Proposed unilateral extension of prescription by SARS

Section 99 of the Tax Administration Act, 28 of 2011 ("**Tax Admin Act**") regulates prescription in relation to tax assessments and provides for a three year prescription period in respect of income tax assessments and a five year prescription period in the case of self-assessment taxes (e.g. value-added tax and employees' tax).

Generally, the prescription period that prohibits SARS from issuing an additional assessment does not apply if the reason why the full amount of tax was not charged was due to fraud, misrepresentation or non-disclosure of material facts by the taxpayer. When the tax is a self-assessment tax, the basis on which the prescription period does not apply differs in that it refers to fraud, as well as intentional and negligent misrepresentation or non-disclosure.

In terms of the draft Tax Administration Laws Amendment Bill, 2015 ("draft Bill"), released for public comment on 22 July 2015, it has been proposed that the Commissioner for the South African Revenue Service ("**the Commissioner**") may extend the relevant prescription period prior to the expiry thereof, *inter alia*, if an audit or investigation relates to a complex matter such as the application of the general anti-avoidance provisions ("**GAAR**") under a tax Act, an audit or investigation under section 31 of the Income Tax Act, 58 of 1962 (which deals with transfer pricing), or a matter of analogous complexity. It is proposed that, in these circumstances, the relevant prescription period may be extended by the

Commissioner by a period of up to three years. The proposed amendment appears to have the effect of allowing the Commissioner to unilaterally extend the prescription period provided for in section 99(1) of the Tax Administration Act, in the case of income tax, to a maximum of six years.

A number of issues arise from this proposed amendment. Firstly, the terms “complex matter” and “analogous complexity” are wide, and no objective standard is given by which SARS must measure the alleged complexity of a matter. The citing of examples of complex matters as being GAAR and the transfer pricing rules is in our view not helpful, and does not set an objective standard against which the complexity of a matter may be measured. The decision as to the complexity of a matter and whether an extension of the legislative prescription periods is thus warranted, and therefore appears to be a largely subjective matter which is left to the discretion of the Commissioner. This will lead to uncertainty for taxpayers in relation to whether a decision by SARS to extend the prescription period in relation to a particular tax aspect in this context is justified or appropriate.

Secondly, the proposed amendment does not stipulate that SARS has to notify the taxpayer that prescription has been extended. Section 3 of the Promotion of Administrative Justice Act 3 of 2000 (“**PAJA**”) provides that administrative action which materially and adversely affects the rights or legitimate expectations of any person must be procedurally fair. In terms of section 3(2) of PAJA, in order to give effect to this right, an administrator (i.e. SARS) must give adequate notice of proposed administrative action. It is trite law that any decision taken by the Commissioner constitutes administrative action and therefore has to comply with the provisions of PAJA. It is therefore submitted that, in order to create certainty for taxpayers and to bring the proposed amendment in compliance with section 3 of PAJA, a requirement should be added that the Commissioner notifies the taxpayer of its intention to extend prescription.

Thirdly, there is no procedure for a taxpayer to challenge a decision by the Commissioner to extend prescription on the basis that it regards a matter as being complex, as a taxpayer is not given the ability to object to such a determination by SARS in terms of section 104 of the Tax Administration Act. Therefore, since such a decision by the Commissioner would constitute an administrative action, a taxpayer's only remedy would be to request reasons in terms of PAJA, and, following the receipt of reasons and if considered necessary, to take such a decision on review under PAJA. This is a costly and time-consuming process, and does not seem to be an appropriate manner in which to deal with this issue. Presumably, the taxpayer would have to wait for SARS to issue an additional assessment after availing itself of the additional time, and then raise this aspect as a ground of objection against the raising of the assessment.

Lastly, the proposed effective date of this amendment is the date of promulgation of the draft Bill. The question arises how this will affect a taxpayer's existing rights in relation to prescription and in particular where an assessment was issued prior to the date that the proposed amendment comes into effect. The untenable situation could arise where a taxpayer's 3 year (or 5 year) prescription period is close to expiry, the draft Bill is promulgated and the Commissioner, prior to expiry of such period, unilaterally decides to extend the prescription period based on a subjective determination of the complexity of a particular tax aspect. It is therefore submitted that the proposed amendment should only apply to years of assessment commencing on or after the date of promulgation of the proposed amendment.

