INTEGRITAX

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COMPANIES

2611. Hedge fund collective investment scheme

Before 1 April 2015, hedge funds were unregulated and were constituted (broadly speaking) as limited liability partnerships or trusts. For tax purposes, these structures functioned as flow-through entities with investors being responsible for the disclosure and payment of tax resulting from investment activities. As such, fund managers were not typically involved in the disclosure of and accounting for the tax resulting from investment activities.

However, on 1 April 2015, this changed when a hedge fund was declared to be a portfolio of a collective investment scheme. The impact of this declaration was that an unregulated portfolio of a hedge fund was required to transition to a regulated portfolio of a hedge fund collective investment scheme (hedge fund CIS).

By now, most unregulated hedge funds would have transitioned or will soon transition to a hedge fund CIS, raising the question whether the tax implications of the hedge fund, the investors and manager will differ subsequent to the transition.

After the transition, the investor would hold a participatory interest in a hedge fund CIS. This is a different asset from the one the investor held prior to the transition and it will have different tax implications, which we summarise below. In addition, the hedge fund CIS constitutes a person for tax purposes and is liable for the disclosure and payment of taxes in its own name whereas an unregulated fund constituted as a limited liability partnership or vesting trust would effectively have been transparent for tax purposes.

After the transition, the differences in tax treatment are as follows:

- From the investor’s perspective, it would be taxed only on amounts distributed by the hedge fund CIS and its proceeds when it disposes of its participatory interest in the hedge fund CIS. To the extent that the distributions by the hedge fund CIS constitute interest and dividends, the tax implications for the investor should not differ from the unregulated structure. However, if any amounts not of a capital nature are not distributed to the investor within 12 months after accrual, the investor would not disclose or pay tax on such amounts since these would be accounted for in the hedge fund CIS. Gains made on the sale of the participatory interest by the investor would be of a capital nature and subject to capital gains tax if the participatory interest was held on capital account. Gains made on the sale of the participatory interest by the investor would be of a revenue nature and subject to normal tax if held as a trading asset, unless the participatory interest is held for a period of at least three years.

- From the perspective of the hedge fund CIS, seeing that it constitutes a person for tax purposes, it is required to submit tax returns and to account for tax in respect of all amounts that it did not distribute or which are not subject to a specific exemption. The hedge fund CIS is further required to submit certain third party returns to the South African Revenue Service. The hedge fund CIS therefore picks up tax risk, in that it is required to disclose and account for amounts not of a capital nature that are not distributed to its investors. Incorrect disclosure or payment of tax may result in the hedge fund CIS being liable for interest, penalties and/or criminal liability in certain instances.

- From the manager's perspective, its own tax implications in respect of the management fees would not change, but as it is responsible for the financial affairs of an entity that is a taxpayer in its own right, being the hedge fund CIS, it may potentially pick up secondary tax liability. For example, the Tax Administration Act, 2011 (the TAA) contains withholding agents and third party liability provisions which may, in certain instances, apply to the manager.

- Furthermore, the TAA contains provisions that make certain acts or omissions criminal offences. The impact of these provisions should be carefully considered by the hedge fund CIS, the trustees and the manager to determine the risks and impact of these provisions, particularly to the extent that these provisions relate to the compliance obligations of the hedge fund CIS for which the manager would typically be responsible.

On the basis set out above, the tax implications and compliance requirements post-transition may be very different for the hedge fund, the investors and the manager when compared with the situation before the transition.

ENSafrica
ITA: Sections 9C and 25BA
TAA: Sections 156, 157, 158 and 159

GROSS INCOME

2612. Contingent liabilities assumed in a going concern sale

The South African Revenue Service (SARS) has released a very comprehensive and detailed analysis of the issue in their Interpretation Note 94, dated 19 December 2016 (IN94), which concluded that:

"when the seller disposes of a business as a going concern and the purchase price of the assets disposed of is partly settled by the purchaser assuming a free-standing contingent liability –

- the seller must include the agreed value of the free-standing contingent liability assumed by the purchaser in gross income and proceeds (as appropriate);
- the seller does not incur expenditure in relation to the assumption of the free-standing contingent liability by the purchaser and is not entitled to a deduction;
- the purchaser will incur expenditure only if the free-standing contingent liability materialises and the purchaser is required to incur expenditure in settling the liability at that time; and
- in the purchaser's hands, the assumption of the free-standing contingent liability relates to the assets acquired and any deduction must be

> determined with reference to the deduction and allowance provisions which apply to the particular assets whose purchase price was settled or partly settled by the assumption of the free-standing contingent liability.

Embedded obligations and valuation provisions ... depress the value of the asset and do not represent an additional amount of proceeds."

In arriving at these conclusions, SARS draws a distinction between free-standing liabilities and liabilities that relate to particular assets. SARS also draws a distinction between liabilities that are taken over as a free-standing item, and liabilities that are taken over as a way of paying for the business being acquired.

Importantly, SARS' application of the latter distinction appears to follow the reasoning put forward by the Privy Council in *Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd* [2001] 250 ITR 819 (PC), wherein it was held that expenditure incurred in respect of provisions taken over was incurred as part of the purchase price, which was capital in nature and therefore not deductible.

IN94 accordingly seems to suggest that SARS disagrees with the potentially contradictory views which have been touched upon by the tax court in South Africa when dealing with this topic.

Taxpayers should therefore be careful to ensure that they obtain comprehensive tax advice when considering the structure of, *inter alia*, M&A transactions involving contingent liabilities, in order to avoid unnecessary uncertainty and/or disputes with SARS.

ENSafrica

ITA: Section 1(1) – definition of 'gross income' and paragraph 35 of the Eighth Schedule

SARS Interpretation Note 94

PROVISIONAL TAX

2613. Penalties on underpayment

Under paragraph 20(1) of the Fourth Schedule to the Income Tax Act, 1962, (the Act), if the actual taxable income of a provisional taxpayer, as finally determined under the Act, exceeds R1 000 000 and the estimate made in the return for the payment of provisional tax, the second provisional tax payment, is less than 80% of the amount of the actual taxable income, the Commissioner is obliged to levy a penalty, which is regarded as a percentage based penalty imposed under Chapter 15 of the Tax Administration Act, 2011 (the TAA).

