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COMPANIES

2670. Dividends tax

Section 64E(1) of the Income Tax Act, 1962 (the Act) provides that dividends tax must be levied at a rate of 20% of the amount of any dividend paid by any company, other than a headquarter company.

In terms of section 64EA(a) of the Act, the beneficial owner of a cash dividend is liable for dividends tax in respect of that dividend. However, in terms of section 64F(1), a cash dividend is exempt from dividends tax in various instances. Despite these exemptions, section 64G(1) provides that, subject to section 64G(2) and (3), a company that declares and pays a cash dividend must withhold dividends tax from that payment.

Section 64G(2)(a) provides that a company must not withhold any dividends tax from the payment of a dividend if the person to whom payment is made has (i) by a date determined by the company or (ii) if no date has been determined by the company, by the date of payment, submitted to the company:

- the prescribed declaration by the beneficial owner that the dividend is exempt from dividends tax; and
- a written undertaking should be made to inform the company, in writing, should the circumstances affecting the exemption applicable to the beneficial owner change or should the beneficial owner cease to be the beneficial owner.

The "group of companies" exemption from withholding dividends tax, in terms of section 64G(2)(b) of the Act, is not discussed for purposes of this article. The discussion below relates to dividends declared by unlisted companies to beneficial owners who/which do not form part of the same group of companies.

For dividends tax purposes, a cash dividend declared by an unlisted company is deemed to be paid on the earlier of the date on which the dividend is paid or becomes “due and payable” in terms of section 64E(2)(a)(ii).

It is therefore important to determine the date by which a dividend declared becomes “due and payable” as this would be the date by which the beneficial owner of such dividend must submit the requisite declarations and undertakings evidencing that the dividend is exempt from dividends tax if this date precedes the date on which the dividend is settled. For example, despite the fact that a public benefit organisation (PBO) may be approved by the Commissioner in terms of section 30(3) of the Act (and that cash dividends to such entity should therefore be exempt from tax), if the PBO does not provide the company declaring the dividend with the requisite declarations and undertakings on a timeous basis, the company must withhold dividends tax and the PBO would have to rely on section 64L to claim a refund of the dividends tax paid.

As the phrase “due and payable” is not defined in the Act, regard must be had to the ordinary meaning thereof, informed by case law, commentary thereon and the context of the legislation. Our courts have considered the meaning of “due” and “payable” on a number of occasions. In *Rhodesia Newspapers Company Ltd v Allison*, 1934 SR 60, the court stated the following as regards the meaning of “due”:

> ‘The word ‘due’ is capable of two interpretations – it may, dependent upon the context in which it is used, mean ‘payable’, or it may mean ‘owing’ irrespective of whether it is immediately payable.’

In considering an attachment under a garnishee order of “so much of the debt due” as provided for in the relevant legislation, Innes CJ (as he was then) stated the following in *White v Municipal Council of Potchefstroom,* 1906 TS 47 1040:

> ‘I give to the words ‘the debt due’ their ordinary meaning. The garnishee must be under an obligation to pay the judgment debtor…’

These statements echo the meaning given to “due” in the Oxford Online Dictionary, where it is stated as denoting, inter alia, “(of a thing) required or owed as a legal or moral obligation”.

The draft Comprehensive Guide to Dividends Tax (Issue 2) issued by the South African Revenue Service (the Guide), released for comment on 27 July 2017, states the following on page 61 as regards the meaning of “due and payable” in section 64E(2)(a)(ii):

> ‘The declaration of a dividend creates a debt owing to a holder of a share. Such a debt arises out of a formal act performed by a company. A dividend declared by a company that is not listed is generally due on the date which it is declared.’

As regards the meaning of “payable”, the court in *Schenk v Schenk*, stated the following:

> ‘For ‘payable’ can have at least two different connotations: (a) that which is due and must be paid, or (b) that which may be paid or may have to be paid…The sense of (a) is a present liability – due and payable –…(b) is a future or contingent liability…’

On page 61 of the Guide, the following is noted as to the meaning of “payable”:

> ‘It has been held that the word ‘payable’ can have different meanings. In *CIR v Janke*, 1930 AD 474, 4 SATC 269, Stratford J quoted the judgment of Searle J, *Stafford v Registrar of Deeds*, 1913, C.P.D. 329: ‘*It*

is clear that the word payable is sometimes construed as meaning 'payable at a future time' or 'in respect of which there is a liability to pay'…it is sometimes used to mean 'payable immediately' or actually due and presently demandable…''

An amount will be payable only when the time for payment arrives. For an amount to be 'due and payable' the amount must not only be owing, but a person must have the right to claim payment to it.

In summary, to avoid dividends tax being withheld from an exempt dividend, the beneficial owner of a dividend must submit the requisite declaration and undertaking to the company declaring such dividend by the date on which the company has an unconditional obligation to make payment of such dividend and the beneficial owner has a corresponding right to claim payment of the dividend, irrespective of the fact that actual payment of the dividend may only occur sometime thereafter.

ENS

ITA : Sections 30(3), 64E(1), 64E(2)(a)(ii), 64EA(a), 64F(1), 64G, and 64L

SARS Draft Comprehensive Guide to Dividends Tax (Issue 2)

INTERNATIONAL TAX

2671. Dutch decision on the 'Most-Favoured Nation' clause

The double taxation agreement between the Netherlands and South Africa (the SA-Netherlands DTA) expressly provides for a minimum rate of 5 per cent on dividends paid by Dutch resident companies to South African residents (and vice versa). However, the dividends article in this DTA also includes a 'most favoured nation' clause (the Dutch MFN clause).

For some time, the position taken by many taxpayers is that the Dutch most-favoured nation (MFN) clause, when read with at least two other double taxation agreements (DTAs), can effectively result in an exemption from Dutch or South African dividends tax (provided, of course, that the requirements as to beneficial ownership and shareholding in the company declaring the dividends are met).

When applying the dividends article in the SA-Netherlands DTA to dividends paid by South African companies to Dutch shareholders, it appears (to date, at least) that SARS has not agreed with the above position and is of the view that the lowest rate possible in respect of dividends is 5 per cent.

The Dutch courts have, however, held that the exemption applies in respect of dividends paid by Dutch resident companies to their South African shareholders. In October 2015, a Dutch District Court held that dividends paid by a Dutch resident company to its South African shareholder were, as a result of the application of the MFN clause, exempt from Dutch dividends tax. On appeal by the Dutch revenue authorities against the decision of the District Court to the Court of Appeals (Hertogenbosch), the decision of the District Court was, as per a judgment of the Court of Appeals (Hertogenbosch) dated 17 August 2017 and published on 31 August 2017, confirmed by the Court of Appeals (Hertogenbosch).

These decisions of the Dutch courts have important implications for dividends paid by South African residents to their Dutch shareholders.

Operation of the Dutch MFN clause

In terms of paragraphs 1 and 2 of the dividends article (Article 10) of the SA-Netherlands DTA, the maximum rate of tax that may be imposed by the source state (i.e., the country of residence of the company paying the dividend) is 5 per cent where the recipient of the dividend is the beneficial owner of the dividend and holds at least 10 per cent of the capital of the company paying the dividend.

However, paragraph 10 of Article 10 (i.e., the MFN clause), provides for the automatic application of a lower rate of tax on dividends if South Africa and a 'third country' conclude a DTA which provides for a lower rate. If this is the case, the lower rate will apply for the purposes of the SA-Netherlands DTA.

The Dutch MFN clause was introduced into the SA-Netherlands DTA by way of a protocol that was concluded (simultaneously with the SA-Netherlands DTA itself) in 2008 (the SA-Netherlands protocol). This fact is important since one of the other requirements for the MFN clause to apply is that the treaty with the 'third country' must have been concluded after the conclusion of the SA-Netherlands DTA and protocol (i.e. 2008).

South Africa currently has one DTA (with Kuwait) that expressly provides for a zero rate in respect of dividends. However, that DTA (the SA-Kuwait DTA) was concluded in 2006. It is therefore clear that Kuwait cannot be the 'third country' contemplated in the Dutch MFN clause.

