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A year draws to a close and another begins, the Centre of Tax Excellence looks back at 2014 and reflect on the successes and challenges. We recovered from the change-over introduced in 2013 from the debit push to a credit pull system. In July this year SARS rolled out the single registration system which gave a huge shake up in the industry. Tax practitioners had to be uploaded on their recognized controlling bodies’ database shared with SARS. This could only be done if the member was in good standing; fees paid up to date and hold a valid tax clearance certificate. We trust that all members have now activated their e-filing profiles and updated their status and clients uploaded on their profiles.

**Some of the submissions made in 2014**

We made the following submission to SARS and National Treasury:

- Comments on the draft Taxation Laws Amendment Bill of 2014,
- Comments on the Draft Tax Administration Amendment Bill of 2014,
- Review of the taxation of alcoholic beverages in South Africa,
- Response to the Draft Guide on Taxation of Special Trusts, and
- SAIPA’s submission to Annexure C – Budget 2015.

Although vast improvement on our tax services was the outcome of our performances for 2014, CoTE does not intend to remain complacent in 2015.

**Free structured CPDs**

Whilst you are on vacation you may want to ‘catch-up’ on CPD hours. The online VAT Guide makes it possible for CoTE members to qualify for four structured CPD hours by answering the questions listed on the SAIPA website. To obtain additional unstructured hours, members can review the Tax Professional magazine obtainable on the SAIPA website under ‘SAIPA Tax Professional Journals’.

The year ahead promises to be another good and challenging one there are new legislative amendments which will come to effect in 2015 and we are looking forward to these.

**CPD topics for 2015**

- Tax update and amendment to tax legislations as per 2015 budgets – March 2015
- Dispute Resolution – July 2015
- VAT – Advanced level – October 2015
- Cross-Border Tax – November 2015

We take this opportunity to wish you a successful and prosperous 2015.

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**SAIPA**

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Three events in 2014 have resulted in the registration process and procedures for VAT to be substantially overhauled. These include the following:

- Amendments contained in the Taxation Laws Amendment Act 31 of 2013 (promulgated 12 December 2013) and Tax Administration Amendment Act 39 of 2013 (promulgated 16 January 2014),
- Amendment of the Value-Added Tax Act No 89 of 1991 (the VAT Act) requiring VAT registration for non-resident electronic service suppliers with effect from 1 June 2014, and
- The implementation of a single registration process on 12 May 2014.

Section 24 of the Tax administration Act 28 of 2011 provides for a single tax account and allows SARS to implement a single registration process for all tax types over time. Taxpayers will have one account that reflects their entire tax liability and, ultimately, a single view of a taxpayer’s account. The single registration process, commenced on 12 May 2014, and taxpayers will only have to register once as a new taxpayer and thereafter add only the relevant details to register for any subsequent taxes. Single registration results in all tax types for a single taxpayer having the same tax number, that is, if a taxpayer is registered for income tax, VAT and PAYE, then all these tax types will have the same tax reference number.

This begs the question: what is the implication of the single registration for VAT registration? Essentially, there will be two VAT registration process as a result of the implementation of the single registration process. We now have a VAT registration process for

- First-time taxpayers, and
- Existing taxpayers

Vat registration for first-time taxpayers (manual application)

Vat registration for first-time (meaning new taxpayers) taxpayers is essentially a manual process. In practice this implies new clients of tax practitioners must physically visit a SARS branch in order to register
for a tax. SAIPA-CoTE has advised tax practitioners to send a staff member from their practice to accompany the new client to a SARS branch in order to complete the registration. New clients registering for VAT for the first time must also complete the VAT registration form and supply all the required supporting documents.

SARS argues that a taxpayer only needs to visit a SARS branch for the first tax registration. Once registered for a tax, the taxpayer’s details can be transferred to the profile of the tax practitioner. Once the details of the taxpayer are included in the tax practitioner’s profile, the tax practitioner may register the said client for any other subsequent tax (for example, PAYE) online, without anyone having to visit a SARS branch (assuming that the taxpayer’s affairs are in order). A tax practitioner may undertake many other transactions on behalf of a taxpayer, once the taxpayer’s detail are located in the profile of the tax practitioner registered with a professional body, such as SAIPA.

**Vat registration for existing taxpayers (online application)**

If the client of the tax practitioner is an existing taxpayer, the taxpayer must first log into eFiling if the tax payer is a registered eFiler, and complete the Registration, Amendment and Verification form (RAV01) where all registered details can then be updated.

The following details cannot be updated on eFiling:

- Name and ID/Registered name, and
- Company registration number and the nature of entity.

Taxpayers must visit a SARS branch in order to update abovementioned details. Tax practitioners have informed us that the online VAT registration process for existing taxpayers is quite uncomplicated and the outcome of online VAT registration is favourable to taxpayers.

Tax practitioners, however, are reminded that the new online VAT registration does not prohibit SARS from inspecting enterprises seeking VAT registration.

In addition, SARS is also not prohibited from interviewing online VAT applicants in their offices. The SAIPA head office Tax Help-Desk has been informed of such isolated incidences. This could occur because the SARS online VAT application system has picked up inconsistencies, which could relate to address of the enterprise, company or corporation registration number, ID number, physical address of taxpayer, etc. SARS, in these circumstances, could request that certain documents be submitted to their offices. SARS may also interview online applicants to explain those inconsistencies. SAIPA-CoTE is mindful of the distances involved in visiting SARS offices but we wish to remind tax practitioners that the SARS online applications for VAT registrations is based on validation parameters and the distance travelled to a SARS branch cannot be one of the validation parameters.

However, Section 47 (4) of Tax Administration Act 28 of 2011 allows persons to decline an interview if such persons have to travel more than 200 kilometres between the place designated in the notice and the usual place of business or residence of the person and back.

Only existing taxpayers and not new taxpayers may decline an interview if they have to travel more than 2500 kilometres between the place designated in the notice and the usual place of business or residence of the person and back

a) A company listed on a recognised stock exchange as referred to in paragraph 1 of the Eighth Schedule to the Income Tax Act, or

b) A company whose gross receipts or accruals for the ‘preceding year’ exceed R500 million, and

c) A company that forms part of a ‘group of companies’ as defined in section 1 of the Income Tax Act, which group includes a company described in item (a) or (b).

**Legislative changes affecting VAT registration**

### I. VAT registration of electronic service suppliers

With effect from 1 June 2014, non-resident suppliers of certain electronic services to South African residents or where payment originates from a South African bank account are required to register and account for VAT in South Africa if the total value of taxable supplies has exceeded R50 000.

The different types of electronic services to which these new rules apply are:

- Educational services;
- Games and games of chance;
- Information systems services;
- Internet-based auction service;
- Maintenance services;
- Miscellaneous services (examples eBook, film, images, music and software); and
- Subscription services (includes subscription to any blog, database, journal, magazine, newspaper, social networking services, webcast or webinar).

The effect is that non-resident suppliers that fall within the new rules are now required to levy VAT
on supplies from 1 June 2014, and the supplies
concerned will no longer be regarded as imported
services. Instead, the supplier would be required to
register for VAT in the RSA and to charge VAT in terms
of section 7(1)(a) of the VAT Act, as taxable supplies
made in the course and furtherance of an enterprise
carried on in the RSA.

