

  It is not the amount of the loan but the interest not charged which is deemed to be a dividend. Relevant low-interest loans are accordingly subject to dividends tax payable by the company in respect of the interest benefit.

- Loans to trusts by natural connected persons with interest charged below the official rate create a donation subject to donations tax at 20% (25% if cumulative donations of the donor amount to more than R30m) on the interest forgone each year.

- With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African "repo rate" plus 1%. For foreign-currency loans, the rate is the equivalent of the foreign "repo rate" plus 1%. The South African repo rate, at time of writing, stands at 8.25% per annum (with effect from 1 June 2023).

THE "OFFICIAL" RATE OF INTEREST OVER THE PAST FIVE YEARS

With effect from		*Rate per annum*
1 April 2018	–	7.50%
1 December 2018	–	7.75%
1 August 2019	–	7.50%
1 February 2020	–	7.25%
1 April 2020	–	6.25%
1 May 2020	–	5.25%
1 June 2020	–	4.75%
1 August 2020	–	4.50%
1 December 2021	–	4.75%
1 February 2022	–	5.00%
1 April 2022	–	5.25%
1 June 2022	–	5.75%
1 August 2022	–	6.50%
1 October 2022	–	7.25%
1 December 2022	–	8.00%
1 February 2023	–	8.25%
1 April 2023	–	8.75%
1 June 2023	–	9.25%

Kent Karro

Tags: deductible expenses; natural connected persons; donations tax; taxable fringe benefit; low-interest loans; repo rate.

PROPOSED AMENDMENTS IN THE 2023 BUDGET

In this article proposed amendments are briefly discussed that relate to public benefit organisations (PBOs) and other tax-exempt entities approved under sections 30, 30A, 30B or 30C of the Income Tax Act, 1962 (the Act), along with an update on the additional requirements that now must be met for the issue of receipts issued under section 18A of the Act.

PERSONS ACCEPTING FIDUCIARY RESPONSIBILITY

In terms of section 30, one of the requirements to become an approved PBO is that an organisation must appoint at least three unconnected persons to accept fiduciary responsibility for the organisation. Section 30A, dealing with recreational clubs, section 30B, dealing with tax-exempt associations, including trade unions or chambers of commerce, and section 30C, dealing with small business funding entities, also contain this requirement. In practice, this would mean that if the entity takes the form of a trust, there would be at least three unconnected trustees that take fiduciary responsibility, or where it takes the form of a non-profit company, this requirement would be met through the appointment of three unconnected directors. In the case of section 30, it is also expressly stated that no single person may directly or indirectly control the decision-making powers of the entity.

In Annexure C to the 2023 Budget Review, it is stated that because these entities enjoy a special tax dispensation, various rules exist that limit the manner in which these entities operate or require greater accountability and stricter governance. (The Budget Review does not specifically refer to section 30C entities but it is possible that this was an accidental omission.) It proposes that the legislation be amended to clarify that "person" in each section in this context refers to a natural person.

EXPANDING THE GENERAL DISCLOSURE PROVISIONS FOR SECTION 18A APPROVED ORGANISATIONS

In terms of section 18A of the Act, PBOs and certain other specified entities may receive deductible donations from the public. In practice, the entity receiving the donation must issue a section 18A certificate containing certain information, which the donor will use as proof of the donation made. Annexure C to the Budget Review notes that in terms of the Tax Administration Act, 2011, the South African Revenue Service (SARS) may disclose a list of PBOs approved in terms of sections 18A and 30 of the Act. Such a list may be found on SARS' website. Considering that there are also other entities that may receive tax-deductible donations and issue receipts under section 18A, it is proposed that SARS be explicitly empowered to disclose all entities with a section 18A approval.

ADDITIONAL REQUIREMENTS FOR THE ISSUE OF RECEIPTS UNDER SECTION 18A

In terms of section 18A(2)*(a)* of the Act, to claim a donation as a deduction under section 18A, the entity to which the donation is made must issue a receipt containing certain prescribed information, including the reference number of the entity, date of the receipt of the donation and certain details regarding the donation and the donor. Section 18A(2)*(a)* was amended with effect from 19 January 2022 by the addition of subparagraph (vii), which states that in addition to the specific requirements listed in the section, SARS may also require that the receipts include "such further information as the Commissioner [for SARS] may prescribe by public notice."

On 24 February 2023, SARS issued a public notice indicating that the following further information must be included in the receipt:

- donor: nature of a person (natural person, company, trust etc);
- donor: identification type and country of issue (in case of a natural person);
- identification or registration number of the donor;
- income tax reference number of the donor (if available);
- contact number of the donor;
- electronic email address of the donor;
- a unique receipt number; and
- trading name of the donor (if different from the registered name).

RELEVANCE OF THE CHANGES

In relation to the issue of persons accepting fiduciary responsibility, it is unclear whether there is any mischief that the legislature seeks to address by defining the meaning of "person" in section 30(3). From a practical perspective, there are instances where an international charitable organisation broadens its scope of activities to South Africa or decides to set up a branch in South Africa, where the South African branch or unit could then apply to SARS to become an approved PBO. It is then common for such international organisation to attempt to exercise some oversight by making provision in the founding document for it to appoint some of the persons accepting fiduciary responsibility of the local entity. Objectively, this should not create an issue unless the power to appoint resides solely with the international organisation, where the argument could then be made that it controls the entity's decision-making powers.

The expansion of the general disclosure provisions should be seen as a positive development and the proposal here may promote public awareness of all the entities to whom they can make tax-deductible donations. For example, aside from PBOs approved for purposes of both sections 30 and 18A, section 18A refers to a number of United Nations entities that may receive deductible donations, as well as entities approved as tax-exempt in terms of section 10(1)*(cA)*(i) of the Act.

Finally, the publication of the notice regarding additional information to be included in section 18A receipts may be an indication that SARS is trying to expand its third-party data collection processes. It is notable that virtually all the additional requirements pertain to donor information. Although audits relating to PBOs and disputes involving them do not often reach the tax court, it may be that the SARS Tax Exemption Unit will use the donor information included in the receipts to identify donors who they believe may not be fully compliant with tax laws in general.

In light of South Africa's greylisting by the Financial Action Task Force (FATF) early in 2023, it is also interesting to note that FATF Recommendation 8 focuses on the non-profit-organisation (NPO) sector and the potential use of NPOs as vehicles for money laundering and terrorism financing. However, there is no indication in the notice that its publication was in response to FATF Recommendation 8.

"Finally, the publication of the notice regarding additional information to be included in section 18A receipts may be an indication that SARS is trying to expand its third-party data collection processes."

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Sections 10(1)*(cA)*(i), 18A (emphasis on subsection (2)*(a)*(vii)), 30 (emphasis on subsection (3)), 30A, 30B & 30C;
- Tax Administration Act 28 of 2011.

