Synopsis
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A monthly journal, published by PwC South Africa, that gives informed commentary on current developments in the tax arena, both locally and internationally.

Through analysis of and comment on new laws and judicial decisions of interest, Synopsis *helps executives to identify developments and trends in tax law and revenue practice that may affect their business.*

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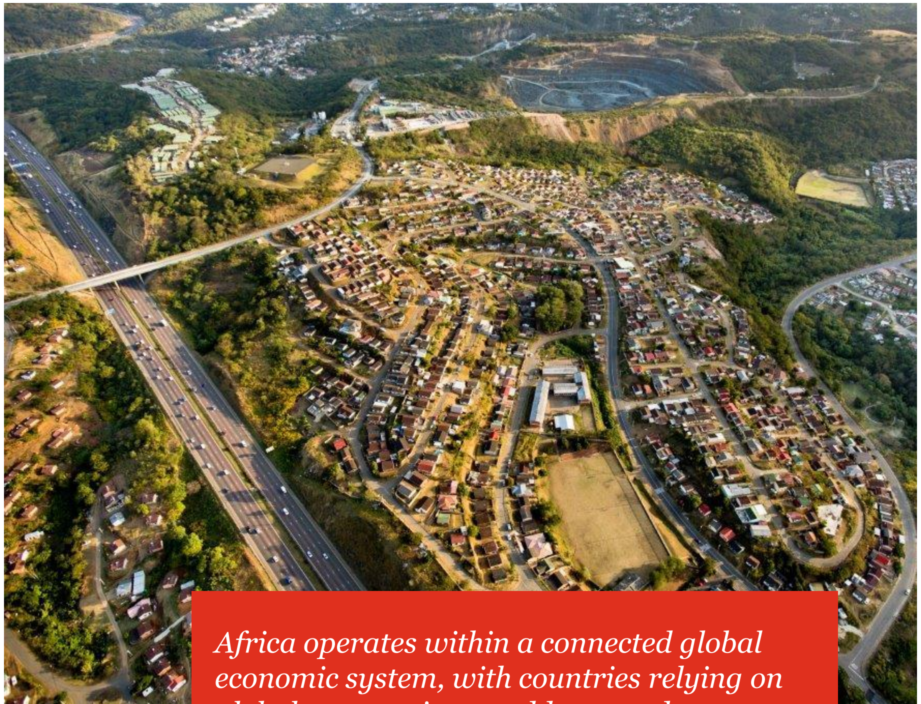
The under-estimated value of VAT in Africa



Africa operates within a connected global economic system, with countries relying on global cooperation to address trade imbalances, the abuse of tax havens and the coordination of financial stabilisation efforts. Recently, there has been an increased focus on cross-border trade, and the VAT base has been broadened to include new types of supplies across the continent.

There is mounting pressure on governments to increase the emphasis on VAT instead of income tax, relying less on unpredictable taxpayer profits in order to ensure a sustainable economy. Tax authorities across Africa recognise this, with 36 countries having put a VAT system in place.

Tax authorities are also building up tax resources and introducing legislative changes. Tanzania enacted an entirely new VAT Act in 2015, as did Ghana in 2013 and Kenya in 2012. Elsewhere on the globe, India passed a GST law in 2016, and the UAE plans for all GCC countries to introduce VAT in between 1 January 2018 to 1 January 2019.

In terms of corporate income tax, taxpayers often benefit from double-tax treaties signed between two contracting states with the aim to reduce the risk of double tax. However, there are no such tax treaties for VAT/GST. It is good tax policy for VAT/GST to be neutral in international trade, but this needs to be achieved through the local VAT/GST legislation. Differences in the various VAT/GST systems expose businesses to risks such as double taxation or penalties, interest and additional taxes in the event of the VAT/GST not being paid correctly. The risk of not being compliant with VAT/GST legislation in a particular country increases where there are inconsistencies and complexities in the application of that country's legislation.

This results in businesses experiencing common issues across Africa, often with no clear answers or conflicting views. These include the extent of the activity which will trigger a VAT registration liability; the extent to which exported services are subject to the zero rate; when imported services will be subject to VAT; and whether VAT may be claimed as a refund or has to merely be reflected as a credit to be offset against other taxes payable. In addition, non-residents may appoint a tax representative agent in some countries, yet whether that agent is entitled to claim tax credits or tax refunds is contentious.

There are similarities in VAT systems in African countries. For example, educational services as well as health and medical services are generally exempt from VAT. However, South Africa and Ghana are exceptions as far as private health and medical services are concerned. International transport services would generally be either exempt or subject to VAT at the zero rate. Again, there are differences in interpretation of the VAT legislation in many countries, specifically regarding which portion of the transportation supply chain would fall within the exempt category and which portion would be taxed at the zero or standard rate.

