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COMPANIES **2659**. Venture capital companies	**TAX ADMINISTRATION** **2664**. Grounds for Assessments **2665.** Incorrect interest rates **2666.** Remedies under section 9 **2667.** SARS' conduct and obligations
INDIVIDUALS **2660.** Tax free investments	**EXEMPTION** **2668.** Tax emigration and foreign employment income
TRANSFER PRICING **2661.** Country-by-country documentation **2662.** Hard-to-Value Intangibles	**SARS NEWS** **2669.** Interpretation notes, media releases and other documents
INTERNATIONAL **2663.** Governing tax risks	

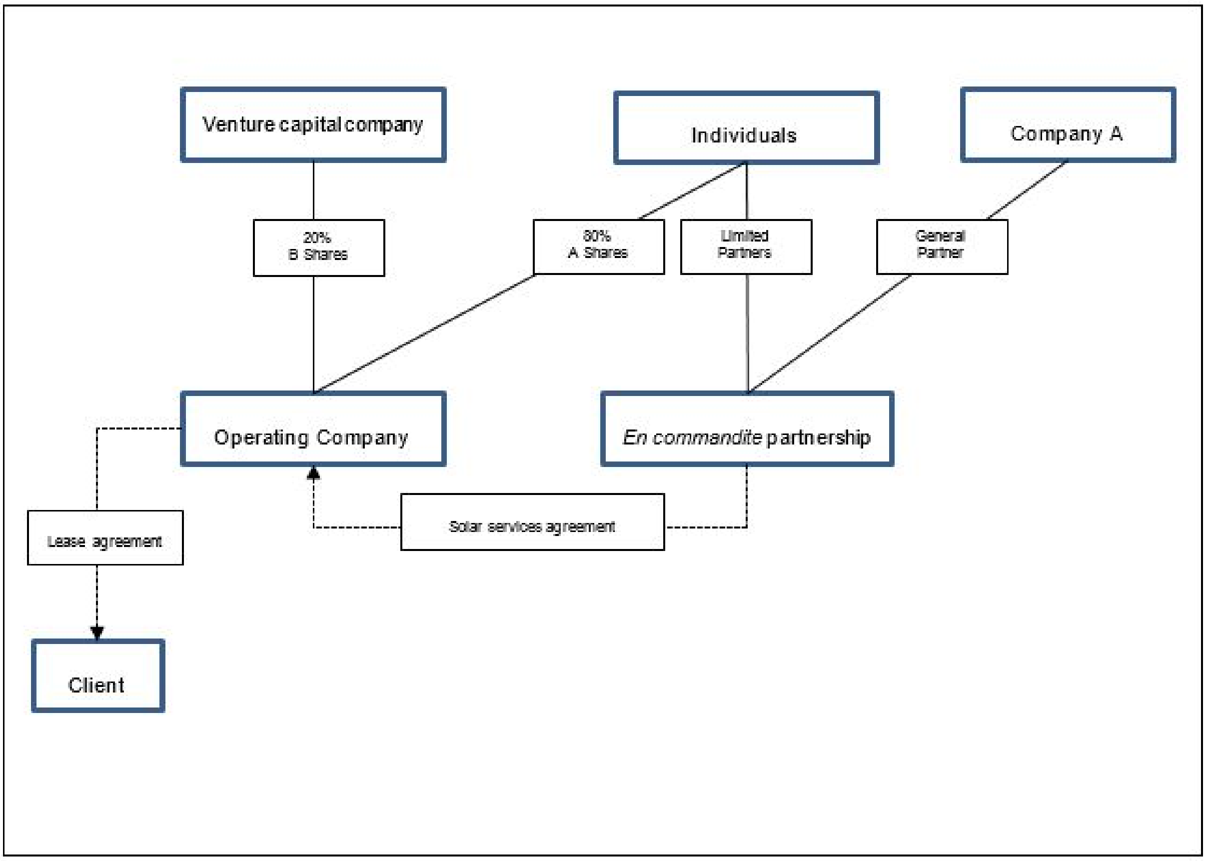
COMPANIES

2659. Venture capital companies

On 6 June 2017, the South African Revenue Service (SARS) issued binding private ruling 274 (BPR 274). BPR 274 deals with a venture capital company (VCC) investing in a company providing and expanding plants for the generation of solar electricity.

This brings the number of binding private rulings that SARS has issued in respect of venture capital companies to four. Below, we compare the rulings in this matter with prior rulings issued by SARS to determine whether there are any trends with regard to rulings issued by SARS in respect of venture capital companies.

Before dealing with these trends, we first set out the proposed transaction in BPR 274.



BPR 274 deals with two issues that have been a common feature in all the VCC-related rulings given thus far by SARS: equity share and controlled group company. The table below indicates that all four binding private rulings have considered the equity share and the controlled group company issue:

	BPR 205 11 September 2015	BPR 242 15 June 2016	BPR 264 3 February 2017	BPR 274 6 June 2017
equity share	✓	✓	✓	✓
controlled group company	✓	✓	✓	✓
impermissible trade	✗	✓	✗	✓
investment income	✓	✗	✗	✓

Controlled group company

The reason why many VCCs request a ruling from SARS on this issue, is that a VCC may not invest in a qualifying company if it is a controlled group company in relation to a group of companies. A controlled group company in relation to a group of companies is where at least 70% of its shares are held by a controlling group company or by other controlled group companies within the group of companies.

The practical problem faced by VCCs occurs where they contribute 70% of the contributed tax capital to the qualifying company. If the qualifying company issues a commensurate number of equity shares to the VCC, then the VCC becomes a controlled group company in relation to the qualifying company, as it will hold 70% of the equity shares in the qualifying company.

The mechanism that is used to overcome this problem is for the qualifying company to issue different classes of shares. The VCC subscribes for a class of share with a high subscription price, for example, R1 000 per share. The other investors subscribe for a class of share with a low subscription price, for example, R10 per equity share.

As a result, the VCC contributes more of the contributed tax capital but acquires fewer equity shares. These rulings confirm that the test is the number of shares that the VCC holds in the qualifying company, not the VCC's economic interest (i.e. the value of those shares) in the qualifying company.

Equity share

The VCC that acquires higher-priced shares in the qualifying company would naturally want a preferential right to distributions from the qualifying company. This is why it is necessary that in all the VCC rulings issued by SARS, the applicants seek rulings that the shares are equity shares.

