INTEGRITAX

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2652. Share incentives arrangements

In terms of paragraph 2(1) of the Fourth Schedule to the Income Tax Act, 1962 (the Act), every employer, who is a resident of South Africa, or representative employer in the case of any employer who is not a resident, (whether or not registered as an employer under paragraph 15) who pays or is liable to pay any amount by way of remuneration to any employee shall, unless the Commissioner for the South African Revenue Service (SARS) has granted authority to the contrary, deduct or withhold from that amount by way of employees' tax, an amount that will be determined as provided in the Fourth

Schedule in respect of the liability for normal tax of that employee and must pay the amount so deducted or withheld to SARS within seven days after the end of the month, during which the amount was deducted or withheld or within such further period as SARS may approve.

The term “remuneration” is defined in paragraph 1 of the Fourth Schedule to mean any amount of income that is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered, subject to certain specific inclusions, one of which is any amount referred to in section 8C that is required to be included in the income of a person, and subject to certain conditions that are not relevant for the purposes of this article.

Therefore, any amount referred to in section 8C that is required to be included in the income of a person constitutes “remuneration” for purposes of employees’ tax. To the extent that a section 8C gain arises upon the vesting of an equity instrument in terms of a share incentive arrangement, the employees’ tax implications should be determined.

Paragraph 11A(1) of the Fourth Schedule provides, *inter alia*, that where the remuneration of an employee includes any amount referred to in section 8C, which is required to be included in the income of that employee, the person from whom the equity instrument was acquired is deemed to be a person who pays or is liable to pay to that employee the amount of the section 8C gain.
In terms of paragraph 11A(2), employees’ tax in respect of such remuneration must, unless SARS has granted authority to the contrary, be deducted or withheld by that person from, *inter alia*, any cash remuneration paid or payable by that person to that employee after that equity instrument has to the knowledge of that person vested.

However, in terms of the proviso to paragraph 11A(2), where that person is an "associated institution", as defined in paragraph 1 of the Seventh Schedule, in relation to any employer who pays or is liable to pay to that employee, any amount by way of remuneration during the year of assessment during which the section 8C gain arises and:

- is not a resident nor has a representative employer; or
- is unable to deduct or withhold the full amount of employees' tax during the year of assessment during which the gain arises, by reason of the fact that the amount to be deducted or withheld from that remuneration by way of employees' tax exceeds the amount from which the deduction or withholding can be made,

that person and that employer must deduct or withhold, from the remuneration payable by them to that employee during that year of assessment, an aggregate amount equal to the employees' tax payable in respect of that gain and shall be jointly and severally liable for that aggregate amount of employees' tax.

An "associated institution" is defined in paragraph 1 to mean, in relation to any single employer:

"(a) where the employer is a company, any other company which is associated with the employer company by reason of the fact that both companies are managed or controlled directly or indirectly by substantially the same persons; or

(b) where the employer is not a company, any company which is managed or controlled directly or indirectly by the employer or by any partnership of which the employer is a member; or

(c) any fund established solely or mainly for providing benefits for employees or former employees of the employer or for employees or former employees of the employer and any company which is in terms of paragraph (*a*) or (*b*) an associated institution in relation to the employer …”

A “representative employer” is defined in paragraph 1 of the Fourth Schedule to mean, in the case of any employer who is not resident in South Africa, any agent of such employer having authority to pay remuneration who resides in South Africa.

Paragraph 11A(4) of the Fourth Schedule provides that, before deducting or withholding employees’ tax in respect of a section 8C gain, that person and that employer must ascertain from SARS, the amount to be so deducted or withheld. In practice, this requires a tax directive from SARS.

In terms of paragraph 11A(5), if that person and that employer are, by reason of the fact that the amount to be deducted or withheld by way of employees’ tax, exceeds the amount from which the deduction or withholding is to be made, unable to deduct or withhold the full amount of employees’ tax during the year of assessment during which the gain arises, they must immediately notify SARS of that fact.

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ITA section 8C, Fourth Schedule para 1, 2, 11A and 15, Seventh Schedule para 1 definition of ‘associated institution’ and ‘representative employer’

2653. Cross-border financing

Transfer pricing in relation to cross-border financing within groups of companies can become risky business if the principles that should apply are not fully appreciated. A decision in the Australian Federal Court of Appeals, handed down on 21 April 2017, provides guidance on the approach to be adopted in setting interest rates in these circumstances.

Background

The facts in the matter of *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 are not complex.

The subject of concern was a loan that had been made by Chevron Texaco Funding Corporation (CFC), a US resident company, to its parent company, Chevron Australia Holdings Pty Ltd (CAHPL). These companies were part of the Chevron Texaco Group, the holding company of which was resident in the US. The loan was denominated in Australian Dollars (AUD) for an amount equivalent to 2.5 billion United States Dollars (USD). The purpose of the loan was to effect an internal refinancing of the debt of Chevron Australia Ltd and to finance the acquisition by CAHPL of Texaco Australia Pty Ltd.