Due to the importance of prescription for taxpayers in obtaining finality as to their tax affairs, it is crucial for taxpayers to be aware of the prescription status of assessments and their rights in this context. ENSafrica is submitting comments to National Treasury in respect of, *inter alia*, this proposed amendment, as it has far reaching implications on the rights of taxpayers and will result in great uncertainty for taxpayers in relation to prescription of assessments, will severely impact on a taxpayer’s ability to reach finality in relation to their tax affairs and will widen the already considerable powers of SARS in the context of tax disputes

ENSafrica – Nicolette Smit

Binding Ruling on issue of capitalisation shares

The South African Revenue Service (SARS) issued Binding Private Ruling No 201 (Ruling) on 13 August 2015.

The Applicant, being a natural person, held 100% of the equity shares in a resident operating company (OpCo). OpCo, in turn, owned 100% of the shares in a dormant resident company (Co-Applicant). The parties wished to introduce a black-owned company (BEECo) as a shareholder in OpCo in order to improve its Black Economic Empowerment (BEE) credentials.

In order to achieve this, it was proposed that:

- OpCo would dispose of its shares in the Co-Applicant to the Applicant for nominal value;
- The Applicant would dispose of its ordinary shares in OpCo to the Co-Applicant in exchange for ordinary shares in the Co-Applicant (ie an asset-for-share transaction in terms of s42 of the Income Tax Act, No 58 of 1962 (Act));
- The Applicant would then hold 100% of the equity shares in the Co-Applicant and the Co-Applicant would hold 100% of the equity shares in OpCo;
- The Co-Applicant would issue 10 000 capitalisation shares to the Applicant for no consideration; and
- The Co-Applicant would issue 25.1% ordinary shares to BEECo for a negligible subscription price.

The 10 000 capitalisation shares would:

- be participating, cumulative, redeemable preference shares;
- be redeemable at the option of the Co-Applicant at 100% of the current equity value of OpCo;
- only have to be redeemed by the Co-Applicant if a default is triggered by the Co-Applicant falling into financial distress;
- entitle the Applicant to a cumulative preference dividend equal to the unredeemed balance of the redemption price of the shares, plus arrears, times 72% of the prime rate; and
- entitle the Applicant to 1% of all distributions made in respect of the ordinary shares.

SARS ruled that:

- The receipt by the Applicant of the capitalisation shares would not be seen as a disposal of the Applicant’s ordinary shares in the Co-Applicant (presumably as a result of dilution), and the anti-avoidance provisions contained in s42(5) of the Act would not be triggered (Please refer to our Tax Alert dated 31 July 2015 for the latest developments regarding s42(5) of the Act);

- The Applicant will continue to hold a "qualifying interest" in the Co-Applicant subsequent to the issue of the capitalisation shares, and s42(6) of the Act will not be triggered;
- The receipt of the capitalisation shares would not constitute "gross income" in the hands of the Applicant, presumably because it is a capital receipt as opposed to a dividend, and would also not have to be included as an amount in respect of services rendered;
- The capitalisation shares would also not be subject to s8C of the Act;
- The capitalisation shares would not constitute a "dividend" or a "return of capital" as defined in s1 of the Act;
- The exchange of the Applicant's personal right to receive the capitalisation shares, for the actual capitalisation shares upon receipt will constitute a "disposal" by the Applicant, but will be disregarded for capital gains tax purposes (presumably because the base cost of the right would equal the proceeds, but this is unfortunately not made clear);
- The expenditure incurred by the Applicant in respect of the capitalisation shares will be deemed to be nil in terms of s40C of the Act; and
- No "contributed tax capital" will be created by the issuing of the capitalisation shares.

SARS did not make this ruling subject to any conditions or assumptions, but it did clearly indicate that the Ruling does not extend to any issues regarding company law, accounting treatment, or BEE accreditation.

[Tax Alert – 14 August 2015 (97KB)]

Construction and interpretation of tax legislation: then and now

The principle relating to the **construction and interpretation of fiscal legislation** are in general those relating to the construction and interpretation of statutes.

As early as 1926 Judge Stratford held in Farrar's Estate v CIR that '*[the]* ***governing rule on interpretation****is to endeavour to ascertain the* ***intention of the law-maker*** *from a study of the provisions of the enactment in question*'.