In Kenya there is currently ambiguity as to whether VAT should be charged on membership/entrance fees, subscription fees and other charges to members. South Africa has always been clear in that VAT at 14 per cent applies to sports, social and recreational activities. The claiming of input tax on membership fees and entertainment is generally expressly denied across Africa.

Understanding the tax environment and 'getting it right' remains a priority for businesses until there is better alignment across the continent and more consistency in applying the legislation.

Different rules also apply in respect of the rate applicable to services rendered to non-residents. South Africa and Namibia take the view that services rendered to non-residents may, under certain circumstances, be subject to the zero rate. Madagascar and the Ivory Coast, on the other hand, provide that because the services are rendered locally, they would also be subject to the standard rate. There is some uncertainty in Mauritius as to whether such a service would be zero-rated or not, with the legislation providing for the zero rate to apply while a court decision states the contrary. The Mozambican VAT Code provides that most services will be subject to VAT as the services are provided by a resident in Mozambique. Only certain services provided to non-residents are not subject to VAT, such as consultancy, advertising and telecommunication services.

In 2014, South Africa introduced provisions requiring foreign businesses providing defined electronic services to South African consumers to register as VAT vendors. It has now been proposed that the regulations be updated to broaden the scope of electronic services. Uganda has similar provisions, while Ghana has a provision that allows for such services to be supplied through an agent.

VAT rates also vary across Africa, with Djibouti applying a rate of 10 per cent, Botswana 12 per cent and South Africa, Swaziland and Lesotho 14 per cent. Ethiopia, Gambia and Namibia have a VAT rate of 15 per cent, whereas countries like Benin, Cameroon, CAR and Guinea Conakry have much higher rates of between 18 and 20 per cent.

Navigating the VAT landscape in Africa remains a challenge, but there is a drive towards harmonising legislation and aligning it with global best practice.

The OECD is leading the debate in the International VAT/GST Guidelines, and many African countries are considering the impact of the Guidelines.

Understanding the tax environment and 'getting it right' remains a priority for businesses until there is better alignment across the continent and more consistency in applying the legislation. PwC's recently released *VAT in Africa Guide* includes details about VAT systems in a number of African countries.

Cross-border financing – getting it right

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

Background

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

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

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

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

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

In pricing the loan (i.e. establishing what should be regarded as an arm's length rate of interest), the experts were requested to assume that intercompany loans within the Chevron group were not subject to a guarantee by the ultimate parent company. In addition, it was evident that the underlying assets controlled by CAHPL were oil and gas exploration concessions, in respect of which they were negotiating but had not fully finalised exploration rights and joint venture agreements, with the result that CAHPL did not have underlying security that it could provide to a lender.

In the circumstances, the experts considered that the credit rating of CAHPL, as a standalone entity completely divorced from the Chevron group, would be significantly lower than that of its parent entity or its treasury entity, and assigned a credit rating of BB+ to CAHPL. On this basis, CAHPL was advised that an arm's length rate of interest for a loan equivalent to USD2.5 billion with no security and no parent guarantee would be AUD LIBOR BBA + 4.14% (an effective rate of approximately 9% p.a.).

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

The dispute

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

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

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

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

The ATO argued that the group connections could not be ignored, and that the correct approach is to consider the basis upon which an independent lender would be prepared to lend the same amount of funds to CAPHL, which would include the terms and conditions of such a loan as well as the rate of interest.

The question therefore revolved around whether the borrower (CAHPL) is evaluated hypothetically in a vacuum (i.e. without regard to its group connections) or whether the actual circumstances of the borrower (including its group connections) may be taken into account in determining the terms and conditions on which a loan may be advanced by an independent lender.

The judgments

The appeal was dismissed, with all three judges concurring.

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

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

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

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

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

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

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

At paragraph 43, Allsop CJ points out:

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

In the paragraphs that follow, Allsop CJ considers the concept of independence, and in particular what is encompassed in the term 'independent parties'.

He comes to the view in paragraph 50 that:

'The independence required is independence of the parties to the agreement from each other; it does not require any other hypothetical relationship; nor does it necessarily require the removal of characteristics of the party as the borrower that take it away from identity with the taxpayer in character or situation.'

In examining the approach of CAHPL, it was noted at paragraph 53 that CAHPL:

'...approached the task dictated by s 136AA(3)(d) as it had before the primary judge by identifying the task at hand to price the interest rate that would be paid by a stand alone borrower from an independent lender for a loan structured in the identical terms to the credit facility. This was based on a submission that the property and agreement must remain identical and only the consideration in the form of the interest rate could be the subject of adjustment by reference to what could be reasonably expected.'

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

'That approach, however, almost dooms to failure the application of Div 13 if its task is to substitute commercial reality based on independence, for intra-group reality based on group control. All one would have to do would be to constrain internally the transaction to give the highest price and include or omit terms of the agreement that would never be included or omitted in an arm's length transaction and which are not driven or dictated by commercial or operational imperatives, as the foundation for assessing an hypothesised arm's length consideration. Such unrealistic inflexibility would undermine the sensible operation of the Division by a rigid construction of the hypothesis in a shape and form controlled by the taxpayer.'