How then is the Dutch MFN clause triggered? The answer lies in the DTA between SA and Sweden (the SA-Sweden DTA), which also contains an MFN clause (the Swedish MFN clause) in its article dealing with dividends.

As is the case with the Dutch MFN clause, in terms of the Swedish MFN clause, if South Africa has a DTA with any other country (the other country) in terms of which a lower rate of dividends tax applies, the lower rate will apply for the purposes of the SA-Sweden DTA. The critical difference between the Swedish MFN clause and the Dutch MFN clause is that the Swedish MFN clause applies irrespective of when the treaty with the 'other country' was concluded. Consequently, the fact that the Kuwait DTA might have been concluded before the conclusion of the Swedish DTA is irrelevant in determining whether the lower rate applies for purposes of the SA-Sweden DTA.

Although the SA-Sweden DTA was concluded in 1995, the Swedish MFN clause was introduced into that DTA by way of a protocol that was signed in 2010 and that entered into force and became effective in 2012. The protocol (the Swedish protocol', which (as a result of the zero rate applicable in terms of the SA-Kuwait DTA) provides for a zero rate of tax on dividends paid by South African companies to Swedish residents, was concluded after the conclusion of the SA-Netherlands DTA.

Consequently, as was successfully argued by the taxpayer before the Dutch courts and as is the position of many South African companies that pay dividends to Dutch shareholders:

(1) South Africa has concluded a DTA (i.e., the Swedish protocol) with a third country (i.e., Sweden);
(2) that DTA was concluded after the conclusion of the SA-Netherlands DTA (and the protocol that introduced the Dutch MFN clause into the SA-Netherlands DTA); and
(3) the Swedish protocol provides for a rate of tax on dividends lower than the rate provided for in Article 2 of the SA-Netherlands DTA (i.e., it provides for a zero rate).

Accordingly, it is argued, it follows that all of the requirements for the Dutch MFN clause to be triggered are met, and that the zero rate therefore applies for the purposes of the SA-Netherlands DTA.

The approach of the Court of Appeals (Hertogenbosch) in the Netherlands

As stated above, the Court of Appeals (Hertogenbosch) was faced with an appeal from a Dutch District Court. The appeal (brought by the Dutch revenue authorities) was against the decision of the District Court to allow the taxpayer a refund of Dutch dividend withholding tax. The taxpayer, a resident of South Africa and the holder of all of the shares in a Dutch-resident company, sought the refund based on the above interpretation of the MFN clause.

Quite correctly, there was no dispute between the parties that the SA-Netherlands protocol and the Swedish protocol both constitute 'conventions for the avoidance of double taxation' for the purposes of the MFN clause. Notably, the parties also agreed that the provisions of the Vienna Convention of 23 May 1969 (the Vienna Convention), particularly Articles 31 and 32 thereof, are relevant in the interpretation of the MFN clause.

Articles 31 and 32 of the Vienna Convention state the following:

> ‘Article 31
> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
> (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
> (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
> 3. There shall be taken into account, together with the context:
> (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
> (b) any subsequent practice in the application of the treaty which ‘establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) leaves the meaning ambiguous or obscure; or

(b) leads to a result which is manifestly absurd or unreasonable.'

Ordinary, grammatical meaning

The Court held that, under the ordinary, grammatical meaning of the MFN clause, the zero rate of dividends tax indeed applied to participating dividends paid by both Dutch resident companies to South African residents, and South African resident companies to Dutch residents. Having so held, the Court proceeded to enquire as to whether, in light of the provisions of Articles 31 and 32 of the Vienna Convention, the object, purpose and/or context of the MFN clause would require a different conclusion from the conclusion that the zero rate applies.

Object, purpose and/or context

The context of a treaty would include, for example, a joint statement drawn up by the Contracting States in the form of a preamble, explanation, annexes or other agreements that are known to parties relying upon the treaty. In the opinion of the Court, there were no documents submitted by the Dutch revenue authorities that were of such a nature. Moreover, the Court held that no statements had been issued by the individual tax authorities of the Netherlands and South Africa that could be regarded as evidence that there is a 'subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation'. The Court held that, to the extent that there were any such statements, all such statements had been made after the dividend was paid and that there was no evidence that any such statements were known by the taxpayer (or the company declaring the dividend) at the time the dividend was paid.

As regards arguments by the Dutch revenue authorities to the effect that it could never have been intended that a zero rate would apply to dividends paid between South Africa and the Netherlands (and that therefore allowing a zero rate of tax on dividends would frustrate the object and purpose of the MFN), the Court held that this argument could not be supported. In this regard, the Court drew attention to certain Explanatory Notes to the SA-Netherlands protocol, which state the following:

> ‘Article 10, tenth paragraph, contains a so-called most favoured clause. This clause implies that if South Africa, after the signature of the treaty, agrees with another country a lower rate of tax than 5%, an exemption or a lower taxable basis, the more favourable provisions will automatically (without further negotiation) be applicable to the relationship with the Netherlands from the date of entry into force of the treaty with that other country.’

Accordingly, the Court held that both South Africa and the Netherlands were clearly, at the time of negotiating the MFN clause, fully aware that there was a possibility that a rate of tax on participating dividends at source of less than 5 per cent could apply to a resident of the Netherlands or South Africa at any point in time.

The Court also noted that, from the text of the Dutch Standard Convention on Participating Dividends (produced at the hearing) it appears that, in treaty negotiations, the Netherlands generally pursues an exemption from tax at source on participating dividends.

On the basis of the above, the Court concluded that the object, purpose and/or context of the MFN clause did not require a different conclusion from the conclusion that a zero rate applied to the dividend.

'In good faith'

Two arguments were raised by the Dutch revenue authorities to the effect that the interpretation sought by the taxpayer would amount to giving an interpretation of the MFN clause that is not in good faith, and therefore contrary to the principles enshrined in the Vienna Convention.

Firstly, it was argued by the Dutch revenue authorities that the outcome of the negotiations between the Netherlands and South Africa in 2008 (and thereby the good faith between South Africa and the Netherlands) would be undermined by an interpretation of the MFN clause that gave the MFN clause the scope sought by the taxpayer. The Court acknowledged that Article 31 of the Vienna Convention requires that a treaty be interpreted in good faith. However, in the Court’s view, this merely meant that a clause in a treaty that confers a right to tax on one of the Contracting States cannot be eliminated or avoided by, for example, a reclassification or a unilateral change in the national law of the other Contracting State. In the present case, the Court was of the view that its judgment would not result in an interpretation of the MFN clause that is in violation of good faith.

Secondly, it was asserted by the Dutch revenue authorities that it would not be in good faith between the Contracting States to allow, through the MFN clause, indirect access to treaty benefits agreed to by South Africa with third parties and available to South Africa well before the conclusion of the SA-Netherlands DTA. The Court dismissed this argument, stating that it could not be supported based on all of the conclusions already reached by it in its judgment.

Conclusion

In both of the decisions in the Netherlands (in the District Court and in the Court of Appeals (Hertogenbosch)) the Dutch courts found resoundingly in favour of the taxpayer. It is possible that the Dutch authorities could appeal the decision of the Court of Appeals (Hertogenbosch) to the Dutch Supreme Court, which Court could take a different view.

The impact of the decision of the Court of Appeals (Hertogenbosch) on SARS's approach to the interpretation and application of the Dutch MFN clause will presumably become apparent in the near future.

As regards the impact of decisions of the Dutch courts on the approach of our courts in South Africa, South African courts are not bound by decisions of Dutch courts, nor is South Africa bound by the Vienna Convention in the interpretation of its treaties with other countries. However, the decisions of the Dutch courts would be of persuasive authority and that, applying accepted principles of interpretation, it would be extremely difficult for our courts to depart from the interpretations given by the Dutch courts and to ignore the interpretation and application given to the Vienna Convention by the Dutch Courts.