In regard to **tax legislation**, Income Tax Acts in particular, the **language** imposing the tax **must receive a strict construction**. Judge Rowlett held in Cape Brandy Syndicate v I.R. Comrs that '*…in a taxing Act one has to* ***look at what is clearly said****. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax.* ***Nothing is to be read in, nothing is to be implied****. One can only look fairly at the language used'.*

Similar statements have been made in several judgments on tax cases. In Scott v. Russell (Inspector of Taxes), Lord Simonds said: *'My Lords, there is a maxim in Income tax law which, though it may sometimes be over-stressed, yet ought not to be forgotten. It is that* ***the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax upon him****. It is necessary that this maxim should on occasion be reasserted …'*

According to Lord Simon in Withers v. Nethersole an equitable construction of income tax legislation is, in general, not permitted. **If the meaning of a taxing provision is reasonably clear, the Courts have no jurisdiction to mitigate any apparent harshness**.

Thus the norm was that a **taxing Act must be construed with perfect strictness** whether or not such construction is **against the State or against the person sought to be taxed**. **If however there is any real ambiguity in a taxing Act, such ambiguity may be resolved in favour of the taxpayer**, or, as it is sometimes stated: *contra fiscum.*

Recently in *Natal Joint Municipal Pension Fund v Endumeni Municipality* where Wallis JA said the following with regard to the construction:

'The trial judge said that the ***general rule*** *is that the* ***words used in a statute*** *are to be* ***given their ordinary grammatical meaning unless they lead to absurdity****. He referred to authorities that stress the importance of context in the process of interpretation and concluded that:*

"A court must ***interpret the words in issue according to their ordinary meaning in the context of the Regulations as a whole, as well as background material, which reveals the purpose of the Regulation, in order to arrive at the true intention of the draftsman****of the Rules."*

Whilst ***this summary*** *of the approach to interpretation was buttressed by reference to authority it****suffers from an***

***internal tension because it does not indicate what is meant by the "ordinary meaning" of words**, whether or not influenced by context, or why, once ascertained, this would coincide with the "true" intention of the draftsman. …*

*The **present state of the law** can be expressed as follows: Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, **having regard to the context provided** by reading the particular provision or provisions in the light of the document as a whole and the **circumstances attendant upon its coming into existence**. Whatever the nature of the document, **consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production**. Where **more than one meaning is possibleeach possibility** must be **weighed in the light of all these factors**. The process is **objective** not subjective. A **sensible meaning is to be preferred** to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. **Judges** must be alert to, **and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike** for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation. ….'*

It is also now accepted law that one can **rely on what is said in documents such as Explanatory Memoranda, issued when legislation is enacted, to ascertain the meaning of the relevant legislation**. Thus in *Minister of Health v New Clicks SA (Pty) Ltd*, Chaskalson CJ said the following:

'In S v Makwanyane and Another I had occasion to consider whether background material is admissible for the purpose of interpreting the Constitution. I concluded that:

*“**where the background material is clear, is not in dispute, and is relevant** to showing why particular provisions were or were not included in the Constitution, it can be taken into account by a Court in interpreting the Constitution”.*

Although it is not entirely clear whether the majority of the Court concurred in this finding, none dissented from it. I have no reason to depart from that finding and, in my view, it is applicable to ascertaining the ‘mischief’ that a statute is aimed at where that would be relevant to its interpretation. This would be consistent with the decisions of the Appellate Division in Attorney-General, Eastern Cape v Blom and Others and Westinghouse Brake & Equipment (Pty) Ltd v Bilger Engineering (Pty) Ltd and the cases from other jurisdictions referred to in Makwanyane’s case.‘

It is important for **lawyers to be mindful of the above developments in the principles of construction and interpretation** of legislation, **because words used to draft legislation are imperfect**.

Shepstone & Wylie Attorneys – Johan Kotze

A “how to guide” for SARS objections and appeals

Author: Anton Lockem of Shepstone & Wylie Attorneys

As a taxpayer, if you receive an **assessment from the Commissioner** of the South African Revenue Services ("SARS") that you disagree with, you can **lodge an objection** in line with the **Tax Administration Act**, No. 28 of 2011 ("the Act").

Under section 96(2) of the Act, the Commissioner has to supply the taxpayer with the **grounds of the assessment**. It is often the case that the taxpayer needs to demand that the Commissioner comply with this statutory obligation, as there have been many cases where grounds have not been supplied. The**taxpayer is required to submit a request for grounds** within **30 days** of receiving an assessment. Once grounds have been supplied, the taxpayer has **30 days to submit an objection** to the assessment.

