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DEDUCTIONS

2636. Urban Development Zone allowances

In line with international models, South Africa has attempted to incentivise investment into the development and renewal of certain urban areas. One of these incentives is the accelerated tax depreciation allowance, introduced in 2003 by section 13*quat* of the Income Tax Act, 1962 (the Act) and is commonly referred to as the Urban Development Zone (UDZ) allowance. The UDZ allowance is available in respect of the 'cost' (as defined in 13*quat*) of erection, extension, addition or improvement of any commercial or residential building, or part of that building, within an 'urban development zone' which is owned by the taxpayer and is used solely for purposes of that taxpayer's trade.

This allowance was originally only available until 31 March 2014, but has been extended for a further six years until 31 March 2020.

There are five main requirements that must be met in order for a taxpayer to claim the UDZ allowance. These requirements are:

1. the building in question must be a commercial or residential building;
2. which is owned by the taxpayer;
3. situated within a UDZ;
4. which has been brought into use on or before 31 March 2020; and
5. is used solely for the purposes of that taxpayer's trade.

The UDZ allowance is not limited to the taxable income of a taxpayer and may create an assessed loss. The allowance is restricted to the cost of erection, extension, addition to or improvement of the specific building. The cost of the land upon which the building is located is specifically excluded. Therefore, should the 'purchase price' (as defined) of the building include the purchase price of the land, an apportionment will have to be made to determine the portion of the price attributable to only the building.

There are a number of important documents that need to be completed and retained by the taxpayer in order to validly claim the UDZ allowance. These forms are readily available on the South African Revenue Service (SARS) website. Further, should a 'developer' be involved in a property development project, special reporting requirements are mandated by section 13*quat*(10A).

Reporting to SARS in this context includes, *inter alia*, details of estimated costs of the building that the developer intends to sell, the estimated selling price of the building that the developer intends to sell and, following the sale of the building, actual costs incurred and the actual selling price of the building.

Section 13*quat* defines a 'developer' as:
"a person who erects, extends, adds to or improves a building or part of a building—

a) with the purpose of disposing of that building or part thereof immediately after completion of that erection, extension, addition or improvement; and
b) disposes of the building or part of a building within three years after completion of that erection, extension, addition or improvement".

From 10 January 2012, the amended definition of 'developer' allows a developer, for a period of three years, to use or let the constructed or improved property. This has resulted in the allowance being available to both the initial developer, and the subsequent purchaser, provided the developer has not claimed the UDZ allowance within the period in which the property was used or let.

Rates of the allowance

The amount of the allowance in relation to 'cost' (as defined) varies according to the following distinctions:

The erection of any new building or the extension of or addition to any building, is equal to:

- 20% of the 'cost' to the taxpayer during the year of assessment in which the building is brought into use by the taxpayer; and
- 8% of the 'cost' to the taxpayer in each of the 10 succeeding years of assessment.

The improvement of any existing building or part of a building (including any extension or addition which is incidental to that improvement) where the existing structural or exterior framework thereof is preserved, is equal to:

- 20% of the 'cost' to the taxpayer during which the part of the building so improved is brought into use by the taxpayer solely for the purposes of that taxpayer's trade; and
- 20% of that 'cost' in each of the four succeeding years of assessment.

Where the taxpayer purchased a building or part of a building from a developer, the below will be deemed to be the cost incurred by that taxpayer in respect of the erection, extension, addition to or improvement of that building or part of a building:

- 55% of the purchase price of that building or part of a building, in the case of a new building erected, extended or added to by that developer; or
- 30% of the purchase price of that building or part of a building, in the case of a building improved by that developer.

Section 13*sex*

Since 21 October 2008, section 13*sex* has provided a comprehensive consolidation of allowances available to taxpayers for certain residential units. Generally, this results in an allowance of 5% per annum over a 20-year period of the cost of erection, improvement or acquisition of any new and unused residential units, or any new and unused improvement to a residential unit, owned by the taxpayer. Should the residential units qualify as 'low-cost residential units' (as defined), the taxpayer may be eligible for an additional 5% allowance (i.e. the allowance would be increased to 10% of allowed costs per annum over a 10-year period).

The following four requirements may be distilled from section 13*sex*:

1. the units or improvements must be owned by the taxpayer;
2. the units must be situated in South Africa;
3. the taxpayer must own five (or more) residential units in South Africa, which units must also be used solely for the purposes of the taxpayer's trade; and
4. the unit or improvement must be used solely for purposes of the taxpayer's trade.

It is pertinent to note that this allowance is limited to new and unused units or improvements thereto. The allowance is therefore not available to costs associated with second-hand residential units.

The interaction between sections 13*quat* and 13*sex*

To the extent that a taxpayer qualifies for the UDZ allowance in respect of a particular development, it would be unlikely to qualify for a deduction in terms of section 13*sex* in respect of that same development, as section 13*sex* expressly applies only in instances where no other deduction is available in terms of any part of the 'cost' of the unit(s). This is so as the concept of the 'cost' of a unit, as defined under 13*sex*, largely overlaps with the concepts of 'cost' and ‘purchase price’ in terms of section 13*quat*.

Generally, therefore, should the development have already qualified for the UDZ allowance, part of the ‘cost’ under 13*sex* would have likely already qualified for a deduction, rendering 13*sex* unavailable. However, the exact interaction between the two deductions, needs to be considered specifically on the facts of each case.

It is to the benefit of property developers and investors to consider these and other allowances, as well as the interaction between respective allowances, provided for under the Act.

ENSafrica

ITA: Sections 13*quat* and 13*sex*

INTERNATIONAL TAX

2637. Foreign Service Contracts

SA resident companies (SA Co) providing technical services to clients outside of SA (Client Co) are required to include the following in their SA taxable income:

- profits from services carried out in SA (which would be ‘SA source profits’) (e.g. preparation of technical designs and specifications); and
- profits from sources carried on outside of SA, (which would be ‘non-SA source profits’) (e.g. on-site construction oversight).