The penalty, in the case of a company, amounts to 20% of the difference between the amount of normal tax calculated using the corporate tax rate of 28% in respect of the taxable income amounting to 80% of the actual taxable income and the amount of provisional tax in respect of that year of assessment paid by the end of the year of assessment.

Paragraph 20(2) of the Fourth Schedule confers a discretion on the Commissioner to remit the penalty or a part thereof where he is satisfied that the estimate of taxable income was seriously calculated with due regard to the factors as having a bearing thereon and was not deliberately or negligently understated.

The Port Elizabeth Tax Court was required to adjudicate a matter relating to the imposition of a penalty on the underpayment of provisional tax in Case No. IT14027, as yet unreported, where judgment was delivered on 7 December 2016.

ABC (Pty) Ltd was a provisional taxpayer which delivered its return for payment of provisional tax for the 2010 year of assessment on 30 June 2011. In its return of provisional tax, it estimated the taxable income for the year of assessment and made payment in accordance with its estimate. Sometime later it appeared that the actual income received substantially exceeded the estimate made by the company. As a result, the South African Revenue Service (SARS) imposed an underestimation penalty in terms of paragraph 20 of the Fourth Schedule.

The company lodged an objection which was rejected by SARS and resulted in an appeal which was decided in its favour by the Tax Board. SARS subsequently appealed the decision of the Tax Board to the Tax Court for a hearing *de novo* and subsequently filed a statement of grounds of assessment and opposing the appeal.

In reply, ABC (Pty) Ltd filed its statement of grounds of appeal according to the Tax Court rules. In its grounds of appeal the company abandoned all of the grounds raised in its original objection and in its notice of appeal and sought to rely only on the procedural ground raised for the first time by the chairperson of the Tax Board upon which he had found in favour of the company.

SARS subsequently filed a notice of exception arguing that the company could not rely on a new ground of objection not previously contained in its grounds of objection.

The company originally estimated its income for the 2010 year of assessment in an amount of R431 638,00 and made payment of provisional tax amounting to R64 905,54. Later, on 30 September 2011 the company made a further payment of R1 377 466,22. Subsequently, the company filed its income tax return reflecting a taxable income for the year of assessment amounting to R5 050 076,00.

By virtue of the large difference between the tax actually due per the final taxable income and the provisional tax paid, SARS imposed the underestimation penalty in terms of the provisions of the Act. SARS rejected the objection lodged by the company on the basis that the company did not seriously calculate its taxable income as required.

The TAA had not yet come into force by the time that the company's objection had been disallowed and its notice of appeal lodged. The Tax Board decided that the Commissioner was correct in rejecting the company's objection and that the appeal should be dismissed on its merits.

However, the chairperson of the Tax Board *mero motu* raised a procedural issue under the TAA which had since come into force and decided in favour of the company. The chairperson of the Tax Board reached the view that the manner in which SARS had dealt with the imposition of the penalty was in conflict with Chapter 15 of the TAA, especially sections 214 and 215 thereof.

The Tax Court had to consider whether the company could lawfully amend its grounds of objection even though the matter was already on appeal. Tax Court Rules do not provide for an amendment to the taxpayers' grounds of objection and the Court therefore referred to the rules of the High Court.

The Tax Court considered the various provisions of the TAA and made the decision that SARS's exception to the company's application should be upheld and that the application for the amendment of the company's grounds of objection should be dismissed. The Court therefore dismissed the company's appeal and confirmed the penalty imposed on the understatement of provisional tax.

Based on the judgment it is concluded that taxpayers need to exercise extreme caution in calculating taxable income for purposes of provisional tax, failing which they will become liable to the 20% underpayment penalty.

Furthermore, when a taxpayer disputes the imposition of a penalty, or in fact any assessment, it is important that the grounds of objection are properly formulated as it is not possible to subsequently amend the grounds of objection.

ENSAfrica
ITA: Paragraph 20 of the Fourth Schedule
TAA: Sections 214 and 215 (Chapter 15)

TRANSFER PRICING

2614. Documentation requirements

The final regulations relating to country-by-country reporting standards (the CbC Regulations) have been published by the South African Minister of Finance (Regulation No. R. 1598 published in Government Gazette No. 40516) on 23 December 2016. It is therefore important to take stock and consider the CbC Regulations in the context of various other South African developments regarding the implementation of the recommendations contained in the final Action 13 report issued by the Organisation for Economic Cooperation and Development (OECD) on transfer pricing documentation.

Accordingly, we have summarised below the current status of the master file/local file returns that also form part of the OECD's Action 13 report, the Final Notice on Transfer Pricing Record Keeping Requirements, issued by the South African Revenue Service (SARS), as well as the transfer pricing disclosure requirements in the corporate income tax return (ITR14).

CbC Regulations

The CbC Regulations are, to a large degree, in agreement with the recommendations contained in Action 13, including the CbC Report model template as set out in Annex III.

South African taxpayers that are part of multinational enterprise groups, as defined, need to determine whether they have a filing and/or notification requirement under the CbC Regulations.

In this regard, where the ultimate parent entity of a multinational enterprise group is a South African tax resident and has a consolidated group turnover of more than ZAR10 billion (or, in certain circumstances, EUR750 million), it must file a CbC report with SARS as well as notify SARS of the fact that it is the ultimate parent entity.

A South African member of a multinational enterprise group that is not the ultimate parent entity, or surrogate parent entity appointed to file the CbC report in its jurisdiction on behalf of the ultimate parent entity, must notify SARS of the identity and tax residence of the reporting entity.

SARS is yet to publish a specific form of notification for these purposes. However, the ITR14 already contains questions aimed at establishing the taxpayer's ultimate parent entity and consolidated group turnover. We anticipate that the ITR14 will be updated to bring the questions in line with the requirements of the CbC reporting regulations.