Taxpayers need to submit the **correct documentation for their objection** in order for it to be valid:

- For **personal income tax** payers a notice of objection or form NOO is required via efiling;
- For **corporate income tax** payers a form NOO is required via efiling;
- For **trusts** a form ADR1 is required via hand or email to the appropriate SARS official; and
- For **VAT, dividend taxes, payroll-related taxes and the like**, a form ADR1 is required by post / hand.

SARS has been known to confuse their own process on occasion and dismiss objections on the grounds that the incorrect form / process was used, when in fact the taxpayer used the correct form / process. In such cases, the taxpayer needs to point out the SARS guidelines and legality of the situation to SARS and an **order of apology** will be issued and the objection properly confirmed.

When objecting, a taxpayer must **unpack all the ground of objection in his / her letter** to the Commissioner. He / she also needs to ensure that the **grounds can be supported by all relevant documentation** in order to **substantiate his / her objection**. As per *ABC (Pty) Ltd v Commissioner for SARS*, **neither SARS nor the taxpayer may add to the grounds of objection without following the proper procedures** as laid down in the Act.

An objection to an assessment does not suspend the obligation to make payment, therefore the taxpayer is **still liable for payment of the tax and SARS may collect the tax whilst the dispute is on going**. In order to ensure that SARS do not collect the amount of tax in dispute, the taxpayer can **apply for a suspension of payment** in terms of section 164 of the Act. Requests for suspension of payment must be submitted to the SARS collections official dealing with the matter (where one has been appointed) or hand delivered to the Collections department at a SARS branch office.

There is a **difference between a substantive dispute** between SARS and the taxpayer, **and a general error in assessment**. If the assessment contains errors, then the taxpayer must submit a request for correction from SARS.

By law, SARS is not entitled to dismiss any tax a taxpayer owes, however they may **settle a dispute**where it would be to the best advantage of the state. The settlement circumstances, as laid out in the Act, are in line with the approach that more emphasis should be placed on resolving disputes instead of litigating them.

Once the taxpayer has lodged an appeal (when SARS declines the taxpayer's objection), SARS and the taxpayer may attempt to resolve the dispute through **Alternative Dispute Resolution** (as opposed to the Tax Board, the tax Court, or any other court) under procedures specified in the Act.

The **Tax Board** must be the court of first instance in an appeal if the tax in dispute does not exceed the amount determined by the Minister (currently R500 000), a senior SARS official and the taxpayer agree to such, and the chairperson of the Board believes the matter should be heard before the Board as opposed to the Tax Court (if he believes the appeal should be heard before the Court, he / she may direct that the appeal be laid down before the Court).

If Alternative Dispute Resolution is pursued and unsuccessful and / or the taxpayer is not satisfied with the decision of the Tax Board, the taxpayer may pursue his / her appeal in the **Tax Court**. The Tax Court hears appeals that exceed R500 000 and cases that dispute important tax principles (including those that do not exceed R500 000). The Tax court follows a formal court process like that of the High Court.

In most appeals before the **Tax Court**, the **burden of proof is on the taxpayer** as matters concerning the tax position taken by the taxpayer are within his / her knowledge. It has been held in case law, however, that **SARS bears a rebuttal onus** (evidence to prove that the evidence provided by the taxpayer is incorrect).

Shepstone & Wylie Attorneys – Anton Lockem

Constitutional Court judgment on the in duplum rule – does it limit interest payable on a tax debt?

The recent Constitutional Court judgment of ***Paulsen and Another v Slip Knot Investments 777 (Pty) Limited 2015*** centered on the **common law *in duplum* rule**. The *in duplum* rule operates to **protect debtors from becoming over-indebted to creditors by only allowing arrear interest to accumulate up to the capital amount loaned to a debtor**. **Interest ceases to run once the accumulated arrear interest equals the capital amount**.

In this case, the **Constitutional Court held that the operation of the *in duplum* rule is no longer suspended for the duration of litigation**.

What is **unclear from the outcome** of this case, however, is**whether or not the *in duplum* rule can be applied in respect of interest imposed** by the Commissioner of the South African Revenue Service **("SARS") on tax debts**.