PWC

The SA-Netherlands DTA and the Explanatory Note thereto

The SA-Kuwait DTA

The SA-Sweden DTA

Articles 31 and 32 of the Vienna Convention, 1969

Editorial comment: also see Integritax August 2017 Issue 215, article 2629

2672. Multilateral Instrument's principal purpose test

The Organisation for Economic Co-operation and Development (OECD) published the Action Plan to address Base Erosion and Profit Shifting (BEPS) in July 2013 (the action Plan). The Action Plan identified 15 actions along the following three key "themes": introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

The OECD published the Action Plan to address BEPS in July 2013. The Action Plan identified 15 actions along the following three key "themes": introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

The Multilateral Instrument (MLI) is a multilateral convention which is intended to address the practical difficulty of changing bilateral tax treaties. It seeks swiftly to incorporate the treaty-related results from the OECD BEPS Action Plan into more than 2 000 tax treaties worldwide.

Action 6 of the Action Plan identifies treaty abuse, in particular treaty shopping, as one of the most important sources of BEPS concerns. Action 6, which is incorporated as Articles 6 and 7 in the MLI, is therefore a minimum standard, implying that all the signatories to the MLI are obliged to adopt it in one form or another.

In line with Action 6, Article 6 of the MLI essentially includes as a preamble in tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements.

Whilst this modification on its own widens the scope for revenue authorities to attack certain transactions which they consider as tax avoidance or tax-abuse arrangements, multinational entities are likely to be concerned with the proposed alternative rules to address situations of treaty abuse as contained in Article 7 of the MLI. The first of these alternatives is a general anti-abuse rule based on the principal purpose of the transaction or arrangement (i.e. the so-called principal purpose test or PPT). The other two rules entail a simplified and detailed version of a specific anti-abuse rule, namely the limitation of benefits (LOB) provision, which limits the availability of treaty benefits to transactions or circumstances that meet certain conditions.

In its provisional list of expected reservations and notifications, South Africa has opted to apply the PPT. This rule reads as follows:

> 'Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.'

Simply put, if one of the principal purposes of a transaction or arrangement is to obtain a treaty benefit, the benefit would be denied unless it is established that granting of that benefit would be in accordance with the object and purpose of the provisions of the treaty.

Currently, South Africa's domestic Income Tax Act, 1962, contains general anti-abuse rules (GAAR). Critically, there is a requirement that the GAAR can only apply if "the sole or main purpose" of an avoidance arrangement is to "obtain a tax benefit". In section 80G(1) lies the rebuttable presumption that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining the tax benefit proves that, reasonably considered in the light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

Unlike the current domestic GAAR in South Africa, which suggests the existence of one main purpose (all other purposes being incapable of being more than ancillary or secondary), the PPT implies the possible existence of a number of principal purposes. It will therefore be interesting to see how the South African courts will interpret this phrase.

If the guidance laid down in the case of *Natal Joint Municipal Pension Fund* v *Endumeni Municipality*, [2012] 2 All SA 262 (SCA) is followed, the courts will be compelled to attribute the ordinary grammatical meaning to this phrase, having due regard to the context in which this phrase appears and the purpose to which it is directed.

This might very well lead to the courts reaching a conclusion similar to that in *ITC 156956 SATCS 86(C)*, where the court was tasked with interpreting the phrase 'one of the principal shareholders'. There the court held that:

> 'one of the principal shareholders' envisages that there are more principal shareholders than one... If one shareholder held more shares than any of the other he would, in the language of para (iii), be the 'main shareholder'.

> If shareholders each held an equal number of shares they would be the 'principal shareholders.'

Here is a simple example to illustrate the difficulty in applying the PPT:

> Group X is under pressure to increase its revenue. It determines that it may do so by acquiring the shares in a South African manufacturing company (SAM). The shares may be acquired and held by subsidiary Y or subsidiary Z. Y is resident in a country that has a treaty with South Africa in terms of which the rates of withholding tax are lower than those that apply in the treaty that South Africa has with Z's country of residence. The acquisition is therefore made by Y.

Due to the PPT, Y could arguably be denied treaty benefits if it were to be considered that obtaining a tax benefit was one of the principal considerations for it becoming the sole shareholder of SAM.

Under the current GAAR, Y could have easily discharged any claims by SARS of having embarked on a tax avoidance scheme, as it could have proved that obtaining a tax benefit was not the sole or main purpose in its acquisition of SAM. Thus, under the new regime it will be critical that the taxpayer assesses whether all the hitherto ancillary/secondary purposes remain as such or whether any of them (including treaty benefits) might be elevated to the level of co-principal purpose.

Conclusion

Non-residents dealing with or investing in South Africa in the future will have to consider the potential impact of the PPT. Its very existence creates the opportunity for SARS to institute inquiries into the purpose behind the commercial decisions of the non-resident. In the event of a dispute, final determination will be made in terms of South African law, which, in its current state, appears to require that the obtaining of a treaty benefit must rank above all other considerations or must be equal in rank to the most important of any other considerations.

For South African enterprises investing abroad, the PPT must be kept well in mind, as it may defeat the tax efficiency of proposed investment structures if the reduction of tax is an important element in the decision.

PWC

The OECD BEPS Action Plan

Articles 6 and 7 of the Multilateral Instrument

ITA: Section 80G(1)

2673. Multilateral instrument: no time for BEPS fatigue

The Multilateral Instrument's (MLI's) objective is to let any jurisdiction swiftly implement a range of BEPS minimum standards, bringing significant business impacts.

The last five years have been some of the busiest ever. The global financial crisis gave way to increased scrutiny of taxpayers' activities by the public, charities, media and politicians, not to mention from revenue authorities. A new era of tax transparency started and with almost a decade of austerity under their belts, governments are looking for ways to tackle perceived profit shifting by multinational companies.

Much of the change is attributable to what is known as the base erosion and profit shifting (BEPS) project, mandated by the G20 and driven by the Organisation for Economic Co-operation and Development (OECD).

The next stage of the BEPS journey was marked by the early June signing by 68 jurisdictions (with another 20 to 25 expected to join later during the remainder of this year) of a key OECD recommendation in Action 15, formally known as the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.

The Multilateral Instrument (MLI) focuses on what might at surface level seem to be a relatively simple objective, namely to quickly and efficiently (when compared with bilateral processes) update the world's 3,400 double tax treaties to allow them to take into account the BEPS changes.

However, this also means it has the potential to deliver business a whole range of unexpected outcomes including increased scrutiny of previously accepted transactions, the need to invoke different funding models, and the need to completely restructure supply chains or operations.

At this stage, it is expected that more than 1 100 tax treaties will be modified based on matching the specific provisions that the 68 jurisdictions wish to add or change. That number will likely increase rapidly in coming months.

What the MLI is trying to achieve

Many countries have entered into tax treaties (also called double tax agreements, or DTAs) with other jurisdictions to avoid or mitigate double taxation. Such treaties may cover a range of taxes including income taxes on dividends, royalties or licensing fees.

Many business leaders may not be 100% aware of the mechanics of tax treaties, but they would notice the effects if the treaties did not exist. Consider this, for example, if one resides in country X but has business operations in country Y. A tax treaty may reduce (or eradicate) the tax withheld from interest, dividends and royalties paid by entity X to entity Y.

The G20 and OECD consider, though, that while indeed such treaties help facilitate global business, they can also be abused. Several of the 2015 BEPS recommendations focus on techniques that are enshrined within a tax treaty, which means that these treaties needed to be updated to take such recommendations into account.

However, with the bilateral renegotiation of treaties taking up to a decade or more, a more efficient process was needed. This led to the birth of the MLI.

The objective of the MLI is to enable any jurisdiction to swiftly amend the entirety or part of its treaty network by just signing and ratifying one multilateral convention, instead of having to renegotiate many bilateral ones.

And while many of the recommendations of the BEPS project are optional, a limited number of recommendations are minimum standards, meaning that all 100 countries that have signed up to the BEPS project agree to take these minimum standards forward into their treaties.

During a signing ceremony on 7 June, 67 jurisdictions signed the MLI, covering 68 jurisdictions, as China signed for Hong Kong. Nine other jurisdictions expressed their intent to sign the MLI in the near future, and, since 7 June, three others (Cameroon, Mauritius and Vietnam) have done so.