According to the Income Tax Act, 1962 (the Act), an equity share is "any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution."

It is only if there is a restriction placed on both returns of capital and dividends that a share will not qualify as an equity share and therefore, will not be a qualifying share under the VCC scheme.

What can be taken from the BPRs is that an investor can contribute a disproportionate amount of share capital entitling the investor to a first distribution of profits or capital: in other words, the share is preferential in nature, yet it still remains an equity share.

Impermissible trade

A company cannot be classified as a qualifying company if it carries on an impermissible trade. Section 12J of the Act lists a number of activities that are considered to be impermissible trades. The impermissible trade that BPR 274 deals with, is any trade carried on in respect of immovable property (other than a trade carried on as an hotel keeper).

BPR 274 deals with the business of conducting a solar facility at specific sites to its customer. The facilities provide for solar electricity. The difficulty with renewable energy facilities is that they may be constructed in such a way that they accede to the land, thereby becoming immovable property. It was ruled that solar panels are movable assets, thus the qualifying company is not carrying on an impermissible trade.

Investment income

A VCC may not invest in a qualifying company that receives investment income that exceeds 20% of its gross income for a particular year of assessment. Investment income includes any income in the form of interest, dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature.

Since SARS ruled that the solar facilities are movable assets, it followed that the rental to be derived by the qualifying company is derived from movable property rather than immovable property. The investment income limitation is an important area that we feel will receive more attention particularly in light of the increase in the number of VCCs over the past three years.

For example, companies that license the use of intellectual property to others may be receiving royalty income that could result in them being ineligible to receive financing from venture capital companies if their royalty income exceeds the 20% investment income limitation.

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BPR274

ITA: section 1 definition of "equity share" and section 12J

Editorial Comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear.

INDIVIDUALS

2660. Tax free investments

30 min CPD VERIFIABLE ARTICLE

On 31 March 2017, Government Gazette 40758 (GG 40758) was published, in terms of which the regulations relating to the requirements for Tax Free Investments (TFI) (the Regulations), were amended by National Treasury (Treasury). The Regulations were originally published in February 2015 in terms of section 12T(8) of the Income Tax Act, 1962 (the Act). The Minister of Finance (Minister) is empowered to make regulations prescribing the requirements to which a financial product must conform in order to constitute a TFI.

By way of background, a TFI is defined in section 12T(1) of the Act as any financial instrument or long-term policy (as defined in section 1 of the Long-term

Insurance Act, 1998) which is owned by a natural person, a deceased estate or an insolvent estate of a natural person (Qualifying Taxpayer), and administered by a person or entity designated by the Minister by notice in the GG (Product Provider). Section 12T of the Act provides that any amount received by or accrued to a Qualifying Taxpayer in respect of a TFI is exempt from normal tax and the capital gain or loss from the disposal of such TFI is disregarded for purposes of capital gains tax. In addition, a dividend paid in respect of a TFI is exempt from dividends tax in terms of section 64F of the Act.

Contributions in respect of TFIs are required to be made in cash and, as of 1 March 2017, are limited to an annual amount of R33 000 in aggregate during any year of assessment and subject to a lifetime limit of R500 000 in aggregate. The exempt amount received by or accrued to a Qualifying Taxpayer in relation to the TFI is not taken into account in determining whether an excess amount has been so contributed in a given year of assessment or in aggregate. In addition, the transfer of a TFI account, of whatever nature of a Qualifying Taxpayer to another TFI account, of whatever nature of the same Qualifying Taxpayer and any amount received by or accruing in respect of a TFI is not taken into account in determining whether the Qualifying Taxpayer has contributed in excess of the annual and lifetime limits.

Penalties are triggered in the instance where a Qualifying Taxpayer contributes amounts in excess of the abovementioned limits. If during any year of assessment, a Qualifying Taxpayer contributes more than the annual limit, the excess is subject to normal tax at the rate of 40%. If a Qualifying Taxpayer contributes more than the lifetime limit in aggregate, 40% of so much of the excess as has not previously been taken into account is deemed to be an amount of normal tax payable in respect of the year of assessment in which such excess was contributed.

The amendments to the Regulations contained in GG 40758 deal with, inter alia, the process for the transfers of TFIs, performance fees in underlying funds, restriction on maturity dates, fees to be recovered by Product Providers and various provisions to enable the Financial Services Board (FSB) to adequately administer product offerings.

Treasury has also, in GG 40757 (published on 31 March 2017), included the South African Postbank Limited in the list of Product Providers empowered to administer TFIs.

Transfers of TFIs

GG 40758 provides that on or after 1 March 2018, upon request by a Qualifying Taxpayer, a Product Provider must transfer amounts in cash or assets other than cash in respect of a TFI of the Qualifying Taxpayer to another TFI of the same Qualifying Taxpayer:

(i) if the TFI has a maturity date, within 10 business days after the Qualifying Taxpayer's request or after the maturity date; or

(ii) where the TFI has no maturity date, within 10 business days after the Qualifying Taxpayer's request.

Provision has been made in GG 40758 for Product Providers to refuse to accept any transfer as described in (i) and (ii) above in respect of a TFI. Despite a Qualifying Taxpayer's request, a Product Provider may not transfer any amount in relation to a TFI, in respect of the same natural person, more than twice in a year of assessment and a Product Provider must refuse to transfer any amount in relation to a TFI during the last 10 business days of any year of assessment.

To the extent that a Product Provider is unable to transfer any amount in respect of a TFI to another Product Provider, the first mentioned Product Provider will not be able to accept any further amounts in respect of any TFIs administered by such Product Provider. In addition, the Product Provider will not be able to administer any TFI other than a TFI administered before the date on which the Product Provider is unable to transfer an amount.

GG 40758 goes on further to include the minimum requirements for a valid transfer between Product Providers, such as a transfer certificate and the type of information that must be passed on to the new Product Provider.

Due to the additional administrative requirements imposed on Product Providers, the ability of Qualifying Taxpayers to transfer amounts will be postponed to 1 March 2018 to allow Product Providers sufficient time to prepare for the more onerous responsibilities discussed above.

Performance fees in underlying funds not allowed

GG 40758 states that performance fees may not be charged by Product Providers in TFIs, whether charged as part of the TFI or in an underlying fund into which the TFI contributions are invested. Accordingly, Product Providers must ensure that TFIs do not in any way contain any performance fees.

