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SARS Watch

Synopsis

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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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Primary operations of a business: Am I who I decide to be, or am I simply what I'm authorised to be? The case of SARS v Coronation

On 7 February 2023, the South African Revenue Service ("SARS") found favour with the Supreme Court of Appeal ("SCA") when the SCA handed down its judgment in the case of Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd (1969/2021) [2023] ZASCA 10 ("the Coronation Case").

The case concerns whether Coronation Investment Management SA (Pty) Ltd ("Coronation SA") was required to include the income of one of its foreign subsidiaries, Coronation Global Fund Managers (Ireland) Ltd ("Coronation Ireland"), in its income in terms of the 'controlled foreign company' ("CFC") provisions in section 9D of the Income Tax Act ("the Act"). In short, Coronation SA took the view that the so called 'foreign business establishment' ("FBE") exemption in section 9D(9)*(b)* applied and that, therefore, the income of Coronation Ireland should not have been imputed into Coronation SA's income. SARS disagreed and sought to tax Coronation Ireland's net income in Coronation SA's hands. The key point of contention was whether Coronation Ireland was suitably staffed and equipped, with suitable facilities, to conduct its primary business operations outside SA — in which case the FBE exemption could be relied on.

Before considering the reasoning of the Tax Court and SCA in light of the facts before them, it is worth mentioning an interesting comment in Annexure C to the 2023 Budget Review, which contains commentary regarding tax policy and administrative adjustments. National Treasury indicated that section 9D will be amended to clarify that the FBE exemption requires all important functions, for which a CFC is compensated, to be performed by the CFC or by certain other non-SA companies in order for it to apply. SA-parented multinational enterprises should monitor this closely as it could impact their South African tax liabilities from a CFC perspective.

Background

Coronation Ireland's business model

Coronation is a large fund management group of companies. In 1997, soon after various financial sanctions on South African capital were lifted and while Ireland was undergoing a change with respect to its financial infrastructure, Coronation SA incorporated Coronation Ireland in order to provide South African investors with investment opportunities in the UK and Europe. In 2007, Coronation Ireland applied to the Irish Financial Services Regulatory Authority for Authorisation of an Undertakings for Collective Investment and Transferable Securities ("UCITS").

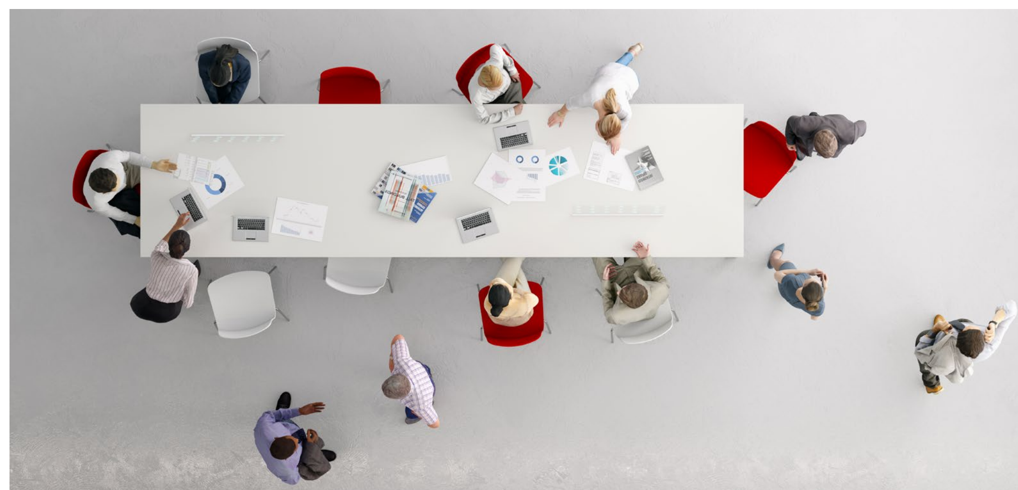
Coronation Ireland's business plan, which was submitted with the above application, indicated that it intended to conduct its business following an outsourcing model.

Under this model, Coronation Ireland's functions would include the maintenance of the required licences to function as a UCITS, it would make policy decisions regarding the funds, ensure compliance with the various applicable regulations and oversee all of the operations for which it was responsible. Coronation Ireland would then outsource functions such as investment management (to two connected companies, one resident in South Africa, and the other in the UK), distribution functions, fund administration and the custodian function (these were outsourced to companies within the JP Morgan group situated in Ireland).

Dispute with SARS

SARS conducted an audit on Coronation SA for the 2011 to 2013 years of assessment whereafter it issued additional assessments to include the income of Coronation Ireland in Coronation SA's taxable income. Coronation SA objected and the matter proceeded to the Tax Court. The Tax Court agreed that Coronation Ireland had a FBE from which the CFC's primary operations were conducted and therefore that Coronation Ireland's income could be disregarded from Coronation SA's income. Importantly, this was on the basis that the CFC's primary business was that of a fund manager — in other words, the activity of investment management, which had been outsourced, was not Coronation Ireland's primary operations.

SARS appealed the matter to the SCA which overturned the finding of the Tax Court and held that while Coronation Ireland had elements of a FBE, it lacked the required economic substance. More specifically, the SCA concluded that the investment management activity was part of the CFC's primary operations and, furthermore, considered it to be fatal that this specific activity had been outsourced.



Applicable legal provisions

It is helpful to provide extracts of the relevant provisions which the Tax Court and SCA had to consider in determining whether Coronation Ireland's income is required to be imputed to Coronation SA.

