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EMPLOYEES’ TAX

2250. Obligation cannot be contractually varied

(Published November 2013)

The decision of the Johannesburg Labour Court in *Naidoo v The Careways Group (Pty) Ltd* [2013] ZALCJHB 96, in which judgment was handed down on 29 May 2013, affirms a clear
principle – the obligation of an employer to deduct employees’ tax in respect of remuneration cannot be varied by an agreement between these two parties.

The rationale is beyond doubt – the obligation to deduct tax is laid down in the Income Tax Act (the Act) and overrides any contract to the contrary.

Thus, even where an employee is entitled to an order of specific performance, obliging the employer to pay an agreed salary or wage, there is still an obligation on the employer to deduct the requisite amount of employees’ tax. In Barnard v Shellard Media (Pty) Ltd [2000] ZALC 57 the Labour Court regarded this obligation as being in the nature of an implied contractual term, but this is unconvincing. If the obligation were merely contractual, then the parties would be at liberty to contract out of it.

The obligation to deduct employees’ tax is a statutory obligation, and for this reason, it cannot be varied by agreement between the parties.

The court in Naidoo v The Careways Group was thus correct in holding (at para [27]) that the duty to deduct employees’ tax –

“arises ex lege and therefore any provisions in an agreement between the parties relating to non-deduction of tax from the applicants salary is irrelevant and of no force and effect.”

**Does the amount in question constitute “remuneration”?**

Of course, it may be in dispute between the employer and the taxpayer as to whether the amount in question is indeed *remuneration*, in other words, a *quid pro quo* for services. And further complexity is introduced where what the employee is claiming is not the contracted remuneration, but *damages in lieu of remuneration*, as for example where the employee elects to cancel the contract because of the breach of the obligation to pay the contracted amount.

The damages that are then claimable may, indeed, be of a revenue nature and thus liable to income tax, but they are not *remuneration* for the purposes of the Fourth Schedule to the Act, from which the employer is obliged to deduct employees’ tax – the juristic (and fiscal) nature of the amount has changed, even if the monetary quantum is the same.

In the present case, the court held that –
“The employer has a duty to make deductions from the employee’s salary in terms of the Income Tax Act. There are however limits to the amount which may be deducted from the employee’s salary. A deduction from an employee’s salary is governed by section 34(1) and (2) of the Basic Conditions of Employment Act. An employer is not permitted to deduct an amount exceeding one quarter of the total salary of the employee, in terms of section 34 (2)(d) of the BCEA.”

The proposition, articulated in this passage, that the quantum of employees’ tax that is required to be deducted by an employer from an employee’s remuneration in terms of the Act is subject to a ceiling imposed by the Basic Conditions of Employment Act is, with respect, wrong.

Statutory deductions may be made without the consent of the employee in terms of section 34(1)(b) of the Basic Conditions of Employment Act, and these deductions are not subject to the limitation set out in section 34(2)(d).

PwC

ITA: Fourth schedule (definition of ‘remuneration’)

Basic Conditions of Employment Act: Sections 34(1)(b) and 34(1)(d)

EXCHANGE CONTROL

2251. Wide ambit in question

(Published November 2013)

For a long time, exchange controls in South Africa (SA) have been the source of great frustration for people bringing money into the country, and South Africans wishing to take their money and other assets abroad.

The controls are governed by regulations initially issued in 1961 pursuant to the Currency and Exchanges Act No. 9 of 1933 (the Act). The regulations are enforced by a department of the SA Reserve Bank (SARB) with the Orwellian name of the Financial Surveillance Department, or FinSurv for short. SARB outsources most of the day to day administration to local retail banks who charge their clients a fee for the privilege of complying with the regulations.
The rules governing exchange controls are opaque. Business people who wish to pay suppliers abroad must sometimes wait days to get approval to remit funds. Even small local internet 'start-ups' are hounded because they ostensibly 'export' intellectual property without permission from FinSurv.

The Minister of Finance regularly announces that exchange controls are being liberalised, but the impenetrable and harsh rules remain.

Enter Mark Shuttleworth, the well-known SA internet billionaire. After making his fortune, Shuttleworth wanted to take some of his money out of the country. Sure, said the SARB, but only if you pay us a 10% 'exit charge'. Shuttleworth paid the levy under protest but wanted the money back. He launched a court application against the SARB, the Minister of Finance and the President. The outcome of the application is reported as *Shuttleworth v South African Reserve Bank and Others* [2013] ZAGPPHC 200.

The court proceedings, which were closely followed by the media, pitted two of SA's greatest legal minds against each other: Gilbert Marcus SC, for Shuttleworth, and Jeremy Gauntlett SC, for the respondents. As far as I am aware, this was the first time that any person seriously challenged the entire exchange control regime in a court of law.