Restriction on maturity date

A Product Provider may not offer any TFI with a fixed-term of which the maturity date occurs more than five years after the date on which that TFI is issued.

Fees to be recovered from the TFI

To the extent that the Product Provider is required to recover any fee in respect of the TFI, the Product Provider may only recover such fee from the TFI.

Compliance with regulations

Product Providers will be required to notify the FSB, within one month before a TFI product is advertised in the market, in order to provide the FSB with an opportunity to review the features of the offering and suggest amendments, if necessary. Such notification must include details of the TFI including the:

(i) date from which the TFI will be advertised or when members of the public will be allowed to invest therein;

(ii) name and nature of the TFI;

(iii) legislation under which the TFI will be issued together with confirmation that the TFI meets the requirements of the legislation; and

(iv) a summary of the benefits, terms and conditions and marketing material of the TFI.

GG 40758 requires that any change undertaken subsequently to the launching of the product should also be submitted to the FSB, at least one month prior to the date on which the alteration takes effect.

Furthermore, where the FSB objects to the intended implementation of a TFI, the Product Provider may not implement the intended TFI until such a time as the objection has been resolved by the FSB.

It will be interesting to see whether these amendments will ensure that TFIs are offered in a transparent manner and carry fees and charges that are reasonable, in order to ensure that customers derive maximum benefits from the vast number of savings and investment products available in the market.

Cliffe Dekker Hofmeyr

ITA: sections 12T(1), 12T(8), and 64F

GG 40757 and 40758, 31 March 2017

Long-term insurance Act: section 1

TRANSFER PRICING

2661. Country-by-country documentation

South Africans who think that their tax burden is going to decrease because country-by-country (CbC) reporting does not apply to their company should think again!

In addition to the recently released draft notice requiring the submission of CbC reports, master file and local file returns, the South African Revenue Service

(SARS) has recently issued the External Business Requirements Specification (BRS) document, setting out CbC and Financial Data Reporting (FDR) requirements.

South Africa's master file and local file requirements are in line with the Organisation for Economic Cooperation and Development's (OECD) requirements and South African taxpayers will now be obliged to submit transfer pricing-related returns.

The filing obligation detailed in the draft notice appears to apply retrospectively for years commencing on or after 1 January 2016. Consequently, qualifying taxpayers who have December year-ends may be expected to submit not only their first CbC report, but also master file and local file returns by 31 December 2017.

Even though these transfer pricing returns may not form part of the annual income tax return, it is probable that the due dates for all the returns (CbC reports, master file and local file returns) will coincide.

Reporting responsibility

Although the BRS does not confirm the filing thresholds referred to in the draft notice, it is likely that:

- South African tax residents with a total consolidated group revenue in excess of ZAR10-billion/EUR750-million will be required to submit a CbC report, master file and local file return within 12 months of the end of their reporting fiscal years; and
- South African tax residents with an aggregate of potentially affected transactions for the year of assessment exceeding ZAR100-million will be required to submit only a master file and local file return within 12 months from the date on which their financial year ends.

Forms

The submission of CbC reports, master file and local file returns will be electronic, via a FDR system to be accessed through the SARS e-filing platform.

CbC reports will be standardised as a CbC01 form in order to meet the specifications of the OECD's CbC XML Schema. Currently, the BRS does not specify any form for notifying SARS of the identity of the reporting entity of a multinational enterprise (MNE).

The master and local file returns will require taxpayers to upload their master file and local file documentation on the FDR website, which will be hosted via SARS e-filing. Whether this will entail the uploading of the actual documentation or only specific information is yet to be confirmed as SARS has not released a specific format of these returns.

Sharing of information

The information submitted in the CbC report will be exchanged automatically between SARS and those countries that recently signed the Multilateral Competent Authority Agreement as well as those countries with which South Africa has entered into an intergovernmental agreement for the purposes of the automatic exchange of information.

The master file information will, however, only be made available to other tax administrations in terms of the exchange of information rules and then only "on request". The local file information will only be made available by SARS to other tax administrations under "exceptional circumstances".

With the first CbC report, master file and local file returns imminent, this leaves taxpayers with very little time to gather the required information and to manage the possible risks in submitting such returns.

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SARS draft notice

The multilateral competent authority agreement

Editorial Comment: Draft documents should always be treated with care as there is no certainty that the final version will be identical to the publicly issued draft.

2662. Hard-to-Value Intangibles

One of the main action items identified by South Africa's National Treasury in its summary of the country's position on the G20/Organisation for Economic Co-operation and Development (OECD) action plan on base erosion and profit shifting (BEPS) is the requirement for the South African Revenue Service (SARS) to update the Transfer Pricing Practice Note in line with the OECD Transfer Pricing Guidelines to include new guidance on the arm's length principle and an agreed approach to ensure appropriate pricing on intangibles that are difficult to value.

Action 8 of the BEPS Action Plan mandated the development of transfer pricing rules or special measures for the transfer of Hard-To-Value Intangibles (HTVI) and the general rules of how to deal with HTVI can be found in section D.4 of the revised chapter VI of the OECD Transfer Pricing Guidelines, contained in the 2015 Final report on Actions 8-10: "Aligning Transfer Pricing Outcomes with Value Creation" (BEPS TP Report), which is now formally adopted as part of the OECD Transfer Pricing Guidelines. However, the BEPS TP Report also mandated the development of guidance for tax administrations on the implementation of the approach to HTVI (HTVI Implementation Guidance). Although the transfer of intangibles by a South African resident to a related party non-resident is currently restricted in terms of South African Exchange Control Regulations, the approach towards HTVI is regarded as one of the main focus areas of SARS and therefore it appears highly unlikely that SARS will issue an updated version of its Transfer Pricing Practice Note until the HTVI Implementation Guidance has been finalised by the OECD.

It is in this context that the discussion draft setting out the HTVI Implementation Guidance, which was released by the OECD on 23 May 2017, appears to be particularly relevant from a South African perspective.

Background

Intangibles are, by definition, mobile and they are also often hard-to-value, in particular at an early stage of their development. According to the OECD, the misallocation of profits generated by valuable intangibles has heavily contributed to base erosion and profit shifting. This, together with the perceived information asymmetry when it comes to the valuation of intangibles, was also the reason why the OECD deemed it necessary to develop special rules on how to deal with HTVI.

What are HTVI?