Section 9D(9)(b):

(9) Subject to subsection (9A), in determining the net income of a controlled foreign company in terms of subsection (2A), ***there must not be taken into account any amount which-***

(b) ***is attributable to any foreign business establishment of that controlled foreign company*** *(whether or not as a result of the disposal or deemed disposal of any assets forming part of that foreign business establishment) and, in determining that amount and whether that amount is attributable to a foreign business establishment* (own emphasis)

Section 9D(1):

"foreign business establishment", in relation to a controlled foreign company, means-

(a) a ***fixed place of business*** *located in a country other than the Republic that is used or will continue to be used for* ***the carrying on of the business*** *of that controlled foreign company for a period of not less than one year, where-*

(i) that business is ***conducted through one or more offices****, shops, factories, warehouses or other structures;*

(ii) that fixed place of business is ***suitably staffed*** *with on-site managerial and operational employees of that controlled foreign company* ***who conduct the primary operations of that business****;*

(iii) that fixed place of business is ***suitably equipped*** *for conducting the* ***primary operations of that business****;*

(iv) that fixed place of business has ***suitable facilities*** *for conducting the* ***primary operations of that business****; and*

(v) that fixed place of business is ***located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic*** (own emphasis)

Tax Court judgment

The Tax Court reasoned that the business of Coronation Ireland was the collection of cash from clients which it used for the purposes of generating income for those clients. The source of the CFC's income was the collection of fees, which were generally determined by the amount of assets under management, noting that there are instances where additional fees are received as a result of the performance of the investment performance.

The Tax Court considered whether Coronation Ireland had all of the required elements of an FBE including whether it had the required economic substance for the FBE exemption to apply. In this regard, the Tax Court was satisfied that the CFC (Coronation Ireland) had several FBE elements, given that:

(i) Its business was conducted in one or more offices in Ireland;

(ii) Coronation Ireland was suitably staffed as it had four employees comprising of a managing director, two accountants and a compliance officer and, further, had four members of its board of directors (only one of which was an employee);

(iii) The offices were suitably equipped on the basis that it had furniture, computers and accessories;

(iv) The offices had suitable facilities considering that it had power, water, internet and telephone connections; and

(v) Coronation led evidence to the effect that the South African tax treatment of this offshore structure did not influence its decision to establish Coronation Ireland.

When considering whether Coronation Ireland had the required economic substance (i.e. whether the CFC conducted its primary business operations from Ireland), the Tax Court took the view that the business of Coronation Ireland was that of fund management which did not necessarily include investment management. This is on the basis that the numerous activities performed by Coronation Ireland were directed at maintaining the required licences and managing Coronation's ability to offer these offshore investment opportunities to South African investors. The Tax Court further noted that without these functions, the other activities such as investment management, administration and distribution functions would not have been possible. The Tax Court ultimately held that the CFC is entitled to outsource certain functions and still retain its primary operations in Ireland (and in fact did so).

SCA judgment

While the SCA agreed that Coronation Ireland had, on the face of it, most of the elements of an FBE, it ruled that it did not have the economic substance to conduct the primary operations of its business because it outsourced the investment management function. In arriving at this conclusion, it considered the background facts, summarised above, in light of the apparent purpose of section 9D, the relevant licensing terms which authorised Coronation Ireland to act as a management company as well as the wording of the company's Memorandum of Association.

Purpose of section 9D

The SCA considered that the purpose of section 9D was to balance horizontal equity and international competitiveness of South African CFCs in light of the change from a sourced-based method of taxation to a residence-based method. The balance needed to be struck between the equity of South Africans earning income within South Africa and those earning income abroad, while also ensuring that South African owned businesses operate on the same level tax playing fields as foreign-owned competitors operating in the same jurisdictions. This balance would be provided through the FBE exemption which, according to the SCA, required that the location of the primary operations of a CFC is conducted in the same jurisdiction as that FBE.

Licensing terms and Memorandum of Association

The licence which was issued to Coronation Ireland is titled 'Authorisation of a UCITS Management Company'. The SCA pointed out that schedule 1 to this licence provided that Coronation Ireland may not engage in activities other than the management of certain UCITS authorised according to the (UCITS) Regulations, 2011 ("the Regulations") (as well as other collective investment undertakings), which authorisation did not include the provision of individual portfolio management services or certain other non-core services (authorisation for which could be obtained through application to the applicable Financial Regulator). The Regulations in turn define collective portfolio management as 'the management of UCITS and other collective investment undertakings, and includes the functions specified in schedule 1'. Schedule 1 then states that functions included in the activity of collective portfolio management include investment management,

administration (including legal and fund management accounting services) and marketing. The SCA further notes that the Regulations make provision for the outsourcing or delegation of functions provided that certain requirements are met.

From the above, the SCA concludes that Coronation Ireland is authorised to conduct collective portfolio management *which includes investment management*, administration and marketing. The SCA pointed out that this was confirmed by an Irish solicitor with expertise in the legal and regulatory aspects of investment services in Ireland as well as the managing director of Coronation Ireland. The SCA further considered the testimony of one of the founders of the Coronation group that the licence obtained by Coronation Ireland permitted it to undertake investment management and that this was one of the core functions which were outsourced.

Turning to the functions performed by Coronation Ireland, the SCA states that the company's managing director indicated that the licence largely looks after itself and that the Irish solicitor said this could have been done in the quarterly board meetings (i.e. no employees were actually required in Ireland for this purpose). The SCA considered that the managerial functions performed by Coronation Ireland were ancillary to the investment function — these functions included 'decision-making, monitoring compliance, risk management, monitoring of investment performance, financial control, monitoring of capital, internal audit and supervision of delegates.'

Based on the above, the SCA concluded that Coronation Ireland conflated the role of a management company with its outsourcing of its investment and other functions. The fact that Coronation Ireland decided to delegate certain functions did not mean that the nature of Coronation Ireland's business changed. Coronation disagreed with this approach and maintained that the 'business' of a CFC for purposes of the FBE exemption must be determined by what the entity actually does (i.e. the normal commercial activity it undertakes on a day-to-day basis). The SCA disagreed with this and stated that dictionary definitions of 'primary' and 'operations' indicated that these should be first in importance and a working activity respectively. The SCA pointed out that investment management is included in the Memorandum of Association of Coronation Ireland.

Based on the above, the SCA concluded that investment management was a core function of the business of the CFC. This is supposedly also evidenced by Coronation Ireland's transfer pricing report which indicates that it pays 50% of the net fund management fee received by it to those who have been delegated the investment management function. The court considered that Coronation Ireland's choice to outsource investment management (which in itself indicates that it was able to do so, as an agent cannot perform a function which does not form part of the business-remit of a principal) does not change the nature of its business from an investment business to a managerial one. Based on this, the SCA concluded that the fixed place of business in Ireland lacked the staff and facilities to conduct the CFC's primary operations — which includes investment management. Accordingly, the FBE exemption did not apply.