The MLI remains open to signature by any interested jurisdiction and in fact, the OECD has announced that it will organize a second signing ceremony later this year. It is expected that by the end of 2017, around 90 jurisdictions will have signed the MLI.

As a result, the new BEPS treaty rules will become applicable widely as of 2019, with early adoption possible for 2018.

Why business should care

The MLI means big changes to cross-border tax law. Indeed, many of the changes represent the most significant changes to tax treaties since they were first used more than 100 years ago.

Whether they introduce a BEPS minimum standard or not, the changes potentially adopted via the MLI will have significant issues for business. Consider this selection of three possible changes (one of which is mandatory for the more than 100 countries that are BEPS members) and their impacts:

1. **Article 7 of the MLI on treaty abuse** mandates that all countries signing the MLI should introduce a Principal Purpose Test (PPT), as well as allowing them to also (optionally) apply a simplified Limitation of Benefits (LOB) provision to curb treaty abuse. Using a PPT, a country may deny treaty benefits (such as reduced taxes) where obtaining the benefit was one of the principal purposes of an arrangement unless granting the treaty benefits would be in accordance with the object and purpose of the relevant provisions of the treaty. So in effect, 68 countries may start scrutinizing every dividend or royalty flow to see if this rule is met. While no one is saying that every treaty benefit will be denied, it is likely that certain structures and transactions will meet that fate, particularly in the early days when this subjective new rule remains untested. During the signing ceremony Secretary-General José Ángel Gurria of the OECD emphasized the determination with which countries have pursued this issue, which led to all BEPS members agreeing on a coordinated implementation of the new rules. That may mean a protracted period of uncertainty for business.

2. **Article 12 of the MLI on the avoidance of permanent establishment (PE)** status sets out how changes to the wording of article 5 of the OECD Model Tax Convention to address the artificial avoidance of PE status through commissionaire arrangements and similar strategies will be embedded in treaties by the MLI. A commissionaire arrangement may be loosely defined as an arrangement through which a person sells products in a jurisdiction in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). The proposed changes delivered via the MLI would deem that a PE exists if a commissionaire's activities are intended to result in the conclusion of contracts that are then to be performed by the foreign principal, unless the commissionaire performs these activities in the course of its own independent business. In effect, this means that businesses currently relying on this model will need to adapt and change their delivery model in response or risk disputes, penalties and business disruption.

3. **Article 13 looks at the artificial avoidance of PE status** through business activities that were previously seen as exempt in terms of resulting in a PE for business. In this regard, some activities previously considered to be merely "preparatory" or "auxiliary" in nature may now correspond to core business activities. To ensure that profits derived from core activities performed in a country can be taxed in that country, the BEPS changes modify the OECD model convention on tax so that each of the exceptions included

therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character. Again, this means that businesses currently relying on such activities to deliver their business model in a jurisdiction will need to adapt and change their delivery model in response, or risk increasing scrutiny and disruption in coming years.

These are just some examples of the many changes that will become reality via the MLI. These are significant changes to the way in which the final tax bill is calculated, potentially driving business to restructure finance and holding companies, supply chain and operations.

Little wonder, then, that OECD Secretary-General José Ángel Gurria remarked that, “We are about to make tax treaty history!” at the Paris signing ceremony, where the 68 jurisdictions not only signed the MLI, but also unveiled which treaties they will be changing first and which options they have agreed with their bilateral partners.

Given the size and nature of the potential changes ahead, one might expect tax department leaders to be picking through the country positions with a fine-toothed comb as a result.

Nearly 60% of company tax leaders watching the webcast, for example, said that the MLI will have a significant or moderate impact on their tax strategy. However, less than 1 in 10 (7%) said they fully understood how it worked or what impacts it might have on their business.

Less than 2 in 10 (16%) say they are already assessing risk or have concrete plans to do so. That's concerning when 61% of the same group also say that the MLI will result in tax disputes rising “significantly” or “somewhat.”

Timing

The MLI is a key part of the OECD's effort toward implementation of the recommended BEPS measures. But countries do not need to use the MLI to adopt treaty changes; such changes may still be made bilaterally and in some cases countries have already pressed on and developed their own national laws that are similar to those suggested by the OECD in effect, if not form.

The MLI will enter into force after five jurisdictions have deposited its instrument of ratification, acceptance or approval of the MLI. During the ratification process, the choices made by jurisdictions may still change.

With respect to a specific bilateral tax treaty, the measures will only enter into effect after both parties to the treaty have deposited its instrument of ratification, acceptance or approval of the MLI and a specified time has passed. The specified time differs for different provisions.

The first modifications to bilateral tax treaties are expected to enter into effect in early 2018. However, given the anticipated time needed for ratification, it is expected that most treaty changes will enter into effect in 2019.

Recommendation

While the existence of the MLI may help the OECD meet a key objective of making sure treaty changes occur as quickly as possible, the pace of the implementation of the BEPS measures by the BEPS members shows just how intricate, voluminous and fast-paced those changes are likely to be. Ratification of the MLI will be a priority for many countries.

Many investment location choices are based on long-standing organisational practices; one may be familiar with every aspect of investing through a particular location and using particular vehicles. These routines may no longer be available; putting new processes in place will take time and considerable effort.

Companies will therefore need to ask themselves a series of questions, which in turn will permit them to formulate a robust assessment and action plan:

- Do we know every situation where we are relying on treaty relief?
- Do we have a process in place to check if the MLI may impact on our treaty analysis?
- Do we have the resources to deliver that process?

Things are still developing rapidly, and what happens now is very much the early days of change. The current MLI positions as stated represent a relevant starting point for an analysis, but not a reference framework that reflects the final situation. Future developments will have to be tracked to be aware of the latest status in relation to a specific tax treaty. In that regard, establishing an ongoing process to monitor and track MLI implementation and then constantly assess impacts against current tax footprint will be an imperative. Again, these are not small changes — they are a real shift in the world of tax — history being made, so to speak.

EY

Article 5 of the OECD Model Tax Convention

Articles 7, 12 and 13 of the Multilateral Instrument

Editorial comment: Also see Integritax August 2017 Issue 215, article 2633

INDIRECT TAX

30 min CPD VERIFIABLE ARTICLE

2674. Indirect tax refund strategies

For most businesses, indirect taxes are intended to be tax neutral, but in reality these levies can create burdensome costs that must be actively managed.

Indirect taxes include broad-based taxes on consumption, such as value-added tax/goods and services tax (VAT/GST) and sales taxes; taxes on imports, such as customs duties; excise taxes; energy taxes; and environmental levies that apply to the trade or manufacture of a range of products, including alcohol, tobacco and fuel.

For most businesses, indirect taxes are intended to be “tax neutral”, because they can be offset against other taxes in the supply chain or can be included in the costs of production, distribution or sale.

But in reality, these levies can create burdensome costs that must be actively managed. Unclaimed tax credits and missed or delayed refunds commonly cause negative cash flow and “tax leakage” that increase business costs and reduce profitability.

Complex local legislation, evolving business models and compliance obligations that vary widely by jurisdiction add to the complexity of making claims and to the risk of disagreements about the validity of credits, rebates and refunds.

To manage these costs effectively, you need to take action across the organisation to gain visibility into the indirect taxes you incur and clarity about how they can be refunded or offset. Ask yourself the following questions:

- Do you know how much duty is trapped in your supply chain?
- Do you know how much VAT/GST is sitting on the balance sheet?
- If you are expecting a refund, how realistic is that receivable?
- Will you receive it in full?
- What will the refund cost to claim, and how long will you wait for reimbursement?
- Can you afford to claim? Can you afford not to?

- Are you missing opportunities to reduce negative balances, obtain rebates and avoid absolute costs?

The answers to the above questions will help you to design an effective refund strategy that increases recovery, improves cash flow, and reduces costs and risks.

Managing cross-border VAT/GST refunds

Recovering foreign VAT/GST and reducing excess foreign VAT/GST credits are crucial parts of an effective indirect tax strategy. However, recovering foreign VAT/GST is difficult or even impossible in many countries. Even where refunds apply, long delays are common, and claims may be subject to intense audit scrutiny that can tie up corporate resources.