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

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

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

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

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

'There may be factual circumstances where the attributes of the taxpayer, or its position in a group of companies, or the nature of the subject matter of the transaction make it appropriate to assess a consideration for s 136AA(3)(d) as one struck between two disembodied parties without some or all of the attributes of the taxpayer. Ultimately, however, the purpose of the hypothesis is to identify what should be deemed to be the consideration instead of that actually given by the taxpayer in respect of the acquisition that occurred. Here, the ascertainment of that consideration naturally and rationally contemplates a company in the position of CAHPL with its attributes, including its inhabiting of the Chevron group, dealing at arm's length with an independent lender.'

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

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

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

Allsop CJ could find '*nothing in the Guidelines that requires other than the independent status of the enterprises* ***from each other*** *in the transaction*'. He therefore summed up the approach under the DTA in the following terms in paragraphs 92 to 95 of his judgment:

'The conditions operating between CAHPL and CFC if they were independent of each other would not include the direction by Chevron Treasury of the officers of both for the benefit of the group as a whole. The conditions between mutually independent CFC and CAHPL could, however, include CAHPL situated within the Chevron group and CAHPL being subject to the direction of Chevron for the benefit of the Chevron group.

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

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

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

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

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

Is there any relevance to South Africa?

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

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

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

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

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

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

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

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

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

SARS Watch 26 April to 25 May 2017

Legislation

23 May	Tables of interest rates	The table of interest rates has been updated to 23 May 2017.
15 May	Customs Sufficient Knowledge Policy	This policy describes the requirements relating to the Customs-sufficient knowledge for prospective customs clients to obtain competency certification before an application for registration or licensing can be submitted to Customs.
5 May	Draft amendments for various technical amendments in Schedules No. 1, 2 and 6	Comments were due to SARS on Monday, 22 May 2017.
3 May	Third draft of the Customs Control Rules made under the Customs Control Act 31 of 2014	The Rule was published for information purposes, only according to SARS. The draft has been "frozen" for purposes of SARS' systems development.
26 Apr	Allocations to be made to the metropolitan municipalities from the General Fuel Levy Revenue in terms of item 3(2)(a) of Schedule 1 to the Taxation Laws Amendment Act No. 17 of 2009	Notice 364 published in Government Gazette no. 40793 with an implementation date of 21 April 2017.

Guides

16 May	TT01(a) - Application for Turnover Tax	A manual external form has been made available for completion.
16 May	TT01 - Application for Turnover Tax	An online external form has been made available for completion.

Interpretation notes

5 May	IN 51 (Issue 3) - Pre-Trade Expenditure Losses	This Note provides guidance on the deduction of pre-trade expenses (sometimes also called start-up costs) under section 11A.
5 May	IN 33 (Issue 5) - Assessed Losses: Companies. The “trade” and “income from trade” requirements.	This Note clarifies when a company may forfeit its right to carry forward its assessed loss from the preceding year of assessment.

Rulings		
23 May	BGR 31(Issue 2) - Interest on late payment of benefits	This BGR provides clarity on when an amount constitutes interest, as opposed to forming part of the lump sum benefit, for purposes of the Second Schedule to the Act.
4 May	BGR 41(Issue 2) – VAT treatment of non-executive directors	This BGR deals with the VAT treatment of the activities conducted by non-executive directors (NEDs) and clarifies whether those activities fall within the ambit of proviso (iii)(aa) or proviso (iii)(bb) to the definition of "enterprise" in section 1(1).
2 May	BPR 273 - Waiver of a contractual right	This ruling determines the income tax, donations tax, capital gains tax and value-added tax consequences of the proposed waiver of a right to receive an annual quantity of produce in terms of a joint venture agreement.
International agreements		
15 May	Summary of all Common Reporting Standards - Bilateral Competent Authority Agreements (CAA)	This report has been updated to include the status of CAAs as at 15 May 2017.
15 May	Common Reporting Standards (also known as the Automatic Exchange of Financial Account Information in Tax Matters) - Singapore	South Africa has signed a competent authority agreement with Singapore with a date of exchange of 30 September 2018.
Organisation for Economic Cooperation and Development (OECD)		
23 May	OECD releases a discussion draft of implementation guidance on hard-to-value intangibles	Comments are due to the OECD by Friday 30 June 2017.
Other publications		
12 May	Tax Alert - Liability of non-executive directors to account and register for VAT	The updated version of Binding General Ruling (BGR) 41 (Issue 2) replaces the version of BGR 41 published in February. Essentially, the new version of BGR 41 addresses the liability of non-executive directors to register and account for VAT before the date on which BGR 41 is to start applying (i.e. 1 June 2017).
10 May	Tax Alert - Changes to SARS dispute management process	SARS announced that certain changes and improvements to the current dispute management process would be introduced on Friday, 12 May 2017.