Understatement penalties

The SCA's pronouncement of understatement penalties is unhelpful. The Court denied the imposition of the penalties (i.e., found in favour of Coronation) but the basis for the finding is not entirely clear from the judgment. It is conceivable that it could have been because Coronation SA was in possession of a qualifying tax practitioner opinion, as contemplated in section 223(3) of the Tax Administration Act ("TAA"). However, there is no analysis of s223(3), nor any evidence that the opinion in question complied with the requirements of for the non-imposition or remittance of the penalty. The SCA simply emphasised that the taxpayer's failure to share the opinion with SARS cannot be a basis for presuming that the opinion was a 'negative' one.

Commentary on the SCA case

The SCA and Tax Court appear to be ad *idem* on the principle that an FBE cannot outsource its primary operations. That is, in order to 'conduct' your primary operations (as contemplated in the FBE definition), you need to be actually doing those functions directly, yourself. However, where the SCA differed from the Tax Court was on a question of fact, i.e. what in fact was Coronation Ireland's primary operations.

From the above it can be seen that the SCA determined the business of Coronation Ireland with reference to the

regulations with which it must abide and the underlying legal documents of the entity, which are often drafted widely in practice to ensure that if the intended business of the company changes that it would be authorised to do so without having to undertake the commercial legal steps to change its memorandum of association/incorporation. That is, there appears to have been an almost-definitive attachment to what the entity is entitled, permitted, and authorised to do. For example, it might be considered misguided to attach importance to the fact the CFC could only outsource the investment management function if, as a starting point, it must have possessed the authority to undertake that function itself. The fact of the matter is that the same is true for any outsourced function including, for example, an administration function — but no-one would suggest that administration generally constitutes a 'primary operation'.

This is in contrast with the Tax Court which considered what Coronation Ireland actually does to determine its business (and thereby what its primary operations include). That is, the Tax Court recognised that there is a difference between what could legally and potentially be the CFC's primary operations, and what the CFC chooses or elects to be its primary operations.

Furthermore, while there was a brief indication that Coronation Ireland's payment to the Coronation entity in SA, which the investment management function was partly outsourced to, was subject to transfer pricing, the SCA did not consider that this was the mechanism which should have been relied on to ensure that SA received adequate taxing rights. If the entity in SA was compensated on an arm's length basis the income from the investment management functions performed by it would be fully taxable in SA. The only profits remaining in Ireland (assuming that it also paid an arm's length fee to the other connected person in the UK to whom investment management was outsourced) would be the profits from the services that Coronation Ireland actually provides through its fixed place of business. Disregarding these profits in terms of the FBE clearly falls within the scheme of section 9D when one has regard to its purpose.

It is noted that Coronation SA has indicated that it intends applying to the Constitutional Court to apply for leave to appeal the SCA judgment.

Budgetary announcement

As indicated above, on 22 February 2023, National Treasury indicated that the wording of the legislation regarding the FBE exemption would be amended.

This means that when these amendments come into effect SARS will not only have this judgment to rely on, but that the actual legislative provisions will support SARS' view as accepted by the SCA, regardless of the outcome of any possible Constitutional Court appeal. This could have a far-reaching impact for outbound multinational companies which rely on the FBE exemption, especially given the change in commercial practice over time with regard to the use of outsourcing to achieve commercial efficiencies.

The Takeaway

Based on the SCA's judgment and given that legislative amendments are expected to reinforce the outcome of this judgment, outbound multinational enterprises should consider the business models of their CFCs which rely on the FBE exemption, particularly having regard to any functions that may be outsourced.

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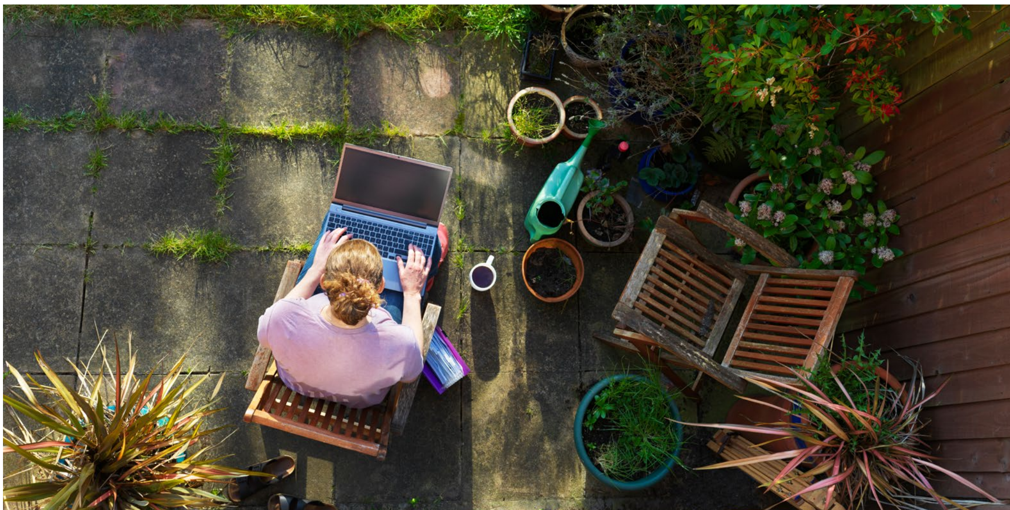
A recent High Court judgment reiterates that SARS bears the onus of proof in the context of understatement penalties

The recent case of *Lance Dickson Construction CC v Commissioner for the South African Revenue Service* (A211/2021) [2023] ZAWCHC 12, serves as a reminder of the onus placed upon the Commissioner of the South African Revenue Service ("SARS") to prove the facts on which SARS based the imposition of an understatement penalty ("USP") in respect of a taxpayer. It also highlights the fact that when SARS exercises the powers conferred upon it, it must do so cautiously and sensibly.