Justice Madlanga, who handed down the main judgment in the Paulsen Case, used several lines of reasoning in coming to his conclusion in terms of the *in duplum* rule during litigation including:

- the **fear of potentially ruinous interest** which could prevent a debtor from raising a defence which that debtor believed was valid; such fear would have the effect of **infringing the debtor's constitutional right of access to courts**; and

- **South Africa's economic disparity** and the **root causes** thereof as justification **for the application of the *in duplum* rule.** In this regard he reasoned that credit providers are, "*large, established and well-resourced corporates*" whereas when referring to the majority of credit consumers he stated, "*it would be ignoring our country's economic reality to suggest that there is any comparison between these corporates and most credit consumers*." He then went on and stated that, "***astronomical interest may mean the difference between economic survival and complete financial ruin***" for these credit consumers.

When applying his reasoning in the judgment, Justice Madlanga was speaking in terms of contracting parties and not in terms of statutorily imposed obligations such as the interest imposed by the Commissioner of SARS in terms of the Income Tax Act and the Tax Administration Act.

Considering the fact that the Paulsen case does not firmly answer the question of whether or not the *in duplum* rule applies to a tax debt, we have to review previous cases for answers. **In *LTA Construction Bpk v Administrateur Transvaal 1992*, the court found that the *in duplum* rule applies to all contracts under which a capital sum owed is subject to a particular interest rate. This seems to limit the application of the rule to circumstances where a contract exists between parties**. **In the case of *CSARS v Woulidge 2002*, the Supreme Court of Appeal found that the rule is applicable only to transactions between contracting parties and where it serves public policy** (in protecting borrowers against exploitation by lenders). The court stated that:

"It is clear that the in duplum rule can only be applied in the real world of commerce and economic activity where it serves considerations of public policy in the protection of

borrowers against exploitation by lenders."

It follows, from both the **Paulsen and the Woulidge cases,** that the ***in duplum*** **rule does not limit interest payable to SARS on a tax debt since a tax debt arises by operation of statute and not by a contract between the taxpayer and SARS.** It has also been **argued by the legal fraternity that** the**public policy argument would not necessarily apply to a taxpayer where SARS only caught the outstanding amount years after the relevant tax period and was thus unable to pursue the taxpayer sooner.** This is, therefore, the **current status** of the law and its interpretation **until** such time as the **court makes a firm ruling** on the use of the *in duplum* rule when it comes to interest payable on a tax debt. It is important to note, however, that in his Paulsen case judgment, Justice Madlanga cautioned the courts to defer issues containing complex policy considerations to the Legislature so as not to usurp a legislative function.

Shepstone & Wylie Attorneys – Daniel Robb

Binding Private Ruling – Exemption from donations tax and the net value of an estate

On 1 July 2015, the South African Revenue Service (SARS) released Binding Private Ruling 197 (BPR 197) dealing with the donations tax consequences arising from the onward or subsequent donation of funds received by way of a donation from a foreign source. BPR 197 further deals with the estate duty consequences that will apply in the event of the foreign sourced funds being retained or used to acquire property that is located and remains outside South Africa.

By way of background, the applicant, a resident of South Africa as defined in s1(1) of the Income Tax Act, No 58 of 1962 (Act), is one of a number of beneficiaries of a foreign trust (Foreign Trust). The funds held by the Foreign Trust consist solely of funds which have been sourced outside of South Africa. In terms of an agreement reached between the trustees of the Foreign Trust, a certain amount of the trust funds would be awarded to the applicant, whereafter the applicant would be removed as a beneficiary of the Foreign Trust.

Subsequent to the funds being transferred to the applicant's offshore bank account, the applicant intends to donate an amount thereof to certain elected individuals, hereinafter referred to as the donees. The applicant further intends to invest and retain the balance of the awarded funds offshore in order to acquire property, as defined in s3(2) of the Estate Duty Act, No 45 of 1955 (Estate Duty Act), located outside South Africa.

Section 56(1) of the Act deals with certain transactions in respect of which donations tax shall not be payable on the value of property which is disposed of. In particular, s56(1)(g) of the Act provides that donations tax shall not be payable in respect of the value of any property which is disposed of under a donation:

“(g) if such property consists of any right in property situated outside the Republic and was acquired by the donor –

(i) before the donor became a resident of the Republic for the first time; or

(ii)by inheritance from a person who at the date of his death was not ordinarily resident in the Republic or by a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic; or

(iii)out of funds derived by him from the disposal of any property referred to in sub-paragraph (i) or (ii) or, if the donor disposed of such last-mentioned property and replaced it successively with other properties (all situated outside the Republic and acquired by the donor out of funds derived by him from the disposal of any of the said properties), out of funds derived by him from the disposal of, or from revenue from any of those properties.”