The foreign resident client (Client Co), due to its in-country tax legislation, very often deducts withholding tax on payments made to non-residents not only in respect of work carried on in-country, but also in respect of work carried out in SA.

The general rule is that SA Co is entitled to claim tax credit relief (i.e. a reduction of SA tax payable) in respect of this withholding tax to the extent of SA tax payable arising from this profit (income less expenses), but only to the extent that the income is not from an SA source (section 6*quat*(1A)) of the Income Tax Act, 1962 (the Act).

In respect of SA source income, tax relief for foreign withholding taxes is restricted to tax deduction relief (i.e. a deduction of the withholding tax against that underlying income) in terms of section 6*quat*(1C). The deduction is limited to the taxable income arising from that SA source income (section 6*quat*(1C)). Tax credit relief which was previously available in terms of section 6*quin* of the Act, in respect of SA source income was terminated with effect from years of assessment commencing on or after 1 January 2016.

This article focuses on technical services provided by SA Co in South Africa, i.e. SA source income and in particular, SA tax deduction relief in respect of the incorrect deduction of withholding tax by Client Co (either through incorrect interpretation or through unwillingness to honour the terms of the Double Tax Agreement (DTA)) and in contradiction to the DTA.

The abovementioned tax deduction relief in respect of SA source income is subject to the proviso that no relief may be claimed by SA Co for foreign withholding taxes where SA Co has a right to recover the withholding tax, other than in terms of a mutual agreement procedure (MAP) in a DTA.

Firstly, what does SARS mean by the phrase "right of recovery"?

In SARS' Interpretation Note 18 at paragraph 8.2, they indicate that "*the term 'right of recovery by any person' is interpreted very broadly and includes any form of relief against a foreign tax liability*". At paragraph 4.3.3 SARS provides an example *"For example, a refund, credit, rebate, remission, or deduction, is considered to be a right of recovery. Any other form of economic benefit to which a person becomes entitled to in consequence of the payment of the relevant tax is also considered to be a 'right of recovery by any person'"*.

The above references seem to indicate that SA Co needs to carry out a due diligence review of its own as to whether the withholding tax imposed by Client Co on SA source work is recoverable, which would require SA Co to determine whether Client Co is entitled to claim relief in terms of any applicable tax treaty.

This analysis should, however, not be carried out by SA Co, but rather by Client Co taking account of its domestic tax provisions, which may seek to restrict tax treaty relief.

Where there is a treaty with SA, relief may be available in terms of either:

- a technical services article, if present in the treaty, (which may grant taxing rights to Client Co as payer of the technical services); or
- in terms of the business profits article that limits the foreign revenue authority's taxing rights to the extent that the income relates to a permanent establishment carried on by SA Co in Client Co country.

It is this treaty relief that foreign tax jurisdictions often ignore, resulting in Client Co withholding tax from payments made to SA Co incorrectly, for fear of the local tax authority holding them responsible for the withholding tax.

Practically speaking, does SA Co need to obtain a tax ruling from Client Co tax authorities in this regard, or is a tax opinion from a reputable local tax counsel sufficient? It appears from paragraph 5 of Interpretation Note 18 that SARS expects SA Co to approach the Client Co tax authorities for confirmation in this regard. But this does not really make sense given that such approach should be undertaken by Client Co.

Secondly, what does SARS mean by a "*right of recovery which forms part of a mutual agreement procedure*"?

The SARS website states that "*In cases where the taxation which is not in accordance with the DTA has been imposed, the taxpayer must first raise the issue with the relevant State as agreement by the other State will negate the need for a MAP , and …..if unsuccessful, the taxpayer may then approach the Competent Authority of his/her country of residence to request a MAP under the relevant DTA".*

The above seems to suggest that SA Co is now back to having to request Client Co tax authorities for a ruling regarding the imposition of withholding tax on SA source income per the treaty.

To summarise then, where SA Co is tendering for contracts to provide services to non-SA resident clients, they should:

1. Ensure that the contract clearly differentiates between work carried on inside and outside of SA and that the contract allocates estimated values to each. Separate contracts may, in certain circumstances, be preferable;
2. Ask Client Co to confirm with their local tax authority in writing whether withholding tax should be imposed on contract payments and if so, to what amounts as well as at what rate; failing which Client Co should at least take professional advice regarding the applicable withholding tax rate taking account of any applicable treaty relief and this should be shared with SA Co;
3. Prepare a summary of after-tax contract cash-flows summarising all applicable withholding taxes as well as available tax reliefs in SA (credit or deduction). It is important to note that both the tax credit and tax

deduction relief are granted in respect of profits, i.e. technical services income less attributable expenses, which may result in relief falling short of withholding taxes for low margin profits. For example, assuming a profit margin of 10% on R100 of SA source technical services and a withholding tax of 20% from gross technical service payments, in the absence of tax deduction relief, SA Co would incur negative after-tax cash flow on this contract (R100 – R90 cost – R2.8 income tax – R20 withholding tax = -R12.80). The contract revenue would have to be grossed up by 38.5% to R138.5 to achieve the desired after-tax cash flow of R7.20 (R10 profit x 72%). If tax deduction relief were available, this negative cash flow reduces to –R10 and the contract revenue would have to be grossed up by 25% to R125 to achieve after tax cash of R7.20; and

4. Consider requesting Client Co to gross up the contract consideration for any possible tax leakage, if there is any uncertainty regarding the imposition of withholding taxes or available SA relief for their withholding taxes.