The OECD defines HTVI as intangibles or rights in intangibles for which, at the time of their transfer in a transaction between associated enterprises, no sufficiently reliable comparables exist, and there is a lack of reliable projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain.

Existing OECD Guidance on HTVI

To deal with this, the OECD's guidance on HTVI proposes that tax authorities be allowed to use *ex post* "evidence", (the use of hindsight to evaluate the appropriateness of the pricing of transactions previously entered into) to assess the arm's length nature of transfer pricing arrangements in respect of intangibles that fall within the definition of HTVI.

Where the HTVI approach applies, tax administrators are entitled to consider *ex post* outcomes as presumptive evidence in evaluating the appropriateness of *ex ante* pricing arrangements.

However, in certain circumstances, a taxpayer can rebut *ex post* outcomes as presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time that the controlled transaction took place.

In particular, the use of *ex post* outcomes/hindsight will not apply in the following cases:

a. The taxpayer provides:
    1. details on the *ex ante* projections used at the time of the transfer together with how risks were accounted for; and
    2. reliable evidence that any significant difference between the financial projections and the actual outcomes is due to unforeseeable or extraordinary events that could not have been anticipated at the time of price setting;
b. the transfer of the intangible is covered by a bilateral or multilateral advance pricing agreement;
c. a safe harbour threshold where the variation in financial projections and the actual outcomes is no more than 20% of the intangible's valuation; or
d. a commercialisation period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialisation period any significant difference between the financial projections and actual outcomes mentioned in a. 2. above was not greater than 20% of the projections for that period.

Additional guidance provided in HTVI Implementation Guidance

The HTVI Implementation Guidance essentially re-enforces the principles laid out in the initial OECD Guidance on HTVI.

In particular, no changes have been made to the underlying principle that tax authorities will be entitled to consider *ex post* outcomes as presumptive evidence in evaluating the appropriateness of *ex ante* pricing arrangements, unless a taxpayer can rebut *ex post* outcomes as presumptive evidence.

Accordingly, once it has been determined that an intangible qualifies as a HTVI, *ex post* outcomes may be considered. Tax authorities are, however, restricted in using the *ex post* outcomes, since the HTVI Implementation Guidance makes it clear that tax authorities cannot base any revised valuations on the actual income or cash flows without also taking into account the probability, at the time of the transaction (i.e. time of transfer of the HTVI) of the income or cash flows being achieved.

In addition, the HTVI Implementation Guidance indicates that in implementing the HTVI approach, tax administrators may make appropriate adjustments, including through the consideration of alternative pricing structures, (i.e. adjustments that reflect a contingent pricing arrangement that is different from the pricing structure adopted by the taxpayer), if it relates to something that independent third parties would have also considered. This should be of great concern to taxpayers and taxpayers are therefore cautioned t to consider potential alternative pricing structures when determining the pricing for the use or transfer of intangibles that could be regarded as HTVI.

Furthermore, the HTVI Implementation Guidance also indicates that the guidance for the tax administrators in implementing the approach to HTVI should not be used to delay or bypass normal audit procedures. It is further stated that, in fact, it remains important for tax administrators to identify HTVI transactions as early as possible and to act on the information at hand as a matter of good administrative practice. The HTVI Implementation Guidance does, however, recognise that some countries may encounter difficulties in implementing the approach to HTVI due to short audit cycles or a statute of limitations. The HTVI Implementation Guidance therefore suggests that tax authorities identify transfers of potential HTVI and seek information about *ex post* outcomes, even where those outcomes arise in years subsequent to those under audit, to be in a position to consider the appropriateness of the *ex ante* pricing at an early stage.

Conclusion

The HTVI Implementation Guidance is an important missing piece of the puzzle in the OECD's approach towards BEPS and, once finalised, should put SARS in a position to issue a first draft of its own Transfer Pricing Practice Note.

From a transfer pricing technical point of view, it does not provide anything substantially new, but to a large degree reconfirms the underlying principles as set out in the existing OECD Guidance on HTVI.

In order for taxpayers to be able to rebut the use of *ex post* outcomes as presumptive evidence by tax authorities in determining the arm's length nature of transactions involving HTVI, it is important that, at the time the transaction is entered into, a detailed analysis is performed, which clearly sets out the following:

- the nature of the intangible, and whether it could be regarded as HTVI;
- the details of the projections used at the time of the transactions and how the main risks were accounted for; and
- if applicable, whether alternative pricing structures were considered to cater for potential substantial deviations of the projections used at the time.

While the use of an advance pricing agreement provides for an alternative option to manage the risks around HTVI, this option is, unfortunately, not available for South African taxpayers at this stage.

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HTVI Implementation Guidance

Action 8 of the BEPS Action Plan

Editorial Comment: Draft documents should always be treated with care as there is no certainty that the final version will be identical to the publicly issued draft.

INTERNATIONAL

2663. Governing tax risks

There has been immense media and public attention on whether multinational enterprises (MNEs) are paying their fair share of taxes in the countries where they generate their profits.

Reputable media outlets have splashed the tax affairs of many MNEs all over the media – highlighting the fact that these highly profitable organisations seem to pay very little or, at times, no corporate taxes in the jurisdictions in which they operate, by using legal but aggressive tax planning arrangements.

While legal, these tax planning schemes can have a significant negative effect on a company's financial performance and its reputation as a good and ethical corporate citizen.

These developments have therefore placed the issue of tax corporate governance firmly in the spotlight and specifically the role which the board must play in guarding against aggressive tax planning strategies, and in upholding ethical business practices and good corporate citizenship.

Sound tax corporate governance is no longer a "nice to have" on a board. Instead, boards are increasingly being expected to include tax corporate governance on their agendas. Sadly, however, the tax risks of organisations and their potentially negative impact are often still not sufficiently understood at board level, mainly due to their complexity, the lack of tax expertise among board members, and the lack of communication by the executive to the board on tax risk management issues.

The public outcry on the issue of profit-shifting by MNEs is further fuelled by the fact that often the countries which are at the receiving end of these aggressive tax avoidance schemes desperately need to achieve economic growth. In the recent "Global Economic Prospects" report issued in January 2016 by the World Bank Group, it was noted that economic growth in sub-Saharan Africa decreased from 4.6% in 2014 to 3.4% in 2015.