Having regard to the background set out above, SARS ruled as follows:

- the awarding of funds by the Foreign Trust to the applicant will not trigger any income tax liability in the hands of the applicant;
- the donations made by the applicant to the donees will be exempt from donations tax under s56(1)(g)(ii) of the Act; and
- the remaining portion of the award received and/or the property acquired using the proceeds of the award from the Foreign Trust will be excluded from the net value of the applicant’s estate for estate duty purposes under s4(e)(ii)(aa) or (iii) of the Estate Duty Act.

It is interesting to note that SARS specifically stated that whether or not the proposed transaction is connected with any arrangement implemented or to be implemented for the avoidance of tax falls outside the scope of BPR 197 and shall not be decided on.

BPR 197 is valid until 28 February 2025.

Tax Alert – 3 July 2015 (125KB)

Binding Private Ruling – Awards from foreign trusts

The South African Revenue Service (SARS) published Binding Private Ruling No 197 (Ruling) on 1 July 2015. The Ruling deals with the receipt of funds from a foreign trust, and the subsequent donation and investment thereof.

The applicant was an individual resident in South Africa. The applicant was also a beneficiary of a foreign trust. The foreign trust only held funds sourced from outside South Africa.

The trustees of the foreign trust resolved to award a specified amount of the foreign trust funds to the applicant, after which the applicant would be removed as a beneficiary.

The funds so awarded would be transferred to the applicant's foreign bank account, after which the applicant would:

- donate some of the funds to certain individuals; and
- invest the balance in a property outside South Africa.

Firstly, SARS ruled that the award of the funds by the foreign trust would not be subject to income tax in the hands of the applicant. Unfortunately SARS did not elaborate on the issue, but it appears that the amount awarded to the applicant would not have fallen within the ambit of s25B(2A) of the Income Tax Act, No 58 of 1962 (Act), and would simply be treated as a capital receipt.

Secondly, SARS ruled that the anticipated donations would be exempt from donations tax because of the exemption contained in s56(1)(g)(ii) of the Act. This provision applies where the property that is being donated constitutes a right in property situated outside of South Africa (such as the foreign funds), and it was acquired by the donor *"…by inheritance from a person who at the date of his death was not ordinarily resident in the Republic or by a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic…"*

Unfortunately the Ruling does not reveal whether the foreign trust was a testamentary trust and whether the award of the foreign funds was seen as having been acquired by way of inheritance. The Ruling also does not specify whether the award by the foreign trust was seen as a donation by a non-resident donor.

Thirdly, SARS ruled that the balance of the award, which would be used to acquire a foreign property, would not be included in the estate of the applicant for estate duty purposes because of the application of s4(e)(ii)(aa) or (iii) of the Estate Duty Act, No 45 of 1955.

The said provision excludes any right to property situated outside of South Africa acquired by a deceased:

"(ii) after he became ordinarily resident in the Republic

for the first time, by:

(aa) a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic; or

(bb) inheritance from a person who at the date of his death was not ordinarily resident in the Republic; or

(iii) out of the profits and proceeds of any such property proved to the satisfaction of the Commissioner to have been acquired out of such profits or proceeds…"

Again, the Ruling is not specific as to whether the award is seen as an inheritance or a donation.

It was also specifically noted in the Ruling that SARS would not rule on whether the proposed transaction formed part of any arrangement for the avoidance of tax.

SARS indicated that the Ruling would be valid for a period of approximately ten years, but it is submitted that, since the Ruling concerned the application of the Estate Duty Act at the time of the death of the applicant, it should have been extended until such time.

[Tax Alert – 10 Juy 2015 (121KB)]

Cross-border technical services income – Double tax

agreements should be considered to reduce double tax burdens

Author: Bruce Russell, tax consultant Grant Thornton Cape

South African resident taxpayers performing advisory or other technical services within South Africa to clients abroad, may be subject to foreign withholding taxes. To reduce the risk of this income being subjected to double taxation, it is necessary to consider the source of this income.

The source of services income

South African courts have interpreted the concept of source in applying the Income Tax Act. Source in this context is not a legal concept, but rather something a reasonable man would regard as the real source of income. In establishing the source of income, our courts have not looked to the origin of the income, but rather have focused on the originating cause of the income. The originating cause is the quid pro quo given by the taxpayer to earn the income. In the case of service income, the source is usually the location from where the services are rendered.

