The end of NRV for closing stock (or not?)

Author: Joon Chong, a Partner at Webber Wentzel.

The Supreme Court of Appeal (SCA) has for the second time in *CSARS v Atlas Copco South Africa (Pty) Ltd*, confirmed that the net realisable value (NRV) method is not a suitable method to value closing stock for income tax purposes. The SCA referred with approval to its earlier decision of *CSARS v Volkswagen South Africa (Pty) Ltd* and held that the NRV method is forward looking, taking into account estimated costs which would still need to be incurred before the stock is sold. The Income Tax Act 58 of 1962 (Act), and calculation of taxable income, is backward looking. The reduction from the cost price of the closing stock should only be allowed in two circumstances: (i) when an event that caused the value of the trading stock to diminish occurred in the tax year; and (ii) when the taxpayer knows with reasonable certainty that an event occurring in the following tax year will cause the value of trading stock to diminish.

The taxpayer purchased stock from its Swedish parent company in the form of machinery and equipment (including spare parts and consumables) for use in the mining and related industries in South Africa. The taxpayer received a finance and accounting manual from its parent company which was followed by all companies in the group. The manual prescribed that closing stock should be written down by 50% if unsold in the last 12 months, and 100% if unsold in 24 months.

The SCA held that the taxpayer had not presented reliable evidence that the time based NRV policy resulted in a diminution of value. In other words, the taxpayer did not show that there was a clear link between the length of time stock was unsold and a corresponding diminution in value of such stock by reason of "*damage, deterioration, change of fashion* [or] *decrease in market value*." The SCA held that the evidence showed that the policy adopted was arbitrary. The taxpayer also did not take into account the actual selling prices of items in the tax year when items were sold below cost price. The taxpayer had argued that there were about 200000 items which needed to be considered, and it would have been impractical for the taxpayer to verify the actual selling price for each item.

There are many examples where financial reporting requirements have differed significantly from the requirements of the Act. The valuation of closing stock is one of these. The NRV method is a common method to value closing stock as it is the method used by companies preparing their financial statements using International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

What should taxpayers do for historic years where they have valued closing stock using NRV?

The SCA accepted that sampling was a well-recognised method of dealing with high volume trading stock. Taxpayers could prepare a file with supporting documents of a sample of items for each category and condition of stock demonstrating that the closing stock value using NRV would have been similar to the closing stock value determined using the valuation approach in the SCA decisions. The file should document the events occurring in the tax year or the events which would occur in the following tax year, which would have resulted in the diminished value of closing stock. Where possible, actual selling prices of stock should be used to support the reduction in value of closing stock in earlier years. Where actual selling prices do not support the reduction in value calculated using NRV, material differences should be explained as more an exception rather than the rule.

The draft Taxation Laws Amendment Bill 2019 proposes an amendment to require any diminution in value to be determined on an item-by-item basis. The sampling of items for each category and condition of stock should meet this item-by-item basis. The item-by-item basis should not be interpreted to require, for example, an analysis of each of the 5 million widgets that are in the warehouse as this would lead to an uncommercial outcome.

Taxpayers should prepare the file for the tax years which have not prescribed and where closing stock could possibly not be valued correctly in those years. (Generally, income tax assessments prescribe three years after the date of the original assessments.)

What can be done for current and future tax years?

As a matter of principle, the NRV method cannot be accepted on its own. IAS 2.6 states that NRV is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale.

It is possible to justify using the NRV method which add back future costs of selling but not costs which would be incurred with reasonable certainty in the next tax year. There could be many instances of industry trends or customer preferences, where additional costs would need to be incurred by the taxpayer in the next tax year to sell the stock. The additional costs which would need to be incurred could be the event occurring in the next tax year causing the reduction in value of trading stock. (For example, without incurring additional marketing costs or massive discounts, the stock would not be sold.) This exercise is a factual analysis and should be appropriately documented by the taxpayer.

Ends

Kind Regards,

NADINE VAN TONDER

Media Jedi

TS COMMUNICATIONS

T: +27 11894 2767

Unbundling transactions by listed companies what are the tax implications for shareholders?

From time to time, listed companies unbundle shares to their shareholders. It is important for the shareholders to understand the tax implications which may arise upon the receipt of the shares.

Absent any relief which may apply in terms of section 46 of the Income Tax Act (the Act) (which deals with unbundling transactions), the general principles are:

- If a South African tax resident company makes a distribution of an asset *in specie* to a person in respect of a share, and the distribution (1) does not result in the reduction of contributed tax capital (CTC), (2) does not constitute shares issued by the company making the distribution, or (3) does not constitute a general repurchase based on the relevant exchanges rules (in the context of listed shares), then the receipt of the distribution constitutes a receipt of a dividend for purposes of the Act.
- The receipt or accrual of an amount as a dividend is included in gross income in terms of paragraph(k) of the definition in section 1 of the Act. The dividend may be exempt from income tax but the exemption is subject to one of the provisos to the exemption not applying. If one of the provisos to the exemption were to apply then the dividend will be subject to income tax.
- In addition, a dividend is subject to dividends tax at the rate of 20%. However, in the context of a dividend that constitutes a distribution of an asset *in specie*, the liability for the dividends tax is on the company declaring and paying the dividend which would be the unbundling company. Various exemptions from dividends tax may apply. For example, if the beneficial owner of the dividend is a South African tax resident company, then the dividend is exempt from dividends tax.
- If a company makes a distribution of an asset *in specie* to a person in respect of a share and the distribution results in a reduction of CTC, then it will constitute a return of capital. CTC is defined in relation to a class of shares issued by a company, *inter alia* as the consideration received by or accrued to a company on or after 1 January 2011 and reduced by so much as the company has transferred on or after 1 January 2011, for

the benefit of any person holding a share in that company of that class in respect of that share.