In order to arrive at the interest rate that was charged on the loan, CAHPL and CFC sought independent advice from reputable banking and finance experts. CAHPL was aware that the interest should be levied at an arm’s length rate. It was also aware that, in terms of the Australian domestic legislation, as well as the double taxation agreement between Australia and the US (the DTA), CAHPL and CFC should be regarded as independent parties acting at arm’s length.

CFC raised its finance in USD from US-resident investors. The prevailing interest rate at the time for USD financing was lower than the prevailing interest rate for AUD financing.

Notwithstanding this, in light of the foreign exchange risks associated with a USD payable, it was determined that the loan would be made in AUD.

In pricing the loan (i.e. establishing what should be regarded as an arm’s length rate of interest), the experts were requested to assume that intercompany loans within the Chevron group were not subject to a guarantee by the ultimate parent company. In addition, it was evident that the underlying assets controlled by

CAHPL were oil and gas exploration concessions, in respect of which they were negotiating but had not fully finalised exploration rights and joint venture agreements, with the result that CAHPL did not have underlying security that it could provide to a lender.

In the circumstances, the experts considered that the credit rating of CAHPL, as a standalone entity completely divorced from the Chevron group, would be significantly lower than that of its parent entity or its treasury entity, and assigned a credit rating of BB+ to CAHPL. On this basis, CAHPL was advised that an arm's length rate of interest for a loan equivalent to USD 2.5 billion with no security and no parent guarantee would be AUD LIBOR BBA + 4.14% (an effective rate of approximately 9% p.a.).

There were other factual circumstances that pointed to a tax avoidance scheme, but the matter was not attacked as a tax avoidance scheme, and therefore no further facts have been taken into account in this analysis.

The dispute

The Australian Tax Office (ATO) formed the opinion that the interest rate of 9% was excessive and, on the basis of the Australian transfer pricing provisions, disallowed a significant portion of the interest and imposed a penalty of 25% of the additional tax assessed on CAHPL.

CAHPL objected to the ATO decision and, following rejection of the objection, the matter was taken on appeal to the Federal court, where a single judge ruled in favour of the ATO. The matter then proceeded to the Full Court of the Federal Appeal Court.

At the heart of the dispute was the degree of separation that has to be recognised when treating connected persons as independent of each other and acting at arm's length.

CAHPL took the view that the correct approach is to treat the parties as if they were standalone entities with no connection to the other members of the group of which they form part. It argued that the test was to determine the interest rate at which an independent lender would lend the funding amount to CAHPL, assuming the conditions that applied to an intra-group loan. This, it argued, was consistent with the domestic law and the DTA.

The ATO argued that the group connections could not be ignored, and that the correct approach is to consider the basis upon which an independent lender would be prepared to lend the same amount of funds to CAPHL, which would include the terms and conditions of such a loan as well as the rate of interest.
The question therefore revolved around whether the borrower (CAHPL) is evaluated hypothetically in a vacuum (i.e. without regard to its group connections) or whether the actual circumstances of the borrower (including its group connections) may be taken into account in determining the terms and conditions on which a loan may be advanced by an independent lender.

The judgments
The appeal was dismissed, with all three judges concurring.

Two of the three appeal judges delivered judgments. Although these judgments dealt with the specific provisions of the Australian domestic legislation applicable to the dispute (which differ in form from the comparable SA provisions), they contain statements of principle which are likely to be universally applicable.

Allsop CJ commenced his judgment with a *caveat* on how words in a statute should be interpreted. In paragraph 3 of his judgment, he cautions against strict literal interpretation:

‘In reaching a view about the meaning of these words and this phrase and how they operate in a coherent and cohesive way, it is paramount to recognise the fiscal and commercial context in which the provisions … are operating. This is not to put to one side or to diminish the necessity to begin and end with the words of the statute. Nor is it to seek to find a purpose of the Division outside its words. To begin and end with the words of the statute does not reflect a call to narrow textualism; it is the recognition that, ultimately, it is the words used by Parliament which frame the question of meaning, and which will provide the answer to that question of meaning. Context, however, is indispensable, whether as an explicit or implicit consideration. It gives the place, the wholeness and the relational reality to words; it helps prevent linear thinking and sometimes beguilingly simple and attractive logic with words driving meaning to unrealistic and impractical ends; and it helps ascribe meaning conformable with common sense and convenient purpose gained from the relevant part of the statute as a whole…’

The judgment provides a brief context of Division 13 (the Division) of the Australian Income Tax Assessment Act in paragraph 4, and thereafter the context provided by a reading of the Division is encapsulated in paragraphs 5 and 6:

‘That is the broad context and purpose of the Division –to bring a transaction, an international agreement, from a state influenced by considerations of lack of independence, to a state reflective of arm’s length dealing, for the purposes of fitting the transaction within the taxpayer’s affairs in that form consistent with commercial reality based on hypothesised independent dealing.

The words used by Parliament for this task … should therefore be given meaning and operation conformable with this purpose and conformably with the necessary flexibility of analysis that may be required in applying the statute to the infinite variety of circumstances of commercial life. The provisions should not be interpreted pedantically.’