The impact of double tax agreements on the source of technical services income

A double tax agreement ("DTA") may contain a technical services clause. For example, DTAs concluded by South Africa with Swaziland, Botswana, Uganda and India contain such a clause. In terms of this clause, fees for technical services that are paid by a resident of a foreign country to a South African resident, are usually deemed to arise in the foreign country. Furthermore, this DTA clause permits the foreign country to impose a withholding tax of 10%.

However, the provisions contained in these DTAs, usually conflicts with the South African common law view of source. The SARS interpretation – Interpretation Note No. 18 (issue 2) and its Draft Interpretation Note No. 18 (issue 3) – is that the DTA deemed source provisions overrides the South African common law view of source. Applying SARS' interpretation, the source of technical services income is located in the payer's resident country.

The importance of determining the source of technical services income in light of double tax relief measures

Where a South African tax resident is liable for foreign taxes, relief in terms of a tax rebate or a tax deduction may be available. The extent or type of relief available depends on the source of the income.

Where the source of the income is South Africa, the taxpayer may be entitled to a section 6quin rebate. To qualify for this rebate, an FTW01 form must be submitted to SARS within 60 days of the tax being withheld. Failing to comply with this requirement means that the taxpayer may only be entitled to claim the foreign taxes paid as a deduction in terms of section 6quat. A deduction for foreign taxes is less desirable, as for instance a corporate taxpayer in this position would only be entitled to reduce their South African income tax liability by up to 28% of the foreign tax paid.

If the source of the income is foreign, the taxpayer may be entitled to a section 6quat rebate. No form needs to be submitted to SARS in order to claim this rebate.

Therefore, South African taxpayers deriving technical services income from which foreign taxes are withheld must evaluate and conclude on the source of this income within a short space of time to ensure that double taxation is minimised. In determining the source of technical service income, a relevant DTA may need to be evaluated.

Interpreting the provisions and implications of DTAs may not be straightforward and to avoid penalties and frustration, please contact us for assistance.

Interpretation of exemption provisions

The Tax Court gave judgment in the matter of *ABC (Pty) Ltd vCommissioner for the South African Revenue Service* (case number 13512, as yet unreported) on 30 March 2015.

Even though the case concerned secondary tax on companies (STC), which has been replaced by dividends tax, it is interesting to see how the court dealt with the interpretation of an exemption provision.

The South African Revenue Service (SARS) assessed the taxpayer for STC in terms of s64B(2) of the Income Tax Act, No 58 of 1962 (Act) on the basis that certain loans made by the taxpayer were loans as contemplated in s64C(2)(g) of the Act. In terms of s64C(2)(g) of the Act, loans made to shareholders or connected persons in relation to such shareholders, are deemed to be dividends.

The taxpayer was a wholly-owned subsidiary of trust X. The taxpayer was part of a group, and it was a property-owning company as well as a treasury company. Interest-free loans were made to the taxpayer, and the taxpayer in turn made interest-free loans to certain borrowers. The loans made by the taxpayer were the subject of the dispute.

The taxpayer did not dispute that the loans were made to its shareholders or connected persons in relation to its shareholders, but relied on an exemption contained in s64C(4)(bA) of the Act.

Section 64C(4)(bA) provided that there will be no deemed dividend:

"…to the extent of any consideration received by that company in exchange for –

(i).. the cash or asset distributed, transferred or otherwise disposed of; or

(ii). any other benefit granted as contemplated in subsection (2)…"

The court noted that STC was a tax imposed on the dividends distributed by a company, and a dividend is essentially a distribution by a company of its profits. The underlying principle of STC was therefore for the state to share in the profits of a company.

The taxpayer argued that, in extending the loans, it did not distribute any of its profits, but merely acted as a conduit of the incoming loans.

SARS argued that, for the loans to qualify for exemption, the loans had to comply with s64C(4)(d) of the Act, which provided that a loan would be exempt from being deemed a dividend where, *“a rate of interest not less than the official rate of interest …is payable by the shareholder or any connected person in relation to the shareholder…”*

SARS’s submission was based on the argument that s64C(4)(d) of the Act dealt specifically with loans, and only loans of this kind qualified for exemption. The other exemption provisions, such as that contained in s64C(4)(bA) of the Act, could not apply because of the application of the maxim *expressio unius est exclusion alterius*: the mention of one matter excludes the other.

