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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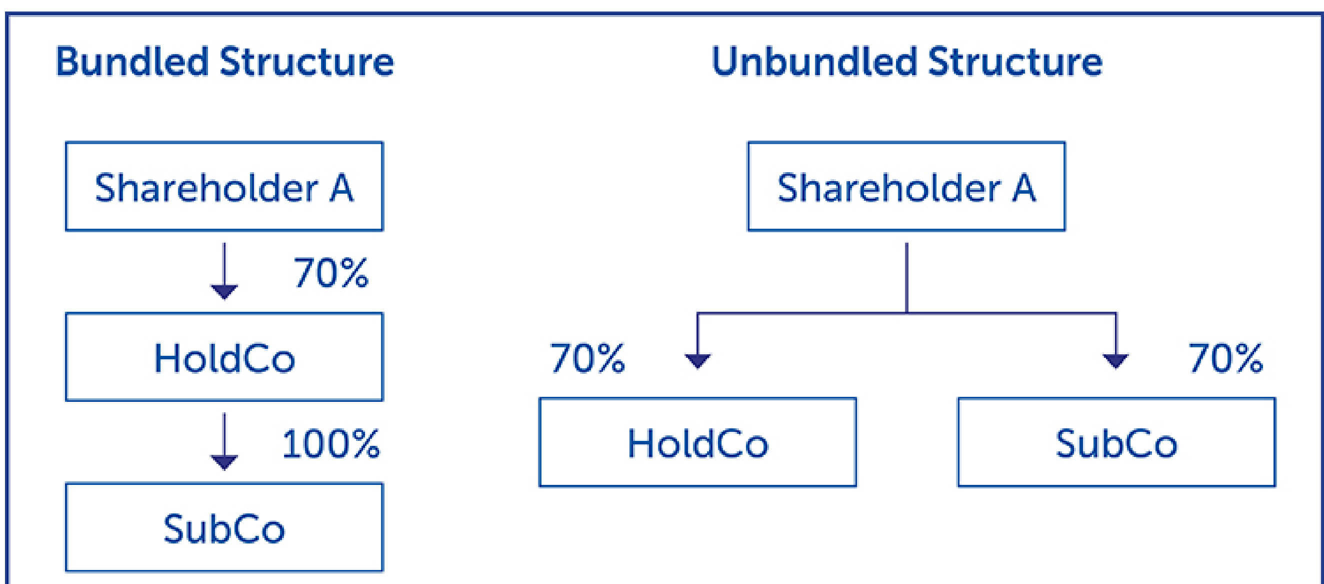

Where an unbundling takes place outside the scope of s46 of the Act, as set out above, several tax consequences would

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.

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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

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& 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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Is it time to lower South Africas income tax rates?

Author: David Warneke, Head of Income Tax Technical, BDO South Africa.

A fundamental question posed by commentators around the 2018 National Budget was whether an increase in personal or corporate income tax rates, or both, would be announced. The consensus, which proved to be correct, was that such increases were unlikely. The main reasons given were that personal and corporate income tax rates are already high by international standards. Personal income tax rates, mainly due to the introduction of the 45% maximum marginal rate in the 2017/2018 income tax year of assessment for taxable income above R1.5 million, and also since relatively high marginal rates are reached at low taxable income levels, by global standards. Corporate income tax rates, as the rates in most of our main trading partners are lower than ours and globally rates are decreasing.

This invites the question whether income tax rates, corporate or personal, are too high. In other words, whether in terms of the Laffer curve South Africa has already passed the top and is on the downward slope. The Laffer curve illustrates the relationship between tax rates and tax revenues. Up to a certain point, increases in tax rates result in increases in tax revenues. However, after that point the opposite holds true, due to the increasing disincentive to produce income at higher rates. Other factors play a role too. Higher rates push

taxpayers to avoid or evade taxes, and Government corruption and inefficiencies are cited as excuses for taxpayer non-compliance.

While it is extremely difficult to determine the top of the Laffer curve, the tax:GDP ratio may be indicative that we have reached it. The tax:GDP ratio was around 26.0% in the 2016/17 fiscal year and remained static, slightly declining to 25.9% in the 2017/18 fiscal year. This, despite sizeable increases in personal income tax rates through the introduction of the 45% marginal tax rate and minimal adjustments for bracket creep, which should have reflected in the 2017/18 fiscal year. Since then the top marginal income tax rate remained at 45% and the corporate tax rate at 28%.