SARS should really be more willing to assist SA-based businesses looking to secure valuable foreign service contracts (which include a large SA-work component), with practical guidance regarding reasonable steps to determine available foreign tax credits. These may ultimately be the difference between winning or losing the contract, if grossing up for tax leakage renders the tender price uncompetitive.

As can be seen from the numerical example above, the absence of tax deduction relief increases the required percentage contract revenue from 25% to 38%, which may cause SA Co to lose the tender to countries with friendlier tax regimes governing relief for foreign tax.

Grant Thornton

ITA: Sections 6*quat* and 6*quin*

SARS Interpretation Note 18

2638. Bad debt on foreign loan

Section 24I of the Income Tax Act, 1962 (the Act) requires that a gain or loss on a foreign exchange transaction be included in or deducted from the income of a taxpayer carrying on a trade within the Republic.

In essence, but with a few exceptions to the general rule, section 24I taxes all gains and losses, related to any foreign exchange transactions, whether realised or not.

Prior to 1 March 2017, a foreign exchange gain or loss arising on a foreign denominated loan granted by a South African taxpayer (who is not a money lender) to another person, would have had to be taken into account in determining the taxable income of the South African taxpayer.

However, where the loan became bad, a taxpayer was not allowed to claim a deduction of the foreign exchange difference in terms of section 11(*a*) of the Act, if the loan was utilised for capital purposes. The taxpayer would also not be able to claim a deduction under section 11(*i*) of the Act, as this section requires that the amount that became bad had to be included in the current or prior year's taxable income.

Therefore, the taxpayer was in a position where he might have been taxed on a foreign currency gain on the annual restatement of the foreign loan, but not allowed to claim a deduction if the foreign loan ever became bad.

SARS has realised the unfairness of this application of the law, and amended section 24I. They have included section 24I(4) to correct this position.

Section 24I(4) states the following:

"Subject to section 11, in determining the taxable income of any person contemplated in subsection (2) in respect of a debt owing to that person as referred to in paragraph (b) of the definition of exchange item, to the extent that it has become bad –

(a) The amount of any foreign exchange gain, relating to that debt, that is or was included in the income of that person in the current or any previous year of assessment must be deducted from the income of that person; and

(b) The amount of any foreign exchange loss, relating to that debt, that is or was deducted from the income of that person in the current or any previous year of assessment must be included in the income of that person."

This addition to section 24I effectively allows a taxpayer to now either deduct or add an exchange gain or loss that relates to a foreign loan that became a bad debt.

This section came into effect on 1 January 2017 and is applicable in respect of years of assessment ending after that date.

Should you have any foreign transactions or foreign assets or liabilities, we advise that you consult your tax practitioner as section 24I is a complex section of the Act and can have a significant impact on a South African taxpayer that trades internationally.

RSM South Africa

ITA: Sections 11(*a*), 11(*i*) and 24I

VALUE-ADDED TAX

2639. Sale of book debts written off

When a vendor, which is registered for value added tax (VAT) on the invoice basis, has made a taxable supply on credit, the vendor is generally required to account for the VAT on the value of the supply when a tax invoice for the supply is issued. If the vendor is unable to recover the debt, then section 22(1) of the Value Added Tax Act, 1991 (the VAT Act) provides relief to the vendor by allowing for a deduction of the VAT previously accounted for, when the debt is written off as irrecoverable.

It often happens that the vendor then sells these book debts that have been written off to specialised debt collectors in an attempt to recover at least a portion of the losses suffered as a result of the non-payment by the debtors. The question that often arises is whether there are any consequences for the vendor regarding the sale of such book debts.

The book debts are generally sold to a debt collector on a non-recourse basis for amounts which are substantially less than the amounts owing. Proviso (iv)(*aa*) to section 22(1), prohibits the claiming of a deduction for VAT on the transfer of accounts receivable at face value on a non-recourse basis. According to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 1997 (the EM), the purpose of proviso (iv) to section 22(1) was to prohibit a deduction of the difference between the face value and the consideration for accounts receivable upon transfer thereof. This is because such discount is not considered to be an irrecoverable debt as contemplated by section 22(1), but a financing cost.

The EM stipulates further that the 'face value' of a debt transferred is, for the purpose of section 22(1), the net value of the account receivable at the time of transfer, after adjustments have been made for debit and credit notes and after bad debts are already written off by the vendor. Therefore, if the special meaning to the term 'face value', as attributed by the EM is applied, then the accounts receivable, which have been written off as irrecoverable by the vendor, are transferred for a consideration greater than their face value, and not at a discount. Therefore, there is in any event no amount that could qualify as a deduction in these circumstances.

Accordingly, proviso (iv)(*aa*) to section 22(1), does not preclude a vendor from claiming a deduction in terms of section 22(1) on irrecoverable debts which are subsequently sold to a debt collector on a non-recourse basis, and no adjustment in relation to deductions previously made is required when the debts are sold.

A further aspect to consider is whether the vendor 'recovers' an amount, as contemplated by section 22(2), when the book debts are sold.

Section 22(2) provides that where an amount, which was previously written off as irrecoverable in terms of section 22(1) and any amount is subsequently recovered, the vendor is required to account for VAT on the amount recovered.

The debtors are never absolved from their obligation to make payment to the supplying vendor, and the total amount owing remains payable. The vendor disposes of its rights and interest in and to the debt owing by the debtors to the debt collector.

Section 12(*a*) of the VAT Act exempts from VAT the supply of 'financial services'. The term 'financial services' includes the transfer of ownership of a debt security. A 'debt security' is in turn defined to include an interest in, or right to be paid money that is owing by any person. The book debts therefore comprise 'debt securities' and the sale by a vendor of such book debts is then exempt from VAT.