**ii. Compulsory registration**

Since 1 April 2014, only businesses that have already
exceeded the R1 million threshold value of taxable
supplies over a continuous period of 12 months
and businesses that have a contractual obligation
in writing to make taxable supplies in excess of the
threshold in the next 12-month period, are obliged to
register for VAT.

From 1 April 2014, the requirement of a reasonable
expectation to exceed R1 million taxable supplies has
been replaced with the requirement that existing or
future businesses have contractual agreement to make
the R1 million thresholds within the next 12-month
period. The expected future taxable supplies are no
longer based on budget or projections but will be
based on facts confirmed by the existence of a written
contractual obligation. The 12-month period is not
a reference to a tax-year or a reference to a financial
reporting period. The R1 million future expected
supplies should not include abnormal transactions of a
temporary nature.

This could be explained by the following hypothetical
examples:

1) Assuming that a taxpayer just purchased
a block of offices for letting, the taxpayer
will not be able to register for VAT
unless the taxpayer has contracts with
tenants that the office block will be
occupied by them at a future date.

2) The taxpayer is a new construction
company. The taxpayer will not be
able to register for VAT unless the
taxpayer has construction contracts with
customers and work will commence by
the taxpayer at a certain future date.

3) The taxpayer is a property developer and
has not sold any units as yet, and there
are no written contracts confirming future
sale of units. The taxpayer, in a sense,
has not met the R1 million turnover
requirements and, therefore, will not be
able to register for VAT.

**iv. Voluntary registration**

The scope of voluntary registration was expanded
with effect from 1 April 2014 to allow a person who
has not yet made any taxable supplies or who made
less than the R50 000 threshold, and is reasonably
expected to be met after a period of 12 months,
to apply for voluntary registration. However under certain circumstances, a person may apply to register voluntarily even if the threshold of R50,000 in taxable supplies in a consecutive 12-month period has not yet been attained. Such registrations will be subject to the conditions and exclusions set out in the applicable Regulation which provides for a person to register voluntarily if the person:

a) Has made taxable supplies which
do not exceed R50,000, or
b) Has not made any taxable supplies as yet,
and the person is reasonably expected to
make taxable supplies in excess of R50,000 in the following 12-month period commencing from the date of registration.

Section 23(3)(d) of the VAT Act– If the nature of the business activity is such that it is only possible to make taxable supplies after a certain period of time, the Commissioner must be satisfied that it is reasonable to conclude that the minimum threshold will be exceeded in a 12-month period. (Plantation farming and mining activities are appropriate examples when such circumstances could apply.)

The above-mentioned facility does not apply to a welfare organisation as defined in the VAT Act. Welfare organizations are already in receipt of relief (see paragraph (b) (ii) of the definition of enterprise). Although welfare organisations must still complete a VAT 101 form to register VAT, they are already construed as enterprise in terms of the VAT Act.

Note that it may be advantageous for a person to register voluntarily where goods or services are supplied mainly to other vendors and where the customer concerned will be able to deduct the VAT charged as input tax. It will generally not be advantageous for a person to register voluntarily where:

- The main or only supplies consist of the supply of services, where there are very few taxable expenses on which input tax can be deducted, for example, where the enterprise’s main expense is salaries and wages; or
- Most of the supplies are made to final consumers who are not registered for VAT.

Persons who register on a voluntary basis for VAT are reminded that they have to undertake all duties and responsibilities of a vendor. For example, such a person will have to charge VAT, submit returns, make VAT payments on time and keep proper records for at least five years. If a person decides to register for VAT, remember that such a person (now a vendor) can only charge VAT on taxable supplies. Vendors may not charge VAT on supplies which are exempt from VAT or supplies which fall outside the scope of VAT.

iii. Cancellation of registration

New rules regarding the cancellation of registration have been introduced. A person who has previously been registered as a vendor by the Commissioner in terms of section 23(1) of the VAT Act or who has been allowed to register voluntarily in terms of section 23(3) of the VAT Act and the relevant conditions have not been met, may be deregistered from such date as determined by the Commissioner. The Commissioner may also deregister such a vendor if that person fails to submit a VAT return in respect of a tax period. The Commissioner must give written notice, informing the person of SARS decision of terminating vendor status. The decision by SARS, in this regard, is subject to objections. These new rules have applied since 1 April 2014.

Conclusion

This article is aimed to alert taxpayers and vendors of all the changes in relation to the registration for VAT by a person. A careful review of the recent Taxation Laws Amendment, and the Tax Administration Amendment Acts, recently concluded in Parliament confirms that the aforementioned discussion on VAT registration is still relevant and no changes are recorded in these tax legislations.
In just over three months’ time, the interest withholding tax (‘IWT’) will come into effect - more than four years after the initial release of legislation governing the IWT provisions. The provisions appear to be fairly straightforward and the parties likely to be affected by the IWT should by now be prepared for the impact that the IWT will have. However, there are aspects of the law which might not have been fully considered to date. A few of these aspects are explored below.

The starting point is the taxing provision contained in section 50B of the Income Tax Act No. 58 of 1962 (‘Act’). In order for the IWT to apply, there must be interest which is from a South African source in terms of section 9(2)(b) of the Act which is paid by any person to or for the benefit of any foreign person (our emphasis).

What exactly is ‘interest’ for purposes of the IWT?
By way of background, the definition of ‘interest’ contained in the initial legislation released in respect of the IWT included interest as defined in section 24J of the Act as well as deemed interest as contemplated in section 8E. These references were subsequently deleted.

In terms of current legislation which will become effective on 1 March 2015, the term ‘interest’ is not
defined. This is surprising since one would expect the provisions to contain a definition of the very element which they seek to tax.

In the report of the Standing Committee on Finance dated 11 September 2013, it was indicated that the IWT provisions will apply to common law interest and that ‘as a general rule of interpretation, in the absence of a specific definition or cross reference to section 24J, the common law definition will apply’. This comment itself is not binding on the South African Revenue Service, nor is it law.

We note that ‘interest’ is defined in the Act in section 24J. In addition, section 50B of the Act refers to section 9(2)(b) of the Act. Section 9(2)(b) of the Act applies exclusively to interest as defined in section 24J. On this basis, the interest subject to the IWT may be interest as defined in section 24J.

The issue is that the scope of the ‘interest’ definition contained in section 24J of the Act extends beyond common law interest. In particular, the definition specifically includes any discount or premium in respect of a financial arrangement as well as compensation payable by a borrower to a lender in terms of any lending arrangement. In addition, the provisions of section 24J of the Act deem repurchase agreements and resale agreements to be interest-bearing. Qualifying repurchase and resale agreements are effectively treated as loans and the differential between the sale price and resale price of the underlying asset constitutes interest for purposes of section 24J of the Act.

Therefore, given the lack of the definition of ‘interest’ in the IWT provisions, the scope of the IWT provisions could extend wider than the legislator may have anticipated.

Interest paid by a non-resident borrower to a non-resident lender may be subject to the IWT where the non-resident borrower has utilised or applied in South Africa, the funding obtained from the non-resident lender. This will result in a withholding obligation being placed on a non-resident. The impact of transactions such as these entered into between non-resident counterparties may not have been considered from a South African withholding tax perspective. Failure to comply with the IWT provisions could lead to an IWT liability and, inter alia, the imposition of penalties and interest on unpaid taxes.

In addition, although details pertaining to the administrative requirements relating to the IWT have not been released, the impact of the above will likely result in non-residents having to register as South African taxpayers in order to submit IWT returns to the extent that the administrative provisions pertaining to the IWT are similar to those of the dividends tax. This may increase the tax compliance burden on non-residents. For example, a non-resident may be required to register as a taxpayer in order to submit an IWT return in instances where the non-resident in question is not required to make payment of any IWT.

**Can the IWT apply to non-residents?**

The IWT provisions apply to South African-sourced interest which is paid to or for the benefit of a foreign person by any person.

The statutory source provisions in section 9(2)(b) of the Act deem interest as defined in section 24J to be from a South African source where that interest is, inter alia, received in respect of the utilisation or application in South Africa by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement.
any taxpayers are generally aware that there is a prescription provision contained in our tax law. However it is not always understood that the prescription provisions apply only if certain statutory requirements are met. In this regard it is not uncommon for SARS to assess taxpayers beyond the prescription period of three years. It is therefore necessary for taxpayers to understand the circumstances in which prescription will apply and also the relevant statutory provisions dealing with prescription.

Section 79 of the Income Tax Act contained the prescription provisions prior to the enactment of the Tax Administration Act. These provisions are now contained in section 99 of the Tax Administration Act.

There is some debate about when the new prescription provisions apply. It seems that the new provisions pertaining to prescription as contained in section 79 of the Income Tax Act should apply where the relevant years of assessment have been concluded and the taxpayer’s tax return submitted prior to the date that the Tax Administration Act came into effect, namely, 1 October 2012. However, it should be noted that in certain circumstances SARS is applying the prescription provisions contained in the Tax Administration Act to years of assessment which ended prior to the enactment of the Tax Administration Act.

In terms of the proviso to section 79(1) of the Income Tax Act, the Commissioner may only issue revised assessments after the expiry of the three-year period, where the Commissioner is satisfied that the fact that the amount which should have been assessed to tax was not so assessed was due to fraud or misrepresentation or non-disclosure of material facts. In order for the Commissioner to raise additional assessments in terms of section 79(1) of the Income Tax Act, there are two elements in respect
of which the Commissioner must be satisfied. First, he must be satisfied that there was fraud, misrepresentation or non-disclosure of material facts. If he is so satisfied, then, secondly, he must also be satisfied that the fact that the full amount of tax chargeable was not assessed, was due to such fraud, misrepresentation or non-disclosure of material facts.

‘Misrepresentation’
The Dictionary of Legal Words and Phrases states that a misrepresentation is:

’a false statement of fact made by one party to another before a contract is entered. Such a statement may be innocent or fraudulent…’

The meaning of the term ‘misrepresentation’ therefore refers to an expression of facts as opposed to a mere expression of opinion or interpretation of law, i.e. it requires a positive statement to have been made by the taxpayer which is false.

Non-disclosure of material facts
In the case of SIR vs. Trow 43 SATC 189, the Appellate Division had to consider whether the prescription period in section 79 applied to an additional assessment issued by the Secretary to the taxpayer in circumstances where the taxpayer had, in reply to the question in his tax return whether he had sold any property during the tax year in question, answered no, when in fact he had realised a capital profit upon the sale of certain land.

The court stated that:

‘It follows, in the circumstances of this case, that the additional assessment could only have been raised if the Commissioner were to have satisfied himself (1) that there had been a non-disclosure of material facts by the taxpayer, and (2) that the fact that the profit in question was not assessed to tax prior to the expiration of the relevant period of three years was due to such non-disclosure, i.e., that the non-assessment was causally related to the non-disclosure of material facts.’

In terms of this case, not only must the Commissioner be satisfied that there was non-disclosure but such non-disclosure must have caused the Commissioner not to assess that amount.

In other words, there must be a causal link between the non-disclosure by the taxpayer and the non-assessment of that amount by the Commissioner.

It should be noted that the court in ITC 1459 51 SATC 142, dealing with the issue of the disclosure of material facts, stated that the question to be considered is whether the Commissioner had all the material facts when he issued all the original assessments. This is an important point, since taxpayers are often subject to a tax audit by SARS after the relevant tax returns have been assessed. Any disclosures made during the course of the tax audit may, therefore, not be relevant in determining whether prescription applies.

Section 99 of the Tax Administration Act
Section 99(1) of the Tax Administration Act provides that:

‘SARS may not make an assessment in terms of this Chapter - (a) three years after the date of assessment of an original assessment by SARS…’

In terms of section 99(2)(a) of the Tax Administration Act, section 99(1) of the Tax Administration Act does not apply to the extent that:

’in the case of assessment by SARS, the fact that the full amount of tax chargeable was not assessed, was due to - i) Fraud; ii) Misrepresentation; or iii) Non-disclosure of material facts...’

However, in terms of section 99(2) of the Tax Administration Act, the Commissioner may issue revised assessments after the expiry of the three-year period, where the fact that the full amount of tax chargeable was not assessed was due to fraud or misrepresentation or non-disclosure of material facts. In light of the above, the test pertaining to prescription as contained in the Income Tax Act remains largely unchanged subsequent to the introduction of the Tax Administration Act, the most significant amendment being that the test as to whether the presence of the elements listed in section 99(2)(a) caused the non-assessment of the taxpayer, now requires an objective consideration and does not have regard to the subjective satisfaction of the Commissioner.

Therefore, in order for the Commissioner to raise additional assessments in terms of section 99(1), the presence of two elements must objectively be determined. First, the presence of fraud, misrepresentation or a non-disclosure of material facts must be demonstrated. Secondly, it must, in accordance with an objective fact based approach, be evidenced that the fact that the full amount of tax chargeable was not assessed was due to such fraud, misrepresentation or non-disclosure of material facts.
LEGAL PROFESSIONAL PRIVILEGE - THE DEBATE CONTINUES…

Mahomed Kamdar, Tax Advisor, SAIPA

SAIPA-CoTE has been on the forefront of the battle to obtain Legal Professional Privilege (LPP) for its members – the practising tax accountants. Currently, LPP is recognised in common law but it is restricted to attorneys. The reality is that many taxpayers seek legal counsel, with regards to tax law, not only from an attorney, but also from a tax accountant and tax specialist. Therefore, SAIPA-CoTE argues that legal privileges should be extended to tax practitioners as well. A taxpayer should have the right to seek advice without the fear of self-incrimination or risk. Also, a tax practitioner cannot be expected to give proper advice without all the relevant information and facts.

The legal privilege, as argued by Ettiene Retief – the SAIPA-CoTE, chairperson of the Tax Board – will only apply to ‘tax advice documents’ to the extent that such is held by the tax practitioner, that is, appropriately qualified to give such advice, who has a significant function of giving advice on tax law, registered with a professional body or institute, which has an appropriate professional code of conduct and disciplinary processes enforcing compliance with such code of conduct.

SAIPA-CoTE further argues that LPP will not impede the collection or assessment of taxes, nor will it undermine the provisions of the Tax Administration Act no 28 of 2011.

It is noted that recently a South African High Court passed a judgment on LPP. The rest of this article is a summary of this high court judgment.
The verdict of the South African High Court: 17 March 2014

Introduction
The court case concerns a claim by the taxpayer to legal professional privilege. The court confirms that the right to legal professional privilege is a general rule of our common law which states that communications between a legal advisor and his or her client are protected from disclosure, provided that certain requirements are met. The requirements are as follows:

i) The legal advisor must have been acting in a professional capacity at the time;
ii) The advisor must have been consulted in confidence;
iii) The communication must have been made for the purpose of obtaining legal advice;
iv) The advice must not facilitate the commission of a crime or fraud;
v) The privilege must be claimed.

Further, this court tax case law, makes reference to a judgment of Dawson J in Baker vs. Campbell in the High Court of Australia to the effect that legal professional privilege extends beyond communications made for the purpose of litigation to all communications made for the purpose of giving or receiving advice and this extension of the principle makes it inappropriate to regard the doctrine as a mere rule of evidence. It is a doctrine which is based upon the view that confidentiality is necessary for proper functioning of the legal system and not merely the proper conduct of particular litigation...

Background
The three taxpayers are three companies in a well-known group of companies, have applied for a declaratory order that certain content of two fee notes rendered by their attorneys to the first company is properly subject to the claim of legal advice privilege that they have sought to assert as the basis of their refusal to disclose portions of the invoices, when complying with a request by the Commissioner of the South African Revenue Service (SARS) in terms of s 46 of the Tax Administration Act 28 of 2011. Copies of the invoices in question have been supplied to SARS, but the taxpayers have redacted the content thereof that is subject to the claim of privilege. The application by the companies for declaratory relief has been brought in the context of the Commissioner’s insistence on being provided with unexpurgated copies of the documents concerned.

It has not been suggested by SARS that the provisions of the Tax Administration Act or any other applicable statutory instrument overrides a taxpayer’s right to claim legal professional privilege. The issue to be determined is thus simply whether the privilege that has been claimed actually exists.

The court concluded that three of the redacted passages in a tax invoice qualify for the assertion of legal advice privilege.

Conclusion
The Tax Administration Act re-affirms the doctrine of legal professional privilege that is any communication between attorneys and clients that is closely linked to the advice sought; the communication itself does not have to be disclosed.

With reference to the on-going dialogue between SARS and professional bodies, SARS argued that lawyers are recognized professionals while tax accountants are not as yet recognised as professionals. The granting of legal professional privilege to tax accountants may only be finalised once their professional status reached an advanced stage.

“...the right to legal professional privilege is a general rule of our common law which states that communications between a legal advisor and his or her client are protected from disclosure, provided that certain requirements are met.”

1 The Western Cape High Court Division: A company and two others and SARS. Case Number 16360/2013
FAMILY BUSINESS

TAXATION OF A FAMILY BUSINESS AND AN IMPENDING SARS AUDIT

Mahomed Kamdar, Tax Advisor, SAIPA

Many SAIPA members have clients that are essentially family-owned businesses. Senior members of a family actually own these businesses and employ other members of the same family or extended family to occupy senior positions, such as directors, senior managers and, more importantly, also employ relatives to undertake the tasks as accountants.

SARS understandably would apply the Connected Party rule, should a family business be selected for a tax (income tax, PAYE or VAT) audit. Generally, a ‘connected person’ in relation to a natural person refers to a spouse of such person or anybody related to him or his spouse within the third degree of consanguinity. ‘Consanguinity’ does not only refer to relations by marriage, but it also refers to ‘relationship by blood and to relationship of the same blood’.

A relative of a natural person therefore includes –
- That person’s spouse;
- Anybody related to that person within the third degree of consanguinity;
- Anybody related to that person’s spouse within the third degree of consanguinity;
- The spouse of anybody related within the third degree of consanguinity to that person or his or her spouse.

The following persons therefore qualify as relatives in relation to any person:
- Children (first degree of consanguinity)
- Grandchildren (second degree of consanguinity)
- Great-grandchildren (third degree of consanguinity)
- Parents (first degree of consanguinity)
- Grandparents (second degree of consanguinity)
- Great-grandparents (third degree of consanguinity)
- Brothers and sisters (second degree of consanguinity)
- Nephews and nieces (third degree of consanguinity)
- Uncles and aunts (third degree of consanguinity)

In addition, all of the above relatives of that person’s spouse would be relatives of the person as well as the spouses of any of those relatives.
Family-owned businesses aptly fit the definition of ‘connected party’ and, therefore, it is quite natural that SARS will target such entities for an audit. SARS will, without exception, aggressively investigate a family-business for tax irregularities practised both by the family-business and its employees who are ‘connected’ to the business. It is, therefore, likely that family-businesses and their employees will be audited. It is possible that family-businesses will be audited for ITR14 submission and PAYE (EMP 201 and EMP 501) while their employees could be audited for their individual tax returns (the ITR12). The SARS audit for the entity and the SARS audit for their employees would not necessarily occur simultaneously, but there would be a reference made to these types of records.

What are the tax risks likely to face a family business and their employees?

There is no need to fear any audit by SARS if the family-business appoints a tax accountant belonging to a professional body, such as SAIPA. A tax accountant is likely to be aware of the following tax risks faced by family-owned businesses:

**Fringe benefits supplied to employees who are relatives of the owner of a family business**

Fringe benefit refers to payments made to employees, usually in a form other than cash. Paragraph (i) of the definition of gross income in section 1 of the Income Tax Act includes the ‘value’ of fringe benefits received by a family member (who is an employee) from an employer (who is the owner of a family business) in the employee’s gross income. The value of the fringe benefit must be determined as per the provisions of the Seventh Schedule of the Income Tax Act. The gains made by a family member (recall that such a family member is simply an employee) under the provision of the Seventh Schedule must be included in the family member’s individual gross income in terms of paragraph (n) of the gross income definition.

Moreover, paragraph 2 of the Seventh Schedule sets out a basic list of fringe benefits that all individual taxpayers (including family members who are employees) should pay attention to. Meanwhile, paragraphs 5 to 13 of the Seventh Schedule of the Income Tax Act demonstrate how the value of a taxable benefit must be calculated. There are no special tax dispensations for family members who are employees of family-owned businesses. The calculation of the value of taxable benefit is the same for all employees, irrespective of their ‘connectedness’ to the owner of the family business. If the employer (the owner of a family-business) pays ‘remuneration’ to employees as defined in the Income Tax Act, it is consequently required to deduct PAYE on the cash value of the fringe benefit from the employee’s earnings, which must be paid to SARS before the 7th day of each month and to submit the standard EMP201 just as any other employer has to.

**The claiming of ‘home office’ expenses**

The owners of family businesses have a temptation to deduct ‘home-office’ expenses against the taxable income of these entities. Since these owners take
work home, there is a perception that such owners are eligible to claim such expenses against taxable income of their businesses. However, the deduction of ‘home office’ expenses is governed by a very unambiguous set of rules as explained in the first proviso of section 23 (b) of the Income Tax Act.

The Income Tax Act does permit a business entity to deduct expenses incurred in maintaining that part of the domestic home that may be occupied for the purpose of conducting tasks essential to business. This means that expenses relating to the taxpayer’s home office may be claimed as a deduction for income tax purposes if a part of the taxpayer’s home is occupied for purposes of the family business owner’s trade and that part is regularly and exclusively used and specifically equipped for purposes of his or her trade. It is assumed that if the nature of the family-business is repairing motor vehicles, the family-business owner (a motor mechanic in this instant) will, of necessity, install a lubrication bay which would allow a mechanic to view the vehicle from below the undercarriage. In other words, such equipment is installed for the purposes of the family-owned business or trade. The designated area of the home cannot be used for any other personal reasons except to ply a trade.

In addition, it should be noted that SARS would disallow any such deduction, unless the income derived from that employment or office is mainly (that is more than 50% of the taxpayer’s total income from employment or office) commission or other variable payments which are based on the taxpayer’s work performance and his or her duties are not performed mainly in an office provided by the taxpayer’s employer. Very few family-business owners are familiar with the aforementioned rules governing the deduction of home-office expenses.

The claiming of travel expenses from home to work

The courts have ruled on many occasions that the cost of travelling between a taxpayer’s home and place of work is private travel and is therefore not tax deductible. So when an employee (a family member in this situation) receives an allowance in respect of transport expenses, any portion of this allowance which is utilised for private travel (i.e. not for business travel), will be included in the taxable income of the employee.

If an employee receives a travel allowance and intends to claim expenses for business travel, a travel logbook must be maintained and the required details accurately recorded. The adage of ‘no travel logbook, no travel claims’ must be honoured. If the travel allowance is excessive, then it will be regarded as normal salary. The family-business will have to deduct employees’ tax for its relative-employees.

If a relative-employee is in receipt of fringe benefit due to the use of company cars, the relative-employer has to calculate the PAYE on 80% of the amount of the fringe benefit. Where the relative-employer is satisfied that at least 80% of the use of the motor vehicle for a tax-year will be for business travel, then the PAYE will be on 20% of the fringe benefit. SARS will only allow the 20% PAYE deduction after viewing the job description of the relative-employee.

A company car and a pool vehicle: The dichotomy

A pool car does not result in fringe benefit tax. A pool car is:
- Not assigned to a particular relative-employee;
- Not parked near the residence of a relative-employee when not in use outside of business hours; and
- Used privately infrequently and incidentally to its business use.

The purchase of a vehicle for the owner’s spouse who is also an employee is not a pool car. Such a vehicle is assigned specifically to the spouse (assuming that the spouse is also an employee) for the private or domestic use for no consideration.
The no-consideration use of such vehicle is a taxable fringe benefit and must be taxed as per paragraph 7 of the Seventh Schedule of the Income Act.

Any other free use of assets or use of assets at less than market value will be taxed by the appropriate provisions as listed in the Seventh Schedule of the Income Tax Act. Examples are laptops, cell phones and iPads.

**The declaration of output tax for VAT on fringe benefits supplied to relative-employees**

Family-owned businesses often omit to declare the output tax on fringe benefits supplied to related-employees. VAT auditors are often on the alert of such omissions, especially when the parties concerned are “connected” as per the tax legislation. It is noted that fringe benefits offered to any employee in relation to residential accommodation and in relation to free or low interest loans are VAT exempt.

**The hiring of spouses of family-owned businesses as employees**

This last item on the hiring of spouses in family-owned businesses is probably the most high-tax risk area of all the aforementioned areas listed above. SAIPA-CoTE wrote a detailed article on this subject, *Income-Splitting: Is it feasible?* in *Tax Professional*, Quarter 1, 2013. This article does not refer specifically to family-owned businesses, but refers to any business that hires a spouse of the owner (or director of a company) as an employee. This article can be accessed electronically from the SAIPA website (electronic page reference is page 36 of 56). Please click on this link: http://www.saipa.co.za/sites/saipa.co.za/files/SAIPA_Q1-2013_Acc_Tax_Pro_0.pdf

**Conclusions**

Family-businesses contribute significantly to most economies of the world. Their relative importance has also increased significantly over time. It is, therefore, imperative that this important category of businesses and their owners become acquainted with some of the inherent tax risks. The list of risks stipulated in this article is not exhausted, but adequately alert owners of family-businesses of possible tax risks.
Loans between companies and their shareholders, or other group companies are a common method of providing finance in the South African corporate environment. Loans of this nature may, however, give rise to tax implications in the hands of the lender or the recipient, and careful consideration should therefore be given to these transactions.

**Dividends tax**

Dividends declared by a company to its shareholders up until 31 March 2012 were subject to secondary tax on companies (‘STC’) at a rate of 10%. The Income Tax Act, No. 58 of 1962 (‘the Act’) also contains provisions designed to circumvent tax avoidance transactions that enable the shareholder of a company to benefit in some way even though no cash dividend was actually declared. Under these provisions, certain types of transactions gave rise to deemed dividends with the result that STC became payable, subject to certain exemptions.

Dividends tax is levied at the rate of 15% on dividends paid on or after 1 April 2012, subject to certain exemptions, or the application of a lower rate of dividends tax in certain circumstances. Low-interest loans may also fall within the dividends tax ambit by virtue of these loans constituting a deemed dividend in certain circumstances, giving rise to a liability for dividends tax.

Loans or advances from company to shareholder (or any person connected to the shareholders) will automatically be deemed to be a dividend in certain circumstances.

The current deemed dividend provision applies where a debt arises ‘by virtue of a share held in the company’ and where the following conditions are present: the debtor is a person other than a company; the debtor is a South African resident and the debtor is either a connected person in relation to the company, or a connected person in relation to that person. Broadly speaking, a ‘connected person’ in relation to a company means any company that forms part of the same group of companies (where at least 70% of the equity shares in a controlled group company are held by the controlling group company), or any person, other than a company, who individually or jointly with any connected person holds, directly or indirectly, at least 20% of the company’s equity shares or voting rights.
If all of these requirements are met, the company is deemed to have paid a dividend in specie, which is deemed to be an amount equal to the greater of the ‘market-related interest’ in respect of the debt, less the amount of interest payable to that company in respect of the relevant year of assessment. In other words, the amount of the dividend is determined by applying an interest rate to the debit balance on the loan during the year. For purposes of determining the deemed dividend, the term ‘market-related interest’ is the difference between the ‘official rate of interest’ that applies for fringe benefits tax purposes, and as defined in paragraph 1 of the Seventh Schedule (currently 6.5%), and the actual interest rate charged on the loan. Only the interest effectively foregone, and not the capital amount of the loan, is deemed to be a dividend. If therefore, the loan bears interest at an acceptable rate, there would be no deemed dividend. This can be distinguished from the STC regime where the tax in respect of a deemed dividend was calculated on the principal amount of the loan.

The dividend is deemed to be paid by the company on the last day of the year of assessment, and the company is required to pay the resulting dividends tax by the end of the month following its year-end. Since the dividend is deemed to be a dividend in specie, the company (as opposed to the shareholder) is liable for the tax.

In order for a shareholder loan to constitute a deemed dividend, the debt has to arise ‘by virtue of’ a share held in the company. The meaning of the phrase ‘by virtue of’ is not defined in the Act and guidance can be found in a number of cases.

The phrase ‘by virtue of’ was considered in the context of employment, in the case of Standen vs. CIR, 59 SATC 212, where the court considered the meaning of the phrase ‘in respect of or by virtue of any employment or the holding of any office’. The words ‘by virtue of’ do not, in view of the court, bear a meaning materially different from the words ‘in respect of’ and referred to ST vs. Commissioner of Taxes, 35 SATC 99, at 100 where, in regard to the phrase ‘by virtue of’ Whitaker P stated at 100:

> ordinarily the phrase (and this was common cause between counsel) means ‘by force of’, ‘by authority of’, ‘by reason of’, ‘because of’, ‘through’ or ‘in pursuance of’. (See Black’s Law Dictionary 4 ed 252). Each of these definitions suggests there must be a direct link between the cause and result.

The principles established in the Standen case were confirmed in the Supreme Court of Appeal case of Stevens vs. CIR, 69 SATC 1, where the court held that there was no material difference between the expressions ‘in respect of’ and ‘by virtue of’. They connote a causal relationship between the amount received and the taxpayer’s services or employment.

It is evident from the above that there has to be a direct causal relationship between the holding of the relevant shares and the advance of the loan in question in order for a deemed dividend to arise. The deeming rule will thus only be triggered when a loan or advance has been made to a South African resident person that is not a company (e.g. a trust or a natural person) who is a connected person in relation to that company or a connected person in relation to the aforementioned person (that is connected to the person who is connected to the company).

To the extent that the amount owing to a company by a shareholder of that company or other qualifying person as set out above, was deemed to be a dividend that was ‘subject to STC’, no deemed dividend implications will arise in terms of the dividend tax regime. In other words, a debt that was deemed to be a dividend that was subject to STC will not be deemed to be a dividend for dividends tax purposes.

> “In order for a shareholder loan to constitute a deemed dividend, the debt has to arise ‘by virtue of’ a share held in the company.”

The term ‘subject to tax’ is not defined in the Act, nor has it been the subject of any South African court decisions. Guidance can, however, be found from United Kingdom (‘UK’) judgments in respect of the phrase. In the recent case of Paul Weiser vs. HM Revenue and Customs (TC02178), the First Tier Tribunal considered the interpretation of the double tax treaty between the UK and Israel and in particular the meaning of the phrase ‘subject to tax’. The case centred around the meaning of the phrase ‘subject to tax’ and the difference in international tax treaties between this phrase and the phrase ‘liable to tax’. In HM Revenue and Custom’s view, the distinction...
between the two phrases is that the expression ‘liable to tax’ requires only an abstract liability to tax (i.e. a person is within the scope of tax generally irrespective of whether the country actually exercises the right to tax) and therefore has a much broader meaning than the phrase ‘subject to tax’ which requires that tax is actually levied on the income. The First Tier Tribunal decided the case in favour of HM Revenue and Customs such that relief was not available under the UK-Israel tax treaty to exempt the pension from UK tax because the pension in question was not subjected to tax in Israel.

Income would thus not be regarded as ‘subject to tax’ if the income in question is exempt from tax in terms of a statutory exemption from tax.

“In order to determine whether an interest-free or low interest loan results in a taxable benefit, one will have to determine the reason or cause for the granting of the loan.”

In the context of shareholder’s loans, unless STC was actually paid in respect of the debt in question, such interest-free or low interest loan would be subject to dividends tax. This effect appears to create unintended adverse consequences for taxpayers in that, even though loans of this nature may not have constituted deemed dividends under the STC regime as a result of the application of an exemption, the full capital amount of the loan would be subject to dividends tax.

Employees’ tax

For employees’ tax purposes, the issue that requires consideration is whether a ‘taxable benefit’ as defined in para 2(f) of the Seventh Schedule to the Act, read with paragraph 11 thereof, arises in consequence of an interest-free or low interest loan to a shareholder that is a connected person in relation to the lender.

In order to constitute a ‘taxable benefit’, the debt in question has to arise ‘in respect of’ the employee’s employment with the employer. As discussed above, in terms of the applicable case law, there is no material difference between the expressions ‘in respect of’ and ‘by virtue of’. With regard to both, if there is an ‘unbroken causal relationship between the employment on the one hand and the receipt on the other’, the payment will be ‘in respect of services rendered’ (Stevens vs. CSARS supra). It is submitted that the same principle will apply for purposes of paragraph 2 of the Seventh Schedule to the Act.

In order to determine whether an interest-free or low interest loan results in a taxable benefit, one will have to determine the reason or cause for the granting of the loan.

It is important to bear in mind that an interest-free or low-interest loan to a connected person in relation to the company (or a connected person in relation to a connected person in relation to the company) will only be subject to either dividends tax or employees’ tax, and not to both.
A son owes R1 000 000 on a bond for a property that he keeps for investment purposes. His father offers to settle the bond on the condition that the father and the father’s new wife are permitted to reside in the house until their permanent exit from earth. The son wants to retain ownership of the property. The father wants to ensure that his new wife is protected should he pre-decease her.

**QUESTION**

1) What are the legal issues relating to the occupation of the house owned by the son?
2) What are the tax implications for the son and the father?

**ANSWER**

In law there is a concept called ‘usufruct’. By definition it is a limited real right that allows the usus (user) the right of use and/or enjoyment of a thing possessed while the title to ownership remains with another person.

In relation to the query, the son maintains his right to ownership of the investment property but his father and the father’s wife may receive the benefit (‘fruits’) of the property for a particular period of time. These requirements must be given legal expression in the title deed and must be registered against the title deed.

**Legal issues:**

Response from the SAIPA Legal Department

In law there is a concept called ‘usufruct’. By definition it is a limited real right that allows the usus (user) the right of use and/or enjoyment of a thing possessed while the title to ownership remains with another person.

This tax response assumes that the aforementioned arrangement (as per SAIPA’s legal department reply) is formalised (as it should be to provide the parents with security of tenure) the effect is as follows:

- **The son is granting a usufruct over the house for a consideration of R 1 000 000.** This represents a part-disposal of the residence and a capital gain or loss must be determined. Paragraph 33 of the Eighth Schedule of the Income Tax Act is relevant and states:
  i) One has to determine the base cost attributable to the part disposed of, and
  ii) Prevent the allocation of a portion of the base cost in the case of certain part-disposal.

- **The parents are acquiring a usufruct for R 1 000 000.** On their death any capital loss upon its extinction would be disregarded under para 15(c) of the Eighth Schedule because the residence is not being used for trade purposes.

- Whether donations tax is payable by either party would depend on whether R1 000 000 is a market-related price to pay for a life usufruct. If the cost of the usufruct is less than the market value, then donation tax is a likely outcome and the son will be liable for the tax. It will be necessary to determine the current market value of the property.

  - It is given that the parents and son are connected persons, hence the proceeds must be equal to market value (para 38). So if the market value of the usufruct was say R700 000 then this figure would be used instead of the R1 000 000 and the difference of R300 000 would be a donation and potentially attract donations tax. In terms of section 56 (2) (b) of the Income Tax Act, the sum of the values of all property disposed of as a donation that does not exceed R100 000 will be exempt from donation tax.
In the first version of the Draft Taxation Laws Amendment Bill of 2014 that was released in July, it was proposed that Public Benefit Organisations (PBOs) that provide assets or funding to other PBOs would have to comply with a prescribed investment regime.

In terms of the current law, such PBOs have to distribute or incur the obligation to distribute at least 75% of the donations received during the year of assessment for which Section 18A receipts were issued, within 12 months of the end of the year of assessment (s18A(2A)(b)). The Commissioner is given the discretion to vary this requirement, having regard to the public interest and the purpose for which the PBO wishes to accumulate the funds.

Presently, there is no stipulation regarding the form in which undistributed funds have to be held, for example whether accumulated in savings accounts, unit trusts or other types of accounts. In terms of the first version of the Bill, it was proposed that the 75% distribution requirement would be reduced to a 50% distribution requirement. The undistributed balance in respect of donations for which section 18A receipts had been issued would have to be: 
1) Distributed (or the obligation to distribute would have had to be incurred) within a period of five years. The five-year period was to be calculated from the date of the coming into operation of the Taxation Laws Amendment Act of 2014 if the PBO was incorporated prior to 1 January 2015. In the case of PBOs that are only incorporated after 1 January 2015, the five-year period is calculated from the date on which the Commissioner issued a reference number to the PBO.

2) Invested in prescribed investments. These were to include financial instruments issued by collective investment schemes, long-term insurers, banks, mutual banks, the government or financial instruments in listed companies. Any amounts received or accrued in respect of such financial instruments were to be included in the compulsory distribution requirement in (a) above.

In the latest version of the Bill, which was released on 16 October 2014, the prescribed investment regime has been scrapped. However, the adjustment to a 50% distribution requirement has been retained.

“In terms of the current law, PBOs have to distribute or incur the obligation to distribute at least 75% of the donations received during the year of assessment for which Section 18A receipts were issued, within 12 months of the end of the year of assessment”

In respect of the undistributed amounts, i.e. which amounts would have arisen from receipted donations, the PBO has to incur the obligation to distribute all amounts received in respect of ‘investment assets’ held by it (other than amounts received in respect of disposals of those investment assets to a PBO) by no later than six months after every five years from 1 March 2015, if the PBO was formed and issued with a reference number prior to 1 March 2015. If the PBO was formed on or after 1 March 2015, then the five-year period is calculated with reference to the date on which the Commissioner issued the reference number. Failure to comply with the five-year distribution requirement will result in such amounts being included in the taxable income of the PBO.

The effective date of the above amendments is said to be 1 March 2015.

Many challenges are likely to arise due to the above-mentioned amendments. First, the term ‘investment assets’, is not defined. It is uncertain whether, for example, a current banking account would be regarded as an ‘investment asset’ in circumstances where no interest is paid on credit balances. According to the Chambers 21st Century Dictionary, the word ‘invest’ means ‘to put money into a company or business’, e.g. by buying shares in it, in order to make a profit. Where no profit can be made it may be argued that money has not been ‘invested’.

In our view, savings accounts, shares and properties should be regarded as ‘investment assets’. If rental income accrues in respect of a property, for example, it would seem that no running or other expenses may be paid in respect of the property from funds in respect of which Section 18A donations were originally issued.

The draft is likely to be enacted in its current form and although the change from a 75% distribution requirement to 50% is welcomed, the need to track amounts received in respect of the ‘investment assets’ is likely to create a significant compliance burden. In order to minimise headaches, a clear separation should exist between assets that represent donations for which Section 18A receipts were issued and other assets, for example representing exempt trading income of the PBO. It would seem that a reconciliation of the PBO’s assets at 28 February 2015 will have to be performed in order to separate assets that arose from such donations from other assets.

The increased compliance burden associated with these above-mentioned changes is unfortunate, and is likely to detract from funds available for public benefit purposes.

Source: BDO’s Tax Pulse, Issue 10, 2014
By now, most South African taxpayers should be aware that when they enter into transactions with related parties who are not South African taxpayers, such transactions should be concluded on terms and prices that are at arm’s length in nature. The term ‘arm’s length’ essentially indicates a position that two unrelated parties would adopt in an open market transaction, as a willing buyer and willing seller.

Critical to managing tax risk for any taxpayer that has transactions of this nature is being able to defend the transfer pricing (TP) position that they have adopted and the only way to adequately do so is through the preparation of TP policy documentation.

What is Transfer Pricing documentation?
As a starting point, it is important to highlight that, for now, it is not a statutory requirement to prepare TP documentation in South Africa – but there is a sting in the tail, and more on that later. Many years ago, SARS issued Practice Note 7 that provided guidance on their approach to TP and what TP documentation should cover.

This Practice Note was largely based on the Organisation for Economic Cooperation and Development’s (OECD) guidelines. In this process, SARS also pointed out that TP documentation should be relevant to each taxpayer’s circumstances and that it was not expected that a taxpayer should spend a disproportionate amount of money of preparing TP documentation. Unfortunately, many taxpayers have taken a very aggressive position and have compiled a one- or two-page document that simply states what price they charge their related parties – although this may deal with inter-group pricing, it is not what the OECD and SARS would consider to be a TP document.

TP documentation should provide the user (in most cases, SARS or the South African Reserve Bank) with insight into the following:

- The company and the group it forms part of, what products or services the group sells and some financial and statistical information like revenue, profit, number of employees, key locations, etc.
- The industry the company and group operate in, the regional and global factors that affect that industry, the competitive landscape, etc.
- The functions that the company undertakes, the various risks it assumes and the assets it uses to perform the said functions.
- The TP methodology that the taxpayer has elected to use in determining and setting its prices and why it has not used any of the other recognised TP methods.
- If appropriate (which in most cases it is), an economic analysis supported by benchmarking studies and analysis, of which the outcome is a pricing range commonly referred to as the inter-quartile arm’s length range.

In the context of what SARS expects to see when a taxpayer says that they have prepared a TP document, when a taxpayer presents a one-pager document to SARS, they arguably compromise their position even further. Critically, a taxpayer needs to discharge the onus of proof on why their pricing is considered to be at arm’s length, and merely stating that one thinks that the price is fair does not do so. SARS, and any other revenue authority, will want to see objective data or market information that provides appropriate support.

Coming back to the sting in the tail – when submitting an ITR14 tax return, the taxpayer is required to do this on an arm’s length basis.

When answering questions relating to related party transactions with non-residents, the taxpayer is asked to confirm whether they have a TP policy document. If the taxpayer answers ‘no’, there is an immediate red flag, as SARS will question how the taxpayer knows that the tax return is submitted on an arm’s length basis when he has not prepared TP documentation. By not having adequate documentation or any documentation at all, the taxpayer is immediately on the back foot – a precarious position from which to engage with SARS from! The alternative is to prepare appropriate TP documentation that could also serve to reduce any potential penalties that SARS may wish to impose on the finalisation of any TP audit by SARS.
We are often spoken of as an economy with high levels of debt. Even when interest rates are high, we have never been scared of gearing ourselves so that we can buy that expensive car or holiday house in Hermanus. Companies too often have high levels of debt.

In addition, in virtually every corporate structure there is a multitude of intercompany loan accounts. These loan accounts often arise either through funding being provided by one company to another, or in circumstances where, for example, a company provides services or sells goods to another company and the consideration remains outstanding on loan account.

Often such loan accounts are written off, particularly in circumstances where the borrower is not able to repay the loan or, in a group context where the group wishes to ‘clean up’ its inter-group transactions. Debt is also written off in many other circumstances such as when it is not able to be repaid by the borrower. One just needs to look at the African Bank scenario to find an example of debt being written off or reducing in value.

This article focuses on certain tax consequences arising from the writing off or waiving of debt. Assume for the purposes of this article that Company A has advanced interest-bearing loans to Company B. It is now proposed that the loan will be waived.
Section 24J of the Income Tax Act

On the basis that the loans are interest-bearing, the provisions of section 24J of the Income Tax Act (‘Act’) should be considered. A gain on redemption of the loan will arise for the borrower (Company B) upon the waiver of the loan. This gain will be deemed to accrue to Company B for tax purposes in terms of section 24J(4).

Conversely, a loss on redemption of the loan will arise for the lender (Company A) upon the waiver of the loan. This will be deemed to have been incurred by Company A for tax purposes in terms of section 24J(4). However, section 24J(4) only deems such gain or loss to accrue to, or be incurred by, the taxpayer.

It must still be determined whether such gain or loss is to be of a capital or a revenue nature.

Generally, unless the taxpayer is a money-lender, an adjusted gain or loss should be capital in nature in which case section 24J should not apply. If the gain or loss is revenue in nature, then Company A may obtain a deduction in relation to such loss. Conversely, a gain which is revenue in nature and which has not already been taken into account in terms of section 19 (see below) will be included in the income of Company B.

Finally, section 24J(12) states that section 24J does not apply in respect of a loan, inter alia, which is repayable on demand. Therefore, if the loan is repayable on demand, then no gain or loss arises in terms of the provisions of section 24J of the Act.

Debt reduction provisions

The ‘debt reduction provisions’ contained in section 19 and paragraph 12A of the Eighth Schedule should also be considered in the context of any proposed waiver of loans. Essentially, section 19 deals with the income tax consequences of a loan waiver while 12A deals with the capital gains tax (‘CGT’) implications thereof.

Broadly speaking, section 19 applies where:

- A debt that is owed by a person is reduced;
- The amount of the debt was used to fund deductible expenditure, acquire allowance assets or trading stock; and
- There is a difference between the amount advanced under the loan and the amount repaid in terms of the loan (‘Reduction Amount’).

Paragraph 12A of the Eighth Schedule represents the capital gains tax equivalent of section 19. It essentially applies where the debtor applied the loan to acquire an asset which is held on capital account and there is a Reduction Amount.

Income tax implications for the borrower: Section 19

In order to determine the tax implications in respect of section 19, it must be determined how the debtor applied the debt proceeds and, in particular, whether such proceeds were used to fund:

- Expenditure incurred in the acquisition of trading stock that is held and has not been disposed of by the debtor at the time of the reduction of the debt; or
- Expenditure incurred in the acquisition, creation or improvement of an allowance asset; or
- Deductible expenditure other than set out above.

In summary, section 19 of the Act essentially functions on the following ‘two step’ approach:
Cost price reduction

The Reduction Amount will first reduce the cost price of the trading stock held by the debtor. However, this cost price reduction will apply only to the extent that:

- The borrowed funds were used to acquire trading stock still held by the debtor; and
- That trading stock has a remaining cost price.

Ordinary revenue or recoupment

If the Reduction Amount falls outside the cost price reduction rules mentioned above, any residual amount will trigger a taxable recoupment. Amounts of this nature can, for example, represent:

- Debt funding related to trading stock where the cost price has already been reduced to zero, or where the trading stock is no longer held;
- Debt funding for allowance assets to the extent of prior depreciation (after their base cost is reduced to zero in terms of paragraph 12A); and
- Debt relating to operating expenses which have been deducted for tax purposes.

CGT implications

In respect of the borrower (Company A), paragraph 12A(3)(b) provides that, in relation to an asset held at the time of the debt reduction, the base cost of the relevant asset held by the borrower must be reduced by the Reduction Amount. Where the Reduction Amount exceeds the base cost, such excess amount must be applied to reduce any assessed capital loss of the borrower for the year of assessment in which the reduction takes place.

Donations tax

A donation is defined as any gratuitous disposal of property including the gratuitous waiver or renunciation of a right. A waiver of a loan may constitute a donation.

However, section 56(1)(r) provides that no donations tax shall be payable in respect of a donation by a company to another company that is a resident and a member of the same group of companies as the company making the donations.

Conclusion

In respect of the example set out above, it is unlikely that Company A will make a tax deductible loss on redemption or Company B will make a taxable gain on redemption in terms of section 24J of the Act. This is because Company A and Company B will likely hold the loans on capital account and potentially also because section 24J does not apply since the loan is repayable on demand.

The capital gains tax provisions of paragraph 12A should also not apply if the loans are waived between group entities.

However, the income tax provisions of paragraph 19 may apply to the loan if Company B used the loan proceeds to acquire allowance assets and/or fund deductible expenditure. To the extent that any amount is included in the gross income of Company B in terms of section 19, Company A would then obtain a capital loss on the loan waiver.

No donations tax implications should arise from the waiver of the loan if, inter alia, Company A and Company B form part of a group of companies.

It can be seen from the above very high level analysis, that a multitude of tax issues must be considered before writing off a loan.

“"A donation is defined as any gratuitous disposal of property including the gratuitous waiver or renunciation of a right. A waiver of a loan may constitute a donation.""
While it is hard to smile about paying taxes (wouldn’t we all like free taxes?), here are a few stories that should amuse:

- On 15 April 1951, a 70-year-old couple in Syracuse, New York received a US$27 refund cheque for an income tax overpayment. They returned it to the Internal Revenue Collector, explaining their refusal to accept it as being due to their thankfulness for ‘the opportunity to continue working’.

- According to an article written in 1952, the Bureau of Internal Revenue (its name at the time) had one employee whose main job was to read newspapers and magazines for stories that might shed light on people dodging taxes. The article noted that a success story in the New York Times about a ‘boy wonder’ who had amassed US$15 million in his first few years out of college led the tax collector to a fellow who was not paying his taxes. But for the most part, a collector noted: “The most helpful snitches are divorced wives.”

- While the list of interesting tax deductions is almost certainly endless, in the 1950s, one fellow listed his dog as a dependent noting: “It costs as much to keep Butch as myself.” Another wrote that food ought to be deductible because it constituted ‘fuel for my engine’.

- In more recent times, a CPA reported that he was preparing a return for a single mother with one child. At their meeting, she did not have the child’s social security card but she gave what she assured the accountant was the correct number. Later the return came back because the social security number was incorrect. When the accountant called and the mother read off the number from her child’s card, she said: “I don’t see why there was a problem… I was only off by one number.”

- The IRS office in Albany, New York received a call in 1988 from a man who asked: ‘I don’t live in New York and I don’t work in New York. But I took a vacation in New York last year. Do I have to pay New York taxes?” The answer: only if he wants to.

And perhaps calls like that may explain the preventive measures taken in Albany in the 1980s. A reporter for the Albany Times Union wrote: “The harried final days of the tax return rush was abundantly clear Wednesday as the state’s top tax collectors led several reporters on a tour of the processing centres at the tax department. “To stress the stress, the first stop on the tour was a room where a handful of tax auditors and examiners were brushing up on their cardiopulmonary resuscitation (CPR) skills – just in case. “Last year the ambulance took away eight people (workers) for stress,” said Karl Felsen, a department spokesman. “We thought we’d be better prepared this year.”

So whether you’re e-filing or sending by mail—or still have a question or two—take care of your taxes right away. As the Albany fellow said, it’s high stress for workers who have to help other people deal with a deadline!

Source: http://americacomesalive.com/newsletter-archive/income-tax-stories-to-make-you-smile/
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