One often finds in practice that investors into Africa consider South Africa or Mauritius as possible gateway jurisdictions. The attraction of the latter is the low corporate tax rate of 3% which could be reduced even further by foreign tax credits. The lack of foreign exchange controls adds to the attraction. Factors favouring South Africa include the developed infrastructure, large domestic market, and a more extensive double tax treaty network. The relatively high corporate tax rate of 28% certainly does not help South Africas cause, although it is doubtful whether South Africa would ever consider lowering its corporate rate to such an extent so as to compete with the low rate of Mauritius. South Africa also offers a headquarter company tax regime that effectively allows external investors leeway on the pricing of debt finance and intellectual property royalties in a number of situations, which may result in minimal exposure to South African corporate tax.

The effect of a decrease in corporate or personal tax rates on stimulating economic activity and tax revenues in South Africa is difficult to assess. It seems likely that decreases in personal tax rates would impact economic activity less than decreases in corporate tax rates. The corporate tax rate has

remained static at 28% for many years. The corporate tax rate was last reduced around a decade ago in the 2008/2009 fiscal year, when the rate reduced from 29% to 28%. Before that, the rate was decreased, also by one percentage point, in the 2005/2006 fiscal year. On both occasions the ratio of corporate tax collections to GDP increased, although of course there were many other factors that could have had a material influence on the ratio.

On the other hand, the corporate tax rate, if combined with the dividends tax rate, should not lead to tax arbitrage if compared to the personal tax rate. Presently, the effective corporate tax plus dividends tax rate, if the dividend is paid to a South African resident, is 42.4% whereas the top marginal personal tax rate is 45%. This results in a 2.6% arbitrate opportunity, favouring conducting business in a company, assuming that an investor already reached the highest marginal personal tax rate. A reduction in the corporate tax rate should be linked to a reduction in the personal tax rate, to reduce arbitrage possibilities.

The 2018 National Budget Review acknowledged the international trend towards lower corporate tax rates in the context of an exclusion from our controlled foreign company regime. Presently an exclusion exists which is intended to cater for SA- controlled foreign companies operating in highly taxed foreign jurisdictions. The benchmark of what constitutes high levels of foreign taxes was set at a minimum of 75% of the comparative South African income taxes that would have been payable on the equivalent taxable income of the controlled foreign company. However, with corporate income tax rates in the UK, for example, currently at 19% and set to decrease to 17%, we are left in a situation that compared to 75% of South Africas rate of 28% i.e. 21%, a SA-controlled foreign company taxed in the UK no longer falls into the exclusion. The Budget Review stated that a review of the appropriateness of the 75% threshold would be undertaken to determine whether a reduction

in the threshold is warranted.

There is no doubt that South Africa is in desperate need of economic growth and increased taxpayer compliance. It is certainly not axiomatic that our relatively high rates of income tax are producing more tax revenue than would be produced by lower rates. Consideration should be given to the lowering of income tax rates as a possible way of benefitting the National *fiscus*.

ENDS

Kind regards,

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Revised debt reduction rules

The debt reduction provisions contained in section 19 of the Income Tax Act, 1962 (the **Act**) and paragraph 12A of the Eighth Schedule to the Act have been amended with effect from 1 January 2018 and are applicable to years of assessment commencing on or after that date. As a result of the changes, the ambit of these provisions has widened significantly, as discussed below, and the additional circumstances to the rules find application are worth noting.
Subject to the exclusions provided for in section 19(8) and paragraph 12A(6), the debt reduction provisions apply where:

1. a debt benefit in respect of a debt owed by a person arises;
2. by reason or as a result of a concession or compromise in respect of that debt; and
3. the amount of the debt was used by that person as envisaged in section 19 or paragraph 12A.

The focus of this discussion is on the phrases debt benefit and concession or compromise introduced in terms of the latest changes to section 19 and paragraph 12A.