The taxpayer, *in casu*, concluded a written agreement for the sale of its property with Kwali Mark Construction CC ("KMC") for the sum of R25,2 million, which was calculated on the basis that the property, once sub-divided, would comprise 72 individual erven each valued at R350,000.



The sale agreement contained significant terms to the effect that:

- KMC would pay the taxpayer the sum of R350,000 when each erf in the development (which had been fully developed with a residential dwelling thereon) was on-sold to the ultimate purchaser; and
- Capital gains tax ("CGT") on the entire transaction would be paid by the taxpayer on an *ad hoc* basis, as and when each individual erf was on-sold by KMC and the relevant amount had been received by the taxpayer.

The property was transferred to KMC in October 2016, however when the taxpayer submitted its 2017 tax return to SARS, none of the individual erven had been on-sold by KMC, thus the taxpayer did not disclose the sale thereof. SARS queried the omission by the taxpayer and the taxpayer's auditors responded by setting out the basis upon which the taxpayer adopted its tax position. SARS, however, maintained that the taxpayer was liable to pay the full amount of CGT to SARS during the 2017 tax year, as the property was transferred to KMC during such tax year. Additionally, SARS imposed a USP of 25% because it was of the view that the taxpayer's understatement resulted from it not having taken reasonable care in the completion of its 2017 tax return.

The Taxpayer lodged an objection under section 104 of the Tax Administration Act, No. 28 of 2011 ("TAA") and the matter proceeded to the Tax Court, which upheld SARS' determination.

Before considering the arguments of both SARS and the taxpayer, it is crucial to take note of some of the key applicable legislation pertaining to the imposition of USPs by SARS.

Section 222(1) of the TAA states that:

> "In the event of an 'understatement' by a taxpayer, the taxpayer must pay, in addition to the 'tax' payable for the relevant tax period, the understatement penalty… unless the 'understatement' results from a bona fide inadvertent error."

Section 221 of the TAA states that:

> "'understatement' means any prejudice to SARS or the fiscus as a result of –
>
> (a) …
>
> (b) an omission from a return..."

S223(1) of the TAA contains the USP percentage table in which the relevant penalty payable by a taxpayer is calculated with reference to the specific category of alleged behaviour on its part.

1	2	3	4	5	6
Item	**Behaviour**	**Standard case**	**If obstructive, or if it is a 'repeat case'**	**Voluntary disclosure after notification of audit or criminal investigation**	**Voluntary disclosure before notification of audit or criminal investigation**
i	'Substantial understatement'	10%	20%	5%	0%
ii	Reasonable care not taken in completing return	25%	50%	15%	0%
iii	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
iv	'Impermissible avoidance arrangement'	75%	100%	35%	0%
v	Gross negligence	100%	125%	50%	5%
vi	Intentional tax evasion	150%	200%	75%	10%

Inextricably linked to the imposition of a USP (under Chapter 16 of the TAA), is section 102(2) which states that:

> "The burden of proving … the facts on which SARS based the imposition of an understatement penalty…, is upon SARS."

Turning to the judgment, the High Court,[1] indicated that where an alleged understatement of tax has occurred, a three-phase process is contemplated by the Legislature.

- **Phase 1**: SARS must consider whether the understatement constitutes an 'understatement' as defined in section 221 of the TAA.
- **Phase 2**: If there is an 'understatement', SARS must then consider whether the understatement results from a "*bona fide* inadvertent error". If such an error is established, that is the end of the inquiry, and no USP may be levied.
- **Phase 3**: Where there is no "*bona fide* inadvertent error", SARS is then required to identify the appropriate behavioural category under which the taxpayer's conduct allegedly resorts, in terms of the table set out in section 223, before it can impose a penalty.

In applying the three-phase process to the taxpayer, it was common cause that there was an understatement on the basis that there was an "omission from a return" and that a "*bona fide* inadvertent error" was not applicable. Thus, the crux of the dispute related to whether SARS had identified the appropriate behavioural category in respect of the taxpayer's conduct i.e. reasonable care not taken in completing its tax return.

SARS argued, *inter alia*, that:

- Reasonable care requires the taxpayer to take the same care in fulfilling his tax obligations that could be expected of a reasonable ordinary person in the same position.
- Consequently, reasonableness required the taxpayer to have known that the sale of the property on 26 September 2016 and the subsequent registration on 27 October 2016 was a disposal event which triggered proceeds that accrued to the taxpayer during the 2017 year of assessment.
- The taxpayer's failure to make such declarations to SARS constituted actions that fell below the standard of a reasonable person in similar circumstances.
- On this basis, SARS submitted that the USP was correctly imposed at 25% as reasonable care was not taken by the taxpayer in completing its tax return.

1 See paragraph 13 of the judgment.

The taxpayer argued, *inter alia*, that:

- An 'understatement' did not arise from its return completion process and therefore the imposition of a USP on the basis of "reasonable care not taken in completing its return", was inappropriate. Rather, if an 'understatement' was present, it arose from the tax position taken by the taxpayer.
- SARS therefore identified the incorrect behaviour against which it applied the USP.
- The taxpayer's calculation of its tax liability could not be described as being unreasonable, solely due to the fact that it had interpreted the time of disposal and time of accrual rules in a manner that was different to SARS.
- The reasonableness of the taxpayer's provisional tax calculation is further borne out by the fact that SARS elected not to penalize the taxpayer for any 'understatement' on the basis of no reasonable grounds for 'tax position' taken. Had SARS truly considered the taxpayer to have no reasonable grounds for the 'tax position' adopted, it would have been obliged to levy a 50% penalty as opposed to a 25% penalty. It is for this reason that the USP percentage table in section 223 of the TAA provides for the behavioural category of "no reasonable grounds for 'tax position' taken", and which behaviour attracts penalties in a 'standard case' at 50%.
- The taxpayer's position had been confirmed by an independent expert opinion which was further support therefor that its 'tax position' adopted was in fact reasonable.