The crux of the interpretation placed by Allsop CJ on the term ‘independent persons’ is found in paragraphs 40 to 66 of his judgment. For ease of understanding, in the judgment the loan is referred to as ‘the property’ and the interest rate as ‘the consideration’.

At paragraph 43, Allsop CJ points out:
‘There is no reason derived from the language of s 136AA(3)(d) why the hypothesis based on independence should, of necessity, do other than assess what the taxpayer or a person in the position of the taxpayer would be expected to give by way of consideration in respect of the acquisition of the property to a party independent from it. The independence hypothesis does not necessarily require the detachment of the taxpayer, as one of the independent parties, from the group which it inhabits or the elimination of all the commercial and financial attributes of the taxpayer being part of the circumstances that gave the commercial shape to the property the subject of the acquisition and that may be relevant to the consideration for the property.’

In the paragraphs that follow, Allsop CJ considers the concept of independence, and in particular what is encompassed in the term ‘independent parties’.
He comes to the view in paragraph 50 that:
‘The independence required is independence of the parties to the agreement from each other; it does not require any other hypothetical relationship; nor does it necessarily require the removal of characteristics of the party as the borrower that take it away from identity with the taxpayer in character or situation.’

In examining the approach of CAHPL, it was noted at paragraph 53 that CAHPL:
‘…approached the task dictated by s136AA(3)(d) as it had before the primary judge by identifying the task at hand to price the interest rate that would be paid

by a stand alone borrower from an independent lender for a loan structured in the identical terms to the credit facility. This was based on a submission that the property and agreement must remain identical and only the consideration in the form of the interest rate could be the subject of adjustment by reference to what could be reasonably expected.'

This submission was considered to be contrary to the purpose and context of the Division, as Allsop CJ noted at paragraph 55:

'That approach, however, almost dooms to failure the application of Div13 if its task is to substitute commercial reality based on independence, for intra-group reality based on group control. All one would have to do would be to constrain internally the transaction to give the highest price and include or omit terms of the agreement that would never be included or omitted in an arm's length transaction and which are not driven or dictated by commercial or operational imperatives, as the foundation for assessing an hypothesised arm's length consideration. Such unrealistic inflexibility would undermine the sensible operation of the Division by a rigid construction of the hypothesis in a shape and form controlled by the taxpayer.'

The judgment then turns to considering what the hypothetical transaction should be for the purposes of determining whether the interest was levied at arm's length. It recognises that CAHPL is part of a group of companies; that the group has a policy of borrowing from third-party lenders at the lowest cost; and that it is commonplace in such circumstances for the holding company to provide a guarantee to the lender.

The appropriate comparison is therefore summed up in paragraphs 61 and 62 of the judgment:

'For the comparison here to be of utility one would compare what the taxpayer, CAHPL, gave … and what it, or a borrower in its position, could reasonably be expected to give if dealing with an arm's length lender.

Thus one asks: What is the consideration that CAHPL or a borrower in its position might reasonably be expected to have given to an independent lender if it had sought to borrow AUD 2.5 billion for five years? The answer to this question is to be found in the evidence. Here the borrower in the independence hypothesis is a company in the position of CAHPL. It is part of a group the policy of the parent of which was to borrow externally at the lowest rate possible. Further, it was usual commercial policy of the parent of the group for a parent company guarantee to be provided by it (the parent) for external borrowings by subsidiaries. In those circumstances, the consideration that might reasonably be expected to be given by a company in the position of the taxpayer CAHPL would be an interest rate hypothesised on the giving of a guarantee of CAHPL's obligations to the lender by a parent such as Chevron.'

The approach is defended and justified in paragraph 65 by reference to the relevance of factual context:

'There may be factual circumstances where the attributes of the taxpayer, or its position in a group of companies, or the nature of the subject matter of the transaction make it appropriate to assess a consideration for s136AA(3)(d) as one struck between two disembodied parties without some or all of the attributes of the taxpayer. Ultimately, however, the purpose of the hypothesis is to identify what should be deemed to be the consideration instead of that actually given by the taxpayer in respect of the acquisition that occurred. Here, the ascertainment of that consideration naturally and rationally contemplates a company in the position of CAHPL with its attributes, including its inhabiting of the Chevron group, dealing at arm's length with an independent lender.'

The judgment then went on to consider the application of Article 9 of the DTA by reference to the OECD Transfer Pricing Guidelines. The Chief Justice quoted extensively from the Guidelines, but the following extract, taken from C.1.38 of the Guidelines, concisely justified his interpretation:

'… the character of the transaction may derive from the relationship between the parties rather than being determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.'

The judgment of Pagone J also concluded that the lower court had been correct in determining that what might reasonably have been expected in the circumstances was a borrowing by CAHPL with security provided by its parent at a lower interest rate.

Allsop CJ could find '*nothing in the Guidelines that requires other than the independent status of the enterprises* ***from each other*** *in the transaction*'. He therefore summed up the approach under the DTA in the following terms in paragraphs 92 to 95 of his judgment:
'The conditions operating between CAHPL and CFC if they were independent of each other would not include the direction by Chevron Treasury of the officers of both for the benefit of the group as a whole. The conditions between mutually independent CFC and CAHPL could, however, include CAHPL situated within the Chevron group and CAHPL being subject to the direction of Chevron for the benefit of the Chevron group.