Concession or compromise

A concession or compromise is defined in section 19(1)(*a*) and paragraph 12A(1)(*a*) as any arrangement in terms of which:

- any term or condition in respect of a debt is changed or waived;
- any obligation is substituted, whether by means or novation or otherwise, for the obligation in terms of which that debt is owed (paragraph (*a*) of the definition); or
- a debt owed by a company is settled, directly or indirectly by (1) being converted to or exchanged for shares in that company or (2) applying the proceeds from

shares issued by that company (paragraph (*b*) of the definition).

Accordingly, where the terms of a debt are changed, or where an obligation is substituted or novated, it should be considered whether the remaining requirements of the debt reduction provisions are met.

Another scenario that is often encountered and may now result in the application of the debt reduction provisions is where a creditor subscribes for shares in a debtor company and the creditors obligation to make payment of the subscription price is set off against the debtor companys obligation to repay the debt, thereby resulting in the settlement of a debt by a company by way of set off. This is on the basis that the debt would be settled by applying the proceeds from shares issued by the company as envisaged paragraph (*b*) of the concession or compromise definition. It should then be considered whether a debt benefit arises as a result of such concession or compromise in respect of the debt.

Debt benefit

Debt benefit, in respect of a debt owed by a person to another person, means for purposes of section 19 and paragraph 12A, any amount by which the face value of the claim held by that other person in respect of that debt, prior to the entering into of any arrangement in respect of that debt, exceeds:

- in the case of an arrangement described in paragraph (*a*) of the definition of concession or compromise, **the market value of the claim in respect of the debt**;
- in the case of an arrangement described in paragraph (*b*) of the definition of concession or compromise:
  - where the person who subscribed for or acquired shares did not hold shares in that company prior to the entering into of that arrangement, the **market value of the shares**; or

- where the person who subscribed for or acquired shares in a company, held shares in that company prior to the entering into of that arrangement, the amount by which **the market value of the shares held by that person in that company after the implementation of that arrangement exceeds the market value of the shares held by that person in the company prior to entering into that arrangement**. (our emphasis)

Therefore, simply put, a debt benefit will arise if the face value of the debt prior to the concession or compromise exceeds the market value of the claim in respect of the debt or the shares acquired in terms of the concession or comprise.

In the context of a concession or compromise within a group, the debt reduction provisions may be excluded by virtue of section 19(8)(*e*) and paragraph 12(6).

Same group of companies exclusion

In terms of this exclusion, the debt reduction provisions do not apply to a debt benefit in respect of any debt owed by a person to another person where the person that owes the debt is a company that:

- owes the amount to a company (ie, creditor company) that forms part of the same group of companies (defined to only include South African resident companies) as that company (ie, debtor company); and
- reduces or settles the debt, directly or indirectly, by means of shares issued by that debtor company.

However, this exclusion does not apply in respect of any debt that was incurred or assumed by that company (the debtor company) in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which 1) did not form part of that same group of companies at the time that that other company incurred that debt or 2) does

not form part of the same group of companies at the time that that company (the debtor company) reduces or settles that debt by means of shares issued by it.

Conclusion

The revised debt reduction provisions now apply under significantly wider circumstances than before. Unless any specific exclusions apply, where changes to the terms of a debt or the settlement of a debt by way of set off involving the issue of shares are envisaged, the application of the funds and whether a debt benefit would arise should be carefully considered. Essentially, whether a debt benefit arises is determined with reference to the difference between the face value of the debt prior to the concession or compromise and the **market value** of the claim or shares acquired, and any difference may give rise to adverse tax consequences for the debtor, unless the exclusions apply.

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Notification of commencement of audit

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The obligation of SARS to collect tax and taxpayers' rights are often at odds with each other. In an attempt to address this issue, the Budget 2018 (Budget) proposes to reconcile the taxpayers' constitutional rights with SARS' constitutional obligations by including a provision in the Tax Administration

Act 28 of 2011 (TAA) stipulating that SARS must inform the taxpayer at commencement of the audit when the information submitted in a tax return will be audited. The provision is intended to cover desk audits which involve inspection or enquiries, without necessarily meeting with the taxpayer or third parties in person.