- Paragraph 76B(2) of the Eighth Schedule to the Income Tax Act (the Eighth Schedule) provides that where a return of capital by way of a distribution of cash or an asset *in specie* is received on or after 1 April 2012 and prior to the disposal of the share, the holder of the share must reduce its expenditure incurred in respect of the share with the amount of that cash or the market value of the asset on the date the asset or the cash is received. If the cash or the market value of the asset exceeds the expenditure incurred in respect of the share, then the excess is treated as a capital gain in the year of assessment in which the return of capital is received.

Based on the above, if a South African tax resident company unbundles shares (unbundling company) that it holds in a subsidiary (unbundled company) by distributing those shares to the unbundling companys shareholders (the shareholders), the receipt of the shares by the shareholders would constitute a dividend (if the distribution does not result in the reduction of CTC by the unbundling company) or a return of capital (to the extent that it reduces the CTC of the unbundling company).

Section 46 of the Act contains specific provisions for an unbundling transaction and broadly deals with the following:

- the tax consequences for the unbundling company distributing the shares. The unbundling company is required to disregard the distribution in determining its taxable income (any capital or revenue gain is not taxed);
- the expenditure of the shareholder receiving the shares. The shareholder is required to allocate a portion of the expenditure incurred in acquiring the shares in the unbundling company to the shares it received in the unbundled company in accordance with a specified ratio;

- the CTC of the unbundling company and the unbundled company immediately after the distribution. The CTC of the unbundling company is effectively proportionately split between the unbundling company and the unbundled company in accordance with a specified ratio;
- the dividends tax implications for the unbundling company. The distribution of the shares must be disregarded in determining any liability for dividends tax;
- the impact of paragraph 76B of the Eighth Schedule for the shareholder. It provides that paragraph 76B of the Eighth Schedule does not apply.

Section 46 of the Act does not deal with the tax implications arising for the shareholder upon receipt of the shares which are unbundled other than stating that paragraph 76B of the Eighth Schedule does not apply.

It is therefore important to determine if the receipt is a return of capital or a dividend. If it is a return of capital then paragraph 76B of the Eighth Schedule does not apply.

If the receipt does not result in the reduction of CTC, then it would constitute a dividend. As noted above, dividends are exempt from tax in terms of section 10(1)(k)(i) of the Act. However, section 10(1)(k)(i) contains various provisos which, if applicable, would result in the exemption not applying to the dividend. By way of example, if the shareholder borrowed the shares in the unbundling company and receives the shares being unbundled as a dividend, then that dividend is not exempt from income tax.

Based on the above, shareholders in listed companies that receive shares by way of a distribution should, *inter alia*, check whether they are receiving the shares as a return of capital or as a dividend in order to ensure that they understand the tax implications.

Magda Snyckers

director | tax

msnyckers@ENSafrica.com

Inbound interest bearing loans section 31 versus section 23M of the Income Tax Act

There can be no objection in principle to the deduction of interest on loans in suitable cases. Loan capital is the life blood of many businesses but the mere frequency of its occurrence does not bring about that this type of expenditure requires different treatment.

Whilst these words of Hefer JA in the well-known judgment of *Ticktin Timers CC v The Commissioner for Inland Revenue* (1999 (4) SA 939 (SCA) at 942I) are still apposite two decades later, there has been increased focus by National Treasury on cross-border financing and how it may lead to tax avoidance, base erosion and profit shifting. As a result of this scrutiny, sections which are intended to have an effect on the deductibility of interest incurred in respect of cross-border loans have been included in the Income Tax Act No. 58 of 1962 (the **Act**). For the current purposes, we have only focused on section 23M and section 31 of the Act, and specifically revisited the interaction between the two.

Section 23M of the Act provides for a limitation on the deduction of interest incurred where a loan has been advanced by a creditor who holds more than 50% of the equity shares or voting rights in such a debtor (i.e. a controlling relationship exists). The limitation will also be applicable where the creditor is not in a controlling relationship with the debtor, if the creditor obtained the funding for the debt so advanced from a person who is in a controlling relationship with the debtor. However, such an interest deduction limitation will only apply if the amount of interest is neither subject to tax in the hands of the recipient, nor included in the net income of a controlled foreign company and also not disallowed under the provisions of section23N of the Act, which deals with the limitation of interest deductions in respect of reorganisation and acquisition transactions.

Generally speaking, the provisions of section 23M of the Act apply to cross-border inbound interest-bearing loans advanced by foreign holding companies to their subsidiaries in South Africa. In terms of such an arrangement, the interest income derived by the foreign company would usually not be subject to tax in terms of the provisions of the Act. This is especially prevalent where loans are advanced from creditors who are resident in Luxembourg, Cyprus, and the Netherlands because of the Double Tax Agreements concluded between South Africa and these respective countries.

Such inbound loans may also be subject to the transfer pricing provisions of section 31 of the Act. Section 31 of the Act targets affected transactions, which are, generally speaking, transactions or agreements concluded between connected persons (as defined in section 1 of the Act), where one person to the transaction is resident in South Africa for income tax purposes and the other person is non-resident. In addition, a transaction will only be an affected transaction if any term or condition thereof would not have existed if the contracting parties had been dealing at arms length.

Section 31(2) of the Act provides that where such a transaction results in a tax benefit, the taxable income of the person who derives the tax benefit must be determined as if that transaction had been entered into on the terms and conditions that would have existed between independent persons dealing at arms length. Accordingly, where the quantum or interest-rate of an inbound loan does not reflect what would have been agreed between parties dealing at arms length (e.g. between a Bank and a third-party borrower), the taxpayer is required to disregard such interest incurred for purposes of calculating its taxable income. This is known as the so-called Primary Adjustment.

In addition, section 31(3) of the Act provides that to the extent that the application of section 31(2) of the Act causes a difference in any amount applied in the calculation of the taxable income, the difference is deemed to be a dividend *in specie* declared by the taxpayer (i.e. the so-called Secondary Adjustment). Effectively, the amount of interest which was disallowed as a deduction is treated as a deemed dividend *in specie*, and is subject to dividends tax at a rate of 20% in terms of section 64E(1), read with section 64EA(b) of the Act.