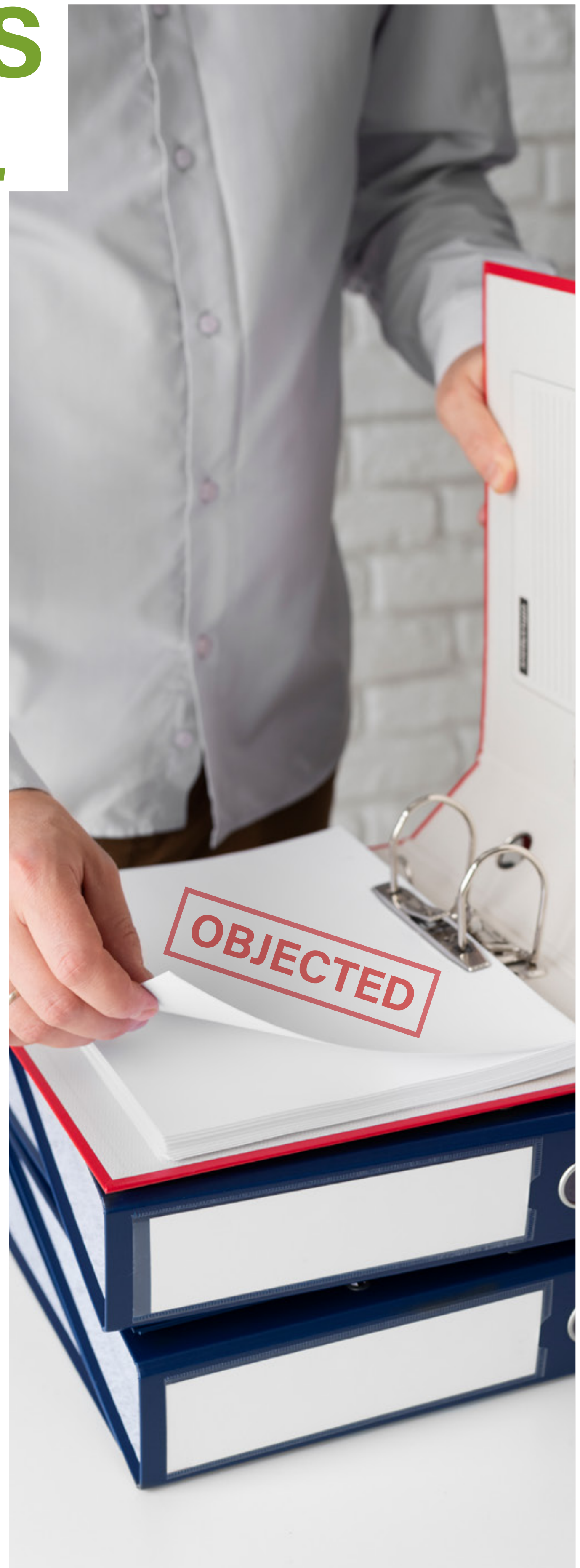
Other documents

- 2023 Budget Review: Annexure C;
- Financial Action Task Force (FATF): Recommendation 8.

Tags: public benefit organisations (PBOs); tax-exempt entities; natural person; tax-deductible donations; approved PBO.

OBJECTIONS – REFERRAL BACK TO SARS

The rules (the Rules) promulgated in terms of section 103 of the Tax Administration Act, 2011 (the TAA), provide for parties to raise points in limine, *prior to the merits of the matter being heard.*



The tax court has dealt with different types of preliminary points raised, such as which party has the duty to begin, whether portions of a party's pleadings should be struck out, or whether a party has raised new grounds of assessment or new grounds of appeal that are inconsistent with the Rules.

However, a preliminary point the tax court had not yet been asked to consider, is whether a matter can be referred back to the South African Revenue Service (SARS) for consideration and assessment, prior to the hearing on the merits proceeding. This was the question to be considered in *AB v The Commissioner for the South African Revenue Service,* [2022], which was heard by the tax court on 23 August 2022 and which is discussed here.

Facts

The taxpayer is a shareholder in several companies that loan money to one another and a central issue in the tax dispute was the loan account in one of the taxpayer's companies. In an unaudited financial statement for 2014 (one of the tax periods to which the dispute relates), the taxpayer's loan account was recorded as amounting to R30,179,163. The taxpayer contended that this amount was incorrect, that the financial statements were rewritten to correct this and that the correct value was R10,390,949.

"While not mentioned expressly in the judgment, it reaffirms the principle that the tax court is a creature of statute and that its jurisdiction and powers are limited to what is provided for in the TAA and the Rules."

SARS questioned the taxpayer's submission and how the error went undetected for more than five years. It alleged that the taxpayer gave three different versions during the objection and appeal process and that a fourth version was put forward after the appeal had been lodged, during the alternative dispute resolution process. As such, SARS said that it was unable to investigate and consider the second version of the revised financial statements and requested that the matter be referred back to it for further examination and assessment. This practically meant that SARS would conduct a further audit of the companies in the group and other related companies to determine the taxpayer's liability.

SARS argued that the tax court had the power to refer the matter back to SARS for examination and assessment in terms of section 129(2)*(c)* of the TAA, which the taxpayer disputed.

Judgment

The tax court considered the relevant sections. Section 129(2)*(c)* states that in the case of an assessment or "decision" under appeal or an application in a procedural matter referred to in section 117(3), the tax court may refer the assessment back to SARS for further examination and assessment. Section 117(3) of the TAA states that the court may hear and decide an interlocutory application or an application in a procedural matter relating to a dispute under chapter 9 of the TAA as provided for in the Rules.

The tax court accepted the taxpayer's argument that the referral contemplated in section 129(2)*(c)* could only be granted after the hearing of the taxpayer's appeal. It rejected SARS' argument that the referral could be granted as SARS was not seeking final relief and it was merely an interim order that could be appealed against.

The court further accepted the taxpayer's argument that the order would be final as when SARS makes a new assessment, that decision is final in nature. The court based its decision in this regard on the judgment in *Metlika Trading Ltd and Others v Commissioner for SARS,* [2004], which held that where an interim order is intended to have an immediate effect and will not be reconsidered on the same facts in the main proceedings, it will generally be final in effect.

The court thus found that it could not grant the order requested by SARS and dismissed the preliminary point. However, it indicated that SARS would not be without remedy as the court ultimately hearing the tax dispute on the merits could refer the matter back, in terms of section 129(2)*(c)*, after the hearing contemplated in that section.

Comment

While not mentioned expressly in the judgment, it reaffirms the principle that the tax court is a creature of statute and that its jurisdiction and powers are limited to what is provided for in the TAA and the Rules. The finding in this case is potentially very significant, as a finding in favour of SARS could have created a situation whereby SARS' power to audit is broadened, such that it could essentially restart or revisit a completed audit if it wished to do so, in an attempt to ensure an ultimate outcome in its favour. Furthermore, such a finding could have potentially resulted in a situation where tax disputes take even longer to resolve, which would not be in the interests of SARS, taxpayers or the administration of justice, given the number of tax disputes already ongoing and being heard by the tax court.

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Chapter 9 (sections 101 to 150); emphasis on sections 103, 117(3), 129(2)*(c)*.

Other documents

- Rules for dispute-resolution promulgated in terms of section 103 of the Tax Administration Act 28 of 2011.

Cases

- *AB v The Commissioner for the South African Revenue Service* (35746) [2022] ZATC 9 (23 August 2022);
- *Metlika Trading Ltd and Others v Commissioner for SARS* [2004] 4 All SA 410 (SCA).