As a result, unclaimed or irrecoverable foreign VAT/GST is a common cause of excess indirect tax credits for many global businesses, leading to negative cash flow and absolute costs. Not all non-resident businesses qualify for direct VAT/GST refunds.

Is it time to review your foreign VAT/GST refund strategy?

Developing an effective strategy for dealing with or mitigating foreign VAT/GST can improve recovery rates and reduce associated costs. However, many organisations assume that the costs and difficulties of recovering foreign taxes will outweigh the benefits.

Now may be the time to review and challenge that assumption. Changes in tax legislation and advances in technology mean that fact patterns, assumptions and decisions made even just a few years ago can be quickly out of date.

Claiming direct refunds of foreign VAT/GST

A successful foreign VAT/GST refund claim depends on complying with all of the conditions imposed by tax administrations in every jurisdiction where you want to claim. Understanding the detailed rules and thoroughly applying them can improve your chances of success in reclaiming foreign VAT/GST on your business expenses.

Accurate documentation, in particular, is key. Planning ahead and complying with how and when you make your claims and understanding the reciprocity rules are also crucial factors.

Alternatives for recovering foreign VAT/GST

As few countries make direct VAT/GST refunds to non-resident claimants, global businesses must explore other options to reduce and avoid irrecoverable costs and long delays in receiving reimbursement, such as registering for VAT/GST locally or rerouting supplies.

Identifying the key jurisdictions for your business where VAT/GST may be refunded, or where incurring tax should be avoided, is a vital aspect of planning cross-border activities.

Managing domestic VAT/GST credits

Input tax credits are an inevitable part of the VAT/GST system. They arise when the VAT/GST paid on a VAT/GST payer's purchases (input tax) in a tax period is greater than the VAT/GST charged on its sales (output tax) in that period.

Carrying forward excess input tax is one of the biggest cash flow concerns for VAT/GST payers. Accounting for input VAT/GST correctly and actively managing VAT/GST credits are essential aspects of any effective indirect tax strategy.

These may seem like straightforward tasks, but detailed domestic rules on VAT/GST recovery and differences in how countries handle refunds can complicate the picture, especially for global companies.

VAT/GST — never a cost to business?

As a flow-through tax borne by final consumers, VAT/GST should not be a cost to businesses, but that is not always the case. Most VAT/GST payers encounter “sticking tax,” i.e., irrecoverable VAT/GST incurred on legitimate business expenditure. Equally important, for businesses that frequently accumulate excess input tax credits, the impact of negative VAT/GST cash flow on working capital may be significant.

Recovering VAT/GST on business costs

Most tax administrations apply strict rules to the recovery of input tax, but the rules for VAT/GST recovery are not harmonized. Making a successful refund claim depends on knowing and applying the detailed rules in every country where you operate or incur costs.

Where do credits accumulate?

Excess input tax is a common cause of negative cash flow for VAT/GST payers. Different countries treat excess input tax credits in different ways. The excess may, for example, be refunded, carried forward or used to offset other taxes.

These different approaches can have significantly different impacts on affected businesses and should be factored into strategic decisions about managing VAT/GST costs and cash flow. In some jurisdictions, receivables may be outstanding for months or even years. Understanding how and where credits arise and taking action to deal with excessive delays and “crunch points” can greatly improve management of working capital.

Business start-up costs

Setting up a new company, starting a new business venture or entering a new market is a crucial stage in the life of any business, when effective cash management is vital to success. These phases can also be common sources of excess input tax credits, because most new businesses pay VAT/GST on setup costs before they start to trade and charge VAT/GST on their sales.

However, only 55 of 120 countries refund input VAT/GST incurred on preregistration costs. Engaging in strategic planning and taking action can greatly improve VAT/GST cash flow and reduce additional VAT/GST costs.

Exploring alternatives may help new businesses to avoid incurring irrecoverable VAT/GST on setup costs or to greatly reduce the financial impact of long delays.

Avoiding or reducing domestic VAT/GST credits

Managing VAT/GST refunds and credits involves looking critically at the VAT/GST you pay and identifying ways to reduce or avoid accumulating sticking tax and excess credits. One of the most effective ways to manage refunds is to avoid incurring excess input tax.

Effective strategies to mitigate excess input tax may include identifying opportunities to buy goods and services VAT/GST-free (e.g through VAT/GST grouping), to accelerate refunds (e.g., as a frequent exporter) or to use reverse charge accounting (e.g. by purchasing services cross-border).

Managing customs duty refund opportunities

More than ever, effectively managing global trade requirements and costs is crucial to obtaining and maintaining a competitive advantage.

Free trade agreements

Effectively identifying and using free trade agreements (FTAs) can significantly reduce, or even eliminate, duty costs. With more than 400 trade agreements in force, optimising utilisation has become a primary focus of many importers.
While the fullest benefit of FTAs is achieved when claims for preferential treatment are made at the time of entry, importers should remember that many agreements do permit refunds for a certain time after entry. However, in today's environment, the FTA climate is changing.

This is illustrated by the US withdrawing from the Trans-Pacific Partnership and the potential renegotiation of the North American Free Trade Agreement (NAFTA). Such moves may signal a shift away from large multilateral agreements to more bilateral agreements. Companies should be mindful of how potential changes might affect their overall duty impact.

Duty drawback

Duty drawback is a refund mechanism used globally, typically to promote job creation for manufacturing and export activity. The specific drawback opportunities and requirements vary by jurisdiction.

Generally, duty drawback programs permit refunds of customs duties, fees and taxes paid in connection with the importation of products if those goods (or like-kind goods) are later exported or destroyed.

Classification

Correct classification of goods is necessary to properly assess customs duties. In most countries, incorrect classification can result not only in penalties for the importer but also in overpayment or underpayment of duties.

With average rates of 2% to 3%, duties are not an insignificant cost, and they can directly affect a company's bottom line. Compliance objectives aside, correcting classification errors can be worthwhile, particularly in jurisdictions where an importer can obtain a refund for overpaid duties.

Valuation

Refund opportunities may be available for companies importing from related parties where transfer pricing adjustments occur. These adjustments may change product pricing. A downward adjustment may result in a duty refund, while an upward adjustment will require additional payment of duties.

Managing excise duty refund opportunities

Excise taxes apply to specific goods and services, and they are often seen as an inevitable cost of doing business in industries that produce and sell alcohol, tobacco, fossil fuels and snack foods.

But these taxes apply to different products in different countries, sometimes at different stages of the supply chain; opportunities to reduce the impact of excise duties also vary between countries.

Managing excise taxes and understanding opportunities to mitigate their impact are crucial for all businesses operating in affected industries.

EY

TAX ADMINISTRATION

2675. Condonation for late appeal

On 5 October 2017, SARS released a string of Tax Court decisions. Included in these is the case of *ABC (Pty) Ltd v The Commissioner for the South African Revenue Service* (Case number 0018/2016) (ABC Case), which deals with the question of whether the taxpayer was entitled to condonation for the late filing of an appeal in terms of section 107(2) of the Tax Administration Act, 2011 (the TAA).

By way of background, once a taxpayer has been issued with an assessment, the dispute resolution process can be summarised, in simple terms, as follows:

- to the extent that the grounds provided in the assessment do not sufficiently enable the taxpayer to understand the basis of the assessment, the taxpayer may request SARS to provide reasons for the assessment;
- the taxpayer may object against the assessment and SARS must consider the objection and either disallow or allow it in whole or in part;
- if the taxpayer is dissatisfied with SARS's decision following the objection, the taxpayer may lodge an appeal against such decision; and
- the dispute may be resolved either through alternative dispute resolution, the Tax Board or the Tax Court.

An objection or appeal against assessments or decisions by SARS must be lodged in the manner, under the terms and within the periods prescribed in the rules promulgated under section 103 of the TAA (the Rules). An objection against an assessment or decision must be lodged within 30 business days of the date of assessment or decision. Similarly, an appeal against the disallowance of an objection must be lodged within 30 business days of the date of the disallowance of the objection.