Thus, while sub-Saharan Africa is growing, we are not growing fast enough; more importantly, we are also not growing inclusively enough and as a result poverty and income inequality remain key challenges on the African continent's agenda. To address these challenges, we need a buoyant revenue base and historically corporates have been one of the main contributors to the countries' revenue coffers. However, if corporates, through the use of aggressive tax planning strategies end up making low effective tax contributions to the tax coffers of the countries in which they generate their profits, then these countries cannot achieve their targeted economic growth rates. The debate therefore rages on as to how governments can effectively combat the significant financial leakages from their economies which occur as a result of base erosion and profit-shifting by MNEs.

Against this backdrop, it was no surprise that the Draft King IV Report on Corporate Governance for South Africa 2016 (King IV) addressed this issue head on and specifically the role that the board needs to play in this regard. More broadly, King IV also shines the spotlight on the role of the board in tax governance and notes that the board and the audit committee should be responsible for a tax strategy and policy that are compliant and congruent with corporate citizenship and wider stakeholder considerations and that, in particular, the board should also take into account the reputational consequences of tax decisions to the organisation.

This article specifically focuses on the King IV proposals dealing with aggressive tax planning arrangements by MNEs and the role of the board in guarding against such practices.

What is King IV asking?

King IV highlights the fact that the use of tax havens and aggressive tax structures by multinationals (whereby profits are shifted (albeit legally) to no-tax or low tax jurisdictions where the taxpayer has no or very little economic presence), is a matter that is directly linked to ethical leadership, responsible corporate citizenship and the reputation of the company.

The report also correctly acknowledges that while it is questionable for companies to have overly aggressive tax strategies and exploit tax loopholes (albeit within the legal parameters of the tax laws), the legitimate expectation of shareholders, that costs (including tax costs) should be kept to a minimum, should also be met.

The board therefore has the important task to strike a careful balance between these two seemingly conflicting tax governance objectives.

Is it a fair ask?

The low global effective tax rates of a number of reputable MNEs have come under the spotlight. Closer to home, in South Africa, there is still a material gap between our nominal corporate tax rate of 28% and the effective tax rates paid by some MNEs.

That said, our tax legislation and case law also recognise the principle that every taxpayer is entitled to order its tax affairs in such a manner that it pays the least tax possible, provided it does so within the boundaries of the law. Importantly however, our courts distinguish between tax avoidance, including "aggressive" tax avoidance strategies (i.e. those which are done through legitimate tax planning) and tax evasion.

Unlike tax evasion which is illegal, aggressive tax planning schemes are legal, but they very much rely on, (and exploit) the grey areas of interpretation in tax law, in order to reduce the organisation's tax bill.

For example, the mismatches between the domestic tax laws in various countries and double taxation agreements can often be exploited by MNEs to reduce their corporate tax liability on a global basis.

The question which thus arises is: If an MNE is able to significantly reduce its tax liability by optimally structuring its tax affairs, through legal, but aggressive tax arrangements, does this mean that the company's board has not exercised proper oversight over its ethical business practices from a tax governance perspective or does it simply mean that the tax legislation governing MNEs is in need of drastic reform to effectively combat such practices?

It would seem that internationally the answer is a combination of these two remedies. Governments and tax authorities across the globe have recognised that more needs to be done, both from a tax corporate governance and a tax technical reform perspective to address aggressive tax planning strategies.

International developments in tax corporate governance

In South Africa, King IV has signalled that it is now becoming an imperative for tax risk management to be incorporated into the corporate governance framework of the board. More importantly, each board member (and not only the members of the audit committee or the risk committee) needs to have a good grasp of the organisation's tax control framework and in particular, board members need to know whether any aggressive tax planning strategies have been implemented by the organisation. The latter should then be balanced against ethical business behaviour and good corporate citizenship.

In the United Kingdom (UK), tax corporate governance by boards is also receiving attention. The UK tax authority released a discussion document during 2015 which inter alia sought consultation to implement a proposed legislative requirement that would require MNEs (with a certain turnover/balance sheet total threshold) to publish their tax strategy as it relates to, or affects UK taxation and inform the tax authority when it is published. The intention is that the strategy "should be formalised, articulated and owned by an executive board member within the business" from a board governance perspective.

The Australian Tax Office (ATO) also issued its tax risk management and governance review guide which among others, focuses on the board's responsibility regarding the tax control framework in the organisation. The guide sets out various best practices which the board should apply when it comes to tax corporate governance.

The United States of America has also adopted various measures to improve tax corporate governance by boards and in New Zealand, the tax authority included tax governance as a criterion in its assessment of large enterprises' risk ratings.

International developments in tax technical reforms

Over the last few years, many governments have collaborated to deal with the issue of base erosion and profit shifting by MNEs. These collaborations resulted in the release by the OECD of its 15-point action plan on Base-Erosion and Profit-Shifting (also known as BEPS).

BEPS represents the most far-reaching effort to date by governments in modern history to reform the international tax system in order to combat aggressive tax planning. The primary goal of BEPS (which covers a wide range of international tax issues) is to ensure that there is alignment between the jurisdiction where the profits are taxed and the jurisdiction where the economic activity which generated the profits took place.

A very important aspect of BEPS, which will have far-reaching consequences for MNEs and the boards which govern them, is the new country-by-country (CBC) reporting rules. These rules, when adopted by a country, will require MNEs to prepare a global financial blueprint of their operations in all the countries where they operate and do business. Such information must then be submitted to the tax authority of the ultimate parent company and various tax authorities may then exchange the information.

While at this stage it is anticipated that these CBC reports will be confidential, there have already been calls for these reports to be made public and executive committees and boards need to be aware of this eventuality, and more importantly should prepare for it. These reports will contain significant amounts of information about the organisation. It will accordingly enable governments (including tax authorities) to thoroughly inspect and analyse the global operations of MNEs which operate in their countries and more importantly, to compare this operational analysis to the global tax footprint of the MNE – thereby checking if the MNE is paying its taxes in the countries where it earns its profits.

To date, the US and the UK have formally adopted CBC reporting and many other countries, including South Africa, are also expected to adopt it. Specifically in SA, draft regulations were recently issued which indicate that the reporting period for MNE groups commences for fiscal years commencing on/after 1 January 2016. It is further anticipated that the first CBC reports will need to be filed with SARS as from 31 December 2017.

In addition, South Africa is also working with many other governments on a multilateral instrument that will enable preventative measures to be incorporated into our network of double taxation agreements to avoid treaty abuse. This will also include information sharing between the South African tax authority and foreign tax authorities.

