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Tax developments

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In the pipeline: Most important tax law amendments for 2015

The National Treasury released the Taxation Laws Amendment Bill (TLAB) and Tax Administration Laws Amendment Bill (TALAB) on 27 October 2015. These bills contain many amendments with very specific application, which if applicable may have a significant impact on the particular taxpayer, and only a few changes that are likely to affect all taxpayers. The discussion in this article focuses on some of the amendments that I am of the view will have an impact on a wide group of taxpayers.

Retirement reform

The retirement contribution tax reform was initially enacted in 2013, at that stage to become effective from 1 March 2015. The reform essentially entails that contributions to all retirement funds be treated similarly for tax purposes. This means that employer contributions to the fund are taxed as fringe benefits with a deduction for the employee capped at 27,5% of the higher of taxable income or remuneration (excluding lump sums) up to a maximum of R350 000 per annum. This deduction is available for contributions made by the employer that were taxed as a fringe benefit as well as for the employee's own contributions.

A uniform deduction regime however requires uniform rules for retirement funds and this is where the problem came in. Trade unions have raised concerns with the fact that in future provident fund benefits would also have a compulsory annuitisation component. The government is however concerned that a provident fund which allows a member to withdraw all benefits as a lump sum upon retirement does not protect retirement savings of such members sufficiently and should as such not be encouraged by a 27,5% deduction for contributions.

At the time of writing it appeared as if the position is that the reformed regime will come into effect for pension fund and retirement annuity fund contributions from 1 March 2016. There are a number of alternatives being considered in respect of provident fund contributions to provide more time for consultation and agreement between the government and trade unions as well as to enable a phased in annuitisation requirement.

Repeal of section 6quin rebates

Taxpayers that render services from South Africa to foreign customers (particularly in other African countries) often face the challenge of withholding taxes (WHT) on service fees. In many instances, the lack of a presence in the customer's country means that such a WHT is not allowed in terms of the relevant double tax agreement (DTA), yet it is still being collected and not refunded by the foreign government. Both the rebate as well as the deduction under section 6*quat* only provides relief if the taxes are proved to be payable, which a tax levied contrary to a DTA would not be. As a concession to enable South African residents to continue doing business despite this obstacle, section 6*quin* allowed a rebate from South African tax for such foreign WHT imposed contrary to a DTA or where a DTA had not been entered into with the customer's country.

For years of assessment commencing on or after 1 January 2016, section 6*quin* is however repealed, which leaves taxpayers in the same position as before its introduction. To assist taxpayers who face this obstacle of double taxation, the requirements of the deduction in section 6*quat* are relaxed to allow a deduction for foreign taxes that are proved to be payable *or paid*. As such, taxpayers will in future be entitled to a deduction for such foreign taxes imposed where the services are rendered from South Africa (which effectively reduces the South African tax liability by the foreign tax multiplied by the tax rate). It should be noted that not all such WHT are not necessarily collected contrary to a DTA – some DTAs contain deemed source rules, which may open up the possibility of section 6*quat* rebates in certain circumstances.

Other amendments in a nutshell

This is by no means a comprehensive listing, but taxpayers should also take note of the following:

- Deferral of the effective date of the withholding tax to be imposed on service fees paid to foreigners until 1 January 2017
- Changes to the capital gains tax treatment of disposal of shares by share incentive trusts
- Changes, with implications for previous transactions, in respect of interest deductions under section 24O
- Extension of prescription period for assessments where information is outstanding, information entitlement disputes are underway or where an audit or investigation relate to certain complex areas
- Process to be followed before a third party collection agent (often bank) can be notified and appointed by SARS to assist in the collection of tax debts

Concluding thoughts

The impact of many amendments for this cycle is in my view very specific to certain cases but may be significant if applicable. It is recommended that taxpayers work through these in detail to determine whether they are affected. Should you require assistance, you are welcome to contact me to discuss or consult on the impact of the amendments.

Corporate tax residence: Interpretation Note 6 & BEPS Action Plans

Corporate taxpayers are residents of South Africa for income tax purposes if they are incorporated, established or formed in South Africa or alternatively if they have their place of effective management (POEM) in South Africa. Many of South Africa's double tax agreements (DTA) use POEM as the tie-breaker provision to determine residence.

A new version of Interpretation Note 6 (IN6) was released by SARS on 3 November 2015. In addition to this, the OECD finalised the BEPS reports that may be indicative of the global view going forward. This article provides an overview of the new IN6 as well as highlights some relevant aspects of the OECD reports.