The CbC Regulations apply in respect of years of assessments of multinational enterprise groups beginning on or after 1 January 2016. In the case of multinational enterprise groups with a December year end, the regulations would therefore apply to the 2016 year of assessment and the CbC Report, if applicable, would be due by the end of 2017.

Master file/local file

The CbC Regulations, together with the master file and local file form the three-tiered approach suggested in the OECD's Action 13 report, which has been incorporated into the OECD Transfer Pricing Guidelines. These agreed amendments to the OECD Transfer Pricing Guidelines represent the consensus of all countries participating in the OECD/G20 Base Erosion and Profit-Shifting Project, which include the OECD member countries as well as non-member countries, such as South Africa.

In particular, the text of Chapter V of the OECD Transfer Pricing Guidelines, dealing with documentation requirements, has been deleted in its entirety and replaced by the content of the Action 13 report together with its annexures, which change was approved by the OECD Council on 23 May 2016.

In terms of the briefing note to the Final Notice, SARS has indicated that master file and local file returns will be required to be submitted under section 25 of the Tax Administration Act, 2011(the TAA), i.e. by notice to furnish a return. It is not clear at this stage, however, whether additional legislation specifying the content of these returns will be passed.

The detailed information to be included in the master file and local file as envisaged by the OECD is set out in Annexures I and II, respectively, to the Action 13 report/the revised Chapter V of the OECD Guidelines.

Based on the revised Chapter V, the master file would contain, *inter alia*, high-level information regarding the global business operations and transfer pricing policies of a multinational enterprise, while the local file would include, *inter alia*, detailed transactional transfer pricing documentation specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

Therefore, at this stage, the master file/local file return requirements are the only major element of South African transfer pricing documentation requirements that are still outstanding.

Final Notice on Transfer Pricing Record Keeping Requirements

Tax administrations may also impose specific record-keeping requirements in addition to the master file/local file standardised transfer pricing returns. The OECD, however, cautions tax administrations to bear in mind the balance between information needs and the compliance burden that will be placed on taxpayers.

In this regard, the Commissioner released the Final Notice on Transfer Pricing Record Keeping Requirements in terms of section 29 of the TAA, (Notice No. 1334 published in Government Gazette No. 40375) on 28 October 2016, setting out the documents required to be kept specifically for transfer pricing purposes.

In terms of the Final Notice, there are two levels of record keeping:

1. Records in respect of structure and operations – a person is required to keep records where the person has entered into a "potentially affected transaction", as defined, and the aggregate of the potentially affected transactions for the year of assessment exceeds or is reasonably expected to exceed ZAR100 million.
2. Records in respect of transactions – a person which has entered into a "potentially affected transaction", must keep records in respect of any such transaction which exceeds or is reasonably expected to exceed ZAR5 million in value.

The Final Notice will apply to years of assessment commencing on or after 1 October 2016.

Records to be kept in terms of the Final Notice must not be submitted to SARS as a matter of course, but must be available upon request and must be retained for a period of five years.

ITR14

It appears that SARS is using the ITR14 to gather additional, non-standard information, not required by either the CbC Regulations or the master file/local file content. In this regard, the current version of the ITR14 requires that full details be disclosed as to the cross-border transactions entered into by a taxpayer with connected persons in terms of the revised provisions of section 31 of the Income Tax Act, 1962.

In particular, in respect of transactions with foreign connected persons, the taxpayer must disclose the total number of jurisdictions for each of these transactions, the top five jurisdictions for each of these transactions, together with the transaction value for each of those five top jurisdictions. In respect of transactions with foreign non-connected persons, the same disclosure is required, with the exception that a disclosure of the transaction value of the five top jurisdictions is not required.

The taxpayer is also required to answer a number of questions in relation to, *inter alia*, documentation and year-end transfer pricing adjustments. In the context of transfer pricing documentation, the taxpayer is asked whether the company has transfer pricing documentation that supports the pricing policy applied to each transaction between the company and the foreign connected person during the year of assessment as being at arm’s length. It would be hard to answer this question in the affirmative without preparing some form of transfer pricing documentation that consider the arm’s length nature of the cross-border transactions entered into by the taxpayer with connected persons.

Conclusion

Taking into account the different transfer pricing related documentation requirements set out above, South African taxpayers need to prepare and submit or retain the following information and documentation:

Documentation level	Relevant information	Effective date	Local legislation implemented
ITR14	Information relevant to cross-border transactions, both with connected and non-connected persons	Years of assessment commencing on or after April 2012	Revised ITR14 format
Record keeping requirements	Information relevant to structure and operations and/or transactions as set out in the Final Notice on Transfer Pricing Record Keeping	Years of assessment commencing on or after 1 October 2016	Yes – Government Notice 1334 in terms of section 29 of the Tax Administration Act
CbC Report	Filing – information necessary to prepare a CbC report Notification – details of the reporting entity in the multinational enterprise group	Years of assessment commencing on or after 1 January 2016	Yes – regulations in terms "international tax standard" definition in the Tax Administration Act

In addition, although local legislation has not yet been implemented to require the submission of the master file/local file returns, we are of the view that taxpayers would be well advised to start considering the information required to prepare these returns, since it is clear that it is SARS' intention to issue legislation to this effect in due course.

ENSAfrica

ITA: Section 31

TAA: Sections 25 and 29

Regulation No. R. 1598 published in Government Gazette No. 40516, 23 December 2016

Notice No. 1334 published in Government Gazette No. 40375, 28 October 2016

OECD BEPS Action 13 - Transfer Pricing and Country-by-Country Reporting

OECD Transfer Pricing Guidelines

TAX ADMINISTRATION

2615. Lodging of objections

Submitting a late objection to an assessment issued by the South African Revenue Service (SARS) can have serious consequences. On 13 May 2016, the Tax Court handed down judgment in *AB CC v The Commissioner for the South African Revenue Service* (Case No. 13635) (as yet unreported), which deals with the late filing of an objection by AB CC, the taxpayer, against assessments issued by SARS for the 2008 to 2011 years of assessment in respect of employees' tax (PAYE).