Consequently, when the vendor sells the book debts to the debt collector, the sale proceeds are consideration for an exempt supply, being the transfer of ownership of a debt security, and do not comprise amounts 'recovered' in relation to the book debts. The debt collector further does not make any payment to the vendor on behalf of the debtors when the book debts are acquired. The vendor merely transfers its right to recover the amounts owing by the debtors to the debt collector, who then becomes entitled to recover the amounts from the debtors concerned.

Accordingly, when a vendor disposes of book debts that have previously been written off as irrecoverable on a non-recourse basis to a debt collector, the sale is exempt from VAT, and the vendor is not required to make any adjustment in respect of the VAT previously deducted when the debts were written off as irrecoverable. The vendor is also not required to account for VAT on the sale proceeds.

Cliffe Dekker Hofmeyr

VAT Act: Sections 12(*a*) and 22

Explanatory Memorandum to the Taxation Laws Amendment Bill, 1997

GENERAL

2640. Tax resistance and tax morality

On 5 September 2016, the first day of the 2016 Tax Indaba, SARS Commissioner Tom Moyane called for "tax morality". There is a well-known saying, "be careful what you wish for". Fast forward to today, and "tax morality" holds a very different meaning. More and more, taxpayers are asking themselves if they can, in good conscience, pay taxes in the same manner as they have done in the past.

Batrancea et al, in a 2012 paper titled *Understanding the determinants of tax compliance behavior as a prerequisite for increasing public levies*, state in relation to political determinants: "*The structure of a tax system can also hinder taxpayers' willingness to comply, if they perceive the system as being too bureaucratic, with a high tax burden, and a high number of taxes. In the same vein, an inefficient fiscal policy mirrored in squandering of public funds and low quality of public goods makes taxpayers think twice before paying the entire share of their tax liabilities.*"

Many of these political determinants of non-compliance are present within the South African tax context. Individuals have a high tax burden, and there is a high number of taxes. Apart from all of our existing taxes, such as income tax, capital gains tax, VAT, PAYE, mineral royalties, transfer duty, donations tax, estate duty and securities transfer tax, the Budget Review 2017 confirmed that we should anticipate new sugar tax, carbon tax, national gambling tax and acid mine drainage tax. Then we have been asked recently to give our submissions to the Davis Tax Committee on various potential wealth taxes.

In addition, the magnitude of the misuse and abuse of funds by government and parastatals is staggering. A cursory view of information already within the public eye makes this abundantly clear. The squandering of public funds is therefore also a matter of general knowledge.

Tax resistance has a long history

In his book, *The economic psychology of tax behavior,* Erich Kirchler states: *"…it has been suggested that tax resistance has played a significant role in the collapse of several major world orders, including the Egyptian, Roman, Spanish and Aztec empires."* Viewed in this context, if one believes that the current use of government funds is wrongful, and one also believes that tax resistance would play a significant role in the collapse of this order, how would one conclude that funding the current government order is the moral choice? Society's moral outrage against state capture, and against fruitless and wasteful expenditure by government employees and parastatals, has been harnessed against SARS, the collector of government funds.

Apart from the crisis of confidence in government, trust in SARS itself has been eroded over the past year, with multiple allegations in the public eye in relation to SARS staff and leadership. This is important because trust is a critical factor in voluntary tax compliance.

In the circumstances, one would expect SARS to rather focus on the legality of paying one's taxes, rather than the morality, since it is clear that government and SARS do not have the moral high ground, in the views of taxpayers. Nowadays, when one pays one's taxes to SARS, one may potentially be caught in a crisis of conscience in relation to one's part in financing a corrupt system through tax payments.

Lawful options should be considered

Engaging in a tax revolt would be an act of civil disobedience, and would be unlawful. While society as a whole has felt the need to engage in this type of behaviour in various contexts in the past, this would really be the exception rather than the rule. Upholding the rule of law is paramount in our society, and there are other manners of engaging in tax resistance that would not be unlawful, such as engaging in legitimate tax planning. The effects of this form of tax resistance would typically only be properly felt by the *fiscus* over the medium term.

SARS has already expressed concerns around "*a disturbing trend whereby tax compliance levels are beginning to deteriorate*". A knee-jerk reaction by SARS may be to impose higher penalties. However, it is interesting to note that various studies have found that higher levels of tax-related penalties are counterproductive in cases where there is limited trust or perceived unfairness. In these circumstances, perceived "unfair" penalties result in higher levels of tax aggressiveness by taxpayers.

What is needed from SARS is not a show of power, but rather a show of service. Whereas the law would not allow SARS to condone a tax revolt, SARS should understand that tax resistance is a legitimate expression of dissatisfaction with the status quo. SARS should:

- Ensure that any taxes sought are clearly set out in the relevant legislation;
- Avoid heavy-handed policing of tax laws;
- Treat taxpayers respectfully, and apply penalties in a restrained manner;
- Commit to a service charter that is more than merely compliance with legal minimums; and
- Enforce tax rules against all persons (including the politically connected), not only the "soft targets" and people who are voluntarily compliant.

In particular, all available law relating to base erosion and profit shifting should be properly applied to collect taxes that are legitimately due, without over-burdening individual taxpayers.

Bowman Gilfillan

TAX ADMINISTRATION

2641. Constitutionality of retrospective legislation

30 min CPD
VERIFIABLE ARTICLE

“Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes.” — Benjamin Franklin, in a letter to Jean-Baptiste Leroy, 1789.

The famous quote by Benjamin Franklin is important not only because of the inevitability of taxes but also due to the fact that taxes, and the laws which frame them, should maintain a level of certainty. In South African law, this is premised on amongst others, section 1(c) of the Constitution of The Republic of South Africa, 1996 (the Constitution) which states that South Africa is founded on the supremacy of the Constitution and the rule of law. Thus, the rule of law proposes that law should not be formulated in wide general terms, but should be reasonably clear and precise; otherwise a decision by discretion is imported.