Questions for directors to ask?

The time has thus come for board members to start challenging the executive on its tax risk management processes. Questions which could be posed in this regard include the following:

1. Does the organisation have a tax corporate governance framework to deal with tax risks and, if so, is it adequate and effective?

2. Is the board able to demonstrate that it has proper oversight over transactions in the organisation which may have significant tax implications?

3. What is the organisation's tax strategy and does it have a formalised tax strategy document?

4. What is the organisation's appetite for tax risk and is this aligned with the overall risk tolerance level of the group?

5. Has the organisation's executive communicated to the board how the BEPS transfer pricing changes and specifically, the country-by-country reporting requirements, will impact the organisation?

6. Is the executive monitoring and documenting BEPS-related activities of the organisation in all countries in which it operates?

7. Has the board discussed how the company should be preparing itself to deal with the changing landscape on BEPS? For example, is the organisation ready/preparing itself to be ready for the significant increase in the local and

global reporting requirements which may be placed on it as a result of the local SARS transfer pricing documentary requirements and the country-by-country reporting requirements? Does the organisation have suitably skilled staff to deal with these requests and will information provided to the authorities withstand scrutiny?

8. Does the legal structure of the organisation and the income flow within that structure expose the organisation to tax risks and how are those risks mitigated? Will the organisation be able to withstand a SARS transfer pricing audit on its structure (e.g. what percentage of profit is allocated to low-tax jurisdictions, such as Mauritius, for example, and does the level of that profit reflect the real economic contributions in that jurisdiction)?

9. What processes are in place to assess the completeness of the tax risks (including transfer pricing tax risks) identified by the group and does the group have a tax risk register which lists both inherent and specific tax risks?

10. Are tax risks properly and timeously communicated to the Board?

Conclusion

As many countries start to adopt the new OECD approaches, global transparency and co-operation among governments are set to increase dramatically. Soon MNEs will have “nowhere to hide” and they will be under immense scrutiny of the tax authorities across all the jurisdictions in which they operate and will be called to account.

What is clear therefore is that, whereas historically boards have generally always known that tax governance should be on their boards’ agenda but have left it to the CFO/FD to deal with, the time has now come for boards to ask the question: Are we governing tax risks in the organisation effectively for the benefit of all stakeholders? In this regard, as noted above, the board and its audit committee should ensure, in line with the King IV recommendation, that it takes responsibility for a tax strategy and policy that are both compliant and congruent with responsible corporate citizenship and wider stakeholder considerations, and importantly, that they take into account the negative reputational repercussions where they neglect to do so.

The board indeed has a very powerful yet extremely difficult role to play in the area of tax corporate governance and perhaps the most important aspect to remember is that every single transaction in an organisation has a tax decision attached to it and getting it wrong, or being perceived to get it wrong, could have significant cash and reputational costs for the organisation.

Deloitte

King IV

TAX ADMINISTRATION

2664. Grounds for Assessments

The Eastern Cape High Court was recently required to adjudicate a dispute between a taxpayer and the Commissioner: South African Revenue Service (the Commissioner) regarding the manner in which the Commissioner had dealt with the taxpayer.

In the case of *V Z Nondabula v The Commissioner: SARS & Another* (case no. 4062/2016 Eastern Cape Local Division: Mthatha, as yet unreported), the taxpayer applied for an interdict preventing SARS from invoking the provisions of section 179 of the Tax Administration Act (the TAA) pending the final determination of the taxpayer's objection to his additional income tax assessment.

SARS had issued a notice to a third party under section 179 of the TAA directing that the party had to pay whatever funds it held for the taxpayer to SARS in settlement of the tax allegedly due.

The taxpayer conducted business as a sole proprietor of a service station and received various assessments for the 2014 tax year. The assessments issued to the taxpayer were paid timeously in respect of the assessments issued in 2015. Subsequently, SARS issued a further assessment to the taxpayer reflecting a debt allegedly due amounting to R1 422 637.83. The first time that the taxpayer became aware of the tax debt was by way of a letter dated 29 September 2016 demanding payment of the tax within ten days, failing which, further action would be taken.

It would appear that SARS provided a statement of account reflecting the amount payable, but did not inform the taxpayer as to how the amount due was arrived at.

The taxpayer called on SARS to provide details regarding the additional assessment issued for the 2014 tax year and how the amount of the tax debt was arrived at.

In the papers before the Court, SARS did not explain how the additional assessment issued to the taxpayer was arrived at. The taxpayer objected to the additional assessment through the offices of his accountants and SARS responded to the objection by advising that the objection did not comply with the rules.

The accountant submitted a further objection challenging the assessments issued by SARS but the objection filed by the accountant was not responded to, and even where there was a response, the Court indicated that it was not a substantive response to the taxpayer's objection.

The Court pointed out that SARS is a creature of statute and is therefore required to operate within the statutory provisions which empower it.

The Court reviewed the statement of account provided by SARS to the taxpayer and other documents provided and reached the conclusion that SARS had not provided the taxpayer with a statement of the grounds for assessment as required in terms of section 96(2)(*a*) of the TAA. The Court pointed out that SARS is an organ of state and SARS exercises a public power or performs a public function.

Under section 195 of the Constitution, SARS must be accountable and must comply with the Constitution. At paragraph 25, Acting Judge Jolwana stated:

"There is no doubt the first respondent dealt with the applicant in an arbitrary manner contrary not only to the Act but most importantly the values enshrined in the Constitution were not observed by the first respondent. The applicant is a business man and employs quite a number of people in our country where the unemployment rate is alarmingly high. The first respondent's actions had the potential to close down applicant's business with catastrophic results not only for the applicant and his family but also for all of his employees in a situation in which unemployment is rampant and reaching crises proportions."

The Court concluded that SARS must comply with its own empowering legislation and most importantly it must promote the values of the Constitution of the Republic of South Africa when exercising its powers. The court further concluded that SARS has failed to do so and particularly failed to provide the taxpayer with information prescribed in section 96 of the TAA.

The court therefore decided that SARS acted unlawfully and unconstitutionally and thus set the third party notice aside and also directed SARS to pay the taxpayer's legal costs.

Unfortunately, there are too many instances where SARS issues an assessment to a taxpayer without explaining the basis of that assessment and then proceeds to collect the tax on that additional assessment.