By his own admission, Shuttleworth is not against the idea of exchange control (view the *Shuttleworth* judgment at paragraph 27). He really only wanted a refund of the 10% levy. However, while denying the refund, in the process the court struck down chunks of the legislation as being unconstitutional.

Unfortunately, the judgment in the *Shuttleworth* case contains numerous editing and spelling errors, and the reasoning is often unclear. However, if nothing else, it does provide an interesting insight into the government's philosophy with respect to exchange controls. In the papers provided to the court, the State's deponent said that "[t]he very stability and sustainability of the financial system and economy of [SA] may be, and indeed has often in the past, been at stake...The flexibility, and ability to change the applicable exchange control regime very quickly, are necessary in this particular sphere...[T]his constitutes an important means whereby our country can adequately safeguard itself, its economy and the public against the vicissitudes of the dynamic world market."
In other words, says the State, we need exchange controls to protect you from the big bad global market wolf.

The court appeared to have simply accepted this view. For instance, said Judge Legodi (at paragraph 114 of his judgement), "imagine what will happen to this country if the wealthiest men and women in the country were allowed to take their wealth out of the country without [sic] impunity every time when the country is in economic grief or when there is a change of government or leaders in government. It could have a devastating effect on the country as whole."

And, equally dramatically, advocate Gauntlett is reported to have said in his address to the court, "[h]e [Shuttleworth] quite deliberately decided to attack the heart of the scheme and seeks to bring down the pillars of the temple."

Speaking as a lawyer with little knowledge of economics, my view is that it is time that the exchange control edifice be toppled. The State is bluffing itself if it thinks that it can protect us against "the vicissitudes of the dynamic world market". The market is a different place to that which existed in 1933 or 1961. Events like a financial crisis in the United States or a volcanic eruption in Iceland, for instance, have startling and immediate world-wide effects which governments have very little power to control.

Give us freedom to take and invest our money where we want; we will take our chances in the global economy. Spend your energy instead on creating an economic environment in SA which will encourage us, and foreign investors, to keep our money in this country.

Having found that the policy of keeping exchange control is important in principle, the court in the Shuttleworth case held that the manner in which the 10% exit charge was legislated and imposed was not unconstitutional. However, the court then proceeded to strike down certain of the provisions of the Act and the regulations. In particular, the provisions of section 9(3) of the Act, which give the President the sweeping power, simply by regulation, to suspend any law, including an act of Parliament, affecting currency, banking or exchange was found to be inconsistent with the Constitution of South Africa, 1996.

Of great importance is the finding of the judge that regulation 3(1)(c), which prohibits payments abroad without approval, offends the constitutional rights of freedom of expression and privacy. The court also held that certain of the other regulations were unconstitutional.
However, the declaration of invalidity was suspended for a period of 12 months to enable the government to attend to the cause of the invalidity – or, in the words of the court, to 'panel-beat' the regulations.

In my view, a properly motivated attack on the exchange control rules has been long overdue. Mark Shuttleworth has struck a blow for freedom in SA. Hopefully, the Minister of Finance will use the case as an opportunity to further liberalise – or, even better, scrap – exchange controls.

(Editorial comment: The attention of readers is drawn to the fact that this judgment is going on appeal)

Cliffe Dekker Hofmeyr
Currency and Exchanges Act: Section 9(3) and Regulation 3(1)(c)
The Constitution of the Republic of South Africa

GROSS INCOME

2252. Sale of shares - capital v revenue

(Published November 2013)

Background
ITC 13003 [2013] involved the disposal of shares by a taxpayer and whether the proceeds realised constituted gross income and were of a revenue nature. The taxpayer happened to be a Special Purpose Vehicle and it was argued that the proceeds of the sale of shares were of a capital nature. There were also additional costs incurred which were closely associated with the acquisition of the shares in question. These costs incurred were the so-called 'equity-kicker' and 'indemnity costs'.

The taxpayer essentially acquired the shares from the bank. The bank disposed of the shares as part of restructuring a furniture business, M Ltd, which was experiencing serious financial difficulties. M Ltd was ultimately merged with the FG Group and the taxpayer bought shares in this merged business. The taxpayer funded the acquisition of shares by issuing preference shares to the bank and ordinary shares to its holding company. When the funding was raised, it was agreed that the preference shares were to be redeemed after three years. The court also had to consider how the ‘equity-kicker’ was going to be funded.
Witnesses and their roles

Key to this case is gaining an understanding of the roles of the major witnesses.