In such circumstances, were CAHPL seeking to borrow for five years on an unsecured basis with no financial or operational covenants from an independent lender, in order to act rationally and commercially and conformably with the interests of the Chevron group to obtain external funding at the lowest possible cost consistently with any relevant operational *considerations, it would do so with Chevron providing a parent company guarantee, if such were available.*

In the light of the evidence as to Chevron's policy concerning external funding and its willingness to provide a guarantee to achieve that end the above is the natural and commercially rational comparative analysis when one removes the controlled conditions operating between CAHPL and CFC and replaces them with the condition of mutual independence.

In the circumstances there would have been a borrowing cost conformable with Chevron's AA rating, which, on the evidence, would have been significantly below 9%.'

This is an instructive analysis as it clearly demonstrates the importance of context, not only of the relevant legislation in relation to the statute of which it forms part, but also of the circumstances surrounding the transaction in question. It highlights the 'unrealistic and impractical ends' that resulted from the application of a pure literal meaning to the term 'independent status' on the part of CAHPL in this instance.

The judgment of Pagone J also concluded that the lower court had been correct in determining that what might reasonably have been expected in the circumstances was a borrowing by CAHPL with security provided by its parent at a lower interest rate.

Is there any relevance to South Africa?

The relevant provisions in South Africa are found in section 31 of the Income Tax Act, 1962 (the Act) In summary, section 31 requires that the income or expenditure arising in an affected transaction be reflected at the amount that would have arisen if that transaction had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length.

Unlike the Australian provisions, which refer to ‘consideration’, section 31 enjoins the taxpayer to report the income having regard to the terms and conditions that might have been expected had the parties been independent persons dealing at arm’s length.

In relation to the concept of independence, there is nothing in section 31 to suggest that the independence that is hypothesised is limited to independence of one from the other. Furthermore, there is no indication that the income or expenditure arising must be considered in light of the very transaction that was agreed rather than on the basis of what would have transpired if the substantive arrangement were negotiated between parties acting at arm’s length.

Also of relevance is the similarity in the approach to the interpretation of legislation as set out in paragraph 3 of the judgment of Allsop CJ to the approach that is now the touchstone for interpretation in South African courts as set out in paragraph 25 of the judgment of Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) at paragraphs 25–26:

‘Most words can bear several different meanings or shades of meaning and to try to ascertain their meaning in the abstract, divorced from the broad context of their use, is an unhelpful exercise. The expression can mean no more than that, when the provision is read in context, that is the appropriate meaning to give to the language used. At the other extreme, where the context makes it plain that adhering to the meaning suggested by apparently plain language would lead to glaring absurdity, the court will ascribe a meaning to the language that avoids the absurdity. This is said to involve a departure from the plain meaning of the words used. More accurately it is either a restriction or

extension of the language used by the adoption of a narrow or broad meaning of the words, the selection of a less immediately apparent meaning or sometimes the correction of an apparent error in the language in order to avoid the identified absurdity.

In between these two extremes, in most cases the court is faced with two or more possible meanings that are to a greater or lesser degree available on the language used. Here it is usually said that the language is ambiguous, although the only ambiguity lies in selecting the proper meaning (on which views may legitimately differ). In resolving the problem, the apparent purpose of the provision and the context in which it occurs will be important guides to the correct interpretation. An interpretation will not be given that leads to impractical, unbusinesslike or oppressive consequences or that will stultify the broader operation of the legislation or contract under consideration.'

Applying the approach that is recommended, it is submitted that our courts would likely adopt the same approach as was adopted by the Federal Supreme Court of Australia in avoiding artificiality that leads to an absurdity.

That is, the borrower would be considered in light of its relationship to its parent company, and the practices of the parent group in relation to assisting group companies that obtain third-party financing, would be a factor that would be taken into account in determining the terms and conditions that might apply if the financing were sourced from a third-party financier.

Had this matter involved a South African borrower, it is likely that a court would have come to the conclusion that a lender would only have advanced such amount on the guarantee of the parent company, in which event the rate of interest would likely have been based upon the credit rating of the parent.

PwC

ITA section 31

The DTA SA/Australia

2654. Section 7C – preference shares

INTRODUCTION

The Income Tax Act, 1962 (the Act) was amended with effect from 1 March 2017 to provide for a further tax burden where (by and large) individuals had advanced loans to local or offshore trusts at low or zero rates of interest. The new provision – section 7C of the Act – deems the difference between the "official rate of interest" for fringe benefits tax purposes (currently 8% for rand denominated loans) (editorial comment: subsequently in August 2017 reduced to 7.75%) multiplied by the loan owing from time to time, to result in a donation deemed to be made on the last day of February, i.e. the last day of the tax year, to be subject to donations tax at the rate of 20%. This gives rise to an effective tax rate of 20% of 8% = 1.6%. Given that the official rate of interest is linked to the equivalent of the repo rate in foreign currency denominated loans, the effective rate of tax for loans to offshore trusts denominated in foreign currency is much lower.