The High Court then considered the evidence adduced before the Tax Court (including the testimony of SARS' factual witness, Ms. Marothodi) and made the observation at paragraphs 28 to 30 of the judgment that:

> "[28] When pressed under cross-examination by Dr. Marais, the witness fell about but eventually accepted that she had chosen the wrong behavioural category in assessing the understatement penalty. She vacillated between contending that the behaviour of the taxpayer was unreasonable in failing to include the CGT figure in the 2017 tax return to unreasonable in relation to the basis for the tax position it claimed to have taken.
>
> [29] Eventually, Ms. Marothodi conceded that SARS had erred in imposing a 25% penalty on the basis of the item (ii) behaviour it had relied on and accepted that the position contended for by the taxpayer (a reasonable assumption in relation to the tax position it had taken) was viable, eventually stating rather opportunistically –
>
> 'Okay, looking at the facts, I must say that SARS lost the opportunity using that 50%.'
>
> [30] The witness then rather brazenly went on to suggest to counsel for the taxpayer that his client should be happy with the lesser penalty because its conduct had been unreasonable either way. The evidence clearly demonstrates that the witness manifestly did not understand the difference between the behaviour categorised in items (ii) and (iii). In light of the damaging concession made by SARS' only witness, the taxpayer astutely closed its case without calling any witnesses."

The High Court went on to state at paragraph 45 of the judgment that:

> "[45]...S 222 (2) carefully circumscribes the powers of SARS.
>
> "222(2) The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall determined under subsections (3) and (4) in relation to each understatement in a return."
>
> It follows that if, for example, SARS finds that there has been an understatement based on the taxpayer's failure to take reasonable care in completing its return, it must impose the 25% penalty: it does not have any discretion to lower the percentage. Similarly, if the behaviour category relied on by SARS is the absence of reasonable grounds for the tax position taken, it must impose a 50% penalty. There is thus no statutory basis to impose a 25% penalty in respect of behaviour falling within the ambit of item (iii)."

The High Court found that if SARS elected to impose a 25% USP (for reasonable care not taken in completing a return) under item (ii) of the USP percentage table, it was required to prove the factual basis therefor when its determination was challenged by the taxpayer in the Tax Court.[2] It was common cause that SARS did not do so, and in the circumstances there was no basis, either in fact or law, for it to recover that penalty from the taxpayer.

The High Court thus concluded that the Tax Court erred in confirming the USP of 25% and that the Tax Court was not permitted to make such an order where the confirmation of a USP was dependent on SARS discharging its burden of proof.

2 See paragraph 43 of the judgment.

The takeaway

1. The onus is on SARS to prove the facts on which it based the imposition of a USP (section 102(2) of the TAA).
2. When a taxpayer is charged with a USP, the taxpayer should critically consider the facts relied upon by SARS for placing it in that behavioural category and evaluate whether it aligns with the taxpayer's behaviour.
3. It is important to understand the difference between the behavioural categories in the USP percentage table in section 223 of the TAA (as can be seen in this matter, the taxpayer's ability to pinpoint the differences in behavioural categories assisted its case).

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Considering the effect of SARS' intended withdrawal of Practice Note 31 for taxpayers

On 16 November 2022, the South African Revenue Service ("SARS") issued a notice announcing its intention to withdraw Practice Note No. 31 ("PN31")[1], which relates to the deductibility of interest paid on borrowed money. This article considers the practical implications for taxpayers of the withdrawal, as well as some of the historic uncertainty surrounding PN31.

Provisions of PN31

PN31 provides that whilst one of the requirements for the deductibility of interest expenses incurred by a taxpayer is that such expenditure must have been incurred in the course of a taxpayer's trade, it is nevertheless the practice of SARS to allow a deduction for interest expenditure incurred purely for the purpose of earning interest income.

The practical import of this is that PN31 permits a taxpayer who is not a moneylender to deduct interest on funds borrowed for investment purposes, notwithstanding the fact that the mere holding of passive investments does not constitute the carrying on of a trade. The deduction will be allowed to the extent that it does not exceed the interest income. The practice is therefore seemingly extended in that it will even apply in cases where funds are borrowed at a certain rate and then invested at a lower rate.

SARS' decision to Withdraw PN31

According to SARS, the concession provided for in PN31 has been the subject of perceived abuse by taxpayers seeking to structure or undertake transactions to obtain a deduction under PN31 of interest or expenditure incurred, which deduction would not otherwise have been permitted under the Income Tax Act No. 58 of 1962 (the "Act").

SARS further notes that various provisions of the Act now result in the reclassification of certain income streams as interest, which has granted taxpayers unwarranted deductions under PN31 against the reclassified income. Transactions are structured through, for example, the use of tax exempt or non-resident taxpayers to maximise interest deductibility on the basis of PN31, whilst there is no corresponding inclusion in gross income for the recipient.

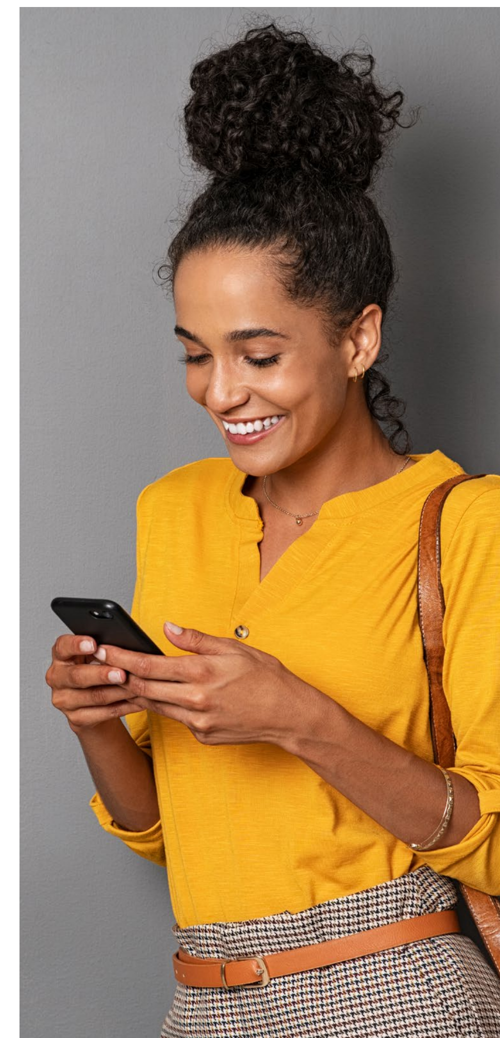
PN31 is commonly relied on in practice, particularly in structured finance transactions, and the announcement by SARS of its intention to withdraw PN31 has been met with concern and apprehension by taxpayers. But just how detrimental will the withdrawal of PN31 be?