- The key witnesses in this case were Mr Y, Mr O, Mr J, and Mr Z. Mr Z was invited by the bank to turn the business around. In approaching Mr Z, the Bank used Mr Y as an intermediary. Mr Z who had previously invested in the SA furniture industry was approached with a view to convince him to invest fresh capital. Mr Z agreed to be part of the deal on certain conditions which allowed him some element of control. Amongst these conditions was that ABC must agree to provide funding to the proposed transaction by way of preference shares that would be redeemable after three years-and-one-day.

- Mr Y was involved in the structuring of the transaction including the funding of the acquisition of shares.

- Mr O was seen by Mr Z as someone who had the necessary skills to turn the ship around. He led the consortium that acquired shares in FG Group. Mr O was the chairman of FG Group.

- Mr J represented the buyer and facilitated the implementation of the book building exercise.

Important dates

- Although the memorandum of understanding, which gave rise to a binding commitment and the passing of ‘risks and rewards’ was signed on 26 June 2002, a written sale and subscription agreement for the sale of shares by the bank to the taxpayer was concluded in May 2003.

- Other changes were made to the agreements in May 2003 and the addendum was concluded and implemented in December 2003.

- Another interesting aspect was the meeting between Mr Y and Mr J in November 2003 to discuss the so-called 'book building exercise’.

This book building concept was explained by Mr J in court as the sale of shares to the institutional market (which in this case was a global audience of institutional investors). Its purpose was to avoid a situation where the market came to the assumption that there was an overhang in the shares.
• In February 2004 Mr Y approached Mr J suggesting that he may wish to submit a proposal in relation to the book building exercise. This was now explained to Mr Z as well.

• In March 2004 a decision was made to proceed with the sale of shares.

• The sale and purchase agreement was concluded on 21 April 2004 by the taxpayer and E Group (the buyer).

**Evidence presented by witnesses**

The witnesses provided the following evidence:

• Mr O testified that he together with Mr Y met Mr Z at a point when the turnaround transaction had met considerable success. Mr O told the court that in this meeting Mr Z had asked them, given what had transpired and what they had achieved, how they felt about Mr Z disposing of his stake. Mr O also testified that in the course of that time they were boastful and in high spirits and had no objections whatsoever. These discussions took place in April 2004 while certain aspects of the agreement were concluded in December 2003.

• Mr Z’s evidence was that his decision to sell was based on overexposure to the South African market and that the appellant had no say in the decision, other than to follow Mr Z and dispose of his shares. Mr Z also testified that he was free to take his money out by disposing of the shares and that his wife was concerned that he had all his eggs in one basket (invested solely in South Africa).

• Mr Y was cross-examined regarding the sources of funding available to the appellant and his approach to selling. With regards to the funding, Mr Y told the court that the parties were looking for a five-year finance plan even though three years was regarded as the maximum for such a loan. Mr Y also testified that he did not discuss the sale of FG Group shares with Mr J, but rather raised the question of whether or not secondary shares could be sold by way of a book building exercise. However, when pressed about the content of the meeting he conceded that he could not deny discussing the FG Group shares.

• Mr J’s evidence involved the book building exercise and their discussions with Mr Y. In his evidence he mentioned that Mr Y gave him the name of the company in enquiring about the book building exercise and enquired as to whether this could be replicated for a parcel of existing shares, these being secondary shares.
**Taxpayer’s argument**
From the facts of the case, counsel for the taxpayer argued that the proceeds were capital in nature because the intention of buying shares was to hold them as capital assets, and such intention did not change until the shares were disposed of. In supporting this argument the following were the main points raised:

- If the appellant’s intention had to be determined with reference to that of Mr Y, then at no material time did Mr Y contemplate or intend the sale of the FG Group shares. The evidence suggested that Mr Y was opposed to the decision of Mr Z to sell the FG Group shares.
- The controlling mind of the appellant had to be determined with reference to the intention of Mr Z as Mr Z was the ‘captain of the ship’ with sole power to make key decisions.
- With regard to the acquisition of shares in December 2003 and their disposal in April 2004, it was argued that the period was insufficient to determine whether the investment was short-term or speculative. The ‘risks and reward date’ was the effective date under the memorandum of understanding signed in June 2002.
- It was the approach by E Group that triggered Mr Z’s decision to sell the shares.