Not surprisingly, despite the fact that the effective rate of tax is quite low, there has been a significant amount of resistance and concern at the imposition of this new tax. And it must be remembered that an interest-free loan also gives rise to a deemed donation for the purposes of section 7, so that the whole or portion of the income of the trust is attributable to the lender (and there is a corresponding provision in the Eighth Schedule to the Act so that capital gains are similarly attributable).

But not in all structures is there an interest-free loan to a trust. Sometimes the trust's sole asset represents a nominal investment in shares in a company, and all of the assets are held in the company, with the planner having made an interest-free loan to the company (and this can be found both onshore and offshore). Hitherto this arrangement has escaped section 7C, as it applies only to a loan to a trust, and not to a company owned by a trust. In the February 2017 Budget, it was announced that this oversight last year would be remedied this year.

OFFSHORE STRUCTURES

In their haste to avoid the application of section 7C to loans made to offshore companies held by offshore trusts, certain individuals are contemplating capitalising these loans into zero coupon redeemable preference shares. In this way the section cannot apply, because it clearly refers only to a loan. Moreover, it is hoped that section 7 will not apply to attribute income, because there is no longer an interest-free loan.

The consequences of such action are much worse than realised. In fact this is a case of the cure being far worse than the illness. Assume that the trust was formed and invested USD100 in share capital of an offshore company, and the planner advanced an interest-free loan of USD1 million to the company. With the base rate in the USA being 1%, the official rate for fringe benefits purposes would be 2%, so that the effective rate of donations tax under section 7C would be 0.4% per annum. In addition, for the purposes of determining how much of the company's income and capital gains should be taxed in the hands of the lender, one would probably say that it is an amount equal to, say, 8% of the loan (this is not to say that the lender will pay tax on 8% of the loan, because if the actual income and capital gains amount to less than an amount equal to 8%, he or she will pay tax on the lesser amount).

By capitalising the loan into a zero coupon redeemable preference shares, the planner now renders that offshore company to be a controlled foreign company in terms of section 9D of the Act. The reason is that he or she has

USD1 million worth of preference shares as against the trust holding USD100 of ordinary shares, so that the planner holds 99.99% of the participation rights (as defined in section 9D) in the offshore company. As a result, he or she will be taxed on 99.99% of the annual income and capital gains of the offshore company – and this notwithstanding the fact that the preference shares are non-participating.

ONSHORE TRUSTS

Similar planning for an onshore situation would not have the same adverse results. There would be a cure for the application of section 7C (but one wonders how long it will take the legislature to incorporate preference shares into the section in addition to loans, as has been done in other sections of the Act).

A zero-coupon preference share will not, however, defeat the attribution rules under section 7, because it will still be considered to be a donation for this purpose, which results in such attribution.

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Sections 7, 7C and 9D, Seventh Schedule para 1 definition of 'official rate'

Editorial comment: with effect from 1 August 2017 the official interest rate was reduced from 8% to 7,75% p.a.

2655. FATCA and CRS

The weight and impact of the comment by the Minister of Finance in the budget speech of 2016 in respect of the Common Reporting Standards and the envisioned Automatic Exchange of Information appears to not have been comprehended to the full extent.

Both the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) require Financial Institutions to obtain information with regards to a customer's tax residency(ies) held via the provision of a declaration/certification from the customer him/herself. Such a declaration/self-certification is not limited to a single tax residency and should include all tax residencies/obligations/liabilities held both locally and internationally. The intent is to report such a customer to the Revenue Authorities of those jurisdictions via the local Revenue Authority (i.e. SARS) under the Automatic Exchange of Information Multilateral Agreement and in the case of South Africa, and any other jurisdiction that has adopted a wider approach, per double tax agreements in place that include such a requirement.

At face value it seems simple enough. However, challenges arise for the ordinary client who has become accustomed to the requirements under the Anti-Money Laundering/Know your Client (AML/KYC) legislation which historically has not asked for tax information due to an exemption – thus the ordinary client would either respond that they don't know or naturally respond that he/she is tax resident in South Africa only, but does not carry information on hand about his/her SA tax number nor in respect of any other jurisdiction. In certain cases for smaller companies the status quo is the same re the provision of its tax residency as well as what the company's classification per its business activities would be under the regime.

The declaration/certification of tax residencies held is not limited to income tax and the expectation is to understand whether such customer holds more than one citizenship, nationality or residency for tax purposes based upon the laws of that jurisdiction. For example, the US issues a person a tax number (social security number) at birth and the person would be tax resident in the US regardless of any other tax residency held by virtue of living and working in another jurisdiction. There is a general misunderstanding that the person is only tax resident in another jurisdiction if there is a requirement to pay income tax to that jurisdiction, thus the general "180 day" rule/test per the Act and a determination of tax payable or not per a DTA doesn't apply in this instance.