Issue 2 of Interpretation Note 6

Previously IN6 suggested the following approach to determine the POEM of a company:

> "The place of effective management is the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets."

The concern with this approach was that unlike the internationally followed view, which focuses on overriding control, IN6 required a more operational analysis. It appeared in the judgment of *Oceanic Trust Co Ltd NO v C: SARS* as if the courts would revert to the international view rather than the SARS IN6 view.

The new issue of IN 6 applies an approach consistent with the OECD commentary and views the POEM as the place where key management and commercial decisions necessary for the conduct of the business as a whole are in substance made. The determination of such a place is fact specific. A substance over form enquiry rather than a formalistic tick-box methodology should be followed. IN 6 suggests that the following factors that play a role in making this determination:

- The presence of a head office location where strategic management and their support staff are located. In particular, it suggests that this may not necessarily be where board meetings are held as key management and commercial decisions would generally require more frequent consideration.
- Location where members of executive committees of the board are normally based.
- Location of board meetings, provided that the board retains and exercises its authority to govern. In this regard, roles of directors (active or custodial), relationship between the place of board meetings and actual activities and the presence of pre-meetings may all have an influence.
- Use of technology for round-robin decision-making, ease of global travel and conferencing reduces the relative importance of the physical location of the board meeting.
- Shareholder decisions would generally not be relevant to the conduct of the business (and therefore POEM), but rather the existence of the company and the shareholders rights. The influence of the shareholder on business must however be evaluated as it may usurp control or limit the authority of management, in which case it may become of more relevance.
- The focus is on key management and commercial decisions as opposed to operational management
- Legal factors (for example, incorporation), presence of support services and economic nexus to a country would generally not be relevant

An important observation made in IN6 is that the POEM determination is not a snapshot determination a point in time (i.e. at the time when the board meets abroad) but an assessment of the continuum of regular and predominant activities of an entity. SARS express the view that the revised IN6 should not change the POEM for most companies.

Action Plan 6 on corporate residence

As part of the action plans to prevent granting of treaty benefits in inappropriate circumstances, the OECD proposes that POEM as a tie-breaker test should be replaced by a mutual agreement process (similar to what has been included in the SA/Mauritius DTA). They suggest that the place of board meetings, regular location of the CEO and senior executives, place where senior day-to-day management takes place, location of headquarters, the country of which the laws govern the entity, place where accounting records are kept, but also risk of improper tax benefits should be considered. This approach is in line with the other recommendations that have a specific focus on sufficiency of substance that is required to enjoy certain tax benefits.

Concluding thoughts

It is submitted that the new IN6 may be a timely intervention for companies with foreign structures to evaluate the residence of such entities in light of the actual operation, as opposed to the theoretical proposals when the structure was implemented. From both IN6 and Action Plan 6 it appears as if there is no getting away from substantial management activities, rather than the performance of formalistic activities, as being the key consideration in determining corporate tax residence.

Stepney Investments case: Valuations performed for tax purposes

Valuations are often viewed as something fuzzy and where you can to a large extent decide what the value should, provided that one stays within some boundaries of reasonability. In commercial transactions where values are negotiated between the parties to an agreement, the value is generally kept in check by such negotiations where each party aims to achieve the best possible outcome for himself. Where no counterparty however is involved and the value becomes a hypothetical value, for example, when such a value is required for tax or accounting purposes, a perception of a certain degree of freedom in estimating such a value may exist. In a tax context, the recent judgment in *Commissioner for the South African Revenue Service v Stepney Investments* shows that this is not the case. This article reviews the highlights of the judgement and thereafter considers some other the instances in the Income Tax Act (Act) where taxpayers are required to perform valuations.

Stepney Investments case

The taxpayer in this case held shares in a private company involved in casino, hotel and leisure activities. The company was awarded a casino license in 2000 but complications arose when external parties litigated in respect of the site where the casino would have been constructed. As a result, an alternative site was acquired with a temporary gambling license.

At the time when the shares were sold capital gains tax (CGT) had taken effect and the taxpayer relied on a valuation of the shares at the valuation date to determine the base cost of the shares. As required under paragraph 29(4) of the Eighth Schedule, the taxpayer obtained a valuation prior to 30 September 2004. From the facts provided it appears as if this valuation was done during 2004.