Furthermore, SARS often fails to properly deal with objections lodged to an assessment, rejecting the objection as invalid. Taxpayers must be aware of the right that they have to be informed of the details of the assessment issued to them and failing SARS's adherence to the Act they can either lodge a complaint with the office of the Tax Ombud, or alternatively, approach the court for relief.

ENSafrica

TAA: sections 96 and 179

The Constitution: section 195

2665. Incorrect interest rates

In brief

The South Africa Revenue Service (SARS) applied the incorrect interest rates from 1 July 2016. Adjustments were made to the SARS system on 1 July 2017 with retrospective effect and as a result some taxpayers were adversely affected.

In detail

On 1 July 2016 the interest rate for purposes of calculating a debt owing to the State or debts that should be paid into the Revenue Fund was increased from 10.25% per annum to 10.5% per annum. This interest rate applies to all debts owing including debts with regard to estates, settlements and compromises. The increase in the interest rate was published in Government Gazette No 39960 of 2016 and should have applied from 1 July 2016. SARS however did not update its systems accordingly from 1 July 2016. The SARS system was only updated on 1 July 2017 with retrospective effect. Taxpayers that paid SARS interest from 1 July 2016 will have an additional tax liability due to SARS, as a result of the late adjustment of interest rates. It should also be noted that the prescribed rate of interest, which is applicable to all debts payable by SARS to a taxpayer, is four percentage points below such rate as the Minister may from time to time fix by notice in the Gazette. This effectively means that the prescribed rate of interest is calculated with reference to the 10.5% per annum as announced in the Government Gazette.

In this regard, taxpayers should ensure that the interest they received from SARS from 1 July 2016 was correctly calculated by applying the rate of 6.5% per annum.

Going forward

SARS is aware of the issue. They have indicated that they will not forgo the interest on ordinary debt but will do so with regard to estates, compromises and settlements. SARS encourages affected taxpayers to approach them. We understand that SARS is in the process of establishing a specific communications channel at its head office for affected taxpayers to contact. They advised that they will communicate further details in this regard during the course of this week.

Conclusion

Taxpayers should consider their statements of account to ensure that they have received and paid the correct amounts of interest. In the event that they feel the amount of interest was calculated with reference to the incorrect rate, they should contact SARS as soon as possible.

This oversight may significantly impact certain taxpayers, for example:

- Tax clearance certificates previously issued by SARS will be withdrawn on the basis that there is an unpaid debt due to SARS (despite the fact that the debt, as previously notified by SARS, has in fact been paid). This will be of particular importance if the purpose for the tax clearance was to apply for a foreign investment allowance or to be used for a tender or a certificate of good standing, or similar purpose.

- Taxpayers who have been granted relief in terms of the voluntary disclosure programme (VDP) and the assessment issued by SARS pursuant thereto may have their application for VDP revised retrospectively.
- Deferred payment arrangements and/or compromises entered into with SARS will also have to be re-calculated.

The Constitution of South Africa and other subordinate legislation provide that organs of state, including SARS, must exercise their powers in a lawful, reasonable and procedurally fair manner. SARS' failure to amend their internal systems may infringe on the taxpayer's right to fair procedure and cause financial loss to the taxpayer.

PwC

BDO

Government Gazette 39960

2666. Remedies under section 9

Currently, in terms of section 9 of the Tax Administration Act, 2011 (TAA) a decision made by a South African Revenue Service (SARS) official and a notice to a specific person issued by SARS, (excluding a decision given effect to in an assessment or notice of assessment) is regarded as made by a SARS official, authorised to do so or duly issued by SARS, until proven to the contrary. Furthermore, section 9 makes provision for such a decision to be withdrawn or amended by the SARS official, a SARS official to whom the SARS official reports or a senior SARS official, at the request of the relevant person.

Section 104 of the TAA

Section 104(2) of the TAA states that the following decisions may be objected to and appealed against in the same manner as an assessment:

- a decision in terms of section 104(4) of the TAA not to extend the period for lodging an objection;

- a decision under section 107(2) of the TAA not to extend the period for lodging an appeal; and
- any other appeal that may be objected or appealed against under a tax Act.

From the above, it appears that whereas section 104 of the TAA defines the decisions against which a taxpayer may object and appeal, section 9 deals with the scenario where a decision is made by a SARS official, but which is not subject to objection and appeal.

Proposed amendment

In the Memorandum on the Objects of the Draft Tax Administration Laws Amendment Bill, 2017 (the Memorandum), it was noted with regard to decisions that are not subject to objection and appeal that a taxpayer can potentially be prejudiced by not having access to other effective internal remedies that may provide relief. The Memorandum notes that under such circumstances the taxpayer's only remedy would then be to take the matter on review before the High Court in terms of the Promotion of Administrative Justice Act, 2000 (PAJA). As we know, High Court litigation of this nature can be an expensive exercise.

The Memorandum states that decisions by SARS are generally subject to the internal remedy in section 9 of the TAA, in terms of which specified SARS officials may reconsider the decisions. Decisions that are given effect to in an assessment or notice of assessment are however excluded, since assessments generally have the separate remedy of objection and appeal. During the public comment process on the 2016 legislation, Government identified a situation where a decision given effect to in a notice of assessment was not subject to objection and appeal. Under such circumstances and based on the current wording of section 9 and section 104 of the TAA, it would mean that neither the internal remedy in section 9, nor the right to objection and appeal in section 104, will be available to a taxpayer under certain circumstances.

Although it is not entirely clear when a decision will be given effect to in an assessment or notice of assessment, as envisaged in section 9, one such example might be where a taxpayer applies for the suspension of payment of tax in terms of section 164 of the TAA. SARS's decision to reject an application brought in terms of section 164 will most likely not be given effect to in an assessment or notice of assessment.

In light of the above, it is proposed in the Memorandum that such a decision, which is given effect to in a notice of assessment, but is not subject to objection and appeal, be subject to the remedy under section 9 of the TAA. This will afford the taxpayer an internal remedy before exercising the external remedy of a review application to the High Court under PAJA.

Comment

While it always appears to be a positive development where legislation is amended to make it easier and cheaper for a taxpayer to exercise its rights, such an amendment will only have the desired effect if the SARS officials who are approached in terms of this section, exercise their powers in a reasonable manner.