The SARS FAQ Guide on CRS, FAQ number 19 clarifies what is meant by "any tax":
"The term "any tax" means any tax imposed by the laws of any Reportable Jurisdiction and is not limited to income tax. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC) applies to taxes on income, profits, capital gains, and net wealth levied at the central government level. It also covers local taxes, compulsory social security contributions, estate, inheritance or gift taxes, etc. As the term clearly also covers local taxes it would include municipal taxes."

The risk that a customer can simply not disclose all tax residencies held is mitigated through a requirement to "test" whether the declaration is reasonable based upon any information collected during the normal course of the account opening process and the transactional data over a period of time. There is a data set known as "indicia" upon which financial institutions can rely as a minimum to determine whether or not their customer may potentially hold other tax residencies. Where there is a conflict in the information the financial institution may need/request further confirmation from the client as to whether all tax residencies have indeed been declared.

What does this mean, you ask. Given that the CRS is implemented globally, the converse should be considered in that SARS will also be receiving information about any offshore accounts held by a South African resident and would need to marry this information to what is declared as part of the person's/company's/entity's tax return and may enquire in respect of the disclosure of such accounts.

What does this mean for the tax practitioner? Consider where a person/company requires assistance in completing a declaration/self-certification for a financial institution that all tax residencies are to be disclosed regardless of whether tax is owed and a Nil return is completed, and it is not just a confirmation of being South African tax resident.

The CRS Commentaries provide the following:
Generally, an individual will only have one jurisdiction of residence. However, an individual may be resident for tax purposes in two or more jurisdictions. The domestic laws of the various jurisdictions lay down the conditions under which an individual is to be treated as fiscally 'resident'.

Generally, an individual will be resident for tax purposes in a jurisdiction if, under the laws of that jurisdiction (including tax conventions), he pays or should be paying tax therein by reason of his domicile, residence or any other criterion of a similar nature, and not only from sources in that jurisdiction.

It may be rare in practice for an Entity to be subject to tax as a resident in more than one jurisdiction, but it is, of course, possible. The domestic laws of the various jurisdictions lay down the conditions under which an Entity is to be treated as fiscally 'resident.
Generally, an Entity will be resident for tax purposes in a jurisdiction if, under the laws of that jurisdiction (including tax conventions), it pays or should be paying tax therein by reason of his domicile, residence, place of management or incorporation, or any other criterion of a similar nature, and not only from sources in that jurisdiction.

…an Entity…that has no residence for tax purposes shall be treated as resident in the jurisdiction in which its place of effective management is situated…

There are no more hiding places for taxpayers as SARS receives CRS reports form all countries that signed the multi-lateral agreement for CRS.

FirstRand

SARS FAQ guide on CRS

The CRS Commentaries

2656. Controlled foreign companies

Controlled foreign company (CFC) legislation that permits a country to tax income derived by non-resident subsidiaries of companies resident in its jurisdiction needs to strike a balance between counteracting deferral of taxation and competitiveness. The principal thrust of the law is directed at taxing the income of foreign subsidiaries which may easily be diverted to foreign jurisdictions or which is derived in foreign jurisdictions where the principal benefit of conducting operations in such jurisdictions is low taxation or no taxation.

Where it is evident that operations are established in a country in which the manner of determining taxable income and the rate of tax applied to such taxable income are substantially similar to those applied in the jurisdiction of the controlling company, it may be inferred that the purpose of establishing operations in that country is unlikely to be to avoid or reduce tax.

Tax authorities generally recognise the need to limit the application of CFC provisions to enable them to combat profit shifting to benefit from low taxation. They do so usually by excluding from the provisions of the legislation CFCs that derive income from countries in which the taxation provisions are unlikely to result in a shift of profit based purely on considerations of tax reduction. From an administrative viewpoint this is also justifiable, in the sense that, in these cases, the major portion of any taxes assessed as a result of imputation of the income of a CFC is likely to be offset by applicable double tax relief.

Two broad approaches may be considered in this regard:

- a ‘schedule’ approach; or
- an ‘effective tax rate’ approach.

Schedule approach

The ‘schedule’ approach requires that a list be prepared specifying the countries which are either excluded from the application of the CFC provisions (white list) or the countries which are compulsorily subject to the application of the CFC provisions (black list). This approach was initially adopted in South Africa by National Treasury when the CFC provisions were originally formulated.

The schedule approach has the elements of certainty and simplicity. However, it requires constant monitoring, as countries may become eligible for inclusion in or exclusion from the list when adjustments are made to their statutory rates of taxation. For this reason, it was replaced with the alternative mechanism after a short period of time.

Effective tax rate

The alternative mechanism is to apply a case-by-case analysis in which the income of a CFC may be exempted from imputation if the CFC is subject to an effective tax rate that is above a benchmark rate.

The benefit to this approach is principally that less regard is paid to the statutory rate of tax that may apply, and greater consideration is given to the global tax exposure of the CFC.

The benchmark is typically set by reference to the amount of tax that might have been payable if the CFC had derived its income as a resident in the relevant controlling jurisdiction.