Historic efficacy of PN31

SARS powers to issue practice notes

Despite taxpayers' general misgivings around losing the PN31 concession, the extent of its effectiveness from a tax technical and practical perspective has long been questionable.

SARS is not specifically empowered in terms of either the Act or the Tax Administration Act No. 28 of 2011 ("TAA") to issue practice notes or interpretation notes, nor are there any provisions in the tax legislation recognising the legal validity of such publications. Section 5 of the TAA does however recognise a "practice generally prevailing" as "a practice set out in an official publication regarding the application or interpretation of a tax Act".



1 Proclaimed in the Government Gazette No. 16018 of 14 October 1994.

An official publication as defined includes both practice notes and interpretation notes.

SARS may not, for example, make an additional assessment in terms of Chapter 8 of the TAA if the amount which should have been assessed to tax under the preceding assessment was, in accordance with the practice generally prevailing at the date of the preceding assessment, not assessed to tax.

However, section 5 of the TAA also states that, despite any provision to the contrary contained in a tax Act, a practice generally prevailing set out in an official publication will cease to be a practice generally prevailing if *inter alia* a court overturns or modifies an interpretation of the tax Act which is the subject of the official publication to an extent material to the practice.

Per the Constitutional Court's decision in *Marshall NO and Others v Commissioner for SARS*[2], it is now settled law that a court should not take into account the provisions of a SARS interpretation note when considering the meaning to be ascribed to any provision of a tax Act.[3] As the court put it [4], "*Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision?... It is best avoided.*"

2 (CCT208/17) [2018] ZACC 11 (25 April 2018).

3 A limited exception exists in the case where the interpretation note evidences an impartial practice that is accepted by all parties concerned.

4 At page 6.

Aside from the question of SARS' power to issue practice notes, there is the added uncertainty regarding SARS' power to depart from the fiscal principles established by the legislature in terms of the Act. As Brincker points out:[5]

> "It is not for the Commissioner to usurp the function of the legislator, but for the legislator to change the laws to the extent that it may result in equitable consequences. Even in the context of legitimate expectation, it may well be arguable whether or not the Commissioner is in fact bound to the practice note."

The author goes on to contend that PN31 may well be found to be invalid if eventually tested in court, notwithstanding the fact that SARS applies its provisions in practice.[6]

Does SARS consider PN31 to be binding?

In addition to the uncertainty raised above in relation to whether a practice note is actually binding on SARS, it appears that SARS may not even consider itself bound by the provisions of PN31 in practice.

In ITC 1675[7] counsel for SARS explicitly contended that SARS was not bound by PN31 on the basis that a practice note cannot override the provisions of the Act.

The court in that case noted that it cannot always safely be assumed that SARS will consider itself bound by its own practice notes. It was further stated that "*…the issue of a practice note is not good policy if the practice note constitutes a departure from the provisions of the Act and that if it is intended to regulate the deductibility of interest in these circumstances, the place to do so is in the Act*".[8]

5 Taxation Principles of Interest and Other Financial Transactions, Issue 7 (2010) ("Brincker").

6 Brincker also notes that it is doubtful whether any reliance on the principle of legitimate expectation will have any force in the circumstances, as this principle rather relates to a procedural remedy as opposed to a remedy in substance.

7 62 SATC 219 (1998).

Similarly, in *Special Board Decision No 187*[9] SARS also issued a revised assessment in disregard of PN31. It was held that SARS is not lawfully entitled to issue assessments in disregard of its own practice notes, however the basis on which SARS is ostensibly bound by such publications was not discussed.

8 See again Brincker.

9 9 SASBDR 3 and again Brincker.

Correct interpretation of the wording of PN31?

It is widely known that, in practice, taxpayers often rely on the concession in PN31 to deduct all expenditure in question up to the amount of interest income earned. However, this interpretation of the provisions of PN31 is not necessarily supported by the wording used, and the exact ambit of the concession is not entirely clear.

On a strict interpretation of PN31, it appears to allow a deduction for '*expenditure [i.e. note not only interest] incurred in the production of interest to the extent that it [i.e. the expenditure] does not exceed such income*'. However, if the

context of PN31 is considered, it becomes clear that it is SARS' intention to apply the practice only in respect of 'interest'. As a result, it is questionable whether other types of expenditure may validly qualify for deduction.

In addition, it seems clear from the context of PN31 that it was issued to assist taxpayers only in overcoming the trade requirement. As such, the remaining requirements under section 11(a) (including, in particular, the non-capital requirement) would still need to be met, and these requirements would need to be considered in respect of each and every interest charge, as opposed to on an aggregate basis.

In the case of *Mr X v C:SARS*[10] the taxpayer, a director at a firm of attorneys was required to advance funds to his employer on loan account for the firm's working capital purposes. The taxpayer purchased a property secured by a mortgage bond from a bank. Relying primarily on PN31, he claimed as deductions various amounts in respect of interest incurred on the mortgage loans on the basis that such interest was incurred in the production of interest income. In this regard the taxpayer contended that the interest incurred on his loan account with the bank did not exceed interest income derived on his loan account with his employer.

SARS adopted a narrow view of the provisions of PN31, arguing *inter alia* that PN31 requires that the funds, on the basis of which interest is paid and the deductions are claimed, should be borrowed and be advanced to a third party from whom interest income earned is derived, and that the interest on the basis of which the deduction is claimed must be expended in the production of interest income.