Cliff Decker Hofmeyr

TAA: sections 9, 104, 107 and 164

Memorandum on the objects of the Draft TLAB and PAJA

Editorial Comment: Draft documents should always be treated with care as there is no certainty that the final version will be identical to the publicly issued draft.

2667. SARS' conduct and obligations

South African taxpayers and companies have been alerted to expect more tax audits as a result of the increase in the SARS 2017/18 revenue budget. It is easy to see the connection: SARS needs to collect as much revenue as it can, and tax audits can have positive effects on revenue collection. However, what is the threshold which SARS must pass before it can select taxpayers for an audit and how is the process governed to ensure efficiency and fairness?

Power to select taxpayers for audits and request documents

"Audit" can mean a wide range of things:

- In terms of the Tax Administration Act, 2011, SARS may select a person for inspection, verification or audit on the basis of any consideration, including on a random or a risk assessment basis.
- Furthermore, in terms of the Customs and Excise Act, 1964, an officer may at any time require any person to produce any book, document or thing that is required to be kept or relates to – or is reasonably suspected of relating to – matters dealt with in terms of the Act.
- In a recent High Court judgment, the court held that an audit can be something as unobtrusive and simple as the verification of very basic information, such as medical expenses or travelling expenses.

This is highly relevant in the current tax season, when taxpayers may be selected for audit following the submission of their tax returns. In selecting taxpayers and companies, and making allowances for the often invasive audit process, which may affect a business's commercial confidentiality and an individual's privacy, such consideration for selection purposes must be relevant for the proper administration of a tax Act. An audit should not be used as a means of accomplishing something by improper motives and as a vehicle to target taxpayers for no good reason. Indeed, the decisions and processes involved in tax administration (including the decision to select a taxpayer for an audit) must be part of an overall fair process which is free from bias, ulterior purpose and corruption. To quote the High Court judge, "only the highest professional standards will do".

The audit process: SARS' conduct and obligations

In practice, when SARS gives taxpayers notice that they have been selected for an audit, the notice is usually accompanied by a request for "relevant" material. In this regard, it is common for SARS to request books of account and financial statements for a period of five years. However invasive and meddlesome this may appear to be, compliant taxpayers are expected to have such documents ready on demand. While not legislated, SARS may furthermore provide reasons for the audit. Until recently, there have not been any known court cases challenging SARS' selection of a taxpayer for audit. This may be so for an array of reasons, but perhaps the most apparent is this: the overwhelming awareness of SARS' vast powers in administering the tax Acts and the lack of appetite of an aggrieved taxpayer to spend thousands of Rands on litigation costs.

Fortunately for taxpayers and tax practitioners, the High Court has pronounced its views on SARS' conduct and obligations in relation to audits. This is especially significant in the absence of any established legislated obligations for SARS in selecting and conducting audits.

Of particular importance for taxpayers, when selected for audits, are the following points raised by the High Court:

- The audit notice is a formal notice, and the start of the use of statutory powers against a taxpayer, which requires some measure of caution. If it is proven that a SARS official is acting with malice, some relief may be granted, such as removing the individual from the audit process.
- The power to select taxpayers for audits and request documents remains an exercise of public power and therefore must comply with the principles of

legality, which include the requirements of lawfulness, rationality and constitutional consistency.

- The threshold for SARS to pass before it can select taxpayers for an audit is extremely low; however, using legislation for ulterior purposes will always be unlawful and will be a serious breach of the mutual trust that should exist between a taxpayer and SARS. A finding that an action was not taken for purposes of the administration of a tax Act would vitiate such action.
- Allegations about the *mala fides* of SARS in deciding to audit taxpayers cannot be rejected or found to be irrelevant by SARS or the courts. In this regard, it is generally accepted that the exercise of all public power is reviewable.

Inasmuch as taxpayers need to be aware of their obligations, SARS must be held to theirs, and be guided by its own values and principles, which include fairness, honesty, integrity, transparency and trust.

Bowmans

EXEMPTIONS

2668. Tax Emigration and Foreign Employment Income

National Treasury intends removing the foreign remuneration exemption contained in the Income Tax Act. The exemption currently exempts from income tax, remuneration earned for employment services rendered outside of SA of employees who are outside of SA for more than 183 days in a 12-month period, of which more than 60 days must be continuous. The exemption does not extend to governmental employees, employees of public or municipal entities or holders of public office.

The exemption was introduced in 2001 to prevent double taxation of employment income in SA and the host country where the employment services are rendered. The reason for the proposed removal of the exemption is that it provides opportunities for double non-taxation if an employee works in a zero-tax country, for example Dubai.

In this scenario, the income would neither be taxed in Dubai nor in SA. This is perceived to be unfair and creates unequal tax treatment between employees in the private and public sectors. If the exemption is removed the employment income will become taxable in SA since SA residents are taxed on a worldwide basis. SA will levy income tax on the income and will give a credit for taxes suffered elsewhere. Taxpayers may consider ceasing to be a SA tax resident.

This can be achieved by ceasing to fall into the two-pronged definition of ‘resident’: ceasing to be ‘ordinarily resident’ in SA, in other words if SA ceases to be the individual’s true or real home and also ensuring that one falls under the threshold number of days present in SA in terms of the physical presence test for tax residence. SA tax residence may also be broken if an individual is deemed to be an exclusive tax resident of another country in terms of a double taxation agreement between SA and that other country.

However, one of the consequences of ceasing to be an SA tax resident is that there is a deemed disposal of one’s worldwide assets (with certain exclusions such as immovable property in SA) at market value for SA capital gains tax purposes immediately before one ceases to be an SA tax resident. Depending on the composition and value of one’s asset base relative to its base cost, the quantum of the capital gain triggered may be substantial. Since it is a deemed and not an actual disposal, this may create cash flow challenges to pay the capital gains tax without realising some of the assets.

The hidden costs of a decision to tax emigrate from SA therefore need to be carefully considered. The Taxation Laws Amendment Bill, 2017 proposes that the deletion of the exemption would come into effect for tax years commencing on or after 1 March 2019. It remains to be seen whether the proposal will be enacted.

BDO

ITA sections 9H and 10(1)(*o*)(ii)

Editorial comment: In the final version of the Bill the new provision comes into force after an initial exemption of R1 million foreign employment income and the commencement date is 1 March 2020.

SARS NEWS

2669. Interpretation notes, media releases and other documents

Readers are reminded that the latest developments at SARS can be accessed on their website http://www.sars.gov.za.

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