Thus, the question arises: which of these provisions must be applied first in the instances where they both apply to the same in-bound loan? We understand that it is the view of National Treasury and the South African Revenue Service, as observed in their Draft Response Document presented to the Standing Committee on Finance in respect of the 2014 Taxation Laws Amendment Bill. As stated above, any adjustment in terms of section 31 of the Act gives rise to both the Primary and Secondary Adjustment, whereas the application of section 23M of the Act only results in a lesser allowable interest deduction, which has the same effect as the Primary Adjustment.

In respect of legislation one should attempt to read the relevant legislative provisions together and, only in circumstances where they conflict, to consider which provision should apply in preference to the other. We analyse below whether it may be possible for the provisions of section 23M and section 31 to be read together.

As stated above, section 23M of the Act applies a statutory formula which limits the deduction of interest. This provision tests factual issues and may therefore be applied in the context of the above-mentioned inbound loans.

The definition of adjusted taxable income in section 23M(1) of the Act refers to an amount of interest incurred that has been allowed as a deduction from income. In this regard it is arguable that consideration could be given to any interest incurred which has been disallowed as a deduction in terms of the provisions of section 31(2) of the Act.

In terms of section 31 of the Act it is necessary to consider, *inter alia*, whether there is any tax benefit and whether the terms of the loan are arms length in nature. In particular consideration will be given to the quantum and interest rate on the loan. If any term of the loan (in particular relating to quantum and interest rate) is not arms length and a tax benefit arises then it will be necessary to calculate the taxable income of the borrower as if the loan was entered into on arms length terms.

In this regard the borrowers taxable income will already be reduced by the application of the statutory formula set out in section 23M of the Act and this should be taken into account in applying the provisions of section 31 of the Act.

In *Natal Joint Municipal Fund v Endumeni Municipality* which is now considered the seminal case on the purposive approach to statutory interpretation, the Supreme Court of Appeal (**SCA**) held that when interpreting legislation, one should consider the text of the document under consideration (as a point of departure) read in context and having regard to the purpose of the provision and the background to the preparation and production of the document. It is submitted that both section 23M and section 31 of the Act are intended to combat base erosion and profit shifting, whilst section 23M has the further specific purposes of addressing the bias for debt funding over equity funding, and hybrid entity mismatches. Accordingly, having regard to the purpose of both provisions does not sway the interpretation in favour of applying either of the provisions before and the exclusion of the other. This supports the argument that both sections could be read together.

In the *Endumeni* case, the SCA held that where a person is faced with two or more possible interpretations of a statute, the one which gives rise to impractical, unbusinesslike or oppressive consequences must be avoided.

In conclusion, where the provisions of section 23M and section 31 of the Act apply to the same inbound loan, the first approach should be to attempt to read the provisions of these sections together. This would mean firstly applying the statutory formula set out in section 23M. The only input required in terms of section 31 in relation to the statutory formula would be the amount of interest incurred that has been allowed as a deduction from income.

The provisions of section 31(2) of the Act would then be applied to the same loan and a determination made as to whether there is a tax benefit and whether the arrangement constitutes an affected transaction. A further adjustment to the taxable income may be necessary having regard to the provisions of section 31(2) of the Act.

Reviewed by Mike Benetello, an executive in ENSafricas tax department.

Simon Weber

associate | tax

sweber@ENSafrica.com

Methods used by taxpayers to write down trading stock to be rewritten?

Author: Jerome Brink.

In its simplest form, s22 of the Income Tax Act, 58 of 1962 (Act) is a timing provision which ensures that the cost of trading stock in the hands of a taxpayer matches the income earned in respect of that trading stock sold, or otherwise disposed of. The 2019 Draft Taxation Laws Amendment Bill (2019 Draft TLAB) proposes a key amendment to the manner in which taxpayers can write trading stock down at the end of any year of assessment which will have far-reaching implications for many taxpayers.

Background

Section 22(1)(a) of the Act sets out the general rule pertaining to closing stock held and not disposed of which

must be included in the income of a taxpayer at the end of the year of assessment. In essence, the closing stock to be included in the income of a taxpayer is the cost price of the trading stock, less such amount as the Commissioner of SARS (Commissioner) may think just and reasonable as representing the amount by which the value of such trading stock has been diminished by reason of damage, deterioration, change of fashion, decrease in market value or for any other reason satisfactory to the Commissioner.
Given the wide discretion afforded to SARSin this respect, SARSs Practice Note No. 36 issued on 13 January1995 (Practice Note 36) provides some guidance on the subject. Practice Note 36 quotes with approval an extract from *ITC 1489 53* SATC99, wherein it was held, amongstothers:

- That if a method of reducing the cost of stock by a percentage is adopted (because, for example, it is impractical to value individual items of stock), the percentage reduction should not only be supported by trading history and, where appropriate, post-balance sheet experience, but the Commissioner should be told how that percentage is arrived at.
- That the Commissioner has to exercise a discretion with regard to the amount by which the value of trading stock has been diminished and cannot exercise that discretion if he is not told on what basis the accounts submitted to him have been prepared; hence the Act, by implication, requires such a disclosure.

Practice Note 36 concludes that where stock is written off on a fixed, variable or any other basis (not representing the actual value by which it has been diminished) that may be acceptable to the Commissioner to the extent that a taxpayer can provide reasonable justification for such method.

The critical issue is that Practice Note36 and the previous case law on the matter accepts that it may be impractical to value individual items of stock and thus a taxpayer may utilise an alternative method so long as suitable justification for utilising that method can be provided. In particular, while one may for examplebe able to value stock on an item-by-item basis where one only has ten items of such stock that will ultimately be sold (eg aeroplanes), the matter is altogether different where the items of stock run into the thousands. For instance, the third category in the definition of trading stock includes consumable stores, and spare parts acquired by a taxpayer to be used or consumed in the course of the taxpayers trade. This includes such specific items as nuts and bolts which would likely be very difficult to value on an item-by-item basis.