Tags: new grounds of assessment; alternative dispute resolution process.

RAISING ALL GROUNDS OF OBJECTION IS CRITICAL

In recent years, SARS has become increasingly litigious, resulting in disputes often ending up in the Tax Court or the High Court. Such a dispute will generally arise when a taxpayer disagrees with an assessment raised by SARS.

An aspect of the dispute process that can have dire consequences if overlooked is that a taxpayer must canvas all relevant grounds of objection from the outset, as these form the basis of any future litigation.

A case in point is *Commissioner for the South African Revenue Service v Airports Company for South Africa,* [2022]. In this case, SARS raised an additional assessment for the taxpayer's 2011 year of assessment, disallowing deductions of corporate social investment (CSI) expenditure and allowances in terms of sections 12F and 13*quin* of the Income Tax Act, 1962 (the Act). The taxpayer only objected to the disallowance of the CSI expenditure. No objection was lodged to section 12F and section 13*quin* allowances and the imposition of an understatement penalty (USP) and interest. The objection to the disallowance of the CSI expenditure did not find favour with SARS and the taxpayer lodged a notice of appeal. This was ultimately settled.

In 2019, SARS issued a Letter of Audit Findings in respect of the taxpayer's 2012 to 2016 years of assessment. indicating that it intended to disallow the deductions claimed by the taxpayer for the CSI expenditure, the 12F and 13*quin* allowances, and to impose USPs and interest, in terms of the Tax Administration Act, 2011 (the TAA). In respect of the 2016 year of assessment SARS increased the USP on the basis that it is a so-called repeat case based on the assessment issued for 2011 year of assessment.

When prompted by the taxpayer's new attorneys (representing the taxpayer in the latter dispute), the taxpayer revisited its 2011 objection (represented by a different firm of attorneys), in which it had not objected to SARS' disallowance of its deductions in terms of sections 12F and 13*quin*. The taxpayer, with the assistance of its new attorneys, requested SARS to agree to the taxpayer's amendment of its objection in relation to its 2011 year of assessment. The taxpayer sought to object to the adjustments effected by SARS in respect of the allowances claimed in terms of sections 12F and 13*quin*, as well as the imposition of USPs and interest.

SARS refused to allow the objection as it was of the opinion that section 104 of the TAA, read with rule 7 of the Tax Court Rules, precluded such an amendment and that the taxpayer was seeking to introduce new grounds of objection, which was impermissible in terms of rule 32(3) of the Tax Court Rules.

The taxpayer applied to the Tax Court, Johannesburg for leave to amend its grounds of objection and such leave was granted by the tax court. This decision was overturned on appeal to the Supreme Court of Appeal (the SCA).

In another case, *Nesongozwi v Commissioner for SARS,* [2022], the taxpayer was unsuccessful in the Tax Court. The matter turned on the value of shares disposed of by the taxpayer and resultant donations tax and capital gains tax liability of the taxpayer and in this regard evidence was led by various experts as to the value of such shares. The taxpayer was unsuccessful in its appeal to the Full Court of the High Court on the basis as set out below. The decision of the Full Court was upheld on appeal to the SCA.

In the taxpayer's heads of argument, it appeared that he wished to revisit certain questions of fact and interpretation. The court found that this raises an important point of principle anterior to the merits, namely whether these points are properly before this court as grounds of appeal. This was because the Tax Court is a creature of statute with the result that, as was held in *Lion Match Company (Pty) Ltd v Commissioner for the South African Revenue Service,* [2018], "the scope of its jurisdiction, its powers and the ambit of any right of appeal from its decisions" are defined in the TAA.

The same principle was applied, in relation to an appeal to the Tax Court in terms of the Value-Added Tax Act, 1991, in *H R Computek (Pty) Ltd v Commissioner for the South African Revenue Services*, [2012], when Ponnan JA held that "not having raised an objection to the capital assessment in its notice of objection, the taxpayer was precluded from raising it on appeal before the tax court". The purpose underpinning this principle (which is of general application in civil and criminal appeals too) was set out thus by Corbett JA in *Matla Coal Ltd v Commissioner for Inland Revenue,* [1986], in a matter concerning the Act:

> "Sec. 81(3) of the Act provides that every objection shall be in writing and shall specify in detail the grounds upon which it is made. And in terms of sec. 83(7)*(b)* the appellant in an appeal against the disallowance of his objection is limited to the grounds stated in his notice of objection. This limitation is for the benefit of the Commissioner and may be waived by him."

He stressed the importance of adherence to this principle, "for otherwise the Commissioner may be prejudiced by an appellant shifting the grounds of his objection to the assessment in issue".

At the same time, however, he held that in the application of the principle, a court should not be "unduly technical or rigid in its approach" and "should look at the substance of the objection and the issue as to whether it covers the point which the appellant wishes to advance on appeal must be adjudged on the particular facts of the case".

These judgments show that the principle that a taxpayer cannot introduce new grounds of objection after the fact is reinforced.

Careful consideration should be given to the merits by taxpayers when preparing grounds of objection, as the grounds of objection (although part of the so-called pre-litigation phase) forms the basis of the pleadings, and therefore the issues in dispute, in the Tax Court litigation process.

"An aspect of the dispute process that can have dire consequences if overlooked is that a taxpayer must canvas all relevant grounds of objection from the outset, as these form the basis of any future litigation."

Andries Myburgh

ENSafrica

Acts and Bills

- Income Tax Act 58 of 1962: Sections 12F, 13*quin*, 81(3) & 83(7)*(b)*;
- Tax Administration Act 28 of 2011: Section 104;
- Value-Added Tax Act 89 of 1991.

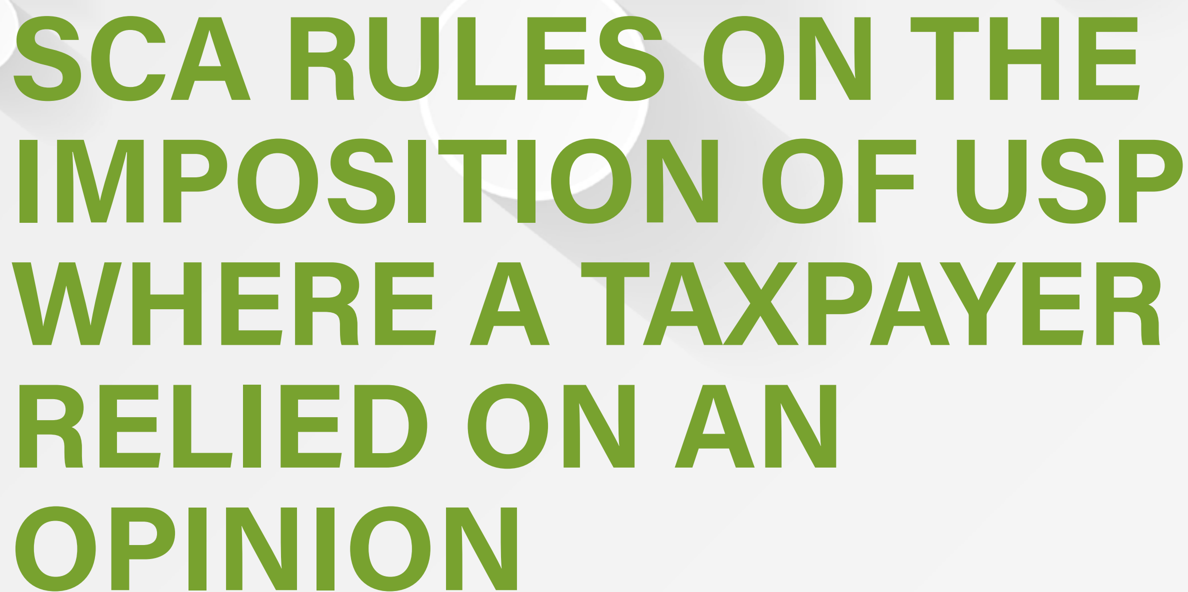
Other documents

- Letter of Audit Findings;
- Tax Court Rules: Rules 7 & 32.