**Decision of the court**
The court decided that the sale of shares should be subject to normal tax on the basis that the proceeds constituted gross income. In coming to this conclusion the court took the following into consideration:

- Whatever the taxpayer had to tell the court had to be analysed through the prism of the objective facts presented to the court. When the evidence of the relevant persons testifying on behalf of the taxpayer were analysed through the prism of objective facts, then the intention of the taxpayer, both at the time of acquiring assets and at the time of the sale were of decisive importance.
- A true picture of the appellant appeared to be that Mr Y was, for all purposes the organiser of the appellant, responsible for the financing of the appellant, and hence the ‘brains’ of the company.
- The objective evidence suggested that the investment in the FG Group shares was to last for a period of at least three years, arguably slightly longer, depending upon the success of the venture.
- A constant theme running through Mr Z’s evidence was that he wanted to have the freedom to deal with his ‘investment’ as he saw fit. There were no significant restrictions imposed upon Mr O and Mr Y insofar as the FG Group shares were
concerned, save that they would remain invested until the M Ltd transaction was ‘bedded down’.

- Whatever Mr Y’s evidence with regard to his long term intentions, he had attempted to raise money for the FG Group transaction for a maximum of a three- to a 5-year period.
- The nature of the ‘equity kicker’ supported the argument that there was an intention to fund the loan repayments by way of a sale of the shares, because the ‘equity kicker’ was clearly calculated to constitute a portion of the gain realised by the borrower on the assets acquired with the loan.
- The loan agreement made it clear that the envisaged source of funds would be the proceeds of the FG shares, the cash from which had to come to KL through a declaration of a dividend by the appellant.
- Mr Y initiated a discussion with Mr J as to whether shares could be sold by way of a book building exercise in November 2003, less than a month before the ultimate acquisition of the shares. It appeared that Mr Y disclosed the name of the FG Group, the size of the stake he had in mind as well as Mr O’s involvement.
- In the present case, these shares were not part of an investment portfolio which might need more rapid responses to protect the overall investment but a once off transaction.
- The evidence suggested that Mr Z was not a reluctant seller. He and the appellant through Mr Y realised that they could take advantage of a transaction which had turned significantly in their favour. The possibilities of a sale had always been in their minds from the commencement of the transaction as is evidenced by the nature of the financing, the discussions between Mr J and Mr Y about the book building exercise and the expedition in the actual sale of shares.
- The question was not if, but when the sale would occur.

The provisions of section 9C are not considered in this case, as this section was introduced after 2005. From the decision reached in this case, it is clear that SPV companies should do some soul-searching before they dispose of their investments.

(Editorsial comment: An interesting by-product of the judgment was that the court rejected the time-honoured test of holding an asset “for keeps” as an indicator of a capital intention. In the current investment environment, the idea of holding an asset permanently is unrealistic.)

Sizwe Ntsaluba Gobodo
INTERNATIONAL TAX

2253. Definition of foreign dividend

(Published November 2013)

The South African Revenue Service (SARS) issued Binding Class Ruling 41 (Ruling) on 24 July 2013 regarding the question of whether a dividend distributed by a foreign company will constitute a 'foreign dividend' as defined in section 1 of the Income Tax Act No. 58 of 1962 (the Act).

The applicant was a foreign corporate partnership limited by shares (Company X). The structure is essentially a hybrid between a partnership and a limited liability company utilised in European countries such as Germany, Belgium, France, Denmark and Poland. The applicant was listed on the London Stock Exchange (LSE) with depository receipts (DRs) listed on the Johannesburg Stock Exchange (JSE).

DRs are negotiable financial instruments that are issued by a bank and represent a foreign company’s shares on a local exchange. DRs make it easier to buy shares in a foreign company, because the company does not have to be listed on the exchange and the shares do not have to leave the foreign country. They are managed through brokers, such as banks, in the local financial sector.

The ruling deals with whether the applicant could be considered to be distributing 'foreign dividends' as defined in section 1 of the Act, where it makes distributions to beneficial holders of DRs locally. The class members to which the Ruling applies are these beneficial owners, who would receive foreign dividends associated from time to time with the applicant’s shares.

Section 1 of the Act provides that 'foreign dividend' means any amount that is paid or payable by a foreign company in respect of a share in that foreign company where that amount is treated, by that foreign company, as a dividend or similar payment for purposes of the laws relating to:

- Income tax on companies in the country in which the foreign company has its Place of Effective Management (POEM).
- Where there are no laws relating to POEM, laws related to companies in the country in which the foreign company has been incorporated, formed or established.
The definition does not include amounts paid or payable which constitute shares in the foreign company.

On the facts, the applicant’s shareholders who are resident in Country X, are taxed on dividend income on the basis that it is treated as interest. SARS made it a condition that the shares of the applicant in respect of which dividends are to be declared are not ‘hybrid equity instruments’ in terms of section 8E(1) of the Act. SARS ruled that a dividend declared by the applicant to local beneficial owners of DRs would constitute a foreign dividend.

It appears that despite the fact that the dividends received by foreign shareholders in the applicant are taxed as interest in the foreign country, SARS ruled that distributions received from the applicant by local holders of DRs will qualify as ‘foreign dividends’ in terms of the definition in section 1 of the Act.