Proposed changes to diminution in value of closing stock

Notwithstanding the guidance on the matter and previous case law, the 2019 Draft TLAB now proposes that any diminution in the value of trading stock must be determined on an item-by-item basis. Section 22 of the 2019 Draft TLAB states that s22 of the Act is to be amendedby the addition to ss(1) of the following proviso:

: Provided that for the purposes of this subsection:

(a) the amount of trading stock must be taken into account in determining taxable income by including such amount in gross income; and

(b) any diminution in the value of trading stock must be determined on an item-by-item basis. [Ouremphasis]

Reasons for the change

Curiously, the draft Explanatory Memorandum on the 2019 Draft TLAB (Memorandum) does not appear to clarify nor explain the rationale for the proposed change and is altogether silent on the proposal, despite various issues that arise.First, such an amendment will have far-reaching implications and ramifications for taxpayers given the various impracticalities already discussed above. This is notwithstanding the fact thatprevious case law has accepted thatthe diminution of trading stock on an item-by-item basis can be impractical. Second, it represents a substantial shift in policy given the guidance in Practice Note 36. Lastly, there is no explanation as to what is meant by item-by-item and whether this includes categories of items or rather each and every item down to the last nut and bolt.

Furthermore, s22(1)(a) of the Act already has a pending amendment wherein the entire s22(1)(a) is to be substituted by s37(1)(a) of the Taxation Laws Amendment Act, 25 of 2015 with effect from a date yet to be determined. This amendment will remove the discretion afforded to the Commissioner in the provision and provide for a mechanism wherein the Commissioner will instead publish, by way of public notice, the additional reasons giving rise to the diminution in value of trading stock. This amendment is in accordance with the policy decision to remove the various discretions afforded to the Commissioner in the various tax Acts while moving to more objective tests and provisions. It is thus interesting that the proposal in the 2019 Draft TLAB has arisen prior to the promulgation of the new proposed substitution of s22(1)(a) of the Act.

Conclusion

The proposed amendments are still in draft form and it is anticipated that there will be various submissions made to National Treasury and SARS on this proposed amendment as well as extensive discussions during the relevant public engagement on the 2019 Draft TLAB. It will be interesting to monitor developments in the coming months given the wide ramifications this will have for many taxpayers.

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SARS issues binding class ruling regarding unbundling transaction

Authors: Tsanga Mukumba and Louis Botha.

Section 46 of the Income Tax Act, No 58 of 1962 (Act) provides tax relief where a company (Unbundling Co) wishes to unbundle its shareholding in a subsidiary (Unbundled Co), to the companys own shareholders. The Unbundling Cos shareholders indirect shareholding in the Unbundled Co is converted to a direct shareholding, in proportion to their shareholding in the Unbundling Co.

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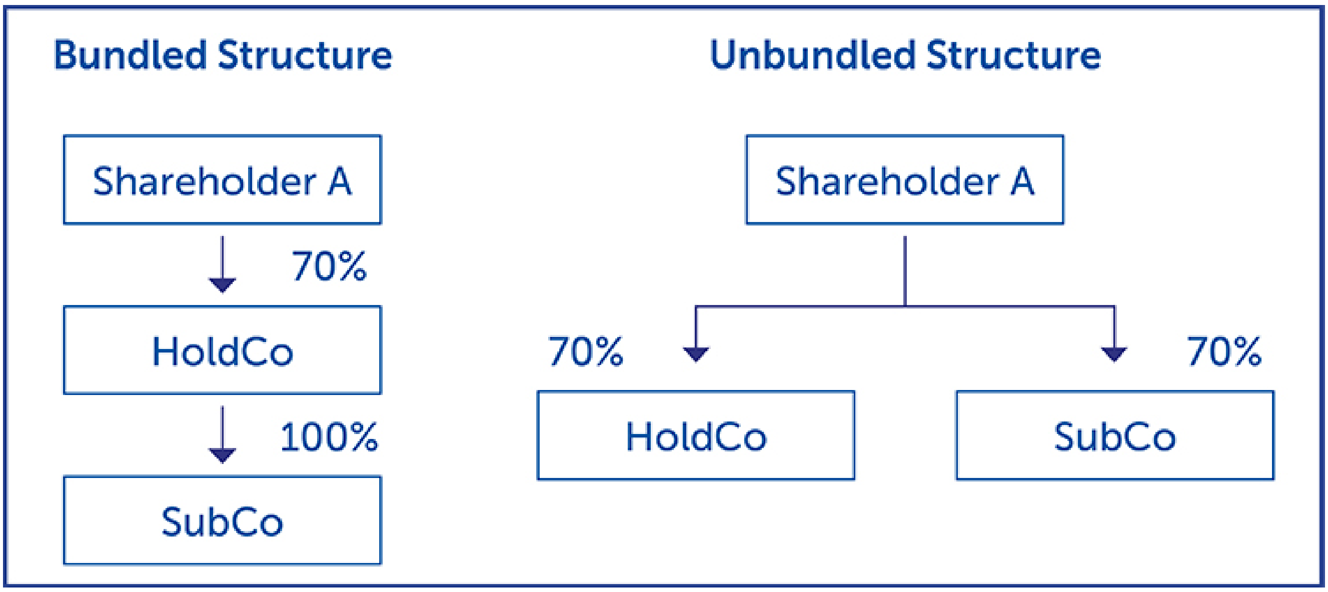

Where an unbundling takes place outside the scope of s46 of the Act, as set out above, several tax consequences would ordinarily apply:

- Shareholder A would receive the shares in SubCo as a dividend in specie, which may result in liability for dividends tax under Part VIII of the Act;
- The disposal of the shares in SubCo, would constitute a disposal under the Eighth Schedule to the Act, potentially leading to a capital gain for HoldCo; and
- Securities transfer tax (STT) would be payable on the transfer of all the shares under the Securities Transfer Tax Act, No 25 of 2007.