Cases

- *Commissioner for the South African Revenue Service v Airports Company for South Africa* (785/2021) [2022] ZASCA 132 (7 October 2022);
- *Nesongozwi v Commissioner for SARS* (838/2021) [2022] ZASCA 138; [2023] 1 All SA 59 (SCA) (24 October 2022);
- *Lion Match Company (Pty) Ltd v Commissioner for the South African Revenue Service* (301/2017) [2018] ZASCA 36 (27 March 2018);
- *H R Computek (Pty) Ltd v Commissioner for the South African Revenue Services* (830/2012) [2012] ZASCA 178 (29 November 2012);
- *Matla Coal Ltd v Commissioner for Inland Revenue* (22/85) [1986] ZASCA 120 (30 September 1986).

Tags: grounds of objection; additional assessment; understatement penalty (USP); Letter of Audit Findings.



SCA RULES ON THE IMPOSITION OF USP WHERE A TAXPAYER RELIED ON AN OPINION

The South African Revenue Service (SARS) may impose penalties on taxpayers who make errors in their tax returns, but relief is available under certain circumstances.

Understatement penalties (USPs) are levied in terms of section 222(1) of the Tax Administration Act, 2011 (the TAA), and provide that in the event of an "understatement" by a taxpayer, the taxpayer must, in addition to the "tax" payable, pay a USP, unless it is the consequence of a "*bona fide* inadvertent error".

A provision in the TAA further states that SARS must remit a penalty imposed for a "substantial understatement" if it is satisfied that –

- the taxpayer was in possession of an opinion by an independent registered tax practitioner that was issued by no later than the date the relevant return was due;
- the opinion was based upon full disclosure of the specific facts and circumstances of the arrangement; and
- the opinion confirmed that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court.

"These SCA decisions therefore support the view that a legal opinion does not only provide relief from USP in the case of a 'substantial understatement' contemplated in section 223(3) but could go further. A taxpayer who does not disclose their tax opinion to SARS (due to the fact that the opinion is subject to legal privilege or for some other reason) may nevertheless place reliance thereon in arguing for a remission of USP."

A "substantial understatement" is defined as where the prejudice to SARS exceeds 5% of the amount that should have been paid or, alternatively, exceeds ZAR 1 million. A "substantial understatement" is also one of the behavioural categories in the understatement penalty percentage table that assigns a level of blameworthiness to a taxpayer in determining the percentage at which a USP is imposed.

In the February 2023 judgment by the Supreme Court of Appeal (SCA) in the case of the *Commissioner for the South African Revenue v Coronation Investment Management SA (Pty) Ltd,* [2023], the SCA considered whether a taxpayer, who placed reliance on an opinion, was liable to a USP.

The SCA found in favour of SARS in respect of the merits of the matter and then proceeded to consider the appeal of Coronation Investment Management SA (Pty) Ltd (CIMSA) against the USP imposed by SARS.

CIMSA argued that it relied on a tax opinion procured from a leading tax expert in the country and was therefore not liable for USP. The opinion in question was never disclosed to SARS and SARS relied on non-disclosure to draw a negative inference that the tax opinion did not support CIMSA's position as disclosed in its tax return (and in respect of which the SCA found in SARS' favour) and that a deliberate and conscious decision was taken to exclude the relevant income from its return.

The SCA said:

> "...there [is nothing] to suggest that CIMSA's tax returns were not submitted in the *bona fide* belief that CGFM [Coronation Global Fund Managers (Ireland) Limited] may be eligible for a s 9D exemption. The fact that this Court has now found that this course is not open to it, does not in any manner reflect on the *bona fides* of CIMSA, any more than it reflects on the *bona fides* of any losing party in litigation".
>
> "Insofar as the tax opinion is concerned, it was not incumbent on CIMSA to disclose a tax opinion that it had obtained, any more than it would be on any other party which litigates on the basis of a procured legal opinion ..."

> "To speculate that a tax opinion must have gone against CIMSA merely because it was not produced to SARS, is simply speculative. It is not sufficient to attribute *male fides* on the part of CIMSA."

For the above reasons, the SCA found that SARS' claim for USP must fail.

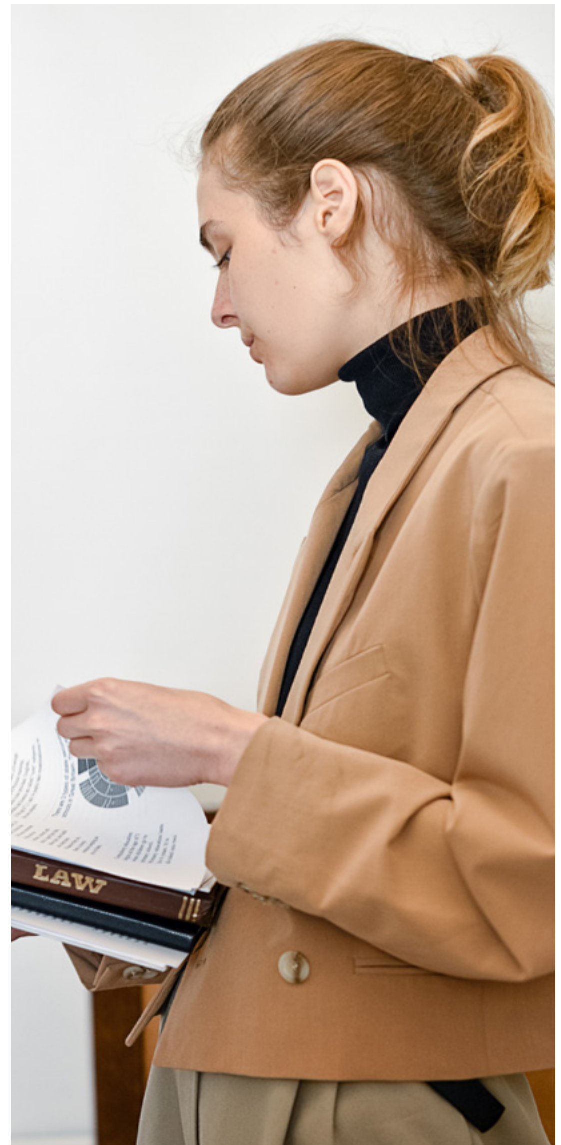
It is interesting that the focus was not on section 223(3) of the TAA and whether the USP should be remitted on the basis that the taxpayer had an opinion, but whether the taxpayer made a *bona fide* inadvertent error and is thus not liable for USP.