Cliffe Dekker Hofmeyr
ITA: Sections 1 (definition of ‘foreign dividend’) and 8E(1)
BCR 041

TAX ADMINISTRATION ACT

2254. Taxpayer’s rights on SARS audits

(Published November 2013)
The Tax Administration Act, Act 28 of 2011 (the TAA) came into effect on 1 October 2012. Its promulgation brought with it many changes to not only taxpayers’ rights and obligations but the reciprocal rights and obligations on the part of the South African Revenue Service (SARS) in its continuous business of revenue collection. Some of the amendments and repeals of sections previously contained in the Income Tax Act No. 58 of 1962 (the Act) have seen a welcome improvement in taxpayers’ rights. One of these improvements is contained in section 42 of the TAA.

Previously, the Act contained no obligation on SARS to keep the taxpayer informed during an audit, nor did it provide for a timeline on the time period SARS could take to complete an audit. The taxpayer could thus be left in limbo and be uncertain as to when an audit may be completed. This position was clearly not conducive to good commercial nor equitable
practice and if the taxpayer were to enquire with SARS for the purpose of obtaining a status update on the audit or request that such an audit be completed within a reasonable time, SARS could merely state that it was under no statutory obligation to complete the audit within a certain timeframe and that complexities in conducting the audit required extensive use of resources.

Section 42 of the TAA, however, now provides that a SARS official involved in or responsible for an audit must, in the form and in the manner as may be prescribed by the Commissioner by public notice, provide the taxpayer with a report indicating the stage of the completion of the audit. SARS issued Public Notice No. 788 on 1 October 2012 in Government Gazette No. 35733 (the Public Notice) for this purpose.

In terms of the Public Notice, a taxpayer is entitled to a status update of the audit within 90 days after commencement of the audit and within 90 day intervals thereafter. The definition of ‘day’ is currently an anomaly in our law, but for the sake of this note it suffices to say that ‘days’ indicate calendar days. The Public Notice goes on to provide the manner and form which the report should take:

“The report must include the following details as at the date of the report:

- A description of the current scope of the audit;
- The stage of completion of the audit;
- Relevant material still outstanding from the taxpayer”

This must be seen as a welcome development in South Africa’s tax law as it attempts to provide the taxpayer with greater certainty and provides suggested timeframes of completion of an audit and hence allows a better opportunity to put into place contingency plans for any eventualities. It is furthermore, in line with many overseas jurisdictions. However, despite this welcome development there are questions regarding its effect and usefulness in enforcing taxpayers’ rights.

Despite this new obligation on SARS to keep the taxpayer informed throughout the course of an audit, it is unfortunate that where SARS fails to abide by its legal obligations there is no sanction against SARS nor remedy for the taxpayer. In effect SARS could continue to issue such reports indefinitely, alternatively, could merely fail to issue the report as it will have no adverse effect on its ability to collect revenue in the long term.
Rule 26(5) of the Rules prescribing the procedures to be observed in lodging objections and noting appeals against assessments (the Rules) provides that where a party fails to comply with any requirement contained in the Rules, the Court may, upon application on notice by the other party, order the defaulting party to comply with that requirement within such time as the court deems appropriate. Rule 26(6) goes on to state that where the defaulting party fails to comply with such a court order in terms of Rule 26(5), then the court may upon application on notice by either party make an order which in effect either confirms the assessment or allows the objection. This remedy therefore ensures finality and certainty and is open to utilisation by both SARS and the taxpayer. It is unfortunate that it only applies to objections and appeals and not to the situation before SARS issues an assessment.

The question therefore remains - what are the remedies available to a taxpayer where SARS does not issue the report nor finalises the audit and the timeframe involved is extensive having regard to reasonability?

One possible solution may be to approach the civil courts for the purpose of granting a mandamus (mandatory interdict) against the relevant SARS official to carry out his obligations in terms of section 42 of the Act. The courts, may, however, be hesitant to grant such an order as it may be difficult to prove the requirements for an interdict, which include, inter alia, that there is a well-grounded apprehension of irreparable harm or that an injury has actually been committed or is reasonably apprehended.

The initiation of an audit does not necessarily mean that SARS will issue additional assessments against the taxpayer, and thus it is most certainly difficult to prove irreparable harm. An exception to this is perhaps the situation where a taxpayer requires a Tax Clearance Certificate (TCC) from SARS for business and commercial purposes, but where SARS refuses to issue such a certificate as a result of the pending audit or an audit which has not been finalised. Notwithstanding the fact that in the aforementioned situation, the taxpayer may be able to prove irreparable harm, litigation in the High Court is time and cost intensive and it seems unnecessarily burdensome taking into account the purpose of such an application.