On 24 May 2019, the South African Revenue Service (SARS) published Binding Class Ruling 066 (BCR 066). BCR 066 provides the income tax consequences and applicability of s46 to the receipt of shares in a listed company by resident and non-resident shareholders, following an unbundling of that company by its listed parent company. It is binding only on the parties to the ruling.

- The ruling dealt, among other things, with the following aspects of s46:
- The definition of unbundling transaction in s46(1)(a); and
- The anti-avoidance provisions in s46(3)(a)(v).

Facts

The applicant in BCR 066 was a listed company with both listed and unlisted shares. A new company (NewCo) was to be formed and its single class of shares listed prior to the proposed unbundling. The shareholders in the applicant would upon the unbundling receive one NewCo share for each listed share they held in the applicant. In line with the participation rights attached to unlisted shares in the applicant, holders of these unlisted shares would receive one NewCo share for every five unlisted shares held in the applicant. In addition, some of the non-resident shareholders in the applicant were not able to take receipt of the unbundled shares, due to being restricted overseas shareholders in their jurisdiction.

BCR 066 explains that because of the distribution of unbundled shares to the applicants shareholders holding unlisted shares, it could result in such shareholders holding fractional entitlements. It was proposed that rather than transferring these fractional entitlements, they be rounded down to a whole number and the aggregated excess fractions to which a shareholder would otherwise have been entitled will not be transferred to the shareholder but will instead be sold on behalf of theshareholder.

A similar mechanism was proposed in relation to the non-resident shareholders who could not receive transfer of the NewCo shares, with the NewCo shares being sold on their behalf and the proceeds paid to them upon completion of the transaction.

Ruling and discussion

Ordinarily, under s46, shareholders of the Unbundling Co will receive transfer of a proportionate number of equity shares in the Unbundled Co. SARS decided on the facts of the ruling, that despite the shares being sold on behalf of the two types of shareholders, rather than the shares themselves being transferred, the transaction still fell within the definition of unbundling transaction in s46(1)(a). It is possible that SARS accepted this due to the specific facts of BCR066. For example, in BCR066, it is stated that the board resolution authorising and detailing the unbundling transaction provided that the entitlement to the NewCo shares would vest in the non-resident and unlisted shareholders and that ownership would transfer upon the unbundling.

Section 46(3)(a)(v) of the Act neutralises the tax value discrepancies which would occur where an indirect shareholding is unbundled into a direct shareholding. Essentially, it provides that the tax values market value and expenditure as defined of the unbundled shares, must be re-determined with reference to the market values of the unbundled and unbundling shares, at the end of the day that the distribution takes place.

In BCR 066, SARS ruled that s46(3)(a)(v) applied to both the holders of fractional entitlements and non-resident shareholders. This meant that the proportionate adjustment of the expenditure and market value of the shares to be sold on behalf of the abovementioned shareholders would be calculated at the record date. This would determine the amount they would be entitled to following the sale of the NewCo shares on their behalf.

BCR 066 is a good illustration of the underlying principles of the roll-over relief provided by s46 of the Act. To facilitate the restructuring of interests held within a group of companies, the indirect shareholding in a company can be unbundled to the shareholders of a parent company, without adverse tax consequences or significant economic distortion.

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SA Budget 2019/20 – Controlled foreign company comparable tax threshold to be decreased

The Budget noted a global downward trend in corporate taxation rates. This downward trend may lead to an unintended increase in the imputation of the net income of controlled foreign companies (CFCs) in South African shareholders taxable income. This is despite the fact that at the inception, the CFC may have operated in a jurisdiction with rates of tax which would have met the present threshold contained in paragraph (i) of the proviso to s9D(2A)(l) of the IT Act.

Currently the proviso deems the net income of a CFC to be nil where the tax payable in the foreign jurisdiction amounts to 75% of the normal tax the company would have paid in South Africa. In the event that the so-called high-tax exemption applies, no income of the CFC is imputed in the hands of the South African shareholder.
The Budget proposes a reduction in the threshold to less than 75%. This would avoid the situation where a taxpayer who had set up a CFC under the assumption that the high-tax exemption applied, is now subject South African income tax on the basis of the change in tax policy of the foreign jurisdiction.

The Budget also notes that this reduction must be done by taking into account the risks to the tax base. This risk lies in a broader range of jurisdictions falling within the new lower threshold thereby reducing the tax base. South African taxpayers may even seek out these jurisdictions and interpose a company in a jurisdiction with favourable tax rates and trap income there, to the detriment of the South African fiscus.

Author: Tsangadzaome Mukumba – Special Edition Budget Speech Alert 2019

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Finality to Debt Benefit Rules

Author: Siyanda Gaetsew.

The Taxation Laws Amendment Act, 2018 (**TLAA**), which was promulgated on 17 January 2018, amended South African tax legislation by overhauling two provisions relating to the reduction of debt, (the **Debt Benefit Rules**), namely section 19 of the Income Tax Act, 1962 (the **ITA**) and paragraph 12A of the Eighth Schedule to the ITA (the **Eighth Schedule**). This article will examine the notable areas where the legislation per the TLAA differs and the importance of the timing of the application of such amendments.

Some amendments to the Debt Benefit Rules are effective retrospectively, as from years of assessment commencing on or after 1 January 2018. These proposed amendments were first introduced in the Draft Taxation Laws Amendment Bill, 2018 which was published for comment on 16 July 2018. This caused a great deal of uncertainty as the proposed amendments were only in draft and were subject to possible change, which made it difficult for taxpayers to manage their tax affairs during 2018.

In this regard, the most significant amendments relate to paragraph (*a*) of the definition of concession or compromise. Previously, the definition of concession or compromise included any arrangement in terms of which

(*a*) **any**

(i) **term or condition applying in respect of a debt is changed or waived; or**

(ii) obligation is substituted, whether by means of novation or otherwise, for the obligation in terms of which that debt is owed ” (our emphasis added)

Therefore, under the previous section 19 and paragraph 12A of the Eighth Schedule to the ITA, changes to any terms or conditions applying to existing arrangements would give rise to a debt benefit where the face value of the debt exceeded the market value thereof as a result of the change. The change to the term or condition need not have resulted in a new debt or novation of the existing debt. Thus, any change that could result in a change in the market value of the debt would (in the absence of an exclusion applying) have had far-reaching consequences for debt arrangements that were normal in the course of business, for example, changing the interest rate or extending the repayment date of a debt.