In reaching its conclusion the SCA made reference to its earlier decision in *Commissioner for the South African Revenue Service v The Thistle Trust,* [2022], where the taxpayer had obtained a tax opinion on the specific tax treatment of consecutive or back-to-back distributions by trusts. The taxpayer accepted the position taken in the opinion, and completed and submitted its tax returns on that basis.

SARS disagreed with the position taken by the taxpayer, assessed the taxpayer accordingly, and imposed a USP. The SCA found in favour of SARS with regard to the tax assessment but commented as follows with regard to SARS' concession in respect of the USP imposed:

> "SARS initially adopted the position that, in the light of the legal opinion, it should be concluded that the Thistle Trust had consciously and deliberately adopted the position it took when it elected to distribute the amounts of the capital gains as it did. However, during the argument before us, counsel for SARS conceded, correctly, that the understatement by the Thistle Trust was a *bona fide* and inadvertent error as it had believed that section 25B was applicable to its case. Though the Thistle Trust erred, it did so in good faith and acted unintentionally. In the circumstances, it was conceded that SARS was not entitled to levy the understatement penalty."

These SCA decisions therefore support the view that a legal opinion does not only provide relief from USP in the case of a "substantial understatement" contemplated in section 223(3) but could go further. A taxpayer who does not disclose their tax opinion to SARS (due to the fact that the opinion is subject to legal privilege or for some other reason) may nevertheless place reliance thereon in arguing for a remission of USP.



Carmen Gers

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 9D & 25B;
- Tax Administration Act 28 of 2011: Sections 222(1) & 223(3).

Cases

- *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (7 February 2023);
- *Commissioner for the South African Revenue Service v The Thistle Trust* (516/2021) [2022] ZASCA 153; 2023 (2) SA 120 (SCA) (7 November 2022).

Tags: understatement penalties (USPs); *bona fide* inadvertent error; substantial understatement; independent registered tax practitioner.

INTERPRETATION NOTE 127

On 17 January 2023, the South African Revenue Service (SARS) released Interpretation Note 127 ("Determination of the taxable income of certain persons from international transactions: intra-group loans") *(IN127).*

The purpose of IN127 is to provide taxpayers with guidance on the application of the arm's length principle, in the context of intra-group loans. IN127 applies to loans advanced in years of assessment commencing on or after 1 April 2012.

BACKGROUND

In 2012, the specific thin capitalisation rules under section 31 of the Income Tax Act, 1962 (the Act), were deleted. Since then, thin capitalisation practices had to be considered in the context of the general arm's length principle applied under the South African transfer pricing rules. The transfer pricing rules govern not only the rate of interest applied to intra-group loans but also the quantum of debt that a taxpayer can support.

The risk of failing to ensure that cross-border intra-group lending transactions meet the arm's length standard is that it could result in the non-deductibility of all or a portion of the interest expense (primary adjustment), a secondary adjustment (ie, the disallowed interest amount paid by a resident company, would be deemed to be an *in specie* dividend that attracts dividend tax), penalties and interest.

The accurate pricing of intra-group arrangements is dependent on attributes of intra-group loans such as the quantum, interest rate, denomination, maturity arrangements, purpose of the loan, level of seniority or subordination, geographical location of the borrower and lender, and security provided.

Historically, complying with the arm's length principle was made simple and relatively inexpensive through abiding by a safe harbour published by SARS. Practice Note 2 (PN2) outlined acceptable debt-to-equity ratios and interest rates for related-party loans. This guidance provided taxpayers with certainty regarding cross-border intra-group funding transactions that SARS would not subject to audit. This reduced the compliance burden and associated costs for foreign investors into South Africa. PN2 was withdrawn on 5 August 2019, with effect from 1 April 2012.

Although South Africa is not a member state of the Organisation for Economic Co-operation and Development (OECD), SARS confirmed, in Practice Note 7, that the guidelines as laid out in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations should be followed in the absence of specific guidance in terms of Practice Note 7 to determine the arm's length pricing between connected persons. In the absence of any safe harbour indication for intra-group loans, to ensure compliance with the arm's length standard, a taxpayer has no other option but to undertake a costly transfer pricing study.

Following the legislative change and the withdrawal of PN2, SARS published a Draft Interpretation Note on Thin Capitalisation (Draft Interpretation Note) in 2013 that was never finalised. In the Draft Interpretation Note SARS indicated the following:

> "SARS adopts a risk-based audit approach in selecting potential thin capitalisation cases for audit. In selecting cases, SARS will consider transactions in which the *Debt: EBITDA ratio of the South African taxpayer exceeds 3:1 to be of greater risk*." (our emphasis)

However, SARS pointed out that the ratio is not a safe harbour and does not preclude SARS from auditing a taxpayer who is within the range of the above-mentioned ratio. The ratio is merely indicative of the level of risk set by SARS for the purpose of selecting cases for audit.

> "Furthermore, taxpayers are strongly advised to maintain adequate documentation to substantiate the arm's length nature of these lending arrangements, especially where the terms conflict with SARS' view."

With the removal of a safe harbour and a lack of clear guidance from SARS on how to apply the arm's length principle since April 2012, taxpayers have been at pains to undertake onerous transfer pricing studies to ensure compliance with the arm's length principle. Unfortunately, IN127 does nothing to alleviate this problem.

SARS states in IN127 that they will consider a taxpayer's debt to be non-arm's length if, amongst other factors, some or all of the following circumstances exist:

- The taxpayer is carrying a greater quantity of debt than it could sustain on its own (that is, it is thinly capitalised).
- The duration of the lending is greater than would be the case if negotiated at arm's length.
- The repayment, interest rate or other terms are not what would have been entered into or agreed to at arm's length.

It is reiterated that the above are not safe harbour rules; rather that SARS would use these measures to select taxpayers for audit. Therefore, meeting these requirements may not be enough to prevent incurring the cost of a transfer pricing study. Taxpayers should therefore seek advice to enable them to weigh up the cost of compliance against the benefits of cross-border debt funding and the risks associated with non-compliance.

With regard to a possible secondary adjustment (ie, the adjusted amount being treated as a dividend *in specie*, in the case of a company), SARS expresses the view that the reduction of withholding tax on dividends under a double taxation agreement (DTA) would not be available to the recipient of the excess (non-deductible) amount which is treated as a dividend. SARS contends that the reduced rates envisaged under section 64FA(2) of the Act require the recipient to be the "beneficial owner" of the dividend. Section 64D defines "beneficial owner" as "the person entitled to the benefit of the dividend attaching to a share". SARS argues that a recipient of a deemed dividend *in specie* under section 31(3)(i) is not entitled to the benefit of the dividend because there is no benefit since the deemed dividend *in specie*, which results from a difference determined between two taxable income calculations, is a figure calculated for tax purposes only which has resulting dividends tax implications.