Facts and issue to be determined

The taxpayer filed a notice of objection on 7 March 2013 which was outside the 30-day period allowed in terms of the rules promulgated in terms of section 103 of the Tax Administration Act, 2011 (the TAA) (the Rules). The assessment was issued on 18 September 2012. SARS issued a notice of invalid objection as the objection was lodged late and no reasonable grounds were provided for the delay. The taxpayer then brought an appeal and the court had to decide whether SARS should have condoned the late filing of the objection to the assessment.

The relevant legal provisions at the time of the decision

At the time of the decision, section 104(4) of the TAA stated that a senior SARS official may only extend the 30-day period in the Rules if reasonable grounds exist for the delay in lodging the objection. Section 104(5) stated at the time that the period for objection must not be extended for a period exceeding 21 business days, unless a senior SARS official is satisfied that exceptional circumstances exist which gave rise to the delay in lodging the objection.

Evidence and judgment

The taxpayer argued that because his auditors only became aware of SARS's letter of assessment (LoA) dated 18 September 2012, on 4 December 2012, exceptional circumstances existed which caused the delay in lodging the objection. The reasons for the auditors becoming aware of the assessments late were detailed by witnesses who testified on behalf of the taxpayer.

Mr K, a manager at the taxpayer's accounting and auditing firm (Company Y), was involved in handling the taxpayer's account, but moved to a different department within Company Y and handed the account to Mr L. Mr K stated that he did not receive the email addressed and sent to him on 28 September 2012 due to technology challenges and only became aware of the LoA regarding PAYE during November 2012. Although the technology challenges he referred to were confirmed by the testimony of Mr J, the person responsible for hosting Company Y's server, Mr K also admitted that he did not inform Mr L of the LoA when he became aware of it.

Mr L testified that he was a team leader within Company Y. He handled, among other things, Secondary Tax on Companies (STC) and PAYE findings by SARS against the taxpayer from 1 November 2012. He only became aware of the PAYE LoA on 8 December 2012 after he had a meeting with SARS regarding the taxpayer's STC objection on 5 December 2012. He initially testified that subsequent to becoming aware of the LoA on 8 December 2012, he believed that the process was ongoing from 12 November 2012 and that he was seeking information from SARS's employees in order to lodge an objection. During cross-examination he testified that the information he was looking for related to VAT and STC. Based on this evidence, the court found that the information he sought had no bearing on the PAYE objection and could not have prohibited him from lodging the objection at least during December 2012. One of his excuses for not doing so was that he had to go on holiday.

The court held that Mr L could have applied for an extension to file the objection once he became aware of the LoA. Mr L's evidence suggested that he was unaware of the consequences of failing to lodge an objection within the prescribed period, which is not what one would have expected from an experienced tax practitioner such as Mr L. The court noted that they could have been more careful and expressed surprise at the fact that Mr L had to be guided on the process for lodging an objection, which was evident from email correspondence he sent to SARS on 20 February 2013 and which caused unreasonable delays.

The court considered the evidence of Mr M, a member of the taxpayer, who conceded under cross-examination that when he received the PAYE notices of assessment in 2012, he did no more than hand the notices to his representatives. Finally, the court accepted the evidence of Ms S, an employee of the entity that handles SARS's mailing system who testified that the assessments in question were dispatched to the taxpayer's email address on 22 September 2012.

Based on the evidence given and on section 153(3) of the TAA which states that "a taxpayer is not relieved from any liability, responsibility or duty imposed under a tax Act by reason of the fact that the taxpayer's representative failed to perform such responsibilities or duties", the court held that the taxpayer did not prove that there were exceptional circumstances that gave rise to the delay in lodging the objection and dismissed the appeal.

Subsequent amendments to section 104 of the TAA

After the abovementioned decision was handed down, section 104(5)(*a*) was amended and now states that a senior SARS official must not extend the period for lodging an objection by more than 30 business days, unless the senior SARS official is satisfied that exceptional circumstances exist which give rise to the delay in lodging the objection. When this section is read with section 104(4), it means that the 30-day period for lodging an objection may be extended by a senior SARS official for up to 30 business days, provided reasonable grounds exist for doing so. An extension of more than 30 business days must only be granted if exceptional circumstances are shown.

The rationale for this amendment is set out in the Memorandum on the Objects of Tax Administration Laws Amendment Bill, 2016, which states that the 30-day period contained in the Rules "has been shown to be too short in practice, particularly in complex matters, resulting in a large number of applications for condonation."

Practical importance of the judgment and the amendments

It has been widely publicised that National Treasury is facing a budget shortfall and therefore it is possible that SARS, as the state entity responsible for enforcing tax legislation, will be more aggressive in collecting tax in future. The judgment discussed here should therefore be taken very seriously as an assessment issued by SARS, whether wrong or right, must be objected against timeously and the negligence of a taxpayer's tax practitioner, cannot be used by the taxpayer to justify late submission.

This is the second judgment handed down in 2016 where a taxpayer was unsuccessful in proving that there were exceptional circumstances giving rise to the delay in lodging an objection.

The amendment to section 104 that came into effect on 19 February 2017 is welcomed as a taxpayer can now receive a 30 day extension, instead of a 21 day extension to submit its objection provided it can show reasonable grounds, although it can certainly be argued that the 30 day extension period in section 104(5)(*a*) should have been increased further.

SARS Interpretation Note 15, dealing with the Commissioner's discretion in allowing late objections and appeals, which was not referred to in the judgment, lists the following as examples of what may constitute 'exceptional circumstances' in terms of section 104(5)(*a*):

- a natural or human-made disaster;
- a civil disturbance or disruption in services;
- a serious illness or accident; and
- serious emotional or mental distress.