This approach cannot ignore the fact that the basis for determining taxable income in foreign jurisdictions may not be the same as that in the home jurisdiction. Two areas are of particular relevance:

- In certain jurisdictions, the law not only permits the carry-forward of assessed losses but also allows the taxpayer to reopen prior-year assessments and carry back losses for a limited number of years.
- Some jurisdictions impose a single tax on a group of companies in terms of which the income and losses of all the companies within the group are aggregated and intra-group items are eliminated, so that tax is payable on the net group income derived from third parties.

When an effective tax rate exemption is used as the mechanism, it must provide a fair basis of comparison between the notional domestic tax liability and the comparable foreign tax liability.

This is achieved, typically, by limiting the comparison to the taxes that would notionally have been incurred if there had been no assessed losses and no group taxation. Therefore, for purposes of the foreign tax calculation, it would be necessary, first, to add back any assessed losses actually allowed and, secondly, to reallocate losses and intra-group transactions to the companies that actually incurred such losses. This results in each company being notionally taxed as a ‘stand-alone’ entity (as is the case in South Africa) and not as an element of a group.

The high-tax exemption in section 9D(2A) of the Income Tax Act, 1962 (the Act), as it applied for years of assessment ending on or before 31 March 2016, displays the hallmarks of a fair benchmark. It recognises that the distorting effect of assessed losses or group losses should be ignored in both the notional domestic tax calculation and the determination of the foreign tax liability for purposes of the comparison.

The determination of the notional foreign tax liability in the case of a CFC that forms part of a tax group in a foreign jurisdiction is, of necessity, hypothetical. If it were not, the tax bases would not be comparable. What is clear is that the requirement in our legislation to exclude assessed losses and losses of other companies in the foreign tax group was not accidental or unintended, but was incorporated into the law in order that there should be a fair and morally defensible basis for comparison.

A brief example illustrates the fairness:
Assume a foreign tax group comprises two companies, A and B.

	A	B
Foreign taxable income	$500 000	($400 000)
Notional foreign tax at 25%	$125 000	$0

Under group taxation, the income of A is aggregated with the loss of B, and the actual tax on group taxable income of $100 000 would be $25 000.

Notional SA taxable income	$520 000	($415 000)
Notional SA tax at 28%	$145 600	$0

Under current provisions, company A would meet the high-tax exemption requirement, because group losses are ignored (naturally, because they arise in determining the eligibility of company B to the exemption). In the following year of assessment, B's assessed loss would be disregarded for both the notional foreign tax and the notional domestic tax calculations.

It is fallacious to argue in this instance that the businesses were established in the foreign jurisdiction to benefit from a low-tax regime. The tax rate is substantially comparable to SA's, and all that is impacted is the timing of the tax recognition. Under SA law, B's loss would be deferred, while under foreign law it may be utilised currently.

New legislation

Parliament enacted an amendment to section 9D(2A) in January 2017. This amendment came into effect for years of assessment commencing on or after 1 April 2017.

The Draft Explanatory Memorandum to the Draft Taxation Laws Amendment Bill, 2016 (no explanatory memorandum was issued with the final Bill) states:

'Generally, the income tax [Act] does not allow foreign tax rebate on notional taxable income. However, in the calculation of the hypothetical amount of foreign taxes some CFCs within a group of companies that are in a loss-making position benefit from the high-tax exemption. This creates an anomaly because in these circumstances, no foreign tax is actually paid or payable by the CFC.'

This explanation is fundamentally misleading. CFCs that are in a loss-making position do not benefit from the high-tax exemption. If the foreign country in the earlier example did not apply group taxation, the assessed loss of company B would be disregarded in any subsequent year of assessment in determining whether the high-tax exemption applied to company B.

Under group taxation, the foreign tax liability of the group of companies in any year may be lower or higher than the liability would have been if each company were taxed as a standalone entity in that jurisdiction, depending on when losses arising have been applied to reduce group taxable income. Over time the amount of tax that the foreign jurisdiction collects on a group basis is the same as the aggregate tax it would have collected if there had not been group taxation.

The amendment completely overlooks the fact that the tax bases that are being compared are fundamentally notional. On the one hand there is a notional South African tax liability against which a notional foreign tax rebate must be compared. The explanation appears to suggest that an *actual* foreign tax liability should be compared with a notional domestic tax liability. It ignores that foreign laws may nevertheless make group members jointly and severally liable for all taxes incurred within the group and that any tax deferred by group losses may lawfully be recovered at a later date from the company that derived otherwise taxable income.

The amendment does not go so far as to require that assessed losses must not be disregarded. This requirement is retained. This demonstrates the inequity that arises from selectively disregarding losses. The amendment effectively provides that the assessed loss of company B would be disregarded if there is no group taxation, but must not be disregarded if group taxation applies. In effect the foreign jurisdiction's treatment of the group of companies governs whether an assessed loss should or should not be disregarded.

The high-tax exemption is there to provide reasonable assurance that the operations in a foreign jurisdiction are exposed to taxation that is comparable to South African taxation and that potential liability to tax is not being abused by establishing companies in low-tax or no-tax jurisdictions. Destroying the very principle of comparability that should underpin the exemption sabotages the purpose of the exemption.