SARS expresses the view that neither section 31(2) nor section 31(3) recharacterises the underlying expense or income to be a dividend; the deemed dividend under section 31(3)(i) arises over and above the underlying transaction. In addition, even if one assumes there is a benefit, that benefit would not be considered to be "attaching to a share". Accordingly, SARS is of the view that the deemed recipient is not a "beneficial owner". SARS concludes that, in the absence of a "beneficial owner" as defined in section 64D, the requirements of section 64FA(1) and section 64FA(2) cannot be met.

SARS clearly ignores the requirement under all South Africa's DTAs that any concept that is defined in the DTA must be given such a meaning in applying the DTA. Therefore, if the DTA in question provides that an amount that is treated as a dividend under our domestic law must be treated as a dividend for purposes of the DTA, the recipient of that deemed dividend must be given DTA benefits, if the recipient qualifies for such benefits.

The disallowed portion of an adjusted interest expense is treated as a deemed dividend under section 31(3)(i). This implies that such amount of interest is recharacterised as a dividend. The recipient of that amount is clearly the beneficial owner of that amount.

In terms of Article 10 of the UK/South Africa DTA, the term "dividends" is defined to mean income from shares, or other rights, not being debt-claims, participating in profits, **as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares** by the laws of the Contracting State of which the company making the distribution is a resident **and also includes any other item which, under the laws of the Contracting State of which the company paying the dividend is a resident, is treated as a dividend or distribution of a company.**

The term "interest" as defined in Article 11 of the UK/South Africa DTA means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures. **The term "interest" shall not include any item which is treated as a dividend under the provisions of Article 10 of this Convention.**

The term "dividends" as defined in the USA/South Africa DTA means income from shares or other rights, not being debt-claims, participating in profits, **as well as income that is subjected to the same taxation treatment as income from shares** under the laws of the State of which the payor is a resident.

The term "interest" as defined in the USA/South Africa DTA specifically provides that income dealt with in Article 10 (Dividends) shall not be regarded as interest for the purposes of the DTA.

Most of South Africa's DTAs contain similar provisions, based on the OECD Model DTA.

The OECD Commentary on the OECD Model DTA considers the impact of a recharacterisation of interest as dividends and comments that the two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends.

In the absence of such specific provisions in the DTA, the excess amount of interest would still qualify as "interest" as defined in the DTA and the recharacterisation under South Africa's domestic law would not be allowed. If the DTA provided an exemption from withholding tax in such a case, SARS would not be entitled to impose dividends tax on such a deemed dividend.

The very objective of the secondary adjustments under section 31(3) is to put the two parties in the same position as if no transfer pricing manipulation had occurred (apart from interest and penalties). The intended effect is that the amount received by the counterparty, which is often the parent company, is simply treated as additional dividend distributions. By not allowing a recipient to claim the benefits under the DTA, SARS would not be complying with South Africa's obligations under the respective DTAs.

Whilst IN127 is not law, it provides insight into the prevailing practice of SARS and guidance on the interpretation and application of provisions of the Act. Taxpayers are cautioned to have regard to these guidelines when implementing intra-group arrangements of this nature so that they can anticipate SARS' view of their arrangements.

Furthermore, taxpayers are strongly advised to maintain adequate documentation to substantiate the arm's length nature of these lending arrangements, especially where the terms conflict with SARS' view.

"The OECD Commentary on the OECD Model DTA considers the impact of a recharacterisation of interest as dividends and comments that the two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends."

Other key considerations outlined in IN127 are highlighted below:

- **Application of the transfer pricing provisions:** The transfer pricing provisions are sufficiently broad to apply to both direct and indirect financial assistance which may include, but is not limited to, back-to-back transactions with banks or other financial institutions.

- **Guarantees provided by related parties:** SARS seems to take the view that the thin capitalisation regime should include domestic lending arrangements that are guaranteed by foreign related parties. However, it is not clear how far they intend to apply the rules to this scenario since the interest is subject to full normal tax in the hands of the local lender. The example provided in IN127 includes payment of a guarantee fee by the local bank to the foreign parent company of the borrower (ie, a cross-border payment of some nature). However, the preamble to this example does not expressly rule out domestic lending arrangements that do not include a cross-border payment. Parties are therefore cautioned to consider the thin capitalisation rules when seeking local funding that is guaranteed by a foreign related party. Where appropriate, adequate documentation should be prepared in support of the exclusion of the domestic funding from these laws.

- **Interest deductibility:** The amount of interest may be limited in terms of section 23M or section 23N of the Act. IN127 confirms that, in SARS' view, section 31 applies prior to the impact, if any, of sections 23M and 23N. Therefore, taxable income must first be calculated as if the transactions had been entered into at arm's length, prior to the application of the abovementioned interest limitation rules.

- **Determining an arm's length interest rate:** Entities should use the most appropriate pricing methodology, consistent with the actual delineated transaction. SARS notes that the comparable uncontrolled price method may be the method easiest to apply, due to the availability of financial information from lending markets.

- **Withholding tax on interest:** Any transfer pricing adjustment to taxable income or tax payable will not impact on the calculation of withholding tax on interest. As indicated above, this may contravene DTA obligations if the provisions of the DTA require the excess interest to be treated as a dividend.

- **Lender and borrower's perspective:** Both the lender's and borrower's perspective must be taken into account in the transfer pricing analysis, given that the perspective of each may vary from that of the other. A lender's perspective would involve, *inter alia*, evaluating the risks inherent in lending to the particular related-party borrower. Conversely, a borrower's perspective would involve, *inter alia,* optimising their cost of capital by meeting short-term and long-term objectives.

- **Effect of group membership and the use of credit ratings:** Implicit support from a group may affect a borrower's credit rating. Therefore, it is appropriate to determine whether the credit rating of the borrower must be used on a stand-alone basis or whether the prevailing facts require that a credit rating more closely linked to that of the multinational enterprise group be used. It is uncertain whether the downgrading of South Africa's sovereign credit rating would be considered by SARS when assessing the credit rating used by a borrower.

- **Timing:** It is necessary for taxpayers to specifically consider whether, at the time of obtaining that debt, the amount of the debt and the cost of the debt reflect arm's length arrangements.

- **Permanent establishments:** A permanent establishment (PE) in South Africa of a non-resident will be viewed as a separate enterprise. Therefore, the dealings with such a PE should also comply with the arm's length principle.

- **Safe harbours:** IN127 does not make provision for the use of either safe harbours or risk indicators by SARS. Therefore, an arm's length analysis is required to determine whether the arrangements of the particular taxpayer are acceptable.

- **Use of bank opinions:** The use of bank opinions to attest to an arm's length interest rate that an independent bank would charge a related-party borrower will not be accepted as evidence to substantiate an arm's length interest rate, as it does not provide a comparison to an actual transaction.

- **Financing policy:** IN127 emphasises the need for a taxpayer to develop and maintain a consistent financing policy. The financing policy should be aligned with the multinational enterprise's overall strategy. The importance of this cannot be stressed enough, as a taxpayer is required to set out, in its master file, a high-level overview of the multinational enterprise's global business, which includes its financing policy, business activities, structure, and global transfer pricing policy.