In a recent judgment in the High Court in *Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue Service and Another (GNP),* unreported case no 87760/2014 of 29 May 2017, Fabricius J was presented with, amongst others, the question of whether the enactment of retrospective legislation, particularly fiscal legislation, which *ex post facto* deems the law at a particular time to be what it was not, offends against the principle of legality and the rule of law which lies at the heart of our constitutional dispensation. The judgment is important as it aims to provide guidance and jurisprudence in an area of South African tax law which has been beset with much debate and consternation.

In the context of retrospectivity of legislation, the court pointed out that South African case law distinguishes between retrospectivity of legislation in the “weak” and “strong” sense. A statutory provision is retrospective in the weak sense if it prospectively effects, or changes the consequences for the future of pre-existing transactions and matters. An enactment is retrospective in the strong sense if the provision is deemed to have been in force from an earlier date than that on which it was in fact enacted. In this case the court had to consider retrospectivity in the latter instance, where the amendment was deemed to be effective from a date earlier than when the relevant amending Act was promulgated.

Facts

Serurubele Trading 15 (Pty) Ltd (the Taxpayer) entered into an amalgamation transaction in terms of section 44 of the Income Tax Act, 1962 (the Act) in which it acquired all the assets of Pienaar Brothers (Pty) Ltd (Pienaar Brothers) on 16 March 2007, which acquisition was effective from 1 March 2007. As part settlement of the purchase consideration, the Taxpayer issued shares to Pienaar Brothers at the purchase price, less the assumed liabilities (equity consideration), which equity consideration less the par value of the shares was credited to the share premium account of the Taxpayer.

On 3 May 2007, the Board of Directors of the Taxpayer resolved, in terms of section 90 of Companies Act, 1973 (the old Companies Act), read with Article 21A of the Taxpayers Articles of Association, to make a distribution to its shareholders *pro rata* to their shareholding, of an amount of R29 500 000 out of the Taxpayer's share premium account (the Distribution).

The applicable law on 3 May 2007 in the context of the definition of a "dividend" in section 1 of the Act meant that a "dividend" excluded from its ambit, any amount distributed out of the share premium account (not being profits previously capitalised to the share premium account). It was the Taxpayer's submission that, as at 3 May 2007 when the distribution was made, the Distribution did not constitute a "dividend" as defined in the Act and no STC was therefore due and payable by the Taxpayer on the Distribution, as the Distribution was made out of the share premium account of the Taxpayer, which share premium arose from the issue of ordinary shares at a premium over the par value.

Background and context

Secondary tax on companies (STC) was introduced by sections 64B and 64C of the Act. It was the tax on net dividends, that is, on a company's distribution of its profits to its shareholders. It was not meant to tax capital distributions. On this basis, paragraph (*f*) of the definition of a "dividend" in section 1 of the Act excluded any distribution that represented "a reduction of a share premium account of a company".

Section 44 of the Act, which facilitates amalgamations, defines an amalgamation as a transaction by which a company (the amalgamated company) disposes of all of its assets to another company (the resultant company) and as a result of which, the amalgamated company is terminated. Section 44(9) catered for amalgamations, such as the Pienaar Brothers' amalgamation in the case at hand, where the resultant company (Newco) issued shares to the amalgamated company (Oldco) which the latter then distributed to its shareholders as a dividend *in specie*. Such a dividend would ordinarily have attracted STC. Section 44(9), however, exempted it from STC by deeming the distribution not to be a dividend for STC purposes.

The purpose of the exemption was to render an amalgamation transaction as STC neutral, by exempting the distribution by Oldco of its shares in Newco. Parliament assumed that the distributable income previously held by Oldco, would be rolled over into Newco and thus attract STC, as it would have done in Oldco if and when distributed by way of a dividend declared by Newco.

The assumption, however, overlooked the fact that distributable income in the hands of Oldco may change character and become share premium in Newco as happened in the Pienaar Brothers' transaction. The parties to such a transaction would then avoid STC altogether.

Oldco would surrender its distributable income to Newco in return for Newco shares. Its distribution of the Newco shares to its own shareholders would constitute a dividend, but be exempt from STC by virtue of section 44(9) of the Act. Newco would receive the assets of Oldco, but in its hands, this would represent share premium and not distributable income. Any distribution to shareholders by Newco from its share premium, would also avoid STC, because it would be a capital distribution and not a "dividend" as defined. The amalgamation accordingly would allow the parties to avoid STC that would otherwise have been payable by Oldco on its distributable income.

Announcement by Minister of Finance in 2007 Budget

As a result of becoming aware of this loophole, the then Minister of Finance, in the 2007 Budget Speech made reference, in general terms, to an intention to pass retrospective legislation to deal with certain anti-avoidance arrangements relating to STC. He provided no further detail as to what arrangements were to be addressed, or in what manner.

On 21 February 2007, the Commissioner for the South African Revenue Service (the Commissioner) issued a press release in terms of which, among other things, the STC exemption for amalgamation transactions contained in section 44(9) of the Act was stated to be withdrawn with immediate effect. The particular statement read as follows:

'21 February 2007: The STC exemption for amalgamation transactions contained in Section 44 (9) of the Income Tax Act, 1962, is withdrawn. This exemption permits a permanent loss of STC, rather than a deferral of tax, which is the intent of the amalgamation provisions.'

What followed thereafter was the ordinary public consultation process in respect of any revenue bill, which ultimately resulted in the promulgation of the Taxation Laws Amendment Act 8 of 2007 on 8 August 2007 (the Amending

Act). Section 34(1)(*c*) of the Amending Act inserted into section 44, a new section 44(9A). The effect was that it deemed Newco's equity share capital (and share premium) arising from the amalgamation to be profits not of a capital nature available for distribution to shareholders to the extent of any profits distributed by the amalgamated company in terms of subsection (9). Effectively therefore, Oldco's profits would be rolled over to Newco, so that STC remained payable when Newco makes the subsequent distribution, thereby closing the loophole.