In finding in favour of SARS, the court held importantly that while PN31 may deem interest to have been incurred for purposes of a taxpayer's trade, PN31 does not extend to the requirement that the interest be incurred in the production of income, and that taxpayers are still required to satisfy this requirement before claiming a deduction under PN31. On the facts of the case, the court held that the taxpayer had not established a causal link between the interest paid and interest earned to qualify for the deduction, notwithstanding the quantum of the interest income earned.

The takeaway

While the withdrawal of PN31 has caused a stir amongst taxpayers, it appears that the perceived detriment of the withdrawal may be exaggerated given that PN31 may in any event have been of limited assistance in the past.

The fact that taxpayers are still required to satisfy the remaining elements of the test for deductibility, coupled with the interpretational uncertainty surrounding PN31 (as well as SARS' seeming unwillingness to be bound by its provisions in all cases) suggests that PN31 may not be as effective a tool for taxpayers as once thought.

As an added silver lining, the Minister of Finance announced in the Budget Speech on 23 February 2023 that, in light of public comments received on the withdrawal of PN31, government will consider the impact of the proposed withdrawal and whether changes could be made in the tax legislation to accommodate legitimate transactions affected by such withdrawal. In light of this proposal, SARS also intends to delay and align the withdrawal of PN31 with the effective date of any legislation arising from the proposed considerations.

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10 An unreported judgment of the Tax Court, Case No 13791 & 13792, 13 December 2016.

SARS Watch

SARS Watch 1 February 2023 – 28 February 2023

Legislation		
24 February 2023	Notice published in terms of section 18A(2)(a)(vii) prescribing the further information that must be contained in a receipt issued in terms of section 18A(2)(a) of the Act	Notice 3082 published in Government Notice no. 48104 with an implementation date of 1 March 2023.
22 February 2023	2023 Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill	The Bill has been released for public comments by National Treasury.
22 February 2023	Income tax notice on fixing of rate per kilometre in respect of motor vehicles – section 8(1)(b)(ii) and (iii)	Official Public Notice on fixing of rate per kilometer in respect of motor vehicles is still to be published in the Government Gazette.
22 February 2023	Income tax notice on the determination of the daily amount in respect of meals and incidental costs for purposes of section 8(1)(c)(ii) (overnight allowance)	Official Public Notice daily amounts in respect of meals and incidental costs is still to be published in the Government Gazette.
22 February 2023	Income tax notice on the determination of the daily amount in respect of meals and incidental costs for purposes of section 8(1)(a)(ii) (daily allowance)	Official Public Notice daily amounts in respect of meals and incidental costs is still to be published in the Government Gazette.
22 February 2023	Postponement of withdrawal of Practice Notes 31 of 1994 and 37 of 1995	In view of the Budget announcement, the withdrawal of these two Practice Notes is postponed to 1 March 2024.
Binding rulings		
10 February 2023	Binding General Ruling 28 (Issue 3) – Electronic services: Specific requirements relating to credit and debit notes, exchange rates, and advertised or quoted prices	Update to BGR 28 which sets out the minimum information that must be contained on a credit or debit note, exchange rate that must be applied in order to determine the amount of the VAT charged in the currency of the Republic and the manner in which prices must be advertised or quoted, for the supply of electronic services by an electronic services supplier.
Customs and excise		
28 February 2023	Next phase of the Traveller Declaration System	The next phase of the implementation is planned at all airports, starting with Cape Town International Airport on 28 February 2023, O.R. Tambo International Airport on 23 March 2023 and other airports in the second and third quarters of 2023, as well as land ports, namely Beit Bridge and Skilpadshek. The Cape Town Seaport is also in line to implement the system during the last quarter of 2023.
22 February 2023	Taxation Proposals as tabled by the Minister of Finance in his Budget Review 2023.	Taxation Proposals as tabled on 22 February 2023.
17 February 2023	Notice R.3061 - Amendment to Part 1 of Schedule No. 1, by the insertion of various 8-digit tariff subheadings in Chapter 30, for vaccines used in the Expanded Programme on Immunisation for both national and provincial Departments of Health.	Published in Government Gazette No. 48067 with implementation date of 17 February 2023.
16 February 2023	Excise – submission and payment dates.	The Excise submission and payment dates for 2023/2024 have been published.
10 February 2023	Notice R.3021 - Imposition of provisional payments in relation to anti-dumping duties against the alleged dumping of windscreens for vehicles, classifiable in tariff subheading 7007.21.20, originating in or imported from the People's Republic of China – ITAC Report No. 707.	Published in Government Gazette No. 48013 with implementation date up to and including 9 August 2023.
8 February 2023	Customs: Registration, Licensing and Designation	Facility codes used in Box 30 on the Customs Clearance Declaration (CCD) have been updated to include the details of the new approved Container Depot in Durban, Afro Persian Shipping (Pty) Ltd.
7 February 2023	Draft amendments to rules under sections 55AA and 120 – Carbon tax account.	The draft form amendments implement the Budget 2022 carbon tax proposals in the Rates and Monetary Amounts and Amendment of Revenue Laws Act, 2022 and the Taxation Laws Amendment Act, 2022. Comments were due on 24 February 2023.