An alternative could be to approach the High Court to take SARS on review for its failure to comply with section 33 of The Constitution of the Republic of South Africa, 1996 (the Constitution), as well as the Promotion of Administrative Justice Act, Act 3 of 2000 (PAJA). Again, the high costs of litigation involved in this process far outweigh the possible remedy.
the court may order. Furthermore, such applications are not financially viable for the majority of taxpayers and it could be too often a case of the taxpayer having to succumb to SARS’ authority.

Unfortunately, at this stage there does not appear to be any further alternative remedies for the taxpayer or sanctions against SARS for not abiding by its legal obligations in terms of the TAA. It is always valuable to compare our position with overseas jurisdictions. However, in this instance it seems that although many foreign jurisdictions recognise the need and importance of keeping the taxpayer informed, there are neither sanctions on the revenue authorities nor reciprocal remedies for the taxpayer.

In the Irish Tax and Customs Code of Practice for Revenue Audit it states that it is in the best interests of everybody that the audit is concluded as quickly as possible and also provides that where the taxpayer has complied with all requests for information timeously, then Irish Revenue must advise of the status of the audit after the expiry of three months, and in so far as possible the estimated timeframe of completion thereof. The Code does not, however, provide for a sanction where the Irish authorities fail to adhere to these obligations.

In the Australian Tax Office (ATO)’s guidelines on the conduct of complex audits, it sets out the auditor’s obligations during the course of the audit, which includes, *inter alia*, to keep the taxpayer informed. Unfortunately there is no mention of a suitable remedy where the auditor abrogates from his obligations. The ATO, did however, recently introduce a system where it develops an ‘Aged Case Report’ showing all audits which have not been finalised within two years and the reasons behind the delays. This report is then forwarded to the ATO’s Deputy Commissioner: Large Business and International on a regular basis, for the purpose of determining any action required to speed up resolution of the audits.

It thus appears that, although the TAA went a long way to improving taxpayers’ rights and enhancing SARS administrative obligations, there are several issues which have arisen since its implementation. While it is accepted that the need for an efficiently functioning revenue authority is key for the success of the country’s economy and this goes hand in hand with the powers given to SARS in the new legislation, one must not lose sight of the fact that the sanctions imposed against the taxpayer for failing to comply with certain provisions are often harsh, whereas the reciprocal sanctions imposed on SARS are often not even catered for. Nevertheless, it is vitally important for all taxpayers to know their rights in these
circumstances and to seek professional assistance where issues surrounding the interaction with SARS pertaining to requests for information, audits, objections and appeals arise.

Edward Nathan Sonnenberg
TAA: Section 42
SARS Public Notice No. 788
SARS Rules for Objection and Appeal: Rules 26(5) and 26(6)
The Constitution of the Republic of South Africa: Section 33
PAJA

2255. Understatement penalty regime

(Published November 2013)
The draft Taxation Administration Laws Amendment Bill, 2013 (TALAB) was released by the South African Revenue Services (SARS) on 5 July 2013 for public comment.

The TALAB proposes, amongst other things, that several amendments be made to the Tax Administration Act, No 28 of 2011 (the TAA) in respect of understatement penalties.

In terms of section 222(1) of the TAA a taxpayer must pay an understatement penalty if that taxpayer has made or caused an 'understatement'. SARS has no discretion in imposing such a penalty.

The understatement penalty is a percentage based penalty determined with reference to the taxpayer's behaviour. In this regard a table in section 223 of the TAA assigns a specific percentage to the relevant behaviour. In standard cases, the percentage ranges from a minimum of 25% to a maximum of 200%. Similarly, SARS has no discretion to reduce the applicable percentage where it has been determined that a taxpayer falls within a particular behavioural category.

The TALAB promises some relief to taxpayers subject to this rather harsh penalty regime.

Under the present provisions, a taxpayer must technically pay an understatement penalty where an honest mistake has resulted in an understatement, provided that the taxpayer's behaviour falls into an applicable category in the penalty table. For example, if a taxpayer has made an honest mistake and this resulted in 'substantial understatement', the taxpayer would
have to pay a 25% penalty. SARS has no discretion to not impose the penalty or to impose a penalty at a lower percentage.

The TALAB proposes that an exception be introduced in respect of taxpayers who make or cause an understatement due to a 'bona fide inadvertent error'.