As per the TLAA, paragraph (*a*) of the definition of concession or compromise has been amended to include any arrangement in terms of which

(*a*) a debt is

(i) cancelled or waived; or
(ii) extinguished by
(aa) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or
(bb) merger by reason of the acquisition, by the person owing that debt, of the claim in respect of that debt, otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (*b*)

Therefore, the approach taken in defining concession or compromise under the current section 19 and paragraph 12A of the Eighth Schedule to the ITA, is much narrower and is welcomed, in that not all changes to terms or conditions applying to existing arrangements would constitute a concession or compromise, which could have given rise to a debt benefit where the face value of the debt exceeded the market value thereof.

The reason for the amendment provided in the Explanatory Memorandum to the Draft Taxation Laws Amendment Bill, 2018 is that although there is an understanding that voluntary intra-group debt subordinations may be used for tax structuring, however, the inclusion of any changes in the terms or conditions of a debt as a concession or compromise may have the unintended consequence of affecting legitimate transactions.

As the taxpayer has been placed in a better position as a result of the amendments, the retrospective nature of the amendments does not dilute the presumption that an amendment to legislation should be prospective as it was previously held in *S v Mhlungu*, which held that the presumption was not intended to exclude the benefits of rights but rather to prevent the limitation of rights.

On the other end of the spectrum are amendments to section 19 and paragraph 12A of the Eighth Schedule to the ITA, which are potentially onerous to the taxpayer, in that they are effective prospectively as from years of assessment commencing on or after 1 January 2019.

Such notable amendments include the insertion of section 19(6A) read with the substitution in paragraph 12A(4)(*b*) of the Eighth Schedule. In broad terms, these provisions have been inserted to address situations where a debt was applied to fund an asset which is disposed of in a year prior to the year in which the debt benefit arises.

The impact of these provisions is effectively that if the amount of capital gain or loss or recoupment that a taxpayer would have had, had a debt benefit arisen, differs from the amount of capital gain or loss or recoupment that arose by virtue of the disposal, then the difference must be taken into account for purposes of determining a capital gain or loss or recoupment in terms of sections 19 or paragraph 12A, in the year in which the debt benefit arises.

Although the current amendments tick all the boxes here, an important consideration is whether the future application of the legislation to events from the past (ie, retrospective application of legislation), is unconstitutional. In *Pienaar Brothers (Pty) Ltd v CSARS and the Minister of Finance*, the High Court dealt with the Taxation Laws Amendment Act, 2007 which inserted section 44(9A) into the ITA. The court, in that case, held that it is not necessarily unconstitutional for legislation which is not in favour of the taxpayer to be retrospective. The decision has not been challenged in a higher court, however this case should not be viewed as authority that any amendments made to the legislation that are made retrospectively would pass constitutional muster. The particular context and impact of the amendment for the taxpayer as well as the fiscus would need to be considered.

Therefore, in our view, the amending legislation relating to section 19(6A) and paragraph 12A(4)(*b*) of the Eighth Schedule has correctly been made prospective and not retrospective.

Siyanda Gaetsewe is a candidate attorney in ENSafricas tax department.

Reviewed by Melanie Harrison, a director in ENSafricas tax department.

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SARS prescription only starts once tax return has been submitted

Author: *Eric Madumo, a Candidate Attorney and Joon Chong, a Partner at Webber Wentzel.*

In the recent case of *CSARS v Char Trade*, the Supreme Court of Appeal (SCA) that prescription begins to run against CSARS when a return for secondary tax on companies (STC) is submitted to SARS by a taxpayer. In the Char Trade case, a return for STC had not been submitted by the taxpayer. Due to this, prescription had not begun to run against CSARS. The result of this is that CSARS was able to make an assessment in

2012 of the taxpayer’s liability amounting to ZAR 1,812,609 for the 2007 cycle.

The essence of the taxpayer’s argument was that more than 5 years had passed since the 2007 cycle and thus, it was not liable for the assessment in relation to that year. In the court a quo, it was found that the 2007 assessment had prescribed because more than five years had passed since the return and payment were deemed due in terms of s 64B(7) of the Income Tax Act (ITA).

The SCA found that prescription had not begun to run and it reasoned that, in terms of s 102 (1)(a) of the Tax Administration Act (TAA), Char Trade bears the onus of proving that it is not liable for STC in 2007. To do so, Char Trade has to show that in terms of s 99 (1)(b) of the TAA, that five years have expired after the date of the original assessment. The court went on further to reason that Char Trade was obliged in terms of s 64B(7) of the ITA, to submit a return for STC for 2007. This required a self-assessment as defined in the TAA as being a determination of the amount of tax payable under a tax act by a taxpayer and submitting a return which incorporates the determination of the tax or if no return is required, making a payment of tax.

The SCA then posed the question of when did the five year prescription period begin to run? S99(1) of the TAA states that an assessment may not be made in terms of this chapter, in the case of self-assessment for which a return is required, five years after the date of assessment of an original assessment by way of self-assessment by the taxpayer or if no return is received by CSARS.

S1 of the TAA defines date of assessment to mean, in the case of self-assessment by the taxpayer, the date that the return is submitted. The SCA then found that the intended effect of s 99(1)(b) of the TAA, read with the definition of date of assessment as per the TAA, is that prescription cannot begin to run against CSARS until such time as a return that the taxpayer informs CSARS about a dividend, including a deemed dividend, and that STC is payable hereon.