7 February 2023	Draft amendments to rule 19A4.01 under sections 19A and 120 – Storage of fuel levy goods.	Amendment was published for comment to clarify that a special customs and excise storage warehouse for the storage of locally manufactured fuel levy goods contemplated in section 19A may remove such goods to the BELN countries or for export including ship stores. Comments were due on 20 February 2023.
6 February 2023	Draft amendments to rules under sections 19A and 120 – Vaping products.	For the implementation of tobacco products related excise duties on nicotine and nicotine-substitute solutions in vaping products. Comments were due on 24 February 2023.
Case law		
In accordance with the date of judgment		
21 February 2023	A v Commissioner for the South African Revenue Services (46206) [2023] ZATC 1	The issue in dispute is whether the taxpayer may, in terms of section 20(1) of the Income Tax Act (ITA), set off the balance of the foreign assessed loss from an aircraft partnership trade, as carried forward, against the income received by or accrued to the taxpayer in the form of recoupments arising from the deemed disposal, under section 9H of the ITA, of partnership assets used in the conduct of a foreign trade.
16 February 2023	Farber v Commissioner for the South African Revenue Service and Another (111422020) [2023] ZAGPPHC 88	This is an application for leave to appeal to the full bench of this division against the court's judgment dated 15 December 2022.
7 February 2023	CSARS v Coronation Investment Management SA (Pty) Ltd (1269/2021) [2023] ZASCA 10 (07 February 2023)	The issue in this case is whether a 'controlled foreign company' is a 'foreign business establishment' as defined in section 9D of the Income Tax Act 58 of 1962. *For the Tax Court case preceding this judgment see:* *ABCDE SA Proprietary Limited v Commissioner for the South African Revenue Service (24596) [2021] ZATC 19; 84 SATC 251 (17 September 2021).*
31 January 2023	Lance Dickson Construction CC v Commissioner for the South African Revenue Service (A2112021) [2023] ZAWCHC 12	This is an appeal of the judgment of the Tax Court in which the determination by the respondent that the taxpayer was liable to pay a 25% penalty for the understatement of its liability for capital gains tax was confirmed. The issue is whether the behavioural category under which the taxpayer's conduct allegedly resorts is appropriate in terms of the table set out in section 223 of the Tax Administration Act 28 of 2011.
29 December 2022	SARSTC IT 45997 (ADM) ZATC JHB	The applicant sought an upfront determination that the new grounds of assessment be struck out from the respondent's rule 31 statement on the basis that it introduces an impermissible new ground of assessment in the appeal.
21 December 2022	SARSTC 2022/12 (ADM) [2022] JHB	Default judgment based on delivery of the notices found to be fatally defective because notices were not delivered to the chosen address for delivery of documents or processes by SARS in terms of rule 2 of the Rules of the Tax Court.
Guides and forms		
28 February 2023	Guide on how to Register for eFiling and Manage Your User Profile.	Updated for eFiling registration enhancements for Trusts.
28 February 2023	Guide for Transfer Duty via eFiling	The Guide has been updated with the new tax rates.
24 February 2023	The PAYE Employer Reconciliation Business Requirement Specification ('BRS') for the 2024 tax year has been published.	The following source codes have been amended: 2025, 2036, 3040, 3231, 3232, 3233, 3234 and 4150.
22 February 2023	2023 Budget FAQs – Solar Panel Tax Incentive for Individuals	This note sets out the basic characteristics and requirements for the solar panel incentive announced by the Minister of Finance on 22 February 2023. This is meant to help individuals in their immediate decision making, rather than postponing any solar installation until the legislative process can be finalised.
14 February 2023	Updated Guide for the SARS Online Query System	The Trust Registration query on SARS Online Query System has been enhanced to allow for the capturing of trusts' beneficial owner's details.
10 February 2023	Updated clarification document for AEOI (FATCA) Reporting TIN Codes	This document clarifies the application of the supplied codes for the Taxpayer Identification Number (TIN) data fields for FATCA submissions.

9 February 2023	IT3(d) Business Requirement Specification	Sets out the manner in which s18A third party information should be submitted to SARS and in preparation for the early adopters phase in April 2023.
8 February 2023	Customs Duty Implications on Imported Goods	This guide aims to provide taxpayers with information to assist in the determination of customs duty implications on imported dutiable goods. It excludes "excisable goods" specified in Part 2 of Schedule 1 imported into or manufactured in the Republic and goods imported through the post and by travellers.
Other Publications		
28 February 2023	Estate Duty webpage update	Information and clarification on whether the executor can be held personally liable for estate duty and when and how to request the Deceased Estate Compliance (DEC) letter.
24 February 2023	OECD: OECD presents international tax update to G20 Finance Ministers and Central Bank Governors	OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors.
24 February 2023	Tax Alert: Budget 2023 (Solar panel tax incentive)	This alert provides more details on the solar panel tax incentive (available for a period of one year) for individuals installing solar panels at private residences proposed in the 2023 Budget.
23 February 2023	Tax Alert: Budget 2023 (VAT proposals)	This alert highlights the key announcements and relevant tax proposals from the 2023 Budget which can be expected for South Africa's VAT landscape.
22 February 2023	Tax Alert: Budget 2023	This alert discusses the main tax proposals from the 2023 Budget.
16 February 2023	Tax Policy Alert: EU's ECOFIN Council releases updated list of non-cooperative jurisdictions for tax purposes	Russia, British Virgin Islands, Costa Rica and Marshall Islands were all added to Annex I (the so-called blacklist). No countries were removed from the previous list (published in October 2022). Annex II of the list (greylisted countries) was also updated with Albania, Aruba and Curaçao added, while North Macedonia, Barbados, Jamaica and Uruguay have been removed from the greylist.
16 February 2023	OECD: Tax challenges arising from digitalisation: Public comments received on compliance and tax certainty aspects of global minimum tax	Comments relating to the compliance and tax certainty aspects of the Pillar Two global minimum tax.
15 February 2023	OECD: New toolkit to strengthen the effective collection of value added taxes on e-commerce in Africa	A new toolkit offers timely and valuable assistance to African tax administrations for the effective collection of VAT revenues on e-commerce.
14 February 2023	OECD: The design of presumptive tax regimes	This OECD working paper provides an analytical framework for characterising and comparing simplified tax regimes. It also highlights key design aspects that deserve further consideration and lists a series of best practices on the design and administration of these regimes.
2 February 2023	OECD: OECD releases technical guidance for implementation of the global minimum tax	The OECD/G20 Inclusive Framework on BEPS provides technical guidance to assist governments with implementation of the landmark reform to the international tax system, which will ensure multinational enterprises (MNEs) will be subject to a 15% effective minimum tax rate.
1 February 2023	OECD: OECD releases manual on the handling of multilateral mutual agreement procedures and advance pricing arrangements ('MoMA') pursuant to tax certainty agenda	The MoMA allows tax administrations to explore whether implementation of these procedures is appropriate considering the circumstances of their own MAP and APA programmes and to consider whether the guidance therein may be incorporated in their domestic guidance on MAP or APA processes to provide additional clarity. The MoMA also outlines the actions and cooperation expected from taxpayers to allow tax administrations to consider MAP and APA cases multilaterally.

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