It has been confirmed that the decision to audit a taxpayer is considered “administrative action” in terms of the Promotion of Administrative Justice Act 3 of 2000 (PAJA). As a result, it is imperative that the Commissioner’s decision as well as the audit carried out by SARS be procedurally fair. Consequently, any administrative action (i.e. a decision to audit or the issue of an additional assessment) must, for the purposes of procedural fairness, comply with the following five requirements listed in section3(2) of PAJA:

- adequate notice of the nature and purpose of the proposed administrative action must be given to the taxpayer;
- a reasonable opportunity to make representations must be given to the taxpayer;
- SARS must give the taxpayer a clear statement of the administrative action;
- where applicable, the taxpayer must be given adequate notice of any right of review or internal appeal; and
- adequate notice of the right to request reasons, in terms of section5 of PAJA, must be given to the taxpayer.

The outcome of the audit, and the corresponding notification to the taxpayer, is therefore a necessary precursor to the issuing of an additional assessment. Sections40, 42 and 48 of the TAA give effect to and echo the administrative justice provisions set out in section33 of the Constitution of the Republic of South Africa Act 108 of 1996 (Constitution) and the aforementioned provisions of PAJA.

The TAA prescribes the procedure that SARS has to follow prior to, during and after a field audit or criminal investigation. Section48(1) of the TAA (which sets out the procedure to be followed by SARS during a field audit or criminal investigation) provides that SARS must notify a taxpayer at least 10business days prior to commencement of the audit of the relevant material that the SARS auditor may require to perform his/her field audit.

Furthermore, section42 of the TAA requires SARS to keep the taxpayer informed during the course of an audit. In addition, SARS must convey the outcome of the audit or criminal investigation to the taxpayer, within 21 days of concluding the audit or criminal investigation.

The case of IT13726, a recent judgement handed down by the Tax Court of Port Elizabeth, confirmed the importance of procedural fairness during an audit. In this case, SARS did not inform the taxpayer that his returns were being audited, nor did SARS convey the outcome of the audit to the taxpayer. The court found that the taxpayer was deprived of the opportunity to respond to the issues raised in the assessment. As a result, the court held that SARS' failure to comply with sections40 and 42 of the TAA was an affront to the Constitution and the principle of legality. Accordingly, SARS' decision to issue an additional assessment without providing the taxpayer with proper notice was found to be invalid and was set aside by the court as it did not comply with the peremptory prescripts of the TAA.

In light of the above, it comes as no surprise that the Budget proposes to require that taxpayers be notified at the start of an audit to ensure procedural fairness to all taxpayers subject to any type of audit.

In difficult economic times where taxpayers are forced to endure declining revenues and ever increasing costs, it important for taxpayers to remember their constitutional

rights and SARS' constitutional obligations when carrying out its function of administering the tax statutes.

Procedure is everything: A win for the taxpayer and the importance of the right to just administrative action

Author: Louis Botha (Associate at Cliffe Dekker Hofmeyr).

In recent times, taxpayers have often been unsuccessful in their disputes with the South African Revenue Service (SARS), especially where the dispute involved the interpretation or application of the substantive provisions of tax legislation. However, where disputes have involved compliance with the procedural requirements of tax legislation, taxpayers have generally had greater success. The judgment in *Mr A v The Commissioner for the South African Revenue Service* (Case No. IT13726) (as yet unreported), falls into the second category and is the subject of this article.

Facts

The taxpayer, Mr A, had been the chief executive officer of a company for just over 16 years, when his employment with the company ended in 2012. When the taxpayers services came to an

end, the company paid him R7,066,530 as an amount equal to a severance package calculated in accordance with the companys retrenchment policies. He declared the amount and described it as a lump sum payment for separation package in his 2012 income tax return. SARS did not accept that the lump sum payment was taxable as a retrenchment benefit and taxed it as other income instead. The taxpayer also traded as a cattle farmer and in his 2012 income tax return, he claimed farming expenses of R1,781,604 as a deduction, which SARS disallowed.

SARS issued two additional assessments (Assessments) pursuant to its decisions and the taxpayer subsequently objected and appealed against the Assessments. The parties agreed that only the following two issues would be argued before the Tax Court:

- As a point in limine (preliminary point), whether the audit conducted prior to the additional assessment was valid, and whether the subsequent additional assessment was valid; and
- Whether the lump sum payment received by the taxpayer at the termination of his employment was a severance benefit as defined in the Income Tax Act, No 58 of 1962 (Act).