Therefore, prescription in relation to the 2007 cycle could only commence once Char Trade had filed a return for STC. Char Trade had acknowledged that it was liable for STC and was obligated to file returns for all the years of assessment from 2007 to 2012. The return for the year 2007 would have constituted the original assessment. Char Trade failed to submit the STC return and therefore, there was no original assessment from which the five year period could run.

The SCA found that prescription had not begun to run and that the court a quo erred in finding that five years had passed. The appeal was upheld and the assessment for the dividend cycle ending in the 2007 year of assessment was confirmed.

Moving forward, it would appear that the reasoning of the SCA will be applied to other forms of taxes with the underlying principle being that if a return requires a self-assessment as defined in in the TAA, and a taxpayer is required to submit a return to SARS then prescription will only begin to run from the date that the return is submitted to SARS.

Tax non-compliance status may be inaccurate

Authors: Joon Chong, a Tax Partner, Nina Keyser, a Tax Partner, Nirvasha Singh, a Tax Partner

& Carryn Alexander, an Associate at Webber Wentzel.

SARS replaced the Tax Clearance Certificate (TCC) system with the enhanced Tax Compliance Status (TCS) system on eFiling in April 2016. The new TCS system is aimed at improving tax compliance as taxpayers can better manage their TCS and remedy any non-compliance through the “My Compliance Profile” (MCP) function on eFiling.

For some taxpayers, their tax compliance status is of utmost importance in ensuring that they are able to tender for new or continue with existing business with government institutions. National Treasury requires accounting officers and accounting authorities of certain government institutions to reject bids from a supplier without written proof from SARS that the supplier either has no tax obligations or has made arrangements to meet their outstanding tax obligations.

MCP now forms the basis for the overall compliance status issued by SARS with regards to TCS applications. The taxpayer’s compliance status on MCP depends on requirements such as their registration status; outstanding returns; outstanding tax debts with SARS for which payment arrangements have not been made; and whether there is a failure to submit information requested by SARS. Taxpayers are able to remedy a specific area of non-compliant status or they can log a request with SARS to rectify the non-compliant status on the MCP.

Taxpayers can request their TCS for a specific purpose (e.g. tender or bid) using the “Tax Compliance Status Request” functionality. When SARS approves the request, the taxpayer is issued with an overall TCS and PIN, which allows the taxpayer to authorise third parties to verify the taxpayer’s TCS online via eFiling. The PIN enables third parties to view the taxpayer’s overall TCS as at the date and time they check it. In addition to the PIN, the taxpayer is able to print a copy of their TCC from the MCP profile. This is a significant improvement from having to obtain original printed TCCs in person from SARS branch offices.

Parallel with the TCS on eFiling is the Central Supplier Database (CSD), which is an initiative of the National Treasury. The CSD is the single source of key supplier information and is aimed at providing consolidated, accurate, up-to-date, complete and verified supplier information (including the TCS status of the supplier) to procuring organs of state. National Treasury has instructed that since SARS no longer issues TCCs, the CSD and the tax compliance PIN are the approved methods that will be used to verify a supplier’s tax compliance.

We make the following observations on the MCP functionality on eFiling and the CSD initiative by the National Treasury. Both these parallel systems are meant to ensure that third parties are able to verify that taxpayers are tax compliant. However, due to certain administrative and procedural factors beyond a taxpayer’s control, the taxpayer may still be reflected as being non-compliant even though it may be compliant.

A taxpayer that has applied for relief under the voluntary disclosure programme (VDP) with SARS may have a non-compliant status even before the voluntary disclosure agreement has been signed. It appears that once SARS uploads the VDP assessments, the taxpayer will show as non-compliant despite the fact that the voluntary disclosure agreement allows for a later date for payment, or that the voluntary disclosure agreement has yet to be signed. To remedy the non-compliant status, the taxpayer’s only alternative is to make the payment before the outstanding debt becomes due and payable; or to apply for an instalment payment arrangement or a compromise.

Where a taxpayer disputes an assessment and has applied for a suspension of the debt, the taxpayer’s status will also reflect as non-compliant despite the fact that the Tax Administration Act 28 of 2011 (TAA) provides that a taxpayer is compliant if the debt is suspended.

The taxpayer could also have made a payment to SARS which SARS incorrectly allocated or failed to allocate, and the system on eFiling could still inaccurately display the taxpayer’s status as non-compliant despite the fact that payment has been made.

There could be an arrangement between the taxpayer and SARS on the outstanding tax debt. For instance, the taxpayer could have entered into an instalment payment arrangement or compromise with SARS. Notwithstanding the payment arrangement, the system on eFiling could display the taxpayer’s status as non-compliant, and in parallel, the CSD may correspondingly record the taxpayer’s TCS as non-compliant, without further information qualifying the non-compliant status.

SARS seems to think that this new system still protects the confidentiality of the taxpayer’s information because third parties (who are authorised to view the taxpayer’s TCS with the PIN issued by SARS) do not have access to any other information on the taxpayer’s eFiling profile, besides the overall TCS. However, the system provides third parties with a description of the taxpayer’s TCS, which includes a detailed statement of area and amount of non-compliance. This was not provided to third parties under the historic TCC system as the TCC only contains a statement that the taxpayer “is compliant” with a list of the tax registration numbers of the taxpayer. Taxpayers have to provide their PIN to third parties, which could be interpreted as the taxpayer impliedly giving consent for their confidential information to be disclosed in the description of their TCS.

Consequently, it is imperative for taxpayers to be aware that despite complying with their tax obligations in terms of the TAA and any arrangement that they may have with SARS, there is no guarantee that the new TCS system will reflect an accurate compliant status, and further, there is no guarantee that the CSD will record the taxpayer’s TCS accurately.

Taxpayers must therefore carefully monitor their TCS information on eFiling and manage their TCS on both the MCP and the CSD by ensuring that their TCS is up to date. Taxpayers should remedy any non-compliant status immediately before providing their TCS PIN to accounting officers or accounting authorities of government institutions for TCS verification.

The capital v revenue question in the context of government grants: The SCA decides in favour of the motor manufacturing industry

Author: Louis Botha and Louise Kotze.