However, the court ruled that the maxim could not be relied on in this matter, and that it does not always follow that the mention of one matter excludes all others. The maxim should only be used with great caution. The court held that without clear words to that effect, it could not have been the intention of the legislature that only loans contemplated in s64C(4)(d) could be exempt.

SARS also argued that s64C(4)(dA), on which the taxpayer relied, was not applicable because the loans were interest free and thus no consideration was received by the taxpayer.

However, the court held that due to the nature of the arrangement between the parties, the taxpayer received *quid pro quo* for granting the interest-free loans, being interest-free incoming loans.

It was noted that the use of the taxpayer as a conduit was, according to a witness, rather bizarre. However, the court was quick to point out that SARS did not rely on anything to the effect that there was something sinister about the arrangements, and that *“taxpayers are entitled to arrange their affairs in the manner they wish as long as the confines of the law are respected.”* Accordingly, the appeal was upheld and the assessments were set aside.

Tax Alert – 24 April 2015 (125KB)

Binding Private Ruling on a Notional Funding Arrangement: the Issue and Repurchase of Ordinary Shares

SARS issued the Binding Private Ruling 190 on 5 March 2015, which deals with the issue and repurchase of ordinary shares. The ruling deals with a proposed arrangement and the contractual rights and restrictions established separately from any class provisions applicable to those shares in terms of the Applicant Company's memorandum of incorporation.

The parties to the ruling include the Applicant, which is a company incorporated in and a resident of South Africa; and the Co-Applicant which is a company incorporated in and a resident of South Africa.

The Applicant established two trusts which would become shareholders in the Co-Applicant for the purpose of the Co-Applicant acquiring ordinary shares in the Applicant. The two trusts subscribed for 51% and 49%, respectively, in the Co-

Applicant’s issued share capital at nominal value which would result in the two trusts being and remaining the sole shareholders of the Co-Applicant. The Co-Applicant subscribed at a nominal value for ordinary shares in the Applicant which would, after issue, constitute 26% of its entire issued share capital.

The ordinary shares which the Co-Applicant subscribed to had exactly the same rights and privileges as the remainder of the ordinary shares issued by the Applicant. The parties contractually agreed (in a subscription and repurchase agreement) that:

- The Applicant will, on the fifth anniversary of the subscription date (the repurchase date), repurchase a determinable number of ordinary shares held by the Co-Applicant at a nominal amount;
- The Co-Applicant will not be entitled to dispose of the ordinary shares until after the repurchase date;
- The ordinary shares shall be held by the Applicant in safe custody until the repurchase date; and
- The number of ordinary shares to be repurchased by the Applicant will be determined in accordance with a pre-determined notional vendor funding formula which will take into consideration the following:
    - The initial market value of the ordinary shares in the Applicant not subject to the subscription and repurchase agreement;
    - The market value of the ordinary shares in the Applicant not subject to the subscription and repurchase agreement, on the repurchase date;
    - An escalation factor; and
    - The period of time that has elapsed since the subscription date to the repurchase date.

Subsequent to the future repurchase of the determined number of ordinary shares from the Co-Applicant, the remaining shares will be released from safe custody and their share certificates will be delivered to the Co-Applicant.

SARS considered section 24J of the Income Tax Act; paragraphs 11(1)(a) and 35 of the Eighth Schedule to the Income Tax Act, 1962 (the ITA); and section 1, definition of “transfer” of the Securities Transfer Tax Act and issued the following ruling:

- Section 24J of the ITA will not apply to the proposed transaction;
- There will be no “disposal” (as contemplated in paragraph 11) in respect of the remaining ordinary shares held by the Co-Applicant following the repurchase transaction;
- The creation of the repurchase and restriction rights in terms of the subscription and repurchase agreement will not give rise to a capital gain or loss as contemplated in paragraphs 3 and 4 of the Eighth Schedule, for the Applicant or Co-Applicant;
- The repurchase of a portion of the ordinary shares from the Co-Applicant by the Applicant at a nominal price will not give rise to a capital gain or loss for the Co-Applicant.
- No securities transfer tax will be levied in respect of the remaining ordinary shares held by the Co-Applicant following the repurchase transaction.

The ruling is valid for a period of six years from 19 February 2015 and is not subject to any additional conditions and assumptions made by SARS.