Diwan Kamoetie, Robyn Berger & Wally Horak

Bowmans

Acts and Bills

- Income Tax Act 58 of 1962: Sections 23M, 23N, 31(2) & (3) (specifically paragraph (i)), 64D (definition of "beneficial owner") & 64FA(1) & (2).

Other documents

- Interpretation Note 127 (released on 17 January 2023) ("*Determination of the taxable income of certain persons from international transactions: intra-group loans*");

- *Thin capitalisation rules* under section 31 of the Income Tax Act (deleted/withdrawn in 2012);

- Practice Note 2 (withdrawn on 5 August 2019, with effect from 1 April 2012);

- Practice Note 7;

- Draft Interpretation Note on Thin Capitalisation (2013) – never finalised;

- UK/South Africa Double Tax Agreement (definitions of "dividends" & "interest") (with emphasis on Article 10);

- USA/South Africa Double Tax Agreement (definitions of "dividends" & "interest") (with emphasis on Article 10);

- Organisation for Economic Cooperation and Development (OECD) Model DTA (a reference to Article 11);

- The OECD Commentary on the OECD Model DTA.

Tags: thin capitalisation; arm's length principle; transfer pricing; intra-group loans; safe harbour; cross-border debt funding; beneficial owner; dividend *in specie*; comparable uncontrolled price method; withholding tax on interest; related-party borrower.

NON-RESIDENT BENEFICIARIES

The Supreme Court of Appeal judgment in Commissioner for the South African Revenue Service v the Thistle Trust, *[2022], has highlighted the interpretive challenges that section 25B of the Income Tax Act (the Act) and paragraph 80 of the Eighth Schedule to the Act, both applicable to trusts, can create. In the 2023 Budget the Minister has proposed to address an apparent inconsistency resulting from the application of these provisions.*

Paragraph 80 deals with the vesting of an asset by a local South African trust in a beneficiary with the effect being that, assuming the asset did not arise from a donation, settlement or other disposition, when an asset is vested by a South African trust in a resident beneficiary, the capital gain flowing from this will be attributable to the resident beneficiary. This capital gain will (in the hands of the trust) be disregarded for purposes of calculating the total capital gain or loss.

"From a South African tax perspective, non-residents are only subject to tax in South Africa to the extent that the income is from a South African source."

On the other side of this, the 2023 Budget expresses the view (similar to what is stated in SARS' Comprehensive Guide on Capital Gains Tax) (the CGT Guide) that if an asset or gain is vested by a resident trust in a non-resident beneficiary, the result is that the capital gain flowing from that will not be attributable to the non-resident as an individual but to the trust and taxed in the South African trust's hands. In other words, it would be taxed in South Africa at the effective rate of 36%. It states that this is the case because it is easier to ensure that the correct tax amount is paid to SARS. However, whereas paragraph 80 distinguishes between residents and non-residents, section 25B contains no such distinction. Section 25B(1) and (2) merely refer to the vesting of amounts in a "person" or a beneficiary but make no reference to the residence of such person or beneficiary.

Although section 25B contains anti-avoidance provisions, they apply to address anti-avoidance where funds are transferred to a foreign trust, with the income then being vested in resident or non-resident beneficiaries by the foreign trust. With the increase of offshore trust structures and the Budget noting that the number of persons applying to make use of their foreign capital allowance increasing, it appears that the anti-avoidance provisions in section 25B generally address the risk of tax avoidance using foreign trusts. However, there is a concern that a South African trust vesting income in a non-resident beneficiary can create the risk of tax avoidance and challenges in collection. From a South African tax perspective, non-residents are only subject to tax in South Africa to the extent that the income is from a South African source.

Therefore, if South African source income is vested by the South African trust in a non-resident individual beneficiary, such as rental income, for example, the non-resident would need to declare such rental income in a tax return to SARS and would be taxed according to the personal income tax tables. However, as section 25B does not distinguish between residents and non-residents, it is possible that in practice, the South African trust can vest South African source income in the non-resident beneficiary, but such beneficiary may intentionally or unintentionally fail to disclose such income to SARS to SARS. Although SARS can take steps to collect the tax owing, including by requesting the assistance of the tax authority of the country where the non-resident resides, as provided for under some double tax agreements, depending on the amounts, the cost of administrative actions required may exceed the benefit of collection of the tax.

The Tax Administration Act, 2011, does also make provision for SARS to take steps to collect tax from such non-resident beneficiaries, with the assistance of a foreign tax authority.

AMENDING SECTION 25B

Therefore, the Budget proposes that section 25B be amended so that it applies in a similar way to how paragraph 80 is applied. If that is the intention, it is possible that a South African trust would be taxed on the taxable income it vests in non-residents at the rate of 45%, as opposed to being taxed in accordance with the marginal tax rates applicable when to resident individuals. The tax payable could be far higher as only an individual's income in the top marginal income tax bracket is subject to 45%. If this is the way in which the amendment applies, only dividends earned by the South African trust from a South African resident company would not be adversely affected. This is because the dividends withholding tax rate of 20% applies equally to dividends paid to South African resident and South African trust shareholders and is not affected by subsequent vesting.

The potential effects of this amendment, depending on how it is implemented (if implemented), will be far-reaching.

Esther Ooko & Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 25B; Eighth Schedule: Paragraph 80;
- Tax Administration Act 28 of 2011.

Other documents

- SARS' Comprehensive Guide on Capital Gains Tax) (CGT Guide).

Cases

- *Commissioner for the South African Revenue Service v the Thistle Trust* (516/2021) [2022] ZASCA 153; 2023 (2) SA 120 (SCA) (7 November 2022).

Tags: anti-avoidance provisions; marginal tax rates; South African resident company.

VAT REVERSE CHARGE AND MINING

South Africa implemented a domestic reverse charge (DRC) on valuable metal relating to gold-containing material on 1 July 2022, which came into full operation with effect from 1 August 2022. The DRC is aimed at curbing VAT refund fraud in the second-hand gold industry. Since its implementation, many uncertainties have arisen on whether the DRC applies to the mining sector, commonly regarded as the primary gold industry.

The DRC Regulations (published in *Government Gazette* 46512 of 8 June 2022) apply to domestic standard-rated transactions between VAT-registered vendors, where the goods concerned are "valuable metal" as defined in the Regulations. Under a reverse charge mechanism, the purchaser, rather than the supplier, accounts for the VAT (at 15%) on the transaction and certain additional documentation and reporting requirements are applicable.

Subject to certain exclusions, the term "valuable metal" is broadly defined in the DRC Regulations to mean any goods containing gold in the form of "jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms, including any ancillary goods or services".

"Residue" is defined in the DRC Regulations to mean "any debris, discard, tailings, slimes, screening, slurry, waste rock, foundry sand, beneficiation plant waste or ash" and largely corresponds with the definition of "residue stockpile" in the Mineral and Petroleum Resources Development Act, 2002 (the MPRDA). Therefore, as a starting point, it would seem that mine material is indeed included in the ambit of the DRC.