In a previous judgment, it was noted that "unusual facts" could constitute exceptional circumstances. It appears, however, that the taxpayer's failure to do more than merely send the assessments to Company Y and Company Y's unjustifiable delay in attending to the matter, was what led to the outcome in this matter.

Cliffe Dekker Hofmeyr
TAA: Sections 103, 104 and 153(3)
Memorandum on the Objects of the Tax Administration Laws Amendment Bill, 2016
SARS Interpretation Note 15

2616. Adjustment of penalty assessments

In a decision of the Tax Court for the Eastern Cape (Case No. IT14027), the Court shed light on the provisions of the Tax Administration Act (the TAA) which apply in respect of the imposition of penalties and any adjustment to the assessment raised imposing the penalties.

It was common cause that the taxpayer company in this instance had filed a return for the payment of provisional tax for the second period of the 2010 year of assessment in June 2011. The estimate of taxable income for the purposes of this return was approximately R440 000. Subsequently, in September 2011, the taxpayer made a voluntary payment of provisional tax for the 2010 year of assessment of approximately R1.4 million. Its return of income, filed shortly after the voluntary payment, and the taxable income assessed was approximately R5.05million.

By reason that the estimate of taxable income for the second payment of provisional tax was understated, the taxpayer was assessed to a penalty on 1 November 2011. Objection was noted against the imposition of the penalty on 18 May 2012. After the objection was disallowed, an appeal was noted against the disallowance of the objection on 4 July 2012.

The TAA came into effect on 1 October 2012.

Before the appeal was heard before the Tax Board, the original assessment was reduced, and as a result the penalty was reduced. The notice of reduced assessment issued on 7 February 2013 reflected a due date in respect of the reduced penalty of 1 November 2011.

The Tax Board, of its own motive (i.e. the issue had not been raised in the objection), came to the conclusion that the reduced penalty assessment was legally unenforceable, because it stipulated a due date for the payment of the penalty that preceded the date upon which the reduced penalty assessment was issued.

SARS therefore took the decision of the Tax Board on appeal to the Tax Court.

Was the reduced penalty assessment legally unenforceable?

The matter at issue was perhaps clouded by the fact that the original penalty assessment had been issued in terms of the Income Tax Act, 1962 (the Act) and the reduced penalty assessment was issued in terms of the TAA.

Eksteen J noted that the penalty had been imposed under the Act. However, after the TAA came into effect, SARS was permitted to issue a reduced assessment in terms of section 104 of the TAA without an objection having been lodged or an appeal noted against the original assessment. Following the issue of a reduced assessment, a taxpayer has the right to object to the reduced assessment in terms of the TAA.

The legal effect of the reduced assessment is well identified in paragraph 23 of the judgment:

"*By virtue thereof that the penalty which had been imposed under the IT Act is a percentage-based penalty the effect of a reduced assessment is necessarily an adjustment in the penalty. The reduced assessment was made in February 2013 after the TA Act came into effect. The appellant was thereafter notified of the outcome of the assessment and the adjustment to the penalty through a "notice of assessment" which reflected the "due date" for payment of the adjusted penalty as 1 November 2011, being the date of the imposition of the original penalty.*"

The thrust of the Tax Board decision had been that the taxpayer had never been issued with a notice of penalty assessment as required under section 214(1) of the TAA, which afforded the taxpayer the opportunity to submit a remittance request before the due date of payment, because the due date preceded the date of issue of the adjusted penalty assessment.

After briefly identifying relevant statutory provisions, Eksteen J set out the requirements for notifying an adjustment to a penalty at paragraph 27:

"*In the present instance the penalty assessment was made under the IT Act and the appellant was duly notified thereof under the IT Act prior to the TA Act coming into force. The provisions of the TA Act have no bearing on the process whereby the penalty was imposed. As alluded to earlier, a reduced assessment* *made in terms of the TA Act necessarily gives rise to an adjustment in the previously imposed penalty because it is a percentage-based penalty*.

The adjustment to the imposed penalty is dealt with in section 213(2) of the TA Act which prescribes:

"(2) In the event of a change to the amount of tax in respect of which a 'penalty' was imposed under subsection (1), the 'penalty' must be adjusted accordingly with effect from the date of the imposition of the 'penalty'."

Thus a distinction must be drawn between a penalty that is imposed in terms of section 213(1) of the TAA, and an adjustment to a penalty. In the latter case, section 214(3) of the TAA prescribes that notice of the adjustment must be given in accordance with section 213(2).

Eksteen J therefore concluded, at paragraph 29:

"*On a proper interpretation of the statute it seems to me therefore that a "penalty assessment" relates to the original imposition of the penalty. Notice of such an imposition must be given in accordance with the provisions of section 214(1) and an opportunity must be afforded to the taxpayer to request a remittance under section 215(1). A penalty adjustment, however, is a different issue. Notice of a penalty adjustment must be given in terms of section 213(2). The adjusted penalty is effective from the date of the imposition of the penalty, which in this case occurred on 1 November 2011. The appeal against the imposition of the penalty remains unaffected by the adjustment.*"

It was therefore clearly established that an adjustment to a penalty assessment does not invalidate the original penalty assessment, which remains valid and enforceable. The effect of the adjustment is that the penalty is deemed to have been reduced from the date on which it was originally imposed and not from the date upon which the reduced assessment is issued. This has the effect of reducing the amount of any interest that may have accrued in respect of unpaid penalty amounts.

Conclusion

This judgment confirms that the TAA provides that any reduced assessment is deemed to take effect from the date of issue of the original assessment. Taxpayers who enjoy the benefit of a reduced assessment will therefore be entitled to a refund not only of any tax or penalty that is remitted as a result of the reduced assessment but also of any interest paid in respect of such tax or penalty.

PwC

TAA: Sections 104, 213, 214 and 215

2617. Business rescue and the payment of assessed tax

The South African Revenue Service's (SARS) statutory position of strength to collect assessed tax, by force of law if necessary, is abruptly curtailed where the taxpayer company enters the business rescue regime provided for in Chapter 6 of the Companies Act, 2008 (the Companies Act).