An objection or appeal that is not lodged within the prescribed time limits (as discussed above) is deemed to be invalid. A taxpayer may, however, request a senior SARS official to extend the period within which such an objection or appeal may be lodged. More specifically, section 107(2) of the TAA states that a senior SARS official may extend the period for lodging an appeal for:

- 21 business days if satisfied that reasonable grounds exist for the delay; or

- up to 45 business days, if exceptional circumstances exist that justify an extension beyond 21 business days.

The TAA does not prescribe the manner in which the discretion to extend the period for lodging an appeal must be exercised. As a result, regard must be had to SARS's Interpretation Note 15 (Issue 4) (IN 15) which deals with the exercise of a discretion in the case of a late objection or an appeal. IN 15 provides, at page 4, that the senior SARS official's decision "must comply with the requirements for administrative justice which are contained in section 33 of the Constitution of the Republic of South Africa, 1996 read with the Promotion of Administrative Justice Act" and must be reasonable. In order for a decision to be reasonable, the senior SARS official is required to consider all relevant matters, which, among others, include:

- the reasons for the delay;
- the length of the delay;
- the prospects of success on the merits; and
- any other relevant factor.

With the abovementioned background in mind, we discuss the ABC Case in more detail below.

Facts

On 9 December 2013, ABC Pty Ltd (the Applicant) timeously lodged an appeal (First Appeal) against SARS's partial disallowance of an objection for the 2012 year of assessment. The First Appeal was uploaded on eFiling by the Applicant's accountant (Mr X), who made the following note on a hard copy of the First Appeal: "ADSL … repaired faulty line 6.12.2013". Mr X submitted that at the time of uploading the First Appeal, the ADSL lines in the neighbourhood where he conducts business had been disrupted.

On 30 June 2014, Mr X was advised that (i) SARS had no record of the notice of appeal and (ii) a further appeal should be filed in which Mr X requests condonation for the late submission of the appeal. Two days after Mr X became aware that the First Appeal had not been filed, Mr X did as advised and submitted a further appeal (Second Appeal) where he cited the disruption of the ADSL lines as a basis for the condonation.

SARS refused to grant the condonation on the basis that the Second Appeal was submitted out of time. Following the submission of a further appeal (Third Appeal) and the further refusal by SARS to grant the condonation, the Applicant approached the Tax Court by way of an interlocutory application.

Arguments by the parties to the application

SARS provided that the main reason for its inability to grant the condonation is that section 107 of the TAA "curtails its powers to come to the assistance of the Applicant" on the basis that SARS may only extend the time period granted under the Rules (that is, 30 days):

- by a further 21 days, thus 51 days in all where there are reasonable grounds; and
- a further period of 45 days, that is 75 days if exceptional circumstances exist.

On the other hand, the Applicant contended that section 107(2) should be interpreted to mean that the time period referred to therein must be calculated from the date of the request. The Applicant's argument was that following SARS's interpretation of section 107 would render the discretion given to SARS by the legislation meaningless, especially in circumstances where the taxpayer only became aware of the fact that the appeal had not in fact been submitted, in the prescribed manner after the expiration of 75 business days.

Tax Court's findings

The court referred to the Constitutional Court judgment of *Ferris v First Rand Bank Limited,* 2014 (3) SA 39 (CC) which found that in condonation applications, a delay cannot be a determining factor. In addition, the Tax Court noted that when dealing with a request for condonation, there are other important considerations to take into account, namely:

- *Whether or not the omission or failure was due to the fault of the Applicant*

  The court found that the late filing of the notice of appeal was not an omission nor a failure on the Applicant's part, as the First Appeal was lodged within the prescribed 30-day period.

  The extent of the delay and steps taken by the Applicant as soon as it became aware there was non-compliance with the Rules.

  The court held that the First Appeal was not recorded on the eFiling platform due to a technological problem and that the Second Appeal was lodged within two days of Mr X becoming aware of the fact that the First Appeal had not been lodged.

- *Whether or not the condonation would prejudice SARS*

  The court found that the granting of the condonation would not prejudice SARS on the basis that the notices of appeal and supporting documents had been available on the Applicant's eFiling profile since December 2014. In addition, the court found that there would be a great prejudice to the Applicant if the request for condonation was not granted.

- *There must be reasonable prospects of success on appeal*

  The court found that at the time of the disallowance of the objection, SARS had not provided reasons for the disallowance. The court stated that the fact that SARS had failed to tender any explanation was a strong indication that there were good prospects of success on appeal.

On the basis of the above, the Tax Court granted the condonation, with leave to the Applicant to file its notice of appeal.

Conclusion

It is clear that taxpayers will welcome this Tax Court judgement. However, taxpayers who wish to dispute an assessment issued by SARS must lodge the objection or appeal within the prescribed time. To the extent that a taxpayer does not comply with the relevant periods, such taxpayer must ensure that he or she has adequate reasons which will support the request for condonation.

Cliff Decker Hofmeyr

Section 107(2) of the TAA

SARS Interpretation Note 15 (issue 4)

2676. PAJA versus TAA

The Tax Administration Act (TAA) confers considerable powers on SARS to enforce the collection of taxes. It is frequently questioned whether, and to what extent, the intervention of a Court might be sought in order to limit the exercise of these powers. In a recent decision, the Pretoria High Court undertook such an intervention.

One of the primary concerns of taxpayers is the operation of the ‘pay now, argue later’ principle. The operation of the principle compels taxpayers to make payment of amounts assessed pending objection or appeal, notwithstanding that the assessment may be disputed. Where a taxpayer does not make payment, SARS is given additional powers to recover the taxes due. One such power is a right to set off the amount of such taxes against amounts that are owed by SARS to the taxpayer by way of refund.

The facts

In the matter of *A Way to Explore v C:SARS [2017] ZAGPPHC 541*, the company A Way to Explore (the Applicant) had submitted VAT returns claiming a refund of input tax, which arose primarily by reason of the fact that its main business was the provision of services to non-resident persons while such persons were physically outside the Republic. As a result, the supply of such services was a zero-rated supply, whereas VAT was incurred in respect of goods and services procured by the Applicant for the purpose of providing such services.

SARS had requested information to enable it to verify the returns submitted. The Applicant, through its managing director, submitted information which it understood to represent the information requested in respect of input tax and output tax. The information was incomplete in the sense that the information relating to output tax that was supplied contained details only of standard-rated supplies. No information was provided in respect of zero-rated supplies.

SARS made repeated additional requests for the information to be provided, but these were ignored by the company, which considered that it had already made full disclosure of the information requested. The Applicant's accountant made a telephonic inquiry to SARS concerning the notices and was informed that the matter was in the hands of the auditors and that the Applicant should await notification from the auditors.

Two months after this discussion, SARS issued additional assessments in which the supplies that had been classified as zero-rated in the VAT return were assessed to VAT at the standard rate. The stated reason for such assessment was that 'the burden of proof was not discharged for zero rating the services'.

The Applicant did not request reasons for the assessment upon receipt of the notification. Its explanation was that the assessment had apparently been issued in error, as all of the previous VAT returns had been assessed on the basis that similar supplies were subject to tax at the zero rate.

There followed attempts to note an objection to the assessment. The first attempt was by way of a letter filed by the Applicant's accountant, which was ruled invalid because it was not made in the prescribed form. A second attempt was made after expiration of the time for filing a notice of objection. The reasons for the delay were considered insufficient to warrant condonation of the late filing of the objection, leading to the objection being declared invalid. However, the Applicant was given time to file an additional notice of objection to remedy the defect.

The Applicant then filed an additional notice of objection and a request for condonation of late filing of the objection. In this instance, it provided proof of the zero-rated supplies by attaching the relevant invoices to its notice of objection. At a date not specified in the judgment, but subsequent to the filing of the additional notice of objection, SARS enforced recovery of the amounts that had been assessed by way of the additional assessments by setting them off against refunds that were payable to the Applicant.

The Applicant therefore sought relief under the Promotion of Administrative Justice Act (PAJA) on the basis that it had been subjected to unreasonable administrative action.