Importantly for our purposes, section 34(2) of the Amending Act provided that section 44(9A) was deemed to have come into operation on 21 February 2007 and would be applicable "to any reduction or redemption of the share capital or share premium of the resultant company, including the acquisition by that company of its shares in terms of section 85 of the Old Companies Act upon or after that date".

Issue

The subject matter of the dispute between the parties was the STC assessment raised by the Commissioner in an amount of R3 687 500 (12.5% of R29 500 000) on the Distribution of the Taxpayer made on 3 May 2007 in pursuance of the amalgamation transaction. This was based on the abovementioned amendment having retrospective effect and therefore applying to the Distribution made on or after 21 February 2007.

The application to the High Court by the Taxpayer in pursuance of disputing the STC assessment required the court to consider two main issues which formed the crux of the Taxpayer's argument:

- That section 34(2) of the Amending Act should be declared to be inconsistent with the Constitution and invalid (Constitutional Issue);
- Alternatively, that the provisions of section 44(9A) did not apply to the distribution by the Taxpayer on 3 May 2007, to its registered shareholders

at that date pro rata to their shareholding, of an amount of R29 500 000 out of the Taxpayer's share premium account (Interpretational Issue).

Interpretational Issue

Fabricius J stated at paragraph 15 that while he would, strictly speaking, not be required to decide the Constitutional Issue if he were to find that the Amending Act, on a proper construction, did not apply to the transaction retrospectively, it would be convenient to deal first with the Interpretational Issue.

In respect of the Interpretational Issue, the Taxpayer's submission was not concerned with the underlying content of section 44(9A), but rather on the supposed retroactivity of the amendment. The alternative submission was thus to the effect that the provisions of section 44(9A) did not in fact apply to the distribution when it was made, which was based on statutory interpretation.

The basis then of the Taxpayer's argument was that the Amending Act had to be interpreted in the same way as any other statutory provision, and that the question was whether, on a proper interpretation, the introduction of section 44(9A) actually had a retroactive effect so as to render the distribution subject to STC.

In that context, it was submitted on behalf of the Taxpayer that while section 34(2) of the Amending Act expressly made section 44(9A) retrospective to 21 February 2007, it did not expressly state that it affected completed transactions. In summation, the consequences of the retrospectivity led to unfair and anomalous results, and it could therefore not be accepted that Parliament intended the new provision to apply to completed distributions.

No such anomalies or difficulties would arise if the new section 44(9A) applied only to transactions and distributions that occurred after its promulgation. In the context of the interpretative challenge, it was accordingly submitted that section

34(2) should be interpreted to limit the retroactive application of section 44(9A) to transactions or distributions that were not complete before 8 August 2007.

Fabricius J dismissed the arguments put forth by the Taxpayer in this regard on the basis that the amendment was clear, its purpose was rational and that it applied to all transactions including completed transactions. As a result thereof, Fabricius J considered the main application, that the introduction of the relevant amendment was constitutionally invalid.

Constitutional Issue

The Taxpayer argued that where the court found that the legislature intended the Taxpayer to pay STC *ex post facto* on the distribution, then it submitted that the Amending Act was invalid on the grounds of being inconsistent (to the extent of its retrospectivity) with the foundational constitutional value, namely the rule of law entrenched in section 1(c) of the Constitution. Importantly, the Taxpayer did not initially put forth the argument that the amendment infringed a right contained in the Bill of Rights of the Constitution wherein the court would have to consider whether the limitation of such right was reasonable and justifiable in an open and democratic society as contemplated in section 36(1) of the Constitution.

However, as will be discussed below, the Taxpayer did ultimately advance arguments that the right to property as envisaged in section 25(1) of the Constitution had been infringed.

Taxpayer's submissions on the Constitutional Issue

The court considered various academic writings and case law on the meaning and ambit of the rule of law. In particular, Fabricius J stated that it was quite correctly submitted that not only must Government act in accordance with laws, but also that the laws must have a certain essential quality, namely, in the present context, that laws should be reasonably clear, accessible and prospective in their operation.

Fabricius J thereafter summed up the rule of law argument at paragraph 41 as follows:

‘In *Veldman v Director of Public Prosecutions*, 2007 (3) SA 210 (C), Mokgoro J, writing for the minority said the following at par. [26], with reference to *Calder v Bull* 1798 USSC 3; 3 US 386 *(1798) at 388 and 396*: “Generally, legislation is not to be interpreted to extinguish existing rights and obligations. This is so unless the statute provides otherwise or its language clearly shows such a meaning. That legislation will affect only future matters and not take away existing rights is basic to notions of fairness and justice which are integral to the Rule of Law, a foundational principle of our Constitution. Also central to the Rule of Law is the principle of legality which requires that law must be certain, clear and stable. Legislative enactments are intended to “give fair warning of their effect and permit individuals to rely on their meaning until expressedly changed”.’

Within this context, Fabricius J offered the following, also at paragraph 41:

‘As it stands, this exposition is generally accepted, but it must be said that context is everything in law, and obviously one needs to examine the particular statute and all the facts that gave rise to it. This principle applies expressly in Criminal Law. See: Section 35(3)(l) of the ***Constitution***, but our Courts have yet to consider definitely whether outside the Criminal Law context, retrospective legislative amendments can be constitutionally valid.

It was therefore submitted in the light of the mentioned constitutional imperative, the Courts <u>must</u> vindicate the Rule of Law by setting aside legislation which contravenes that principle. No longer are the Courts limited to techniques of strict statutory interpretation in the light of presumptions to express their disapproval of breaches of the Rule of Law. Such legislation is contrary to the ***Constitution*** and therefore invalid.'