SARS contended that the valuation was too high, which in turn resulted in a reduction of the taxable capital gain. Without going into the details of how this particular valuation was performed, it suffices for purposes of this newsletter discussion to note that the judge came to the conclusion that SARS was correct in contesting this valuation based on grounds such as the fact that the 2000/2001 projected amounts were not reviewed in light of actual performance subsequently due to the complications with the premises and the appropriateness of the discount rates used. It is submitted that a thorough reading of this judgment will demonstrate that the aspects questioned by SARS are highly technical aspects of valuation methodologies (ranging from the appropriateness of the free cash flow estimates used and the determination of the discount factor), which is a far cry from being a fuzzy amount based on gut feeling that may be accepted.

Market value in the Income Tax Act

The Income Tax Act is scattered with provisions that require a taxpayer to determine a market value. These provisions often relate to deemed tax events or the value of transactions between connected persons. Some examples are:

- As considered in the Stepney case, market value is one of the bases that can be used to establish a base cost for CGT purposes for assets acquired prior to 1 October 2001.
- Where assets are donated, disposed for consideration not measurable in money or at terms that are not arm's length to connected persons, paragraph 38 of the Eighth Schedule deems the disposal to take place at market value.
- Where assets are distributed by a company, the disposal of such asset is deemed to take place at market value under paragraph 75 of the Eighth Schedule for CGT purposes as well as for dividends tax purposes under section 64E(3).
- Possibly in a more complex scenario, some of the roll-over relief provisions require consideration of the market value of the assets involved, for example, the definition of an 'asset-for-share transaction' in section 42 and the base cost apportionment formula under section 46.

In all these instances and others to be found in the legislation, it is important to note that section 102(1)*(e)* of the Tax Administration Act places the burden of proving that a valuation is correct on the taxpayer. As such, a taxpayer may be required to provide detailed reasoning, the type highlighted by the arguments in the Stepney case (depending on the nature of the valuation), as to how valuations were performed and as to its correctness.

Concluding thoughts

The judgment in the Stepney case illustrates that a valuation performed for tax purposes should not be taken lightly. Despite there being no immediate counterparty or negotiation as would be the case in an actual sales transaction at the time of performing the valuation, SARS may prove to be a more technical counterparty than most when having to explain or defend a valuation performed for tax purposes at a later stage.

BPR 208: Latest ruling on capitalisation of loans

The capitalisation of a company coupled with the settlement of a loan has been the topic of a number of binding private rulings (BPR) of late. The next in this line of rulings is BPR 208. This article provides an overview of the transaction and outcome in this particular ruling and compares it with rulings relating to similar transactions.

Transaction is BPR 208

A resident company (hereafter 'SACo) and a non-resident company (hereafter 'ForeignCo') each own 50% of the shares of a resident company (hereafter 'InvesteeCo'). SACo wishes to sell its 50% shareholding to ForeignCo. SACo has however advanced a shareholder loan to InvesteeCo, which ForeignCo does not wish to purchase. As such, the shareholder loan needs to be settled prior to the sale of shares.

The following steps will be undertaken to implement the transaction:

- SACo and ForeignCo would each subscribe for one share in InvesteeCo. SACo will subscribe for a premium equal to the face value of the shareholder loan while ForeignCo subscribes for R1.
- InvesteeCo will use the cash from SACo to settle the shareholder loan owing to SACo. Following this, the shareholder loan will be nil.

Ruling provided

The ruling confirms that the provisions of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act will not apply to the transaction. No view is however expressed on the application of the general anti-avoidance rules (GAAR).

This ruling essentially therefore states that the debt owing by InvesteeCo is not reduced for an amount less than the outstanding amount by SACo. The qualification about the application of the GAAR implies that the taxpayers would still need to be able to demonstrate that the tax benefit obtained (i.e. non-application of section 19 and paragraph 12A) is not the sole or main reason for the transaction or any step in the transaction. If this were the case, the GAAR would not apply unless at least one of the indicators in paragraphs (a) to (c) of section 80A is present.

The ruling does not similarly qualify that it does not deal with the question whether the transaction is simulated or not. As such, one would expect this matter to have been considered by SARS to reach the above outcome.