The statutory moratorium

Where a company commences business rescue through one of the routes provided for in the Companies Act, the immediate and automatic result is that a statutory moratorium falls into place in terms of which, as laid down in section 133(1) of the Companies Act, the company's creditors - including SARS - are (for the duration of the business rescue process) barred from instituting legal proceedings or enforcement proceedings against the company.

For a company whose debts include a large assessment to tax, the attractiveness of entry into the statutory business rescue regime, and the benefit of the automatic moratorium, is self-evident.

Business rescue can be opposed by affected persons

It is of course not a foregone conclusion that a financially distressed company will succeed in entering the statutory business rescue regime, for the Companies Act makes provision for interested parties to oppose such entry.

Thus, if the company's board of directors passes a resolution that the company should commence business rescue and files that resolution with the Companies Commission (as provided for in section 129 of the Companies Act), SARS, as a creditor of the company, has the right to apply to the High Court in terms of section 130(1)(*a*) of the Companies Act for an order setting aside the directors' resolution on the grounds that there is no reasonable prospect for rescuing the company.

It is, however, probably true to say that the court usually favours giving business rescue a chance, unless the company is hopelessly insolvent and beyond salvation.

The business rescue provisions as a delaying tactic

The protracted litigation in the Western Cape High Court which culminated in the judgment in *Van Der Merwe & Others v Zonnekus Mansion (Pty) Ltd (in liquidation) & Another (Commissioner for the South African Revenue Service & Another Intervening)* [2016] ZAWCHC 193, in which judgment was delivered on 19 December 2016, is an extreme illustration of the way in which a company and its controllers can try to exploit the business rescue provisions of the Companies Act to delay or dilute SARS' collection of assessed tax owing by the company.

As each application failed, the company launched another

This matter involved an urgent application by a property-owning company, Zonnekus Mansion (Pty) Ltd, to place itself in the business rescue regime provided for in the Companies Act.

This particular application was the fourth in a series of similar applications (the first three having been unsuccessful) for a court order for the company to commence business rescue.

SARS was by this stage exasperated at what it regarded as interminable delaying tactics on the part of the company in paying its tax debt, which by now was close to R90 million.

From the company's point of view, the ultimate prize in its strategic manoeuvres would be the approval of a business rescue plan in terms of which its creditors, including SARS, would be paid a fraction of what was owed by the company.

The company had been issued with a final liquidation order but was nonetheless entitled to apply to court to commence business rescue

Zonnekus Mansion (Pty) Ltd, owned various properties, including a Herbert Baker-designed and "lavishly furnished" 8 000 square metre mansion, valued at between R30 million and R50 million, located on Woodbridge Island abutting the Milnerton lagoon in Cape Town. The company also owned "a large fleet of motor cars" already under attachment by SARS.

The de facto "guiding mind and corporate controller" of the company was one Gary van der Merwe, a seasoned litigant.

An investigation in 2013 into the tax affairs of Van der Merwe and the company had culminated in a High Court preservation order in respect of specified assets of Van der Merwe and the company.

In 2014, the High Court issued a final order of liquidation against the company in respect of a R5.3 million debt owing to Standard Bank and secured by a mortgage. Claims totalling R14.4 million had been proved in the liquidation.
In 2015, the High Court ordered an inquiry to be held into the affairs of the company. Before the inquiry could commence, however, it was postponed because the company and its allies applied to court for the company to commence business rescue.

SARS argued that business rescue was not legally possible because a final liquidation order had been granted, but it was forced to throw in the towel on that argument when, just at that time, the Supreme Court of Appeal handed down judgment in *Richter v ABSA Bank Ltd* 2015 (5) SA 57 (SCA) which held that, even where a final liquidation order has been made, a company can still be placed in business rescue in an attempt to restore it to solvency.

The company's second application to court to commence business rescue
In June 2016, a second application to court for business rescue of the company was made by what the reported judgment calls its "alleged employees", apparently at the urging of Van der Merwe.

Before this application could be heard, the employees (apparently for tactical reasons) tried to withdraw the application but failed, because they had not secured the required consent of the other parties involved in the application. When the application came up for hearing, the judge ruled that it constituted an abuse of legal process and had been brought in bad faith.

Predictably, the employees responded by giving notice that they were appealing against that judgment to the Supreme Court of Appeal, thereby protracting the legal process still further.

The company's third and fourth applications to commence business rescue

In September 2016, the company launched its third application to court for the commencement of business rescue, but the court dismissed the application on the grounds that (given the pending appeal against the dismissal of the second application) the second application had not yet been finally disposed of.

The company responded the following day by filing its fourth application for business rescue, which on the face of it appeared (apparently deliberately so, for tactical reasons) to be defective on a number of procedural grounds.

SARS responded by asking the court, in response to this new application, to make a final determination on the merits of the company's application for entry into business rescue, to avoid yet further delaying tactics, and the court agreed with this approach.

The court's response to the fourth application for business rescue

Usually, the argument put forward by a company's creditor who opposes its application to commence business rescue is that there is no reasonable prospect for rescuing the company.

A major point of interest in the reported judgment in this particular matter is SARS' successful strategy to outflank the company's application by arguing, inter alia, not that the company's business had no prospects of successful rescue, but that the company was at this juncture no longer carrying on business at all.

In this regard, Gamble J held (at paragraph 56 of the judgment) that, although the company had been carrying on a business in the past and it might at that time have been appropriate to consider business rescue, the company was presently not carrying on any business activities.

Indeed, as the judge pointed out, the company had for two years been in liquidation and was currently (see paragraph 58) no more than "a property holding entity in final liquidation". Its business, said the judge, was "moribund and incapable of resuscitation" through business rescue.

This, said the judge, rendered any consideration of the proposed business plan "redundant".