The arguments

The Applicant alleged that SARS had not observed the procedural requirements relating to the audit that it had conducted before issuing the assessments. It therefore sought to have the additional assessments that were raised following the audit set aside.

The thrust of the argument was that, at the conclusion of an audit, and in conformity with section 42 of the TAA, SARS must notify the Applicant of its findings and provide the Applicant a period of 21 days within which to respond to the findings. This, it alleged, had not happened. Therefore, it urged, the assessments should be declared invalid.

SARS argued that it had repeatedly sought the required information from the Applicant and had, before issuing the assessments, issued a final notice to the Applicant of its failure to respond to requests for information. Only thereafter was the audit concluded and assessments raised.

The decision

Two aspects of the decision are notable.

The first is that the Applicant had filed an objection to the assessments, which had not yet been adjudicated. It is a requirement that applications for a review of administrative decisions may be entertained only once all internal remedies have been exhausted (PAJA section 7(2)(a)). The Court was not in a position to grant a request to set aside assessments in these circumstances.

The second was that the decision to effect a set-off of a liability to tax against a refund due to the Applicant had been taken without notification to the Applicant. In this regard, Khumalo J stated at paragraph 40:

> '… I find it iniquitous and excessive that whilst the process of objection is still pending, the Respondent proceeded to effect a set-off payment, especially under the circumstances where the Applicant was not alerted or

> afforded an opportunity to make submissions to the Respondent's intention to implement a corrective payment after the assessment. It would therefore be just and curb any prejudice on the Applicant if the effect of the decision to set-off is suspended pending the outcome of the process of objection and for the Applicant to be afforded an opportunity to comment or make submissions on the set-off.'

The set-off was suspended and the Applicant was given time to make submissions to SARS concerning the decision to effect set-off.

Conclusion

There is no evidence in the judgment that Khumalo J considered the application of section 191 of the TAA. This section provides:

> 'If a taxpayer has an outstanding tax debt, an amount that is refundable under section 190, including interest thereon under section 188(3)(a), must be treated as a payment by the taxpayer that is recorded in the taxpayer's account under section 165, to the extent of the amount outstanding….'

Section 164 of the TAA entitles a taxpayer to request suspension of payment pending objection or appeal and requires that the taxpayer request such suspension in writing. In the event that a request for suspension is granted, section 191(2) provides that the right of set-off may not be exercised.

The decision to suspend the set-off is difficult to justify, where the Applicant appears not to have requested a suspension in the manner provided in the TAA. If suspension of payment is an internal remedy, should the Court not have dismissed the issue on the ground that the Applicant had not resorted to a request for suspension of payment and consequently had not exhausted all internal remedies?

In passing, a post on an internet site (Moneyweb, 18 September 2017), noted that SARS has been approached by tax practitioners concerning its precipitate action in attaching funds in taxpayers' bank accounts to enforce payment of taxes after applications for suspension of payment had been lodged with SARS, but had not yet been finally adjudicated. A SARS representative reportedly stated that all such cases will be investigated.

It is recommended that persons who dispute assessments and have substantial prospects of success should ensure that they seek suspension of payment and prosecute objections without undue delay. This represents the most reliable basis for ensuring that precipitate action by SARS to collect payment can be contested.

PWC

TAA: Sections 42, 164 and 191

PAJA: Section 7(2)(a)

2677. The pay-now-argue-later rule

One of the most feared provisions of the Tax Administration Act, 2011 (the TAA) is section 164(1), which states that:

> 'Unless a senior SARS official otherwise directs ...
> (a) the obligation to pay tax; and
> (b) the right of SARS to receive and recover tax will not be suspended by an objection or appeal or pending the decision of a court of law pursuant to an appeal...'

This is colloquially known as the pay-now-argue-later rule, namely, that a taxpayer is obliged to pay the tax reflected in an assessment as being due even if he disputes the correctness of the assessment.

This statutory rule stands on its head the usual legal principle that, if a debt is disputed, the alleged debtor has no legal obligation to pay the amount claimed from him unless and until a court of law rules that he is indeed so obliged and enters judgment against him.

In *Metcash Trading Limited v Commissioner for the South African Revenue Service [2000]*, ZACC 21; 2001 (1) SA 1109 (CC) the Constitutional Court held that a similar provision in the Value-Added Tax Act, draconian though it may be, is not unconstitutional.

SARS is thus fully entitled to enforce the pay-now-argue-later rule and in practice usually does so.

The taxpayer is entitled to request a suspension of the obligation

The draconian impact of the rule is, however, ameliorated by section 164(2), which provides that:

> 'A taxpayer may request a senior SARS official to suspend the payment of tax...due under an assessment if the taxpayer intends to dispute or disputes the liability to pay the tax.'

Section 164(3) then says that a senior SARS official:

> 'may suspend payment of the disputed tax ....having regard to relevant factors including ...'

Then follows an itemised list of five factors, including whether the recovery of the disputed tax will be in jeopardy, whether there is a risk that the taxpayer will dissipate his assets, and the taxpayer's compliance history vis-à-vis SARS.

The Act does not give an exhaustive list of factors justifying suspension of the obligation

Since section 164(3) refers to relevant factors including those listed, it is clear that the statutory list of relevant factors is not exhaustive; thus, other factors not listed may be relevant to SARS' decision whether or not to suspend the obligation to pay the disputed tax.

This provision does not accord any relative weight to the various items in the list either.

There has, to date, been no reported judgment by a South African court in which the court has been called on to scrutinise a decision by a senior SARS official not to suspend the taxpayer's obligation to pay an assessed amount of tax in terms of this provision, and to determine whether that decision should be set aside on review as irrational.

A recent decision of the Zimbabwean courts

In light of this uncertainty, the recent decision of the Supreme Court of Zimbabwe in *Zimbabwe Revenue Authority v Packers International (Private) Ltd* (2017) 79 SATC 140 is tantalising for holding out the promise of casting light on the circumstances in which the tax authorities should, as a matter of law, accede to a taxpayer's request for a suspension of the obligation to pay an amount of assessed tax until a court has given judgment on the matter.

However, in this reported judgment the taxpayer lost that invaluable opportunity in failing to make such a request for suspension, and the taxpayer instead embarked on a wrong-headed strategy to stop the Zimbabwean revenue authorities from enforcing the disputed assessment.

The assessment in question was for the eye-watering sum of over 19 million US dollars, a liability so large as to be financially catastrophic for the taxpayer.

The Zimbabwean legislation contains similar provisions to those in South African law

The Zimbabwean tax legislation contains similar provisions to those in the TAA, firstly obliging a taxpayer to pay the amount of tax reflected in an assessment, notwithstanding that the taxpayer is contesting the assessment, but also giving the tax authorities the power to suspend the obligation to pay the disputed tax until a court gives judgment on the dispute.

The Supreme Court of Zimbabwe made the important observation at page 144 of the judgment that:

> '[T]he Commissioner [for the Zimbabwean tax authorities] cannot exercise the discretion [to suspend the payment of assessed tax] *mero motu* [i.e. on his own initiative]. He can only do so upon consideration of facts presented to him by a taxpayer who wishes to benefit from the exercise of discretion by the Commissioner. As a consequence, the taxpayer bears the onus to place the necessary facts before the Commissioner regarding the hardships facing him should the obligation to pay not be suspended.'

In other words, a taxpayer who seeks a suspension of the obligation to immediately pay a tax assessment must make a formal request for such suspension and set out the grounds for his request. If the taxpayer fails to make such a request and put forward such grounds, the tax authority cannot grant such a suspension on its own initiative.

Nor, it seems, would the court have the inherent power to order a suspension of the obligation to pay, for this would be to usurp a power vested solely in the revenue authorities.

The Supreme Court of Zimbabwe then quoted from an earlier judgment *(Mayor Logistics (Pvt) Ltd v ZIMRA SC 7/14),* which held that:

> '[A]s the facts on which the Commissioner would exercise the discretion would be within the exclusive knowledge of the taxpayer he or she must place them before the Commissioner.'

The court (at page 150) said that the issue will then arise as to:

> 'whether or not any facts have been placed before the Commissioner on whether or not there exist hardships which would justify a suspension of the obligation to pay assessed tax by a taxpayer.'