In the recent case of *Volkswagen South Africa (Pty) Ltd v Commissioner for South African Revenue Service* 80 SATC 179, the age-old question of whether a receipt is capital or revenue in nature was addressed by the Supreme Court of Appeal (SCA), in the context of government grants paid to motor vehicle manufacturers.

Background and relevant facts

In order to ensure the South African motor manufacturing industry remained internationally competitive, the South African Government initiated a motor industry development program (MIDP) in 1995. One of the objectives of the MIDP was the rationalisation of the motor car models being produced. In other words, the program sought to reduce the number of models being produced to improve performance and save costs. The rationalisation required plant and machinery upgrades and technology enhancements (both of which involved substantial capital outlay) and as such, the Board on Tariffs and Trade recommended the introduction of a Productive Asset Allowance (PAA). The PAA, which was provided in the form of a PAA certificate, was available to those manufacturers that invested a certain minimum value in productive assets for the manufacture and assembly of light motor vehicles. The certificate provided for a rebate on customs duty for certain categories of motor vehicles, which was to be calculated as a percentage of the value of the productive assets approved by the Director-General: Trade and Industry. As such, manufacturers that participated in the PAA scheme were reimbursed for an amount up to 20% of the capital expenditure incurred in the rationalisation process by setting the rebate off against the customs duty the manufacturer was liable to pay on the importation of vehicles to be sold in South Africa.

Volkswagen South Africa (Pty) Ltd (Taxpayer), is a motor manufacturer involved in the manufacture and sale of motor vehicles, including the importation and exportation thereof. The Taxpayer participated in the PAA scheme and received certificates for the 2008 to 2010 years of assessment, which rebate amounts were reflected in its income tax returns as accruals of a capital nature. The South African Revenue Service (SARS) rejected these amounts as being capital in nature and issued assessments on the basis that these amounts were revenue in nature. The Tax Court confirmed SARSs assessments, which decision the Taxpayer appealed against.

Legal principles considered by the SCA

The pivotal question, in this case, was whether the PAA certificates constituted receipts or accruals which were capital or revenue in nature.

Despite the myriad of court decisions regarding the determination of whether an accrual or receipt is capital or revenue in nature (and the numerous guidelines that accompanied them), there are no set rules that can be applied to make this determination. Various cases have reiterated that regard must always be had to whether the accrual arose from the realisation of a capital asset or whether it was received in pursuance of a profit-making scheme. Despite these guidelines, the courts have also stated that commercial and good sense must always be the overarching basis on which such a determination must be made.

Interpretation Note 59 issued by SARS on 10 December 2010 (IN59) also gives an indication of which receipts or accruals of government grants will be considered as capital in nature and which will be revenue in nature. Most relevant to this matter is paragraph 3.2.3, which states the following :

A government grant will be of a revenue nature in the hands of a person carrying on trading operations if it is a trading receipt. A grant is a trading receipt if its receipt is a normal incident of a persons trading operations. The nature of the grant received and the relationship which exists between the grant received and the recipients activities needs to be examined.

A government grant will be a trading receipt when it is paid in order to assist in meeting a persons trading obligations or in order to assist in carrying on trading operations. A grant of this nature results in trading receipts being supplemented and accordingly is itself a trading receipt.

By contrast, any amount received or accrued for the purpose of:
establishing an income-earning structure, or
compensation for the surrender of such a structure, is of a capital nature.

IN59 suggests that SARS regards the purpose of a government grant of utmost importance in determining whether such grant is capital or revenue in nature.

Judgment

The Taxpayer contended that the matter could be decided by answering two questions, these being:

1. What was the real and basic cause of the accrual (i.e. in respect of what activity was the grant made); and
2. Whether the abovementioned cause was more closely associated with the equipment of the taxpayers income-producing machinery (which would make it capital in nature) or with its income-earning operations (which would make it revenue in nature).

The court considered this approach and found it to be appropriate considering the nature of the matter.

SARS contended that the PAA certificates could only be redeemed by the payment of customs duties and therefore only accrued once the motors had been imported. As such, they were so closely connected to the income producing activities of the Taxpayer that they were revenue in nature. The SCA disregarded this contention and held that the PAA certificates did not accrue only once the imports had been made but immediately after they had been issued to the Taxpayer. It found that the PAA certificates were issued to compensate manufacturers for at least a portion of the capital expenditure incurred in pursuance of the rationalisation of motor vehicle models and that this clearly distinguished them as capital in nature. The SCA added that the inability to trade the PAA certificates was a further indication of the capital nature thereof.

It was held that the capital investment made by motor manufacturers was at the centre of the PAA scheme and that without these capital investments, no certificates would have been issued. Furthermore, if the grants had been paid in cash, there would have been no dispute regarding the capital nature thereof. As such, the fact that the grants were paid in the form of rebates does not change the capital nature of the benefit received by the Taxpayer.

The SCA concluded that the PAA certificates were in no way received as part of a scheme of profit making and reimbursed the Taxpayer in respect of a percentage of its capital expenditure. The SCA, therefore, upheld the appeal and declared that the PAA certificates were capital in nature.

Comment

The case raises a number of interesting issues. Firstly, it is submitted that the SCA applied the principles regarding the classification of the accruals correctly, by determining that the PAA certificates were capital in nature. The SCAs reliance on the contents of IN59 is interesting. In our Tax and Exchange Control Alert of 4 May 2018, we referred to the Constitutional Courts decision in Marshall NO and Others v Commissioner for SARS (CCT208/17) [2018] ZACC 11 (25 April 2018) where it was held that it would only be justified to rely on an interpretation note, if it reflected a practice of an impartial application of a custom recognised by all concerned. Despite the Constitutional Courts judgment that followed the SCA judgment, It could be argued that the principles in IN59 regarding the classification of government grants could be relied on, as the principles appear to be consistent with the established principles laid down in South African jurisprudence regarding the determination of an amount as capital or revenue in nature.

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