Significantly, the court went on to point out (at paragraph 78) that the company's business plan simply ignored the assessments to tax, issued by SARS, in an amount close to R90 million (which, in terms of the pay-now-argue-later provisions of the Tax Administration Act, 2011 (the TAA) was immediately payable), and - in the context of the credibility of the proposed business plan - the court asked, rhetorically, what investor would conceivably be willing to inject the necessary funds into a company with a tax liability of this order.

An investigation into a company's affairs is better conducted in the course of liquidation than in a process of attempted business rescue

Moreover, said the court (at paragraph 79), in the circumstances of the present case, since an investigation into the company's affairs in terms of the Companies Act was required, business rescue was not appropriate in that (see paragraph 81) the inevitable further litigation in this matter (for there seems little doubt that Van der Merwe will take this new judgment on appeal) and the envisaged investigation into the company's affairs would be better conducted in the context of a winding-up process, administered by liquidators, rather than by a business rescue practitioner.

The court's overall assessment of the current situation

Overall, said Gamble J (at paragraph 101), as regards the strategy adopted by Van der Merwe as the company's *de facto* controller and the driving force behind the litigation–

"*There can be little doubt, therefore, that as the one obstacle set up to hinder the liquidators in the exercise of their statutory powers came down, the next was shrewdly put in place.*"

The judge remarked further (at paragraph 103) that–
"*A worthless, revamped business plan has been put up in [the fourth application for business rescue] in respect of a company which does not conduct business.*"

The judgment held (at paragraph 104) that there had been a clear abuse of the court process by Van der Merwe as the *de facto* controller of the company.

The court dismissed the company's application for the commencement of business rescue.
The particular interest of the judgment is the further terms of the order made by the court at the conclusion of the proceedings.

In addition to dismissing the company's application for the commencement of business rescue, it was ordered that Van der Merwe was interdicted from launching further applications for the commencement of business rescue proceedings in respect of Zonnekus Mansion (Pty) Ltd without the prior written permission of a senior judge of the Cape High Court.

This is the first time that an order of this kind has been made in the context of the business rescue provisions of the Companies Act. In all likelihood the constitutionality of such an order will be challenged by Van der Merwe, and it is also likely that the entire judgment of the Cape High Court will be taken on appeal to the Supreme Court of Appeal.

Significantly, although the Cape High Court took the view that it could lawfully interdict Van der Merwe from launching further applications for business rescue without the prior approval of a High Court judge, the High Court could not, constitutionally, deprive the company of the right to appeal against its judgment.

If, as seems likely, such an appeal is lodged, the liquidation proceedings in respect of the company will yet again be postponed, pending the decision of the Supreme Court of Appeal.

Such a further appeal will not, however, suspend the company's obligation to pay the assessed tax, for section 164 of the TAA is explicit that there is no such suspension unless a senior SARS official directs otherwise.

PwC
Companies Act, 2008: Chapter 6, Sections 129, 130(1)(*a*) and 133(1)
TAA: Section 164

TRUSTS

2618. Clawback provision of section 7C

Section 7C of the Income Tax Act, 1962 (the Act) has been in media limelight since its initial publication in the Taxation Laws Amendment Bill, 2016.

The final version of the provision as promulgated on 19 January 2017 in the Taxation Laws Amendment Act, 2016 is less draconian that the first published version of the section.

The net economic effect of the section is, with effect from 1 March 2017, to subject interest free loans from a natural person or at the instance of a natural person to SA discretionary trusts in excess of R1,25 million to an annual donations tax of 1.6% of the loan, payable by the lender within 31 days of the end of the trust's tax year.

But the application of section 7C has a number of unintended consequences.

The aim and purpose of section 7C is to clawback gains made on any growth assets which have been transferred to discretionary trusts often as part of estate duty planning. The estate plan, through the disposal of growth assets to the trust for an interest free loan, resulted in future growth of the asset accruing to the trust instead of to the natural person thereby "escaping" the 20% estate duty levy application to the net assets owned by a natural person upon his/her death.

In practice the application of section 7C has a number of unintended consequences compared to similar estate duty taxation provisions in other parts of the world. A good example of this is the United Kingdom's 10 year inheritance tax charge which is based on the market value of the non-business assets held in a discretionary trust every 10 years during the existence of the trust.

For example, let's establish a hypothetical discretionary trust entitled "The Joy Luck" discretionary trust. Let's also assume the Joy Luck discretionary trust was established with an interest free loan from a natural person - Mr Luck – of R51,25 million, which the trust used to acquire a residential house for Mr Luck. The home cost R6,25 million. The trust further erected a block of flats costing R45 million.

Mr Luck is a beneficiary together with his spouse and children of the Joy Luck discretionary trust.

In addition to the above, the trust owned a company to which Mr Luck lent R40 million, on an interest-free basis to buy a share portfolio. The share portfolio more than doubled in value over five years and was worth R85 million in the hands of the company.

However, the building of the block of flats had significant delays and cost overruns and although R45 million was spent on the flats they were only worth R35 million upon completion.

In applying the provisions of section 7C, the R45 million loan will attract a deemed interest of R3,6 million (R45 million x 8%) which will be taxable at a rate of 20%, being donations tax, resulting in R720,000 donations tax which would need to be paid by Mr Luck (ignoring any exemptions).

The loan to acquire the primary residence (R6,25 million) is not subject to section 7C by virtue of the exclusion contained in section 7C(5)(*d*).

There are a variety of options available to minimise the impact of section 7C regarding the R45 million interest free loan by Mr Luck to the trust:

1. Mr Luck can charge interest of at least 8% p.a. on the R45 million loan. This would result in interest income accruing to Mr Luck and deductible interest being incurred by the trust;

2. The trustees could sell or transfer the block of flats back to Mr Luck at their market value of R35 million but this would still leave a loan outstanding relating to the specific block of flats of R10 million. If the trustees sold the flats to Mr Luck in full settlement of the loan, Mr Luck is losing R10 million and the trust is benefitting by settling a liability for less than its value. On the basis that Mr Luck is a connected person in relation to the trust, the disposal of the flats will be deemed to take place at market value of R35 million. The settlement of Mr Luck's loan may be regarded as a reduction amount (R10 million) in terms of paragraph 12A of the Eighth Schedule to the Act in the trust and would reduce the capital loss arising on the sale of the flats by the R10 million. Mr Luck's agreement to settle his loan of R45 million for an asset worth R35 million may be regarded as

a donation by Mr Luck and subject to donation tax at 20%. To the extent that such a loss arises from a donation by Mr Luck, paragraph 12A of the Eighth Schedule should not apply to such a shortfall, but donations tax would apply in Mr Luck's hands.