Conclusion

The amendment potentially affects South African multinational groups adversely. Eighteen member states in the European Union permit group taxation. Group taxation is also permitted in the United States of America, Australia and New Zealand. Many of these countries are major trading partners and investment destinations for SA multinationals. They are undoubtedly not tax havens.

The additional tax burden that is likely to fall on South African multinational groups adversely affects the competitiveness of South African-controlled operations and tarnishes the attractiveness of South Africa as a holding company location.

PwC

ITA, sections 9C and 9D(2A)

Draft Explanatory Memorandum to the Draft Taxation Laws Amendment Bill, 2016

2657. Increase of estimates by SARS.

In terms of paragraph 19(1)(*b*) of the Fourth Schedule to the Income Tax Act, 1962 (the Act), every company that is a provisional taxpayer shall, during every period within which provisional tax is or may be payable by it as provided in terms of the Fourth Schedule, submit to the Commissioner for SARS (the Commissioner), a return of an estimate of the total taxable income which will be derived by the company in respect of the year of assessment in respect of which provisional tax is or may be payable by the company.

Paragraph 19(3) of the Fourth Schedule provides that the Commissioner may, *inter alia*, call upon any provisional taxpayer to justify any estimate made in terms of paragraph 19(1), and if the Commissioner is dissatisfied with the said estimate, he or she may increase the amount thereof to such amount as he or she considers reasonable.

In terms of paragraph 23 of the Fourth Schedule, provisional tax shall be paid by every company that is a provisional taxpayer:

1. at the end of six months after the commencement of the year of assessment, one half of an amount equal to the total estimated liability of such company (as determined in accordance with paragraph 17 of the Fourth Schedule) for normal tax in respect of that year (referred to as the "first provisional tax payment"); and

2. at the end of that year, an amount equal to the total estimated liability of such company for normal tax in respect of that year less the "first provisional tax payment".

We discuss below an increase by the Commissioner of a taxpayer's estimated taxable income for purposes of its first provisional tax payment.

In our experience, for first provisional tax purposes, a company would typically review its accounting profit before tax for the financial year to date as per the management accounts (ie actual profit to date) and make the necessary income tax adjustments. The profit before tax is then also increased to account for the remaining portion of the financial year by taking into account estimated future income, anticipated expenses as well as factual developments that have occurred or are anticipated to occur.

If SARS is not satisfied with the estimate prepared by the taxpayer, the first provisional tax payment will be queried. If still not satisfied, despite reasons or support provided by the taxpayer, the Commissioner may advise the taxpayer of its intention to increase the estimated taxable income for first provisional tax purposes in terms of paragraph 19(3). In our experience, this may well be the case where the estimated taxable income in respect of the second part of the year of assessment is less than that determined with reference to the actual profit before tax for the first part of that year. In such a case, SARS may advise the taxpayer of its intention to "annualise" the actual profit before tax for first provisional tax payment purposes. This will then result in an increased first provisional tax liability.

If there is a late payment as a result of the increased estimated taxable income, the taxpayer will be exposed to a 10% penalty in terms of paragraph 27(1) of the Fourth Schedule (read with section 213 of the Tax Administration Act, 2011 (the TAA) and interest will, unless the Commissioner "having regard to the circumstances of the case otherwise directs" be imposed in terms of section 89*bis* of the Act. The taxpayer may, therefore, depending on the facts, request a waiver of the interest in terms of section 89*bis*.

Sections 217(3) and 218 of the TAA provide for a remittance of penalties under certain circumstances.

Interpretation Note 1 (Issue 2), issued by SARS on 30 March 2016, lists, *inter alia*, the availability of financial results that support an increase in taxable income and the failure by the provisional taxpayer to justify the estimate when requested to do so by SARS as examples where a discretion may be exercised by SARS. Where, for example, the published results of a listed company do not support the estimated taxable income calculated by a taxpayer for provisional tax purposes and no reasonable explanation is provided, SARS could then reasonably increase the estimate in terms of paragraph 19(3).

However, a decision to "annualise" the actual profits of a company may not be appropriate where the taxpayer can demonstrate (and has demonstrated to SARS) that valid reasons exist for the estimated taxable income for the second half of a year of assessment being less than the estimated taxable income for the first six months determined with reference to actual profits.

A decision by the Commissioner to increase a taxpayer's estimate is not subject to objection or appeal in terms of paragraph 19(3). Where it is alleged that the increased estimate was not determined on a reasonable basis, a taxpayer may request that the decision by SARS be withdrawn or amended as envisaged in section 9(1)(*b*) of the TAA. The basis for such a request would have to be clearly documented with reference to the facts and correspondence with SARS.

Alternatively, the taxpayer could challenge the decision of the Commissioner in terms of paragraph 19(3) by way of a review application in the High Court, relying on the provisions of the Promotion of Administrative Justice Act, 2000.

ENSafrica

TAA sections 9(1)(b), 213, 217 and 218

ITA section 89bis, Fourth Schedule paras 17, 19, 23 and 27

Interpretation note 1

Promotion of Administrative Justice Act, 3 of 2000

2658. 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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