The court noted that the Taxpayer's submission was based on the fact that, as in Germany, the rule of law compels a conclusion that strongly retrospective tax statutes should be presumed to be constitutionally invalid. The Taxpayer, however, did not expressly suggest that South Africa's constitutional dispensation would never allow the legislature to introduce retrospective legislative amendments. There could well be exceptional cases where this could be done without attracting constitutional sanction. The fundamental issue would, however, always be whether the retrospectivity amounts, in the particular circumstances of their case, to a contravention of the rule of law.

It was submitted to the court that knowledge of proposed retrospective amendments to the law is fundamental to the rule of law, and essential for taxpayers to be able to regulate their conduct in accordance with those amendments. Hence, unless there was adequate warning of the intention to implement the change retrospectively, such that the taxpayer cannot be said to have been entitled to rely on the law continuing to apply, a retroactive amendment could never pass constitutional muster.

The Commissioner's counter submissions on the Constitutional Issue

The Commissioner submitted that the Constitution does not in general outlaw retrospective legislation, except in the context of criminal law, (i.e. section 35(3)(l) of the Constitution). The question, therefore, is to what extent the entrenchment of the rule of law inhibited or prohibited retrospective legislation.

The Commissioner submitted that the Taxpayer's contention that the retrospective amendment was invalid, because there had not been adequate notice for its enactment, was untenable for the following reasons:

- It was inconsistent with the approach in the foreign jurisdictions to which our courts frequently look for guidance in such matters, such as Canada, the United States, the European Union and the United Kingdom;
- It was inconsistent with the approach the Constitutional Court has laid down in relation to the constitutional scrutiny of legislation; and
- The Taxpayer's challenge would in any event fail, even on its own test.

Findings – test under South African law

It was submitted that the foreign law comparison makes it clear that retrospective laws are permissible and indeed commonplace in countries based on the rule of law. At the same time, it was not suggested that Parliament may legislate with retrospective effect as it pleases. Fabricius J held that the real question which must be answered is what the standard is by which the constitutional validity of retrospective legislation should be judged.

In this regard, he held that such a question should be answered with reference to the standards of review laid down by our courts when the constitutional validity of a statute is challenged which included two main standards:

- The first is the "rationality" test. This is the standard that applies to all legislation under the rule of law entrenched in section 1(*c*) of the Constitution.
- The second, and more exacting standard, was that of "reasonableness" or "proportionality", which applies when legislation limits a fundamental right in the Bill of Rights. Section 36(1) of the Constitution provides that such a limitation is valid only if it is "reasonable and justifiable in an open and democratic society".

Findings on the rule of law – rationality test

It was submitted on behalf of the Commissioner that the difficulty for the Taxpayer was that once the rationality standard applies, its case would inevitably fail, with which the court agreed. In essence, a mere prospective amendment would have encouraged taxpayers to exploit the loophole in the last few months before the loophole was closed and hence the measure which the legislature chose to close such loophole was properly related to the public good it sought to realise. It was thus fundamental that the Legislature protected the *fiscus* by closing the loophole in the manner that it did.

At paragraph 97, Fabricius J held further that the South African Constitution does not recognise the constraint that knowledge of the proposed retrospective amendment to the law is fundamental to the rule of law. In this regard, Fabricius J held specifically that he was not aware of any authority or legislative provision that provides that a fairly precise warning needed to be given before the legislature could pass retrospective legislation, whether in general, or in the case of a tax statute. In the latter instance, economic demands must be considered in the context of the purpose and effect of an intended statute. If the tax statute is rationally connected to a legitimate purpose, no precise warning is required, if one at all.

Furthermore, it was important that Parliament did not retrospectively amend the Act as it pleased, but rather went through the rigorous and thorough public consultation process where it carefully considered various representations from a variety of stakeholders.

Fabricius J thus held at paragraph 97:
'Similarly, Applicant [Taxpayer] did not provide any authority for their contention that "knowledge" or "adequate warning" is constitutionally required for tax legislation to pass constitutional muster. In any event, if it were to be found that such "knowledge" or "adequate warning" was essential, it was submitted that the process that was followed, and I have given all relevant details, was sufficient and ought to have put any taxpayer who was contemplating amalgamation transactions with a view to derive STC exemption

from such, would have been placed on full guard that legislation was going to be amended to remove the particular exemption.'

Fabricius J held further at paragraph 85 in respect of the Taxpayer complaint that the manner in which parliament closed the loophole differed from the manner in which the Minister had originally foreshadowed in the 2017 Budget:

'I am not aware of any provision in any of the jurisdictions that I have referred to, or indeed in ours, to the effect that the warnings given must relate to the exact same amendment that is ultimately made. To adopt such an approach would undermine the parliamentary process and the public participation process completely. It would also mean that parliament would be bound by an announcement made by the executive. Applicant [Taxpayer] had already suggested that I do not need to find how precise a warning in this context must be, inasmuch as in the present proceedings, no warning at all had been given. I do not agree with this contention, the facts show otherwise, and it loses sight of the fact that there may be cases where no warning needs to be given at all. I am therefore not of the opinion that a precise warning must be given in each and every case, nor that a warning, of whatever ambit, needs to be given in all cases. In my view, a proper approach would be to judge the legality of retrospective amendments on a case-by-case basis, having regard to the various considerations that I have referred to. The Constitution itself certainly does not prohibit retrospective legislation in civil law.'

Further important findings by Fabricius J on the arguments put forth are set out below:

- There is no authority for the proposition that retrospective tax legislation would survive constitutional scrutiny only if there were "good reasons" for it. It is not for a Court to say what a good "reason" is [paragraph 99].
- The language of the present amendment was clear, as it referred to "all" transactions. It was immaterial whether a transaction was completed or

not if it fell within the period of the retrospective operation of that legislation. All the foreign judgments, to which reference had been made, were concerned with completed transactions… [He further added] that modern jurisprudence should never be dogmatic, especially not in the field of fiscal legislation, as economic considerations seem to be presently in a constant state of fluidity, and not only in South Africa [paragraph 100].