Similarities between BPR 208 and earlier rulings

In the June/July 2015 Tax Developments newsletter I included an analysis of BPR 193. The transaction in question in that ruling was similar to the BPR 208 transaction in the sense that a shareholder subscribed for a single share. From the wording of BPR 208, it appears as if the shareholder (SACo) needs to transfer cash to the company for the subscription price for such cash to be used to settle the shareholder loan. In BPR 193, the loan amounts owing under the shareholder loan and outstanding subscription price were allowed to be set-off against each other. The purposes of the two transactions also appear different, even though one can speculate from the share values that both may relate to entities in financial distress. BPR 208 relates to a transaction to groom a company for a sale of shares, while BPR 193 dealt with the company where the shareholder involved remained interested in the company following the re-capitalisation. In this regard, BPR 193 and an earlier ruling, BPR 173, were similar. BPR 173 and BPR 208 share the similarity that it appears as if the cash to subscribe and settle the loan has to flow, even though this is not specifically stated as a condition in BPR 208. What further distinguishes BPR 208 from the other two rulings is the parallel share subscription at a different value by two equal shareholders.

The question is then, is there any new wisdom or guidance that can be taken from BPR 208? In my view the guidance from BPR 208 lies in the reminder given by the qualification in relation to the GAAR. A comparison of these three rulings, show that BPR 208, which has a different purpose and therefore use a slightly different mechanism (parallel subscription), is the only one with a GAAR warning attached to it. This illustrates well that a ruling (for example, BPR 173 and BPR 193) is normally very fact specific and the outcome cannot blindly be applied to a transaction similarly structured but with a different purpose. Commercial reasons and justification for the transaction and steps involved remain of utmost importance, notwithstanding that the steps work technically. The full economic rationale and thinking behind the steps followed are often not completely clear from the published rulings. The importance of purpose of the transaction is further illustrated by the fact that SARS published this particular ruling, even though there are similar rulings relating to the technical steps to achieve the outcome.

BPR 209: Distribution of dividends to employees via share trust

Employee share incentive schemes generally exist at two levels. The first is executive incentive schemes where the scheme is intended to align the interests of management with those of the company. Such schemes often involve that participants become entitled to shares or cash amounts based on changes in the share price for a specified period of time as a means of achieving this alignment of objectives. The other category is a broad-based scheme where a large group of employees participate in the scheme without necessarily receiving shares or the value of shares, but while achieving the sense of being part of the business through being able to share in dividends or possibly voting rights in respect of the shares ring-fenced for this purpose. Binding Private Ruling 209 (BPR 209) deals with the latter type of scheme and specifically the tax treatment of dividend distribution made to employees in this scheme.

Facts of the scheme

A resident company (hereafter 'the company') established a trust to pursue certain BEE objectives (hereafter 'BEE trust'). The trustees of the BEE trust are black persons employed by the company and its subsidiaries. There are also independent trustees. The trustees of the BEE trust must determine the beneficiaries of the trust every year (i.e. not specified beneficiaries and no vested rights). Beneficiaries must be black people but need not necessarily be employed by the company or its subsidiaries.

The trustees can only make any distribution to a beneficiary who is an employee if pursuant to a BEE initiative its purpose is to incentivise that employee or to retain his or her services within the company or its subsidiaries. These distributions are in addition to existing remuneration as opposed to with a view of replacing it.

The company now intends to distribute dividends to the BEE trust, which will in turn distribute the dividends to beneficiaries. The ruling deals with the question whether the company is required to withhold dividends tax on the dividends or not.

Ruling

The ruling only applies to dividends distributed to beneficiaries who are employees of the company or its subsidiaries. The dividends will not be exempt from normal tax based on the application of section 10(1)*(k)*(i)*(ii)*, which excludes the following from being exempt: "…any dividend received by or accrued to a person in respect of services rendered or to be rendered or in respect of or by virtue of employment or the holding of any office…". These dividends will not be subject to dividends tax as they qualify for the exemption in section 64F(1)*(l)*, provided that the beneficiaries provide the declarations and undertakings in section 64G to the company. In the case of lower income earning employees, this may be a favourable outcome.

The ruling is silent on two aspects that may come into play. Firstly, there is no indication whether these amounts, which the wording of section 10(1)*(k)*(i)*(ii)* implies are received in respect of services, would constitute remuneration for employees' tax purposes. Secondly, the ruling does not address the question whether the remunerative nature of these payments in the hands of the employees extend to the employer to be deducted similar to other remuneration. It is submitted that section 10(1)*(k)*(i)*(ii)* arguably does not change the nature of the distribution to be something other than a dividend, but merely prohibits the exemption thereof for the recipient. As such, this still remains a dividend in the hands of the company and therefore not deductible.