A draft explanatory memorandum on the objects of the TALAB (memorandum) was released together with the TALAB. The memorandum explains that to determine whether an understatement was caused by a 'bona fide inadvertent error', SARS will have regard to 'the circumstances in which the error was made', but also other factors including:

- The taxpayer's knowledge, education, experience, and skill.
- The size or quantum, nature and frequency of the error.
- Whether similar errors were made previously.
- In case of arithmetical errors, whether the taxpayer has procedures in place to detect such errors.

In respect of errors relating to the interpretation of tax laws, SARS will have regard to:

- the complexity of the provisions;
- whether the taxpayer tried to understand the provisions, including consulting the relevant explanatory memoranda or making reasonable enquiries; and
- whether the taxpayer relied on information (incorrect or misleading) which came from a reputable source and a reasonable person in the same circumstances would find the information complex.

The TALAB proposes further relief in the form of a reduction of some of the penalty percentages in the penalty table in section 223 of the TAA. In respect of standard cases, the new penalties are to be reduced as follows:

<table>
<thead>
<tr>
<th>Error Description</th>
<th>Current penalty percentage</th>
<th>Proposed penalty percentage</th>
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<tbody>
<tr>
<td>Substantial understatement</td>
<td>25%</td>
<td>10%</td>
</tr>
<tr>
<td>Reasonable care not taken in completing return</td>
<td>50%</td>
<td>25%</td>
</tr>
<tr>
<td>No reasonable grounds for tax position taken</td>
<td>75%</td>
<td>50%</td>
</tr>
<tr>
<td>Gross negligence</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Intentional tax evasion</td>
<td>200%</td>
<td>200%</td>
</tr>
</tbody>
</table>
The reasons provided in the memorandum for the reduction is to align the percentages with that of ‘comparative tax jurisdictions where largely similar penalty regimes apply’.

In terms of section 223(3), an understatement penalty imposed by SARS must be remitted where the taxpayer has fully disclosed particulars of the arrangement to SARS by no later than the due date of the relevant return, and the taxpayer was in possession of a tax opinion, which must meet certain requirements. One such requirement is that the tax opinion must have been issued by no later than the date that the relevant return was due.

The TALAB proposes that the said requirement must be deemed to have been met if the return was due by 1 October 2012. This implies that the taxpayer may rely on an otherwise qualifying opinion even if it was obtained after 1 October 2012, in respect of a matter where the taxpayer’s return was due by that date.

The TALAB also now makes it clear that a taxpayer may indeed object against the imposition of an understatement penalty in terms of section 224 of the TAA, and not only to the refusal by SARS to remit a penalty under section 223(3) of the TAA.

A further clarification made by the TALAB is that the term 'understatement' is now defined as any prejudice to SARS or the fiscus, irrespective of the tax period in which the prejudice manifests. For example, a taxpayer cannot argue that an understatement did not cause prejudice to SARS in the relevant tax year because the taxpayer was in an assessed loss position that year. If the assessed loss would have been reduced had the understatement not been made, and SARS would only have been prejudiced in a future year, it would still be an 'understatement'.

The TALAB proposes that the above amendments apply retrospectively, with effect from the commencement date of the TAA (being 1 October 2012).

Specifically, in this regard, taxpayers on whom SARS has imposed understatement penalties at the current higher rates should insist that SARS reduce the rates in accordance with the TALAB.

Taxpayers are also afforded a further opportunity to obtain qualifying tax opinions to request remittance of understatement penalties in respect of substantial understatements.
Editorial comment: It is important to note that the final version of the legislation might differ from the draft bill referred to in this article.

Cliffe Dekker Hofmeyr
Draft Taxation Laws Amendment Bill, 2013
TAA: Sections 222(1), 223 and 224

TRANSFER PRICING

2256. Section 31 – Further analysis

The provisions of Section 31 of the Income Tax Act No. 58 1962 (the Act) have been revised. Section 31 was introduced in 1995 to grant the Commissioner power to adjust tax calculations where a taxpayer was involved in cross-border transactions not at arm’s length.

The old section 31 provided that the Commissioner could adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services. This meant that taxpayers were not obliged to make the adjustments on their tax returns for transactions even if such transactions were not conducted on an arm’s length basis. Taxpayers could therefore file tax returns with excessive deductions, and then sit and wait and hope for the best - which would be that the Commissioner did not pick up these excessive deductions.

It has long been acknowledged by international bodies such as the OECD that transfer pricing is a complex technical issue and that it requires highly trained staff and specialist skills. In order to deal with these inherent complexities the UK Tax Administration has made use of various specialists such as industry experts, specialist economists and the UK’s Government Actuary Department. In South Africa, however, while external experts have been used to support the preparation of transfer pricing cases and give evidence in court, SARS has also found that industry experts can sometimes be reluctant to assist tax authorities, especially if these experts are anticipating other work elsewhere in their area of expertise.