- Furthermore, there was no basis for holding that under the present Constitution, Parliament can only pass retrospective legislation if "exceptional circumstances" exist. A Court is also not obliged to adopt a "rigorous approach, which would require "a very high level of correlation" between the changes to the law of which the taxpayer has been notified and the actual legislative amendment that follows, as the Taxpayer contended for [paragraph 101].

The application by the Taxpayer to declare the retrospective application of the amendment to the legislation as constitutionally invalid based on the rule of law was thus dismissed.

Further submission – deprivation of property

In a Supplementary Affidavit, the Taxpayer sought to establish a further cause of action based on section 25(1) of the Constitution. This challenge was founded on the fundamental right to property on the basis that the retroactive removal of the exemption from STC in paragraph (*f*) of the definition of "dividend", without adequate notice, would have amounted to a deprivation of property that was both procedurally and substantively arbitrary and thus inconsistent with section 25(1) of the Constitution.

In dismissing the Taxpayer's contention in this regard, Fabricius J held the following at paragraph 110:

‘It was therefore submitted that the Applicant [Taxpayer] had to establish that the impugned provisions give rise to a substantial interference with property rights that go beyond the normal restrictions on property use or enjoyment in a democratic society. In my view it cannot be argued that all taxes involve a “deprivation” of property, in the context of section 25(1). A State cannot exist without taxes. Society receives benefits from them. Taxes are not penalties. Neither can they be, without any qualification, be regarded as unjust deprivation of property use. If it is Applicant’s [Taxpayer’s] view that only retroactive taxation gives rise to such deprivation, then again, no unjust deprivation occurred here. The State used a well-accepted mechanism to close a loop hole in a statute. It did not solely target the Taxpayer. Its purpose was rational. It gave ample warning of its intention. The retroactive amendment does in my view also not amount to illegitimate deprivation. Sufficient reason was established and the process was fair in the present context, not that “fairness” is a requirement.’

Summary

The Pienaar Brothers case is therefore a fundamental judgment on whether retrospective legislation passes Constitutional muster. Importantly, the court did not state outright that all legislation would pass the requirements of rationality and uphold the rule of law, but rather that each specific instance should be decided on its facts and specific circumstances. Nevertheless, the court also importantly pointed out that the Constitution, in itself, does not prohibit the retrospective amendment of legislation.

Furthermore, the court dismissed the alternative submission by the Taxpayer that the retroactive effect of the legislation without adequate notice would have amounted to a deprivation of property that was both procedurally and substantively arbitrary and thus inconsistent with section 25(1) of the Constitution.

It will be interesting to monitor developments on this matter and to see whether the Taxpayer ultimately appeals to the Constitutional Court.

Cliffe Dekker Hofmeyr

ITA: Section 1 definition of 'dividend', sections 44, 64B and 64C (note: the reference is to the 2007 definition of 'dividend' and both the 2007 and amended version of section 44)

Taxation Laws Amendment Act, 2007: section 34

2007 Budget Speech

The Companies Act, 1973: Sections 85 and 90

The Constitution of South Africa: Sections 1(c), 25(1), 35(3)(l) and 36(1)

Editorial comment: also refer to article 2634 in the Integritax August 2017 edition, Issue 215

2642. Limitation on the withholding of refunds

Section 190(1) of the Tax Administration Act, 2011 (the TAA) provides that a taxpayer has a right to any refund due to it by SARS. However, this right is limited by section 190(2), i.e., where the verification, inspection or audit of the refund has not yet been finalised, SARS may withhold such refund. The limitation in section 190(2), however, only relates to the verification, inspection or audit in respect of the particular refund that is due to the taxpayer, and not any verification, inspection or audit under a tax Act:

"190. Refunds of excess payments

(1) SARS must pay a refund if a person is entitled to a refund, including interest thereon under section 188(3)(*a*), of—

(a) an amount properly refundable under a tax Act and if so reflected in an assessment; or

(b) the amount erroneously paid in respect of an assessment in excess of the amount payable in terms of the assessment.

(2) SARS need not authorise a refund as referred to in subsection (1) until such time that a verification, inspection or audit of the refund in accordance with Chapter 5 has been finalised.

(3) SARS must authorise the payment of a refund before the finalisation of the verification, inspection or audit if security in a form acceptable to a senior SARS official is provided by the taxpayer.

The Explanatory Memorandum on the Objects of the Tax Administration Bill, 2011, provides further clarity on this point, and states that:

"Furthermore, a refund need not be authorised by SARS until such time that a verification, inspection or audit of the refund has been finalised [ie not an audit in respect of any tax, rather it only refers to an audit in respect of that particular refund]. A taxpayer will remain entitled to interest from the later of the effective date or date that the overpayment was made, to the date of the payment of the refund by SARS after finalisation of the verification, inspection or audit. SARS must authorise the payment of a refund before the finalisation of the verification, inspection or audit if security in a form acceptable to a senior SARS official is provided by the taxpayer"

SARS is, therefore, not permitted to withhold a refund in respect of one assessment, because a different assessment is under verification, inspection or audit. For example, SARS may not withhold an income tax refund because a securities transfer tax assessment is under audit. SARS would only be able to withhold the income tax refund because the audit in respect of that refund is still on-going, and no sufficient security for that refund has been given to SARS (sections 190(2) and 190(3)).

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TAA: Sections 188 and 190

The Explanatory Memorandum on the Objects of the Tax Administration Bill, 2011

SARS NEWS

2643. 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.