3. The company could realise a portion of the underlying share portfolio and declare a dividend to the trust to enable the trust to settle the loan owing to Mr Luck. Such an option would trigger capital gains for the company upon realising some of the shares and this would then result in a further Dividends tax liability on the dividend paid to the trust. This could be a very costly option.

Not only could overcoming section 7C result in a costly exercise, practically speaking section 7C has a distortive economic effect where the asset held by the trust is not growing at a rate at least equal to the SARS official rate of interest.
It makes economic sense to leave assets in a trust which have been funded by loan accounts from natural persons and also which are growing on an after-tax basis of at least 1.6% (8% x 20%).

Where assets are loss-making or have declined in value, an economic and cash flow distortion arises as tax is being levied based on the assumption that the assets have grown or are growing in value. In addition, part of this growth portion may help to settle the donations tax levied in terms of section 7C on the deemed interest on the loans to the trust.

Sadly, Mr Luck is unlikely to find much joy in having to pay R720 000 of donations tax each year, unless the assets held by the trust which were funded by his loan are growing at least 8% on an after-tax basis.

Grant Thornton

ITA Section 7C and paragraph 12A of the Eighth Schedule

Taxation Laws Amendment Act, 2016

VALUE-ADDED TAX

2619. Auction acquisitions

Before buying anything, a purchaser should always be aware of all its obligations. This is one of the lessons to draw from the decision in *Sheriff of the High Court, Piketberg and another v Lourens*; In re: *Standard Bank of South Africa Ltd v Trustees for the time being of the Eila Trust and others* [2016] 4 All SA 239 (WCC). In this case the court had to decide, among other things, whether the sale of a property in execution could be set aside, where the purchaser had not met his obligations in terms of the Value-Added Tax Act, 1991 (the VAT Act), read with the conditions of sale.

Facts

The respondent, Lourens (L), purchased property at an auction where it was sold in execution, but then refused to pay the VAT amount, R88 200, which was due in terms of the transaction. This was despite the fact that clause 4.7 of the conditions of sale placed the obligation to pay transfer duty or VAT attracted by the sale on L as the purchaser and after the second applicant, the judgment creditor, had demanded the amount from L. As a result, the property could not be transferred into L's name. It was not in dispute that L inspected the property and the conditions of sale, and that at the auction L and his representative did not make enquiries about whether the first respondent, The Eila Trust (ET), whose property was being sold, was a VAT vendor.

L's stated refusal to pay VAT was because it was not disclosed to him prior to the sale in execution.

The applicable legal provisions

In terms of section 7(2) of the VAT Act, where the seller of a property is a VAT vendor, the seller is liable to pay the VAT on the purchase price to the South African Revenue Service (SARS). In terms of section 9(15) of the Transfer Duty Act, 1949 (the TD Act), transfer duty will not be payable in respect of the acquisition of any property, where VAT is payable in terms of that transaction provided that the following requirements are also met:

- The seller has made a declaration to SARS in the prescribed format that the VAT has been paid to him and that he has accounted for the VAT; or
- That the seller has provided security to SARS where the VAT has not yet been paid; and
- SARS has issued a certificate stating that the requirements of section 9(15) have been met.

Where the seller is not a VAT vendor, transfer duty will be payable by the purchaser in terms of section 3 of the TD Act. The same principle will apply if neither the seller nor the purchaser are VAT vendors. From a VAT perspective, it is also important to keep in mind that the time of supply of the property is the date on which the property is transferred into the name of the purchaser or the date on which any payment is made by the purchaser, whichever date is earlier.

Judgment

The court stated that with regard to VAT, the issue for determination was whether the applicants, being the sheriff and the judgment creditor, had a duty to establish the VAT status on the property and disclose this information to L. It referred to the principles mentioned above and stated further that there is “the notion that operates in respect of VAT transactions that the purchase price of the property is deemed to be VAT inclusive, except if the conditions of sale provide otherwise”. This means that the seller as VAT vendor is liable to SARS for the output tax payable at the point of transfer.

On the facts, it emerged that the seller, ET was a VAT vendor and thus under normal circumstances, it would have had to account for VAT and pay the VAT out of the purchase price to SARS. However, it had to be taken into account that the property was sold at a sale in execution, which occurred at an auction, without the judgment creditor's or ET's involvement. As ET was unable to pay VAT to SARS, the obligation to pay VAT fell on the judgment creditor, as holder of rights over the property, to pay the VAT over to SARS. It was therefore correct for the judgment creditor to have demanded the VAT amount from L before transfer of the property could take place.

The court held that under the circumstances L should have established whether ET was a VAT vendor prior to the auction and rejected L's argument. In this regard, the only obligation that lay with the judgment creditor was to enquire whether any real rights attached to the property that was being sold in execution. According to the court, these factors were inconsequential to the main issue regarding the payment of VAT by L.

In conclusion, the court held that L was obliged to pay VAT on the transaction to SARS before transfer of the property into its name could take place and since L didn't meet this obligation, the applicants were entitled to cancel the sale of the property in execution.

Comment

The case should serve as a caution to persons who purchase immovable property at an auction to always determine whether VAT or transfer duty will be payable on a transaction, depending on the parties involved. Usually, a purchaser should ensure that they are able to pay VAT if necessary, so that there is no risk that the transaction can be set aside for this reason at a later stage.

Cliffe Dekker Hofmeyr

VAT Act: Sections 7(2)
Transfer Duty Act: Section 3 and 9(15)

SARS NEWS

2620. 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.