It, therefore, did not come as a surprise that National Treasury decided to amend Section 31 of the Act. The amended section applies to all years of assessment commencing on or after 1 April 2012. Section 31 now requires taxpayers to determine whether the terms and conditions of any transaction meeting part (a) of the definition of an “affected transaction”
differ from the terms and conditions that would have existed should the parties have been independent persons dealing at arm’s length. Should a difference occur or a tax benefit result to one of the parties, the taxpayer is required to calculate their taxable income based on the arm’s length terms and conditions of the affected transaction.

With the amendment to Section 31, the costs of hiring experts to benchmark the terms and conditions of the affected transaction are borne by the taxpayer.

To ensure that the Tax Authorities have the necessary expertise to audit transfer pricing transactions, SARS recently acquired the expertise of a senior transfer pricing specialist from the UK. Seconded by HMRC, he has assisted in identifying a range of transfer pricing products to build transfer pricing capability in the African Tax Administration Forum (ATAF) member countries.

ATAF has made it clear that they intend to develop a register of resources and that this will involve countries with expertise in a particular aspect of transfer pricing agreeing to offer in-depth support to other partner countries in the developing world. As South Africa is part of ATAF, it is clear that when it comes to transfer pricing it is not business as usual.

Taxpayers that are part of or have relationships with multi-national companies can expect additional audits from SARS despite having been audited in the past. With all the powers that have been afforded to SARS now, thanks to the Tax Administration Act No. 28 of 2011, taxpayers who have transactions that are not deemed to be at arm’s length could be exposed to the risk of tax penalties and interest.

Taxpayers will now have to be pro-active and re-look at their cross-border transactions with multi-national companies. For those that have not yet been exposed, there is scope for voluntary disclosure and the waiver of penalties and interest. Once caught and exposed it could be too late! It remains to be seen as to how many will be prepared to take this risk.

Sizwe Ntsaluba Gobodo
ITA: Section 31
VALUE-ADDED TAX

2257. South African investment management services

(Published November 2013)

South Africa has a world class investment management industry. In order to enhance the utilisation of the industry by foreign investors, giving rise to increased inflows of foreign funds to be invested in South Africa and the growth of the investment management industry, there has been a focus by National Treasury on amending the tax legislation in order to allow non-residents to utilise the services of a South African investment manager, without the foreign investment funds being pulled into the South African tax net.

These amendments were mostly made to the income tax legislation. However, an important consideration which is often overlooked is the value-added tax (VAT) implications in relation to the services rendered by the investment managers to non-resident investors.

The Value-Added Tax Act No. 89 of 1991 (the VAT Act) provides that the supply of certain services to non-residents are subject to VAT at the zero rate. However, this provision is limited to, amongst others, supplies of services which are not in connection with movable property, excluding debt securities, equity securities or participatory securities, situated in South Africa at the time the services are rendered.

In order for the above zero-rating provision to find application, the following important considerations should be borne in mind:

- The services must be supplied to a person which is not a resident for VAT purposes. The definition of “resident” in the VAT Act includes a person which carries on an enterprise or other activity in South Africa and has a fixed or permanent place in South Africa relating to such enterprise or activity. In this regard, the activities which are performed by the South African investment manager should be carefully considered in order to determine whether such may give rise to the non-resident investor becoming a resident for VAT purposes;
- Where the assets which are managed by the investment manager are South African assets (for example shares in South African companies, bonds issued by South African companies, etc.), the zero-rating provision will only find application if such assets constitute “debt securities”, “equity securities” or “participatory securities”. These are defined concepts and, whilst fairly wide in application, may not encompass certain types of derivative instruments.
The applicability of the zero-rating provision in relation to the fee charged by a South African investment manager is a relevant consideration in determining whether a South African resident investment manager who is a VAT vendor will be appointed (as opposed to a foreign manager) as the VAT component of the investment management fee is often considered to be material, especially where performance fees are payable. Should a South African entity be utilised as a vehicle for a fund, whilst it may be possible to achieve South African tax neutrality from an income tax perspective for the ultimate investors, the zero-rating provision will not be available in respect of the services rendered to such a fund. As such, foreign investors may be well advised to consider the appointment of a South African investment manager in relation to South African portfolio assets on a segregated basis as opposed to investing into a South African registered fund such as a collective investment scheme.

Edward Nathan Sonnenbergs
VAT Act: Section 11(2)(l)

SARS AND NEWS
2258. 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

Editor: Mr P Nel
Editorial Panel: Mr KG Karro (Chairman), Dr BJ Croome, Mr MA Khan, Prof KI Mitchell, Prof L Olivier, Prof JJ Roeleveld, Prof PG Surtees.

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