The parties agreed that the issue pertaining to the deduction of farming expenses would stand over for argument at a later stage. In this article, we will focus only on the first issue argued before court, regarding the validity of the audit.

Legal framework

In terms of s40 of the Tax Administration Act, No 28 of 2011 (TAA), SARS may select a person for inspection, verification or audit on the basis of any consideration relevant for the proper administration of a tax Act, including on a random or a risk assessment basis.

Section 42(1) of the TAA states that a SARS official involved in or responsible for an audit under Chapter 5 Part A of the

TAA must, in the form and in the manner as may be prescribed by the Commissioner by public notice, provide the taxpayer with a report indicating the stage of completion of the audit.

In terms of s42(2) of the TAA, once the audit or criminal investigation has been concluded and it was inconclusive, SARS must inform the taxpayer of this within 21 business days. Alternatively, if the audit identified potential adjustments of a material nature, SARS must within 21 business days, or longer depending on the complexities of the audit, provide the taxpayer with a document containing the outcome of the audit, including the grounds for the proposed assessment or decision referred to in s104(2) of the TAA.

Section 42(3) states that once the taxpayer has received a document indicating the outcome of the audit and the grounds for the proposed assessment, he must respond within 21 business days of delivery of the document. The period of 21 business days may be extended upon request by the taxpayer and SARS may allow this based on the complexities of the audit.

Judgment

The taxpayer contended that in its Rule 31 Statement of Grounds of Assessment, SARS referred to a personal audit conducted in respect of the taxpayer and that this was the first time that he (taxpayer) had heard of such an audit. The Tax Court held that SARS was not permitted to rely on a procedurally flawed audit conducted without the taxpayers knowledge as a new ground of assessment in its Rule 31 statement, as it would violate the principle of legality.

The Tax Court explained that an additional assessment constitutes administrative action as contemplated in s33 of the Constitution of the Republic of South Africa, 1996 (Constitution), which protects the right to administrative action that is lawful, reasonable and fair. The section also provides that everyone whose rights have been adversely

affected by administrative action has the right to be given written reasons, meaning that an assessment that is procedurally flawed due to a lack of reasons or failure to give reasons, is inconsistent with the principle of legality.

In the Tax Courts view, s40 and s42 of the TAA give effect to the provisions of s33 of the Constitution. The breach of the legality principle was compounded by SARSs failure to comply with s42(1) of the TAA, as it did not keep the taxpayer informed of the status of the audit, made no written conclusions or findings at the end of the audit, did not discover any audit file for 2012 and failed to conduct a financial inspection prior to issuing an additional assessment. SARS also flouted s42(2)(b) of the TAA in that it deprived the taxpayer of the opportunity to respond to any of the issues raised by SARS, particularly the question of the circumstances surrounding the taxpayers resignation and the nature of the lump sum paid to him.

Interestingly, the Tax Court also held that if the taxpayer was afforded an opportunity to explain his position regarding the nature of the lump sum payment, he could have informed SARS that his services came to an end during a retrenchment process as contemplated in the definition of severance benefit in s1 of the Act. The Tax Court stated that if SARS had conducted the audit with due regard to s40, s41 and s42 of the Act, the outcome of the audit may have been very different. The same considerations apply to the farming expenses that were claimed as a deduction and disallowed.

The Tax Court concluded that as SARSs non-compliance with s40 and s42 of the TAA contravenes the Constitution and the principle of legality, SARSs decision to issue an additional assessment without notice must be set aside and the assessment is invalid (presumably the Tax Court meant that both Assessments should be set aside). The taxpayers appeal was therefore upheld and SARS was ordered to pay the taxpayers costs of the appeal.

Comment

The judgment sets out important principles regarding the relationship between SARSs compliance with the audit provisions of the TAA and the effect of an invalid audit on any subsequent assessment issued. This case re-iterates the rights of taxpayers in tax dispute resolution proceedings and is confirmation that a taxpayer can insist on SARSs compliance with the audit provisions of the TAA. Where SARS issues an assessment without complying with the provisions in s40 and s42 of the TAA, such an assessment can be set aside.