Unhappily for the taxpayer in this case, he failed to request a suspension of the obligation to pay the assessed tax and instead put forward an entirely different (and ultimately unsuccessful) argument that the enforcement and tax collection measures taken by the Revenue Authority should be halted by the court on constitutional grounds.

A catastrophic strategic error by the taxpayer

The failure to request suspension of the obligation to pay the assessed tax was an egregious strategic error by the taxpayer and his professional advisers for, as the court went on to say (at page 153):

> 'A court of law cannot go outside the pleadings on a dispute before it.'

In other words, a taxpayer who seeks a suspension of the obligation to immediately pay a tax assessment must make a formal request for such suspension and set out the grounds for his request. If the taxpayer fails to make such a request and put forward such grounds, the tax authority cannot grant such a suspension on its own initiative.

In this case, as was noted above, the taxpayer failed to request a suspension of the obligation to pay the disputed tax, and consequently could not argue in the Supreme Court that the Revenue Authority should have granted the request, or that the court should now order such a suspension.

Instead, the taxpayer in this matter chose to argue his case on the basis that the Revenue Authority had breached his constitutional rights by acting arbitrarily, that is to say, with no rational basis, in issuing the disputed assessment.

Here again, the taxpayer and his legal team misconceived the true nature of their case.

What the taxpayer should have done was, first, to request a suspension of the obligation to pay the assessed tax and then, if the Revenue Authority turned down the request, argue that the decision to refuse the request was arbitrary and lacked a rational basis.

Having failed to make such a request for suspension, the taxpayer was now painted into the corner of having to put forward the shaky argument that the assessment to tax issued by the Revenue Authority was itself arbitrary and should be set aside by the court (see page 153) because, in the words of the taxpayer:

> '…the figure it is claiming has been made arbitrarily without any justification...

> It is arbitrary in the sense that [the Revenue Authority] estimates the figure it feels [the taxpayer] should pay… [and] has deliberately ignored the figures given by the [taxpayer] voluntarily and chose to rely on an unjustified estimate.'

This argument was a non-sequitur in all its facets.

What the taxpayer was, in effect, arguing was that the amount of tax reflected in the disputed assessment was wrong, or to be precise, the taxpayer's argument was that the amount was wrong because the Revenue Authority did not utilise the figures supplied by the taxpayer.

Even if it were true that the amounts taken into account by the Revenue Authority in arriving at the tax reflected in the assessment were not correct, that would not in itself make the assessment arbitrary. It would merely make the amount of the assessed tax wrong, and the way that a taxpayer contests a disputed assessment is by lodging a formal objection to the assessment – he cannot attack the assessment as being invalid, that is to say, of no legal force.

Conclusion

Although this decision of the Zimbabwean Supreme Court is not binding on South African courts, it seems safe to say that the approach taken by the court in this judgment holds true in terms of the TAA, namely:

- the power to suspend the obligation to pay an assessed amount of tax is vested in a senior SARS official;
- a taxpayer who seeks to have the obligation to pay an assessed amount of tax suspended, pending the judgment of a court, must make a formal request for such suspension;
- the onus is on the taxpayer to set out grounds for the requested suspension; and

- if no such request is made, neither SARS nor the High Court has the power to grant a suspension of the obligation to pay the disputed tax.

To these principles, it is suggested, the following can be added:

- if a suspension of the obligation to pay an assessed amount of tax is duly requested by the taxpayer, and the request is refused, such a decision is not subject to objection or appeal and the decision by SARS to refuse to accede to the request can be taken on review to the High Court in terms of the Promotion of Administrative Justice Act, 2000 (PAJA); and
- an aggrieved taxpayer may ask for such decision to be set aside as arbitrary or irrational. SARS, in deciding whether to grant a suspension of payment to a taxpayer, must adhere to the rules of administrative justice in section 33 of the Constitution and section 3 of PAJA.

PWC

TAA: Sections 164(1) and (3)

The Constitution: Section 33

PAJA: Section 3

TRANSFER PRICING

2678. Value chain analysis

Attacks by SARS on the transfer pricing practices of multinational enterprises (MNEs) are on the rise, leading to tax disputes with SARS over significant amounts of tax.

MNEs operating in South Africa provide information to SARS in various forms such as annual Corporate Income Tax returns, Country-by-Country reports as well as the extensive transfer pricing documentation. It is therefore important to ensure that all information submitted to SARS in these various formats is aligned as any difference could assist SARS in challenging not only the transfer pricing policies but ultimately also the tax structure of the group as well as the substance of how a group operates across the globe.

While a Functional Analysis identifies the functions performed, the risks assumed and the assets utilised by various members of an MNE, it has also become important to do a proper Value Chain Analysis (VCA) in order to identify the jurisdictions where the key functions are performed, where the real value is created and where the actual profit is. A proper VCA will provide a much clearer picture as to whether the profits of an MNE are actually generated in those jurisdictions where the real value is added, critical information for preparing a response to any attack from SARS on the transfer pricing policies of the MNE.

Intangibles vs value enhancers vs synergies

In conducting a VCA, it is important to distinguish between intangibles, value enhancers and synergies.

Intangibles are defined as physical or financial assets that are owned or controlled for use in commercial activities and the use or transfer thereof will be compensated had it been a transaction between independent parties.

Value enhancers are generally hard to identify, not registered or protected and not recognised for accounting purposes (off balance sheet item).

Group synergies could contribute to the amount of income earned by an MNE and could include:

- streamlined management;
- elimination of cost duplication;
- integrated systems; and
- increased capacity to borrow.

Synergies should, however, not be confused with passive associations, as incidental benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted action need to be separately compensated or allocated. Where synergy is indeed the result of deliberate concerted action, it is necessary to evaluate:

- the nature of the advantage or disadvantage;
- the amount of the benefit or detriment provided; and
- how that benefit or detriment should be divided among members of an MNE group.

The benefits of synergies should, in general, be shared by members of an MNE group in proportion to the contribution each member makes in the creation of the synergy. For instance, benefits from large scale purchasing synergies should be shared in proportion to purchase volumes.

A Central Purchasing Office (CPO) is a good example of concerted action that could result in discounts or gain. These discounts and gains should be shared by the members of the MNE group based on purchase volumes while the CPO will receive a service fee as compensation for its services. However, if the CPO has unique skills, competencies, leverage or intangible assets, a portion of the gains realised by the CPO can be retained or a higher margin should be added to the cost of the CPO on calculating its service fee. In fact, the compensation earned by the CPO will depend on the purchasing model used such as being a buy-sell distributor or merely acting as an agent.

Location savings vs market characteristics

Location savings are another aspect that has to be carefully considered during a VCA and in considering the impact of location savings, it is important to differentiate between:

- local market advantages or disadvantages that may not be directly related to location savings; and
- cost savings that are attributable to operating in a particular market.

Local market features include aspects such as disposable income of households and the size and competitiveness of the market. Location savings should be differentiated from market features and are not considered to be an intangible. Location savings include cost savings through operating the same business in different markets as well as additional profits derived by operating in a jurisdiction with unique qualities, impacting on the sale and demand of the services or products offered by an MNE group. Such location savings should be allocated among the members of an MNE based on functions performed, risk assumed and assets utilised.

Legal ownership vs functions performed, risks assumed and assets utilised

Although the legal owners of an intangible within an MNE group are entitled to the proceeds from the exploitation of such intangible, other members of the MNE group may have performed functions, or assumed risks or utilised assets which contribute to the value of the intangible.

These other members of the group must then be compensated for this contribution under the arm's length principle. In other words, legal ownership of an intangible no longer confers the ultimate right to returns to the owners of an intangible within the MNE group. In other words, the development, enhancement, maintenance, protection and exploitation, in short "DEMPE", of an intangible, and not only the beneficial ownership of such intangible, should also be considered when allocating the compensation earned from an intangible.

The sooner MNE groups come to grips with the new transfer pricing realities, the sooner they will be able to reduce their tax disputes with SARS.

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SARS NEWS

2679. 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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