Comparison with executive share schemes

Many executive share incentive schemes also have a dividend flow through element. The question is whether the same principle would then also apply to these dividends, which could potentially mean the amounts are taxed at the executive's marginal tax rate rather than the 15% dividends tax.

Section 10(1)*(k)*(i)*(ii)* contains the following carve out: "…other than a dividend received or accrued in respect of a restricted equity instrument as defined in section 8C held by that person or in respect of a share held by that person". This exception gets to the heart of the difference between the scheme in BPR 209 and typical executive schemes – in an executive scheme the participant is likely to have a right to the share or a right linked to the share (for example, right to units in a trust). These instruments would qualify as equity instruments as defined in section 8C, which would result in section 10(1)(k)(i)(ii) not being applicable. This would however also mean that the participant will at some stage in future when these instruments are no longer restricted, be taxed on the market value of that instrument.

Section 10(1)*(k)*(i)*(dd)* however contains a further exclusion from the exemption where dividends are distributed in respect of restricted equity instruments, except where those instruments are equity shares (as opposed to options or other rights).

Back to the basics: An overview of section 24C

Income tax is generally imposed when a taxpayer becomes entitled to an amount (accrual) or when an amount is received, whichever occurs first. In the case of revenue amounts being paid to a taxpayer in advance of the taxpayer performing in terms of its obligations to earn that amount, the receipt will occur before the accrual. In such a case, the taxpayer may however be able to defer the timing of the tax to align with the performance in terms of its obligations to some extent under section 24C.

Overview of the provisions

The principle of the provision is found in section 24C(2). The provision applies where an amount has been received by or accrued to a taxpayer in terms of a contract.

As the legislation reads currently, the Commissioner needs to be satisfied that such amount received or accrued will be utilized by the taxpayer in a future year of assessment in whole or in part to finance future expenditure incurred in the performance of such contract under which the amount is received. In future this determination will rest with the taxpayer as the income tax system moves towards a self-assessed tax. Section 24C(1) defines the term future expenditure as expenditure to be incurred after the end of the year of assessment if such expenditure will be deductible or relate to an asset that qualifies for deductions or allowances. Where an entity expects to incur future expenditure (i.e. anticipated expenditure) but has not yet received income to fund such expenditure, section 24C has no application as this would effectively allow a tax deduction for a future expense.

Where the above requirements are met, section 24C(2) allows a taxpayer to deduct an amount not exceeding the future expenditure from its taxable income. Section 24C(3) requires that this amount be deemed to be received or accrued in the following year of assessment and therefore included in the taxable income of that year.

This cycle will continue until all the future expenditure in terms of the contract has been incurred.

Economic effect of section 24C

The effect of this provision can be illustrated with the following example:

> Taxpayer renders services to a client. The services are priced at a profit margin of 60% on the costs incurred by the taxpayer to provide the service. The taxpayer and client agreed that the client would pay an amount of 80 per cent of the fee upfront and 20 per cent upon completion. The taxpayer received the 80 per cent (assume R1 million) payment at year-end (year 1) and will commence work on the contract in the next year of assessment (year 2).
>
> The taxpayer's calculation of its taxable income for year 1 is as follows:

Income (full amount received)	R800 000
Costs incurred to date	-
Allowance for future costs under s 24C (R800 000 x 100/160)	(R500 000)
Taxable income for year 1	**R300 000**

> The taxpayer's calculation of its taxable income for year 2 will be as follows:

Income (already included on receipt)	R200 000
Costs incurred to date (R500 000 plus R200 000 x 100/160	(R625 000)
Reversal of year 1 allowance for future costs under s 24C	R500 000
Taxable income for year 2	**R75 000**

From this example it can be seen that the effect of section 24C is essentially that a taxpayer will be taxed on the margin included in revenue amounts received in advance, while the amount received to cover future expenditure will be deferred until the same period when such expenditure is incurred. Even though there are some elements of matching involved, this is not matching in the manner normally understood where revenue recognition is deferred in order to be matched with expenses, or vice versa, and show profits in the period when it is earned.

It is important to note that section 24C only defers the inclusion of the income until the expenditure has been incurred. In the case of expenditure incurred to acquire assets that are depreciated over a number of years for tax, there may still be a timing mismatch between the inclusion of the income and deduction of the relevant allowances.

Further reading

During 2014 SARS issued Interpretation Note 78, which deals with the application of section 24C.

About PvdZ Consulting (Pty) Ltd

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