However, paragraph *(a)* of the valuable metal definition (commonly referred to as "the mining exclusion") specifically excludes supplies of goods produced from raw materials by any "holder" as defined in section 1 of the MPRDA, or by any person contracted to such "holder" to carry on mining operations in respect of the mine where the "holder" carries on mining operations.

In terms of the MPRDA, a "holder" means, in relation to a prospecting right, mining right, mining permit, retention permit, exploration right, production right, reconnaissance permit or technical co-operation permit, the person to whom such right or permit (ie, mining title) has been granted or such person's successor in title. And it is here where there is a divergence of opinion on how widely or narrowly to interpret the scope of the mining exclusion in the DRC Regulations. We briefly deal with these differing views below.

- Entity level: Some interpret the mining exclusion to apply as long as the supplier (eg, a mine) is a "holder" in terms of the MPRDA and therefore that it exempts such a "holder" at an entity level from the DRC. Based on this interpretation, no cognisance needs to be given as to whether the goods being supplied have actually been produced by that "holder" in terms of its particular mining title (eg, mining right/permit, etc).
- Transaction level: A narrower interpretation exists that the mining exclusion applies only to those goods that were won or recovered by the "holder" from the mining area or residue stockpile to which the holder's mining title relates. Therefore, one cannot be a "holder" over Area A, but produce and sell goods from Area B and claim that the mining exclusion in the DRC Regulations applies to the supply of the Area B goods. If the holder's mining title relates only to Area A, the supply (in a prescribed form) of gold-containing goods derived from Area B will still be subject to the DRC.
- Supply chain level: Although an unlikely interpretation, there is also a view that the mining exclusion applies throughout the entire supply chain. Therefore, as long as the gold-bearing material (eg, a gold bar) was originally produced by a mining title "holder", the supply of that bar throughout the entire supply chain falls outside the scope of the DRC Regulations. This interpretation undermines the very objective of the DRC Regulations and is not correct.

Regardless of the interpretation, certain practical challenges arise. For example, the primary concern in attempting to apply the transaction level interpretation is that the purchaser is not in a position to factually know, or to practically establish, whether or not the goods it is acquiring have been produced by the supplier (being a "holder") in terms of the supplier's particular mining title.

On the other hand, rights granted to a "holder" in terms of its mining title are limited to the particular land area as stipulated in the holder's right or permit document. A supplier is therefore a "holder" in respect of only that prescribed land area and no other. On this basis, the mining exclusion to the DRC Regulations should only apply where the goods are produced by a "holder" (or any person contracted to such "holder" to carry on mining operations in respect of the mine where the "holder" carries on mining operations) from the same prescribed land area to which the holder's mining title relates.

It is also relevant that these uncertainties were raised as part of the technical tax proposals to National Treasury to be considered for possible inclusion in Annexure C to the 2023 Budget Review. The matter was very briefly addressed by Treasury during the Annexure C workshops held in December 2022 and it appears that their current policy position is that the mining exclusion applies at an *entity level.*

However, we caution that this "policy" has not been articulated in the DRC Regulations and it is not clear how it is to be applied in practice, particularly where a single supplier possesses more than one type of authorisation over completely different land areas (eg, a mining permit over Area A making it a "holder" under the MPRDA over that particular land area, as well as a different licence over Area B such as waste management licence which does not authorise the sale, transfer or disposal of (gold-containing) precious metals from Area B and which is not listed in the definition of "holder" in the MPRDA).

Failure to apply the DRC Regulations to supplies of valuable metal will result in the supplier and purchaser, being VAT-registered vendors, being held jointly and severally liable for any VAT loss suffered by the *fiscus* in this regard. It is therefore important for transacting vendors to confirm the contractual terms of their agreements as regards the source of gold-containing material they buy and sell, and to seek professional advice in the event that there are any uncertainties on the applicability of the DRC Regulations to mine material.

The 2023 Budget Review contained various proposals relating to the DRC Regulations. The uncertainty regarding the scope of the mining exclusion was recognised in particular and it is proposed for the valuable metal definition to be clarified in this regard.

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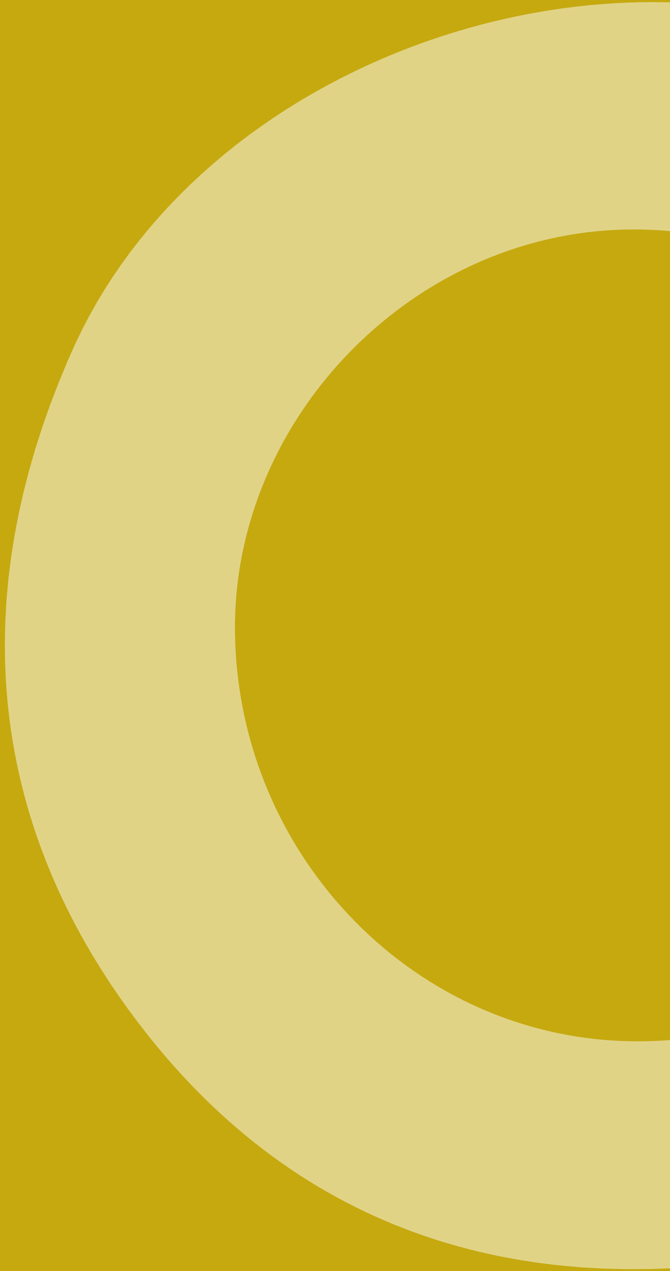
Acts and Bills

- Mineral and Petroleum Resources Development Act 28 of 2002: Section 1 (definitions of "holder" (emphasis on paragraph *(a)*) & "residue stockpile").

Other documents

- Domestic Reverse Charge (DRC) Regulations (published in *Government Gazette* 46512 of 8 June 2022) (definitions of "residue" & "valuable metal);
- 2023 Budget Review: Annexure C.

Tags: domestic reverse charge